Sales Representatives Manual

Volume 3

2024

JSDA

Japan Securities Dealers Association

Volume 3

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Introduction

The Act on Investment Trusts and Investment Corporations (hereinafter the "ITA") states that its purpose is to contribute to the sound development of the national economy by establishing a system whereby persons other than investors collect investors' funds and invest them mainly in securities, etc. by using investment trusts or investment corporations, and distribute the results thereof to the investors, and by ensuring appropriate management of funds by means of these vehicles, as well as taking measures to protect the purchaser, etc. of the securities issued under the system, in order to facilitate investors' investments in securities, etc. (ITA, art. 1).

The ITA provides regulations to promote the sound development of the so-called market-oriented indirect financing mediated by professionals to serve this purpose by setting forth mechanism rules for sound financial products in asset management, thereby ensuring the adequate functioning of the capital market functions.

Abbreviations for laws and regulations used in this Chapter are as follows:

"FIEA"............................ Financial Instruments and Exchange Act (Act No. 25 of 1948)

"FIEAEO"................ Order for Enforcement of the Financial Instruments and Exchange Act (Cabinet Order No. 321 of 1965)

"FIBCOO"...................... Cabinet Office Ordinance on Financial Instruments Business (Cabinet Office Ordinance No. 52 of 2007)

"ITA".............................. Act on Investment Trusts and Investment Corporations (Act No. 198 of 1951)

"ITA Enforcement Order"................................ Order for Enforcement of the Act on Investment Trusts and Investment Corporations (Cabinet Order No. 480 of 2000)

"ITA Enforcement Ordinance".......................... Ordinance for Enforcement of the Act on Investment Trusts and Investment Corporations (Prime Minister's Office Ordinance No. 129 of 2000)

"ITCO"........................... Ordinance on Accountings of Investment Corporations (Cabinet Office Ordinance No. 47 of 2006)

"JSDA Investment Solicitation Rules"….Japan Securities Dealers Association, "Rules Concerning Solicitation for Investments and Management of Customers, Etc. by Association Members"

"JSDA Advertising Rules" …. Japan Securities Dealers Association, "Rules Concerning Representation of Advertising, Etc. and Offer of Premiums"

"JSDA Foreign Securities Rules"…. Japan Securities Dealers Association, "Rules Concerning Foreign Securities Transactions"

"JITA Management Rules"…The Investment Trusts Association, Japan, "Rules on Management of Investment Trusts, Etc."

"JITA By-laws for the Management Rules"… The Investment Trusts Association, Japan, "By-laws on Management of Investment Trusts, Etc."

"JITA MRF Management Rules"… The Investment Trusts Association, Japan, "Rules for Operations of MRF and MMF"

"JITA By-laws for the Complex Investment Trust Rules"… The Investment Trusts Association, Japan, "By-laws on Regulations for Complex Investment Trusts Similar to Over-the-Counter Derivatives Transactions"

"JITA Real Estate Investment Corporations Rules"… The Investment Trusts Association, Japan, "Rules on Real Estate Investment Trusts and Real Estate Investment Corporations"
"JITA Investment Management Report Rules" ... The Investment Trusts Association, Japan, "Rules on Investment Reports, Etc. for Investment Trusts and Investment Corporations"
"JITA Full Members' Business Rules"… The Investment Trusts Association, Japan, "Rules on Full Members' Business Operations, Etc."
"JITA Investment Trust Accounting Rules"… The Investment Trusts Association, Japan, "Rules for Valuation and Accounting of Investment Trust Properties"

* The Prime Minister is the Minister who has administrative jurisdiction over the ITA. However, since much of this authority is delegated to the Commissioner of the Financial Services Agency (ITA, art. 225), the references in the remainder of this Chapter may be made to the Commissioner of the Financial Services Agency.

1 History of Investment Trusts

1 1 Postwar Development of Investment Trusts

After the end of World War II, the dismantlement of the *zaibatsu* conglomerates led to progress in the democratization of securities ownership so that they were made more accessible to ordinary citizens. The foundation for formulating real investment trusts that targeted general investors was solidified, and on June 4, 1951, the Securities Investment Trust Act was promulgated and enacted. Even prior to the war, there were a number of investment trusts and collective investment schemes, but the enactment of the Securities Investment Trust Act established these as a system that was secured by a special law.

Based on the enactment of this Securities Investment Trust Act, Japan's investment trusts have basically increased their assets, although there have been various detours and ups and downs. Let us take a simple look back at that history.

After the enactment of the Securities Investment Trust Act, four major securities companies immediately registered as securities investment trust managers, each establishing unit-type investment trusts, and the investment trust system made its start under the new law. The next year, in 1952, additional offering type investment trusts appeared. Although it appeared that investment trusts were developing smoothly, in the following year of 1953, securities companies failed one after another, and in 1954, the Showa 29 Panic occurred. The environment surrounding investment trusts quickly deteriorated with investment trusts seeing a decrease in establishment amounts and an increase in cancellation amounts.

However, in 1956 when the share market revived on the Jinmu economic boom, investment trusts once again began to walk the path of development and became an engine of the share market's growth. At the same time, voices calling into question the effect of investment trusts on the share market grew strong, and there was increased criticism of concurrent operation of a securities company and a trust company. Consequently, in 1959 the securities companies spun off and made their investment trust settlor companies independent. During this period bond investment trusts also made their start in 1961.

From 1963 to 1964, the share market made weak progress, and finally in 1965 a securities crash occurred. The effect on investment trusts due to the crash was enormous, and the remaining principal of additional offering type stock investment trusts decreased by approximately one third.

While the securities and investment trust industries were turning to implementing reforms in order to regain trust, in October 1967 an amendment of the Securities Investment Trust Act came into force, providing for a fiduciary duty on the part of investment trust settlor companies. The various reforms were effective, and in the latter half of 1969, the number of stock investment trusts which until that time had been decreasing, turned to a net increase.

In 1970, among calls for the internationalization of capital, the inclusion of foreign securities in investment trusts began. Investment trusts overcame the first oil crisis in 1973, and together with stock investment trusts, bond investment trusts also expanded smoothly by riding the tailwind of the massive issuance of government bonds.

In 1980, medium-term government bond funds emerged and were a major hit product, and the competition between banks and securities companies became severe. Against the backdrop of the major expansion of Japan's economy upon the 1985 Plaza Accord and the major rise in the share market, investment trusts, centered on unit-type investment trusts, also increased their balances, and at the end of 1989 the net asset balance of investment trusts had reached JPY58 trillion.

1 2 Investment Trusts in the 1990s

The bursting of the bubble in the 1990s had a profound effect on investment trusts and brought about severe investor flight. There was no means of stopping the long-term declining trend in the net asset balance of stock investment trusts from the JPY45 trillion level at the end of 1989, until the end of 1997 when the financial crisis became severe and such balance fell below JPY10 trillion.

Under these circumstances, the MMF (money management fund), which appeared in 1992, underpinned the total balance of investment trusts. It gained popularity for its convenience, attractive yield, and stable operation, and was an explosive hit product, exceeding JPY5 trillion in net assets eight months after establishment.

In 1994, having learned from the investor flight from stock investment trusts, the investment trust industry worked out thorough reforms focused on relaxing investment rules such as removing the ban on derivatives, improving disclosure, setting up performance evaluations in order to promote competition among settlor companies, and developing fair trade rules for improving the transparency of operations and sale.

While on the one hand this reform on the part of the investment trust industry went forward, the government also furthered efforts to counter the prolonged recession in the Japanese economy and the decline in the international competitiveness of the Japanese financial and securities markets, as well as to rejuvenate Japan's financial capital markets. In 1998, the Financial System Reform Act was enacted and the so-called Japanese Big Bang was born. In this movement, investment trusts were positioned as the core channel for the more than JPY1,200 trillion (at that time) of personal financial assets in Japan to reach the market. The reform measures implemented in the Japanese Big Bang include the lifting of the ban on the handling of sale of investment trusts by financial institutions such as banks (sales at teller windows), which had been almost monopolized by securities companies.

1 3 Investment Trusts in the 2000s

The 2000 amendments to the ITA expanded the scope of eligible investment targets to include real estate, etc. and made it possible to establish real estate investment corporations (J-REIT). In September 2001, the first J-REIT was listed on the Tokyo Stock Exchange. With the trend of protracted super-low interest rate, products whose nature aims to secure stable profitability became popular. Real estate investment corporations were newly established and listed in succession, thus showing solid growth.

The net asset balance of publicly offered securities investment trusts reached JPY58 trillion at the end of 1989, but after that it was unable to break this record due to the after-effects of the bursting of the bubble economy. However, with the expansion of MMFs as the engine, driven by the low interest rate environment and combined with the recovery of stock investment trusts that had at last emerged from the worst period after 1998, the net asset balance of publicly offered securities investment trusts exceeded the said record in June 2000 and reached JPY60 trillion.

Nevertheless, in addition to a rush of MMF cancellations due to the effect of some MMFs, which included bonds from the U.S. company Enron which failed in 2001, having declined below the principal invested, the balances of bond investment trusts remained low due to the protracted super-low interest rate policy. Moreover, the downward trend of the domestic share market grew in strength following the collapse of the IT bubble which peaked in 2000, and the balances of publicly offered securities investment trusts did not experience growth either, following their peak in June 2000.

Thereafter, from around 2003, because of the comparison with domestic interest rates, balances in stock investment trusts have started to increase mainly in funds investing in foreign bonds. This movement was driven by the financial institutions such as banks, which could newly join in the sale of investment trusts due to the Japanese Big Bang. The financial institutions, in addition to the funds that included foreign bonds, focused on funds that invest in multiple assets such as domestic and foreign shares, bonds, and REITs, etc. and raised the balance of funds that they handled, and in August 2005 the banks' net asset balance of publicly offered stock investment trusts classified by selling method exceeded 50%. It was the seventh year after the lifting of the ban on investment trust window sales. Furthermore, along with the increase in teller window sales, the percentage of monthly-closed and monthly-paid funds started to rise.

With this background, the balance of publicly offered stock investment trusts exceeded the bubble period peak of the end of 1989 in June of 2006, and the balance of all publicly offered securities investment trusts exceeded the peak for the June 2000 period in August of 2006. Thereafter the balance of publicly offered securities investment trusts reached JPY82 trillion in October 2007, supported by solid performance on the part of domestic and foreign denominated assets as a result of, for example, an increase in share prices on foreign and domestic share markets as well as a stable trend in the value of the yen.

This trend was upended by the global disruptions in the financial markets which occurred from around 2007, particularly in Europe and the U.S., that were sparked by the problem of delinquencies in subprime loans in the U.S. Funds seeking to avoid the confusion in the U.S. and Europe have flowed into Japan, driving up the value of the yen, while investment trusts that had invested in foreign currency denominated assets faced declines in their net assets. The impact of the failure of the U.S. securities firm Lehman Brothers in September 2008 has led to sharp declines in the share market worldwide.

With these changes the net assets in publicly offered securities investment trusts fell as of the end of January

2009 to a level that was below JPY50 trillion, which was 40 percent less than their peak.

1 4 Investment Trusts in the 2010s and Thereafter

Thereafter, the financial markets calmed down again and the net assets in publicly offered securities investment trusts started to increase again, driven by currency-selected funds, and funds investing in REITs in the United States and other countries in the world. At the end of June 2014, the net assets surpassed the pre-Lehman peak. Partly due to the purchase of ETFs by the Bank of Japan under the monetary easing policy, the net assets in publicly offered securities investment trusts reached JPY189 trillion as of the end of September 2023.

In February 2016, following the action taken by the European Central Bank (ECB) in June 2014, the Bank of Japan introduced the negative interest rate policy. With the impact of this new policy spreading from short-term interest rates to long-term interest rates, early redemption of short-term financial instruments such as money management funds (MMFs) were announced and implemented. In the age of super-low interest rates, there are schemes to promote the shift from savings to investment and support households in stable asset building. Specifically, the NISA program (Nippon Individual Savings Account program, a tax exemption program for small-amount investments) was introduced in January 2014. As the NISA program has undergone a dramatic reform from January 2024 to make it a permanent program and expand the tax-exempt investment limit, investment trusts are expected to play an increasingly prominent role.

Investment trust settlor companies engaging in establishing and operating investment trusts are expected to play a greater role than ever before. In order to ensure the building of stable personal assets, the Financial Services Agency published the “Principles of Customer-Oriented Business Conduct” consisting of seven principles in March 2017. In addition, by publishing the “Progress Report on Enhancing Asset Management Business” which outlines issues and challenges that require initiatives for enhancing asset management every year since 2020, the Financial Services Agency encourages these companies to carry out governance and business operations that give priority to client interests.

2 Concept of Investment Trusts

2 1 Definition of an Investment Trust

(1) Essential Nature of the Investment Trust System

The essence of the investment trust system is found in a structure that aggregates capital from multiple investors and is managed and administered by third party specialists. This type of structure is called a “**Collective Investment Scheme**.” The significance of the existence of collective investment schemes can be said to be found in their fulfilling the function of carrying out financial intermediation in order to invest private funds in the national economy and their contribution to the formation of household and corporate financial assets as well as the invigoration of financial and capital markets.

(2) Features of Investment Trusts

(i) Diversified Investment Is Possible with a Small Amount of Funds

It is a well-known fact that diversifying investments across a broad range of assets is less risky than investing in a single or small number of assets. However, for a single investor to be able to sufficiently diversify his/her investments, he/she would need a large amount of capital. Since investment trusts pool funds contributed by a large number of investors to form a fund (*kikin*), it becomes possible to enjoy the benefits of diversified investments even with a small investment amount.

(ii) Professional Management

Accurate investment with analysis of general economic conditions, interest rates and companies requires a high degree of sophistication. Not only would it be difficult for individual investors to conduct this kind of analysis, but also they are forbidden from investing in certain assets, such as derivative financial instruments, etc. Investment trusts provide a scheme whereby general investors can benefit from professional investment management to which they would not otherwise have access.

(iii) Suitable Investor Protection

A fiduciary duty and a duty of care of a prudent manager (Note) are imposed on asset management companies that manage investment trusts, and under the FIEA, investment trusts must be subject to the government administrative supervision.

Also, investment trusts are obligated to make disclosures, etc. to investors through statutory documents including investment trust explanatory documents (prospectuses) and investment management reports as well as timely disclosures required under the regulations of the Investment Trusts Association, Japan, and it can be said that investment trusts are financial instruments that are based on a legal system that requires appropriate investor protections.

(iv) Assistance in Channeling Funds to the Market

Investment trusts do not allow investors to invest directly in risk assets, such as shares or real estate, but rather, investment trusts are the core product in the so-called market-oriented indirect finance, under which financial service providers offer a broad range of products to investors.

Investment trusts can be said to perform a vital role in the national economy in "deepening the stratum of market participants, and thereby endeavoring to improve the efficient allocation of risk and the capacity to bear risk."

(Note) For the fiduciary duty and the duty of care of a prudent manager, see 5-3 "(1) Fiduciary Duty, Duty of Care of a Prudent Manager."

(3) Major Costs

The major costs for investment trusts to be borne directly or indirectly by investors are listed below.

Name of Costs	When Accrued	Description of Costs
Sales commissions	Upon purchase	Cost to be paid to the distributor when purchasing an investment trust. Generally, such cost is a few percent of the offer price. There are cases where no sales commissions are required (no-load investment). The amount of sales commissions is determined by each distributor.
Management fee (trust fee)	While holding the trust	A fee for carrying out the investment and management of the investment trust property, which is to be received by the investment trust settlor company and the trustee company from the investment trust property. The management fee (trust fee) is specified in the basic terms and conditions of an investment trust, and it is calculated at a fixed rate on a per diem basis and is deducted daily from the investment trust property. Investment trust settlor companies pay part of their own fees to the distributors as commissions for acting as the investment trust settlor company's agent in carrying out administrative work such as the distribution of profits and the payment of cancellation money (administrative agent commission). In the case of a "fund of funds," which is a fund that incorporates another fund (Note), the management fee accrues in relation to the underlying fund as well.
Load	Upon cashing out and/or purchase	Where additional establishments are carried out in a fund or where there is a request to cash out, the fund will purchase assets that correspond to the additional funds or will comply with the investor's request to cash out by selling the held assets. In addition to the costs generated by such transactions, where the liquidity of the included target assets is low, such transactions have an impact on the market and it is possible that the fund will end up bearing a large risk. In this type of fund, in order to maintain the fairness of the cost and risk burden between investors who have purchased additional establishments and beneficiaries who already hold the fund or between investors who cease being beneficiaries due to cashing out and the beneficiaries who continue to hold the fund, upon additional establishments or cashing out, the fund will use a system of collecting a load that is added to the trust assets, in which an additional sum is collected at the time of additional establishment or cashing out or to reduce the amount discharged from the fund.
Sales brokerage commission and expenses for futures trading or options trading	Upon sale and purchase of shares, etc.	Expenses arising from futures or options trading upon selling or purchasing shares and bonds in which an investment trust invests. They are collected indirectly whenever accrued, and because it is an expense arising as a result of investment by the investment trust, the specific amount due cannot be presented in advance.
Audit fee, expenses for keeping assets in custody abroad, and other expenses	While holding the trust	A fee payable to a certified public accountant for an audit of a fund, and expenses arising from keeping assets in custody or trading them abroad (custody fee). Other expenses include expenses for establishing an underlying fund in the case of a fund of funds. (Note) The specific amount due cannot be presented in advance because actual costs will be deducted.

(Note) For details of a fund of funds, see 3-10 "(2) Fund of Funds."

(4) The Terms "Investment Trust" and "Fund"

Although an investment trust is sometimes called a "fund," there are cases in which the word "fund" is used to refer to asset management type collective investment schemes in general.

In principle, in this Chapter, the term "investment trust" or "fund" is used to refer to a financial instrument that is set up and sold under the ITA. Nevertheless, caution is necessary because there are also "funds" that are not investment trusts.

Further, although the term "investment trust" was applied because under Japanese laws the investment trust system started by using trusts, *i.e.*, a structure where a fund (*kikin*) is established based on a contract to have assets administered and managed by another person (trust), under the present ITA, the trust forms for contractual type investment trusts [Note] (*i.e.*, investment trust) and corporate type investment trusts (*i.e.* investment corporations) coexist.

(Note) The law classifies contractual type investment trusts into those managed under instructions from the settlor and those managed without instructions from the settlor. For details, see “3-2 Contractual Type (Investment Trust) and Corporate Type (Investment Corporation)” and “3-3 Investment Trusts Under Instructions from the Settlor and Without Instructions from the Settlor.”

2 2 Comparison Between Investment Trusts and Bank Deposits

In order to deepen our understanding of investment trusts, let us try to compare investment trusts with bank deposits (please be aware that this describes the most typical type of investment trusts in Japan; that is, the contractual type investment trusts under instructions from the settlor).

(1) Common Functions as Financial Intermediary

Broadly speaking, both bank deposits and investment trusts are one type of “financial instrument,” and they are similar in that they possess financial intermediation functions, *i.e.*, collecting funds and supplying such funds to entities that require funds, such as companies. Also, for both of them, individuals are in most cases the target from which funds are collected and companies are in most cases the entities that are supplied with such funds.

In this way, while there is no difference in the essential nature of the financial intermediation function, the method of intermediation differs. In the case of bank deposits, the method of collecting funds takes the form of depositors making deposits with the bank, while in the case of investment trusts, collection takes the form of investors purchasing a share of rights concerning the investment trust property. Also, as for method of supplying funds, banks make loans to companies, while investment trusts supply funds by purchasing shares and bonds that are issued by companies.

(2) Differences in Accounts in Which Collected Funds Are Placed

In the case of an investment trust, the funds collected from depositors and investors only pass through the distributor, such as a securities company or bank that is the liaison, and are maintained at the trust bank in segregated custody from the trust bank’s own assets, as opposed to a bank deposit where it is the liability of the bank at which the deposit is made.

For this reason, if a bank were to fail, there would be cases in which the bank deposits would not be preserved, while in the case of an investment trust, the structure which has been implemented would protect the assets even if the distributor, asset management company or the trust bank were to fail.

(3) Differences in Attribution of Profits and Losses

As we saw in (2) above, in the case of bank deposits, the funds collected from depositors are placed in the bank’s own account and then lent to businesses, etc. Regardless of the amount of interest obtained from lending or the amount of losses suffered due to bad loans, depositors receive their principal and the interest that was stipulated in advance. Even if the profit from the loans is higher than the interest received by depositors, the depositors cannot receive an amount of money that is greater than the interest, and even if the bank suffers a loss, so long as the bank does not fail, the principal and interest are guaranteed. The bank bears the risk for the funds loaned by the bank.

In contrast, the trust assets in an investment trust are in segregated custody and **all profits and losses** in the invested assets such as shares and bonds **are attributed to the investors**. Investors who purchase the investment trust bear the risks concerned with the funds being managed by the investment trust.

Because the assets invested in may fluctuate in price, **the principal is not guaranteed**. Thus, as with shares, the investment trust itself also fluctuates in price. The price of an investment trust is referred to as the "**base value**." In the case of an investment trust, because the collected funds are in segregated custody, it is possible to calculate the total net asset value at the current point in time, which is the current value of the trust assets resulting from investments in shares and bonds, etc. The base value is the value (often expressed as the value per ten thousand units) that results from dividing the total net asset value by the number of shares of the collected funds (referred to as "number of units of beneficial interests"). In principle, the base value is calculated on a daily basis. When investors purchase and redeem an investment trust, it is done at this base value, in principle.

In investment trusts, there exists a price (market value) called the base value that does not exist in bank deposits. It is particularly necessary to fully understand this point in cases where investment trusts are sold by financial institutions, etc. which sell financial instruments with a guaranteed principal such as deposits.

Also, investment trusts have **dividends**, and this is different in character from interest on a bank deposit. (Note 1)

Dividends are paid to investors from one part of the segregated custody trust assets. Because the trust assets will be reduced precisely by the amount of dividends paid to investors, the base value falls by the amount of dividends paid ("**dividend drop**").

In the case of bank deposits, the principal is fixed, the interest rate is expressed as a rate for a fixed amount of principal, and the profit obtained by the depositor can be calculated by only using the interest rate, but in the case of an investment trust, to calculate the profit obtained by the investment trust investor, it is necessary to take into consideration both the amount of dividends and fluctuations in the base value. (Note 2) Because the base value is always fluctuating, the dividend level does not represent the investment trust's earning rate during the relevant term, and it is therefore not possible simply to compare interest (rate) and dividends (dividend rate).

For example, dividends may sometimes be paid beyond the amount of earnings generated during the term. In such case, the base value as of the closing date of the current term would be lower than that as of the closing date of the previous term (for details, see Chart 1-1).

(Notes) 1. For the regulations concerning the explanation on dividends that must be provided to customers when selling investment trusts, please check the description provided later (for details, see 6-2, "(4) Explanation on Expenses Payable by Customers and Dividends, and Measures to Confirm Customers' Understanding of Currency-Selected Investment Trusts").

2. Let us assume the following three cases.

	Base value as of the end of the previous term	Dividend	Base value after the dividend drop
Case A	JPY10,500	JPY100	JPY10,550
Case B	JPY10,500	JPY100	JPY10,450
Case C	JPY10,500	JPY100	JPY10,300

Among the three cases, while the base value as of the end of the previous term and the amount of dividend for the current term are the same, their profit and loss during the term differ as follows

Case A: Dividend [JPY100] + Change in basic value [JPY50] = Profit and loss [JPY150]

Case B: Dividend [JPY100] + Change in basic value [−JPY50] = Profit and loss [JPY50]

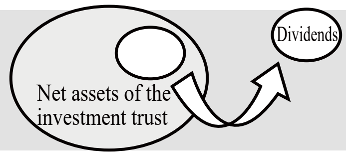
Case C: Dividend [JPY100] + Change in basic value [−JPY200] = Profit and loss [−JPY100]

Thus, the profit and loss from an investment trust should be considered by taking into account the change in basic value in addition to the amount of dividend received.

Chart 1-1 **Points to Consider Regarding Dividends**

Unlike the interest accrued on savings and deposits, dividends from an investment trust are paid from the net assets of the investment trust. Therefore, if any amount is paid as dividends, the base value will decrease by the amount paid.

Conceptual diagram of payment of dividends from an investment trust.

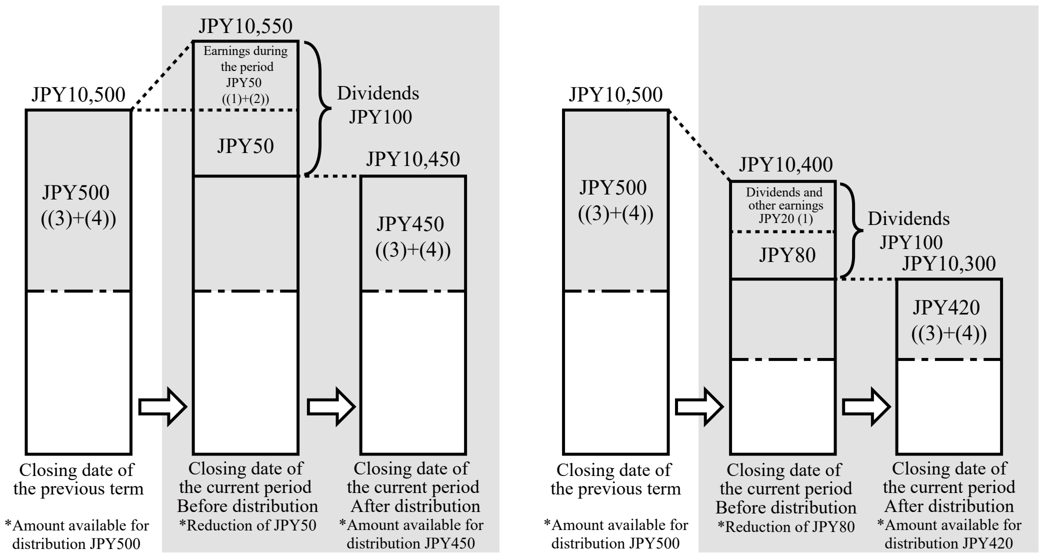


The dividends which are paid may sometimes exceed the amount of earnings (dividends, other earnings and trading gains, including appraisal gains, minus the relevant expenses) generated during the accounting period. In such a case, the base value as of the closing date of the current period would be lower than that as of the closing date of the previous period.
The amount of dividends does not always indicate the rate of earnings of the fund during the accounting period.

Case where dividends are paid beyond the amount of earnings during the term

Where the base value increased from the level as of the closing date of the previous term

Where the base value decreased from the level as of the closing date of the previous term



(Notes) The amount available for distribution consists of: (1) dividends and other earnings minus the relevant expenses, (2) trading gains, including appraisal gains, minus the relevant expenses, (3) reserves for dividends, and (4) earning adjustments money.
Dividends are paid from the amount available for distribution in accordance with the distribution policy.

* Please note that this figure is a conceptual diagram and does not suggest the actual amount of dividends or base value.

(4) Investment Trusts Having Combined Characteristics of Direct Finance and Indirect Finance

Bank deposits, etc. are called "indirect finance" in the sense that the collected capital is finance which is provided to businesses through the filter of bank accounts. On the other hand, the provision of capital to businesses, etc. through investors purchasing shares and bonds in the market (securities companies are only "liaisons") is called "direct finance." In the case of investment trusts, although the financing passes through the filter that is the management of the trust assets by specialists, the investors' profit and loss is decided by the price set by the market. Thus, investment trusts are sometimes called "market-oriented indirect finance."

In the case of bank deposits that are indirect finance, because the act of depositing money can be viewed as entering into a contract with the bank for payment of the principal and interest, the risk to which depositors must pay attention is the bank defaulting on that contract, *i.e.*, it comes down to the issue of the bank's credit risk. However, no matter how much profit the bank receives from its lending, this is solely the bank's profit, and only the fixed interest is paid to depositors.

In the case of investment trusts that are market oriented indirect finance, however, the profit and loss from the fund management is attributed to the investors, and consequently, the risk that investment trust investors must pay attention to covers a wide range such as the **price fluctuation risk** and **credit risk** of the shares and bonds, etc. in which the trust assets are invested (for details, see 6-2 "(3) Duty to Explain Under the Act on the Provision of Financial Services"). For this reason, in order to make it possible for the investor to be responsible for making his or her own investment decisions, the law requires detailed disclosures such as the **investment trust explanatory document (prospectus)** (Note) and **investment management reports** (for details, see "8. Disclosure for Securities Investment Trusts").

When selling investment trusts, it is necessary to have prospective purchasers of investment trust products fully understand what kinds of risks are involved.

(Note) Although the document is legally referred to as "prospectus," it is permitted to use an alternative name that may be easy for investors to understand (the FSA Guidelines for Disclosure of Corporate Affairs, 13-5) Accordingly, the Investment Trusts Association, Japan, designates the term "investment trust explanatory document" as such alternative name under the Regulations for Preparing Prospectuses Delivered Without Request. There are two types of prospectuses due to differences in the legal functions of prospectuses, namely, the "investment trust explanatory document (prospectus delivered without request)" and the "investment trust explanatory document (prospectus delivered upon request)."

2 3 Terminology Found in (Contractual Type) Investment Trusts

As under Japanese laws the investment trust system started in the form of a trust, *i.e.*, a structure where a fund (*kikin*) is established based on a contract to have assets administered and managed by another person (trust), such trust law terminology has become part of the operational terminology for investment trusts under the ITA.

The asset management company of an investment trust under instructions from the settlor is called the "**investment trust settlor company**" because it has a role as the trust's settlor in the investment trust contract that is entered into with the trust bank.

Also, under the ITA, investors that purchase and hold rights in an investment trust are called **beneficiaries**, while the certificate that identifies the investor's share is called the **beneficiary certificate** (Note), and the rights that correspond to that share are called **beneficial interests**.

When an investor purchases an investment trust, the **creation** of an investment trust is carried out. This creation would include instances of an **initial creation** that establishes a trust based on an entirely new investor trust contract and an **additional creation** that adds trust money based on an investment trust contract that has already been concluded.

Conversely, among the methods available for an investor (beneficiary) to cash out an investment trust (for details, see "7-4 Cashing Out"), there is a **redemption request** to demand cancellation of part of the trust and a **repurchase request** by which the beneficiary certificate is repurchased by the distributor.

The remuneration (expense from the standpoint of an investor (beneficiary)) that the investment trust settlor company, distributor, and the trust bank, etc. receive for operating the investment trust is called **management fees (trust fees)**. Aside from management fees (trust fees), it is necessary to be aware that the distributor often levies an **offering (sales) commission** on investors as compensation for selling the investment trust (there are also cases in which there is no offering commission).

(Note) Excluding certain funds such as mother funds (for details, see 3-10 "(1) Mother Funds"), contractual type investment trust beneficiary certificates have been made paperless (no certificate) from January 4, 2007 (January 2008 for listed investment trusts), and the creation, cancellation, and transfer of beneficial interests have been switched to a system of being performed by records kept in a computer system based account (book-entry transfer account). Nevertheless, beneficiary certificates that were obtained prior to the changeover in the system and that are held in hand by investors continue to be effective.

3 Types of Investment Trusts

Chart 1-2 is an overall picture of domestically registered investment trusts as of the end of September 2023 (additionally, there are also investments trusts that have been established abroad and sold in Japan ("foreign investment trusts"). There are numerous investment trusts in existence: 14,515 in number and about JPY314 trillion in net assets.

Based upon the classification in Chart 1-2 below, let us look at the types of existing investment trusts.

Chart 1-2 Overall Picture of Investment Trusts (as of the end of September 2023)

Total Net Assets-Structure of Investment Trusts
(Table End of September 2023)

(Unit: JPY million)

TYPES / ITEMS	Total Net Assets	Number of Funds
Investment Trusts	314,625,648	14,515
Publicly Offered Investment Trusts	200,966,822	6,019
Contractual Type	189,090,127	5,954
Securities Investment Trust	189,090,127	5,954
Stock Investment Trusts	173,439,423	5,863
Unit Type	623,707	93
Open Type	172,815,717	5,770
ETF	73,081,136	272
Others	99,734,581	5,498
Bond Investment Trusts	15,650,703	91
Unit Type	925	6
Open Type	15,649,778	85
Money Reserve Fund	15,153,771	11
Money Management Fund	0	0
Others	496,007	74
Investment Trusts Other Than Securities Investment Trusts	0	0
Money Trust Benefits Fund, etc.	0	0
Investment Trusts Managed by Trustee	0	0
Investment Companies	11,876,695	65
Securities Investment Companies	0	0
Real Estate Investment Companies(*)	11,735,500	60
Infrastructure Funds(*)	141,195	5
Privately Placed Investment Trusts	113,658,827	8,496
Contractual Type	110,224,858	8,437
Securities Investment Trusts	110,223,353	8,436
Stock Investment Trusts	106,827,609	7,033
Bond Investment Trusts	3,395,744	1,403
Investment Trusts Other Than Securities Investment Trusts	1,505	1
Investment Trusts Managed by Trustee	1,505	1
Investment Companies	3,433,969	59
Securities Investment Companies	18,637	1
Real Estate Investment Companies(*)	3,376,525	57
Infrastructure Funds(*)	38,807	1

* Data for Real Estate Investment Companies and Infrastructure Funds are as of the end of August 2023
(Source) Investment Trusts Association, Japan

3 1 Publicly Offered Investment Trusts and Privately Placed Investment Trusts

Investment trusts are generally targeted towards a large number of unspecified investors, but there are also investment trusts which are limited to certain investors (*e.g.*, major institutional investors such as pension funds).

The former are called publicly offered investment trusts, with the latter being referred to as privately placed investment trusts. “Public offering” and “private placement” are defined below.

(i) Public Offering

Under the ITA, a public offering is the solicitation of application for acquisition (including those specified by Cabinet Office Ordinance as equivalent thereto) of newly issued beneficiary certificates made to many (fifty or more; ITA Enforcement Order, art. 7, para. 1) persons (ITA, art. 2, para. 8); provided, however, private placement with qualified institutional investor, etc. explained below is excluded. This is a concept equivalent to the “public offering of securities” under the FIEA.

Publicly offered investment trusts are subject to the information disclosure system under the FIEA (FIEA, art. 4 and below) and under certain investment restrictions (FIBCOO, art. 130, para. 1, items 8 and 8-2, and para. 2).

(ii) Private Placement with Qualified Institutional Investors, Etc.

Private placement with qualified institutional investors, etc. refers to the offering of investment trust beneficiary certificates to professionals and are categorized into two types: solicitation of application for acquisition of newly issued beneficiary certificates to qualified institutional investors only (ITA, art. 2, para. 9, item 1) and solicitation of application for acquisition of newly issued beneficiary certificates to professional investors only (ITA, art. 2, para. 9, item 2).

Qualified institutional investors (FIEA, art. 2, para. 3, item 1) and professional investors (FIEA, art. 2, para. 31, art. 34-3, para. 4 and para. 6, etc.) are based on the concepts of the FIEA.

(iii) Private Placement with General Investors

Solicitation of application for acquisition of newly issued beneficiary certificates that do not fall under any of (i) and (ii) are referred to as private placement with general investors (ITA, art. 2, para. 10).

Privately placed investment trusts are also established under the ITA, and their management is governed by regulations such as the Fair Trade Rules. However, privately placed investment trusts tend to have more “tailor made” features, and therefore, privately placed investment funds are not required to deliver prospectuses during the subscription period or have their books audited by a certified public accountant, etc. as is required for publicly offered investment trusts, and these differences show the more relaxed regulation of management and disclosure for privately placed investment funds than for publicly offered investment trusts.

3 2 Contractual Type (Investment Trust) and Corporate Type (Investment Corporation)

This classification is based on the difference in the statutory scheme that applies to the funds contributed by investors.

In a contractual type investment trust, the fund is established in the form of trust property pursuant to an investment trust contract entered into by the settlor (investment trust settlor company) and trustee (trust bank), and investors acquire the beneficial interests in the said trust. In contrast, a corporate type investment trust is established as a corporation for the purpose of managing the corporate assets, and investors acquire the securities issued by that corporation.

One can list the major differences between contractual type investment trusts and corporate type investment trusts as follows:

(1) Juridical Personality

In the case of a contractual type investment trust, the trust property itself does not have a juridical personality; however, in a corporate type investment trust, the asset management is undertaken by an investment corporation having a juridical personality.

(2) Organization

Contractual type investment trusts are governed by the investment trust contract entered into by the settlor and the trustee, which sets forth the rights and obligations of the parties to the transaction; namely, the settlor, the trustee, and the beneficiaries. In contrast, corporate type investment trust structures are organized to correspond to the organization of a joint stock company.

Under the Japanese ITA, the terminology corresponding to the organization of a joint stock company is provided for as follows:

Company = Investment corporation, Shareholder = Investor, Shareholders meeting = Investors meeting, Articles of incorporation = Certificate of Incorporation, Share certificates = Investment securities, Shares = Investment equity, and Bonds = Investment corporation bonds

(3) Investments

Under the ITA, there are no differences in the types of permitted investments for contractual type and corporate type investment trusts. Nevertheless, because of the historical background whereby investment trusts mainly investing in securities have been created as contractual type investment trusts since the enactment of the "Securities Investment Trust Act" in 1951, while real estate investment trusts only became permitted with the amendment of the ITA in 2000, in most cases securities investment trusts take the form of a (contractual) investment trust, while real estate investment trusts take the form of an investment corporation (corporate type), as shown in Chart 1-2.

3 3 Investment Trusts Under Instructions from the Settlor and Without Instructions from the Settlor

Contractual type investment trusts are classified by law into investment trusts under instructions from the settlor and investment trusts without instructions from the settlor, based on the roles played by the parties that manage the investment trust. The investment trust without instructions from the settlor is a new form that was born from the 2000 revision of the ITA, but as of the end of September 2023, there is no balance of such funds in publicly offered investment trusts.

	Investment trust under instructions from the settlor	Investment trust without instructions from the settlor
Definition	The settlor gives instructions on investment to the trustee based on the trust contract entered into between the settlor and the trustee, and the beneficiaries acquire the divided beneficial interests in the trust (ITA, art. 2, para. 1)	The trustee concludes a trust contract with one or more settlors under a single set of basic terms and conditions of a trust, and manages the assets without relying on the instructions of the settlors (ITA, art. 2, para. 2)
Beneficiary	Investor	
Settlor	Asset management company (investment trust settlor company)	Investor (settlor and beneficiary)
Trustee	Trust company, etc. (meaning a trust company or a financial institution engaged in the trust business)	
Managed by	Asset management company (investment trust settlor company)	Trust company, etc. (manager and trustee)
Distributor	Financial instruments business operator, financial institution, etc.	

Chart 1-3 **Structure of Investment Trust Under Instructions from the Settlor (Contractual Type)**

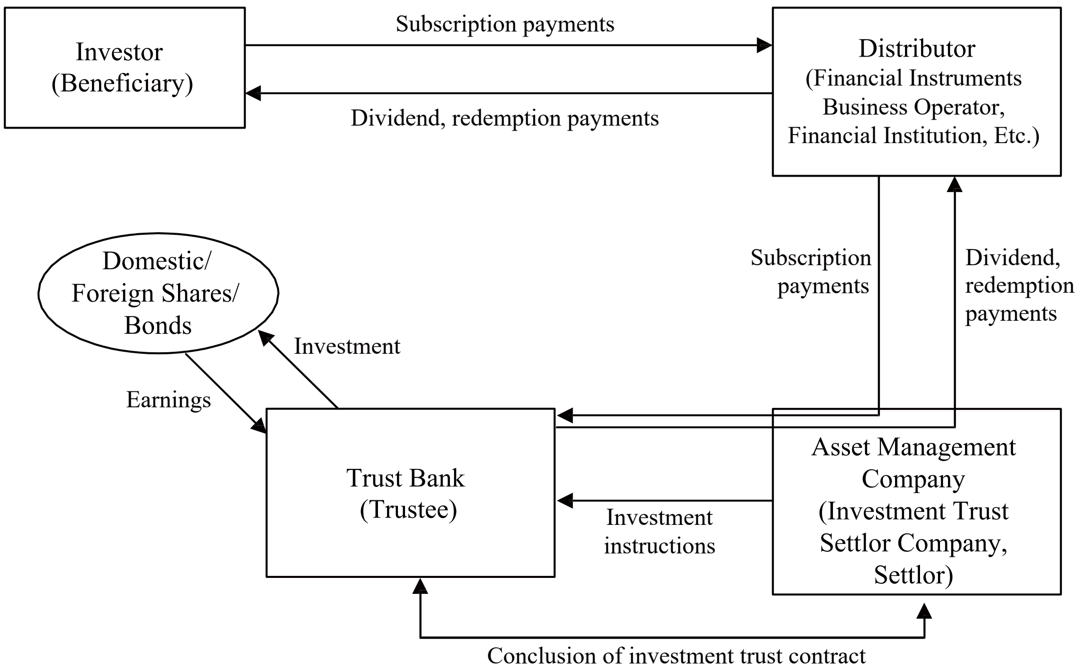
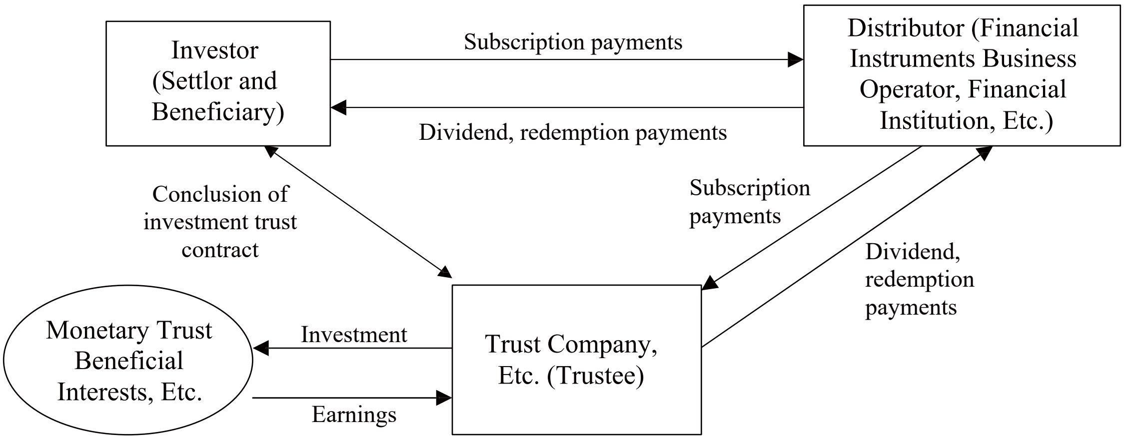


Chart 1-4 Structure of Investment Trusts Without Instructions From the Settlor



3 4 Securities Investment Trusts (Securities Investment Corporations), Real Estate Investment Trusts (Real Estate Investment Corporations), Investment Trusts Other Than Securities Investment Trusts, and Infrastructure Investment Trusts (Infrastructure Investment Corporations)

The principal targets of investment for investment trusts and investment corporations set forth in the ITA (**specified assets**) are listed in Article 3 of the ITA Enforcement Order as assets in which it is necessary to facilitate investment, and can be categorized into five types of assets in accordance with the nature of the assets as follows:

(i) Securities and rights pertaining to securities-related derivatives transactions*;
(ii) Real estate, rights associated with real estate and real estate-associated products;
(iii) Monetary claims, promissory notes, and interests in silent partnership, all of which do not fall under the category of securities, and rights pertaining to derivatives transactions other than securities-related derivatives transactions*;
(iv) Commodities and rights relating to commodity investment transactions, etc.; and
(v) Infrastructure equipment (renewable energy power generation facilities, rights to operate public facilities, etc.).

* “Securities” shall exclude rights deemed as securities pursuant to Article 2, Paragraph 2 of the FIEA and listed in the items of the said Paragraph, and “securities-related derivatives transactions” shall mean securities-related derivatives transactions for securities other than such rights.

Among these five types, classification as a securities investment trust (securities investment corporation), real estate investment trust (real estate investment corporation), investment trust other than securities investment trust, or infrastructure investment trust (infrastructure investment corporation) depends on what the principal target of investment is.

(1) Securities Investment Trust (Securities Investment Corporation)

The ITA defines a “securities investment trust” as an investment trust under instructions from the settlor whose purpose is principally to make the investments (of an amount exceeding half of the total amount of investment trust property) as set out in (i) above (ITA, art. 2, para. 4). Also, the Investment Trusts Association, Japan, in the same manner as with a securities investment trust, defines a “securities investment corporation” as an investment corporation that invests an amount exceeding half of the total amount of the investment corporation’s assets in the investments set out in (i) above (JITA Management Rules, art. 3 and art. 25). No investment trust without instructions from the settlor may be created for the principal purpose of investing in (i) above (ITA, art. 48).

With the exception of securities investment trusts, trusts including a declaration of trust that is to be created for the purpose of investing in securities are, in principle, prohibited (ITA, art. 7); however, trusts other than trusts that issue beneficiary certificates (Trust Act, art. 185) and that are not created for the purpose of dividing up beneficiary interest and having multiple persons acquire the same are permitted. This is to prevent unethical business operators from creating financial instruments similar to securities investment trusts, causing damages to investors and thereby distorting fair price formation in the capital market.

(2) Real Estate Investment Trusts (Real Estate Investment Corporations)

Investment trusts or investment corporations that invest their assets principally in the investments stated in (ii) above are called real estate investment trusts and real estate investment corporations (JITA Real Estate Investment Corporations Rules, art. 3, para. 1).

While it is possible under the ITA to organize in the form of either an investment trust under or without instructions from the settlor (contractual type), as indicated in Chart 1-2, as of the end of August 2023 there are none in the form of investment trusts, and all are organized as investment corporations (corporate type).

Since real estate investment trusts in the United States are abbreviated as **REITs**, Japanese real estate investment trust corporations are also referred to as **J-REITs**.

Compared with securities investment trusts that invest in securities such as shares and bonds which are comparatively easy to liquidate, real estate investment corporations focus on real estate, an asset that has low liquidity (is not easily liquidated), and thus even if there is a cancellation request from a customer, it is difficult to flexibly sell the invested assets and respond to such requests.

Therefore, real estate investment corporations are normally established as closed-end funds which investors are not allowed to cancel but which provide investors with an opportunity to invest and liquidate investments by listing the real estate investment trust on the exchange.

Because real estate investment trust corporations can list investment securities that correspond to share certificates on an exchange in the same way as shares of a company, there are also many securities investment trusts that target real estate investment corporations for investment.

While the method of purchasing and cashing out of listed real estate investment trust corporations is the same as for shares, because securities investment trusts that target real estate investment corporations for investment follow the methods for purchase and cashing out of securities investment trusts, it is necessary to take note of that classification.

(3) Investment Trusts Other Than Securities Investment Trusts

Investment trusts that target investments principally in (iii) and (iv) above are in this category. A typical example of an investment trust falling within this category is one that invests in the beneficial interests of a money trust comprised of auto loans or other receivables.

As indicated in Chart 1-2, there are no longer any publicly offered investment trusts that have been established as investment trusts other than securities investment trusts as of the end of September 2022.

(4) Infrastructure Investment Trusts (Infrastructure Investment Corporations)

Following the ITA amendments as of December 1, 2014, infrastructure equipment (renewable energy power generation facilities, rights to operate public facilities, etc. as mentioned in (v) above) has been included in the scope of specified assets. On April 30, 2015, an infrastructure fund market was opened at the Tokyo Stock Exchange. As of the end of August 2023, five issuances of this type of fund were listed on this new market. Since infrastructure equipment has low liquidity as in the case of real estate, these funds are organized as investment corporations (corporate type), rather than as contractual type investment trusts.

3 5 Stock Investment Trusts and Bond Investment Trusts

Securities investment trusts are broadly classified into stock investment trusts and bond investment trusts.

(1) Stock Investment Trusts

Legally, securities investment trusts that invest exclusively in Japanese government bonds, local government bonds, corporate bonds, commercial paper, negotiable certificates of deposit issued by foreign corporations, government bond futures transactions, etc. are called bond investment trusts (ITA Enforcement Ordinance, art. 13, item 2(a)), and securities investment trusts other than bond investment trusts are defined as stock investment trusts (ITA Enforcement Ordinance, art. 6, para. 1, item 3).

Accordingly, the definition of a stock investment trust would naturally include a fund that focuses on shares, and would also include a fund that contains a certain percentage of both shares and bonds. Moreover, in practice many investment funds that focus on bonds are structured as stock investment trusts by adding shares as an investment target in the basic terms and conditions, even if the fund conducts investment without including any shares at all in its portfolio. Funds that focus on foreign bonds are often established as a stock investment trusts.

The reasons that it is carried out in this way in actual practice are stated in “(2) Bond Investment Trusts” below.

(2) Bond Investment Trusts

As stated in (1) above, bond investment trusts are limited to investing in Japanese government bonds, local government bonds, corporate bonds, commercial paper, negotiable certificates of deposit issued by foreign corporations, government bond futures transactions, etc. Typical bond investment trusts are daily closing funds (funds that close daily) such as MMFs (money management funds) and MRF (money reserve funds, cash management account funds) (for details, see “7. Calculation of Base Value, Closing, Dividends, Cashing Out and Redemption of Securities Investment Trusts”), and so-called long-term bond funds. As of the end of September 2023, there was no MMF on the market.

The characteristics of bond investment trusts are found in the facts that (i) the whole amount of the fund’s net assets that exceed the principal at each closing (every day if it is a daily closing fund) are distributed, (ii) they can be purchased (additionally established) only at the base value on the closing date, and (iii) in daily closing funds, when the base value is other than the principal’s price per unit (*e.g.*, JPY10,000), it is not possible to make an additional establishment.

Thus, speaking about daily closing funds such as MMFs and MRF, the investor's purchase price is always the principal value per unit (*e.g.*, JPY10,000), and this is always the same as the base value (*e.g.*, JPY10,000) so long as there are no operational losses, and all profits on the trust assets become dividends.

Further, as for so-called long-term bond investment trusts, while the base value for one year closing funds fluctuates daily, if on the closing date the base value is over JPY10,000, all of that excess amount becomes dividends (on the contrary while it is possible to make an additional establishment even if the base value on the closing date is below JPY10,000, it is not possible to pay a dividend unless the base value in the following year exceeds JPY10,000, and the portion in excess of JPY10,000 must be distributed in its entirety).

Although the restrictions of (i) and (ii) above are limitations based on the tax system, it is believed that, as long as these kinds of restrictions exist, it is desirable from the perspective of the nature of a market-oriented financial instrument to use the structure of a stock investment trust, in which establishment and cancellation is possible and the base value fluctuates every day, for funds in which there is a strong likelihood that the base value will at times exceed the principal and at times be less than the principal, even if in practice the fund only invests in bonds. It is for this reason that many funds such as those that invest primarily in foreign bonds are established as stock investment trusts.

3 6 Unit-Type (*Tan'i Gata*) and Additional Offering Type (*Tsuika Gata*)

The classification for investment trusts as unit-type or additional offering type depends on whether or not additional funds can be contributed to the fund after the fund is first established.

A unit-type investment trust raises capital from investors during a fixed period of time, and after the fund is established with the collected capital, it will not accept additional funds. While it is possible to calculate the base value, that is the basis on which an investor cashes out the fund and it is not possible to purchase at that base value.

There are two types of unit-type investment trusts, so-called **family fund units** (periodic and stylized investment trusts) under which identically structured unit trusts are established periodically on an ongoing basis, and so-called **spot** investment trusts, which are established in response to and formulated to fit the needs of investors, as well as market conditions such as the share market and the bond market, as they may be from time to time. At present, only spot investment trusts are being newly established, and no new family fund units are being established.

Additional offering type investment trusts (sometimes called **open**-type investment trusts) also raise capital from investors during a fixed period of time, and until the fund is established using the collected capital they are the same as unit-type investment trusts, but afterwards it is possible to raise additional capital. The base value does not mean only the base at which investors that already hold that investment trust can cash out the trust, but it also means the base for the purchase price for investors who intend to purchase the investment trust in the future.

3 7 ETF

ETF is an initialism for Exchange Traded Funds, and refers to investment trusts (Note 1) that are traded on an exchange. ETFs may also be referred to as "listed investment trusts."

ETFs are bought and sold at a market price on an exchange in the same way as listed shares on an exchange. Unlike other securities investment trusts, they are not purchased and cashed out at a price based on the base value, but are characterized by being bought and sold at the market price. Tax treatment also differs from other securities investment trusts, and basically the same system applies as that for listed shares.(Note 2)

When the ETF system was initially established in 2001, only ETFs aimed at tracking specified Japanese share price indexes were allowed to be created. Subsequently, however, new types of ETFs have emerged, such as those tracking foreign share price indexes, commodity prices, and REIT index. In addition, foreign investment trusts (foreign investment corporations) have been listed on Japanese exchanges. Thus, the product types of ETFs have diversified in Japan. In June 2023, actively managed ETFs that do not track any specific indicators were introduced. The product types of ETFs are expected to become further diversified in the future.

(Notes) 1. There is a type of ETF which does not take the form of an investment trust in the legal meaning.
2. Some ETFs are subject to different taxation rules from those applicable to listed shares.

3 8 Foreign Investment Trusts and Foreign Investment Corporations

"Foreign investment trust" means a trust established overseas in compliance with foreign laws that is similar to an investment trust (ITA, art. 2, para. 24), and "foreign investment corporation" means an incorporated organization established based on the laws of a foreign country or unincorporated organization that issues securities similar to investment securities, investment equity subscription right certificates or investment corporation bonds (ITA, art. 2, para. 25).

As stated at the start of this section, among the investment trusts that are offered in Japan, in addition to the domestic investment trusts indicated in Chart 1-2, there are also investment trusts that have been established abroad and brought to Japan.

In this case, in order to protect investors, the disclosure-related regulations of the FIEA (offerings using a securities registration statement and a prospectus) apply to foreign investment trusts (foreign investment corporations) that are publicly offered (excluding private placements) in Japan, and further, it is required under the ITA that the basic terms and conditions of an investment trust, the certificate of incorporation of the investment corporation or corresponding documents be attached and registered (ITA, art. 58 and art. 220).

In addition, it is necessary that the said foreign investment trusts (foreign investment corporation) be in conformance with the screening standards provided by the Japan Securities Dealers Association (JSDA Foreign Securities Rules, art. 16 and art. 17), and one of the Association Members of the JSDA, acting as a proxy Association Member under an agreement entered into with the foreign issuing party, etc., carries out duties such as delivery of prospectuses and settlement reports, etc. and the publication of the base value. The base value of foreign investment trusts is usually not described in yen but in a foreign currency. Upon the motion of the Commissioner of Financial Services Agency, a court may prohibit or suspend offerings of foreign investment trusts (foreign investment corporations) if the instructions on investment concerning the assets of a foreign investment trust (foreign investment corporation) are exceedingly inappropriate, and it is clear that the interests of investors will be harmed thereby (ITA, art. 60, para. 1 and art. 223, para. 1).

3 9 Closed-End Type and Open-End Type

Although the distinction between closed-end type and open-end type is not made in the statistics of Investment Trusts Association, Japan as shown in Chart 1-2, classification by this distinction is often done abroad, and because it is used to classify foreign investment trust (foreign investment corporation) products, we will take a look at it here.

The classification into unit-type (*tan'i gata*) or additional offering type (*tsuika gata*) is based on whether or not additional funding is made after the fund is initially established, but an open-end type means a fund where the issuer can buy back the issued securities (the investor can cancel), and due to this, the fund (*kikin*) can be continually diminished. As opposed to this, closed-end type means a fund where, in principle, it is not possible to decrease the fund (*kikin*) by cancellation or buy-backs.

Although in Japan an additional offering type investment trust is sometimes called open, as discussed above, since, in principle, Japanese investment trusts allow investors to cancel freely (or in the case of a fund for which cancellation is prohibited for a certain period (the closed period), after the expiration of this period), even a unit-type investment trust would be included within the framework of an open-end type.

In closed-end trusts the scale of the fund is more stable than that of the open-end type, enabling the fund manager to concentrate solely on investing the fund without having to worry about this point. Also, because there is no necessity to be pressured to sell and liquidate the invested assets on the market to provide for diminishment in the fund, there is less of an aggravation factor on the market.

Nevertheless, the only way to cash out the beneficial interest in a closed-end type investment trust is to sell it on the market. The price will vary depending on the condition of the market, and will not always match the net asset value (base value) of the fund. Frequently, they can only be sold at a premium or a discount. Conversely, cashing out of an open-end type investment trust is conducted based on the net asset value (base value).

Furthermore, while the closed-end/open-end classification is not directly related to the underlying fund assets, in general, assets that are less liquid are more suited to the closed-end form. Because the manager must respond to investor repurchase or cancellation requests in the case of the open-ended type, it is sometimes necessary to sell or cash out the assets held by the fund in order to pay investors. Thus, it is easier for investment management purposes to organize a fund that incorporates a large percentage of assets that cannot be readily cashed out, such as real estate, as a closed-end investment trust.

For these reasons, investment trusts that target investments principally in real estate are normally organized as a closed-end corporate type investment trust (investment corporation) with the issued investment securities being listed on a financial instruments exchange and traded.

3 10 Others

The major categories of investment trusts are discussed in 3-1 through 3-8 above focusing on the overall image presented in Chart 1-2 presented at the start of this Section. In the following items we examine some of the other types of distinctive investment trusts.

(1) Mother Funds

A mother fund is an investment trust in which the beneficial interests are acquired by another investment trust (**baby fund**) to which the same investment trust settlor company gives instructions on the investment. In order to promote efficient investment management, several baby funds with varying structures are used to target the same underlying investment (**family fund**).

There are also structures that use several mother funds (*e.g.*, a domestic stock mother fund and a foreign bonds mother fund) which each have the same single baby fund, so as to allow that baby fund to invest in different asset classes. Under these kinds of structures, the management of the various investment targets is left to the experts for each asset class at the mother fund, and the baby funds do not perform any management activities other than adjusting the mother fund inclusion. Family fund structures are used to enable a variety of different assets to be packaged into a single product offered to investors, while at the same time promoting the efficient management of the fund assets.

(2) Fund of Funds

Funds of funds are investment trusts (or investment corporations) that invest in investment trusts (investment corporations) and foreign investment trusts (foreign investment corporations); provided, however, a fund that invests principally in a mother fund would fall within the “baby fund” type category of (1) above, and thus should not be included in funds of funds (JITA Management Rules, art. 2, para. 3).

The fund of funds structure is designed to provide investors with new profit-earning opportunities by including a multitude of funds with differing risk characteristics and benefiting from the investment performance of funds managed by institutions with greater investment management expertise.

The Investment Trusts Association, Japan provides detailed regulations for funds of funds depending on distinctions such as whether they are publicly offered funds or privately placed funds, whether the funds invested in are domestic investment trusts or foreign investment trusts, which govern the conditions for fund inclusion, maximum inclusion ratios, etc. (JITA Management Rules, art. 22, art. 23 and art. 24).

(3) Funds Geared Towards Defined Contribution Pension Funds

A defined contribution pension plan is a plan which mimics an American 401(k) plan, and is a private pension in which the benefits vary depending on the performance of the investments. There are individual and corporate plans, and under a corporate plan, the employees can select where to invest their money from among a menu of investment products selected by the employer (bonds, shares, investment trusts, savings deposits, trusts, insurance products, etc.). Similarly, under an individual plan, subscribers select investment products from among those handled by the operational management institutions with which they have completed the subscription procedure. In 2017, the individual plan was reformed to include public employees and housemakers in the scope of eligible subscribers. At that time, the plan was given a pet name, “iDeCo,” with a view to making it more widely known and accepted as a scheme for supporting households through stable asset building.

A fund geared towards a defined contribution pension plan is a fund that is offered as one of the investment choices to the participants in the plan, and is often identified by the letters DC (Defined Contribution) appearing in the fund's name.

3 11 Product Classification and Classification of Attributes Stated in Investment Trust Explanatory Document (Prospectus)

In accordance with the "Guidelines for Product Classification" of the Investment Trusts Association, Japan, the product classification shown in Chart 1-5 "Product Classification" and the classification of attributes shown in Chart 1-6 "Classification of Attributes" are stated in the investment trust explanatory document (prospectus) of a publicly offered (contractual type) investment trust.

Among the items listed in Chart 1-5, the three items, *i.e.*, "unit-type/additional offering type," "investment target territory," and "investment target assets (source of income)," will, in principle, be stated on the cover of an investment trust explanatory document (prospectus) for all funds. The other two items, *i.e.* "independent classification" and "supplemental classification," are indicated only for funds that fall within these categories. In terms of the distinction between stock investment trusts and bond investment trusts described in 3-5 above, mainly for tax purposes, funds may be classified as stock investment trusts even though they do not actually invest in stocks. The product classification discussed here is designed to focus on the kind of assets that are the fund's main source of investment income and to make clear the fund's investment purpose and its risk characteristics.[Note 1] The brackets following "Other Assets" in the Investment Target Assets (Income Source)" column are filled with the type of assets such as "Commodity" or "Beneficial Interest in Money Trust."

Chart 1-5 Product Classification

Unit-Type/ Additional Offering Type	Investment Target Territory	Investment Target Assets (Income Source)	Independent Classification	Supplemental Classification
Unit-Type	Domestic	Share	MMF	Index Type
Additional Offering Type	Foreign	Bonds	MRF	Special Type
	Domestic and Foreign	Real Estate	ETF	
		Investment Trusts		
		Other Assets ( )		
		Composite Assets		

Chart 1-6 Classification of Attributes

Investment Target Assets	Closing Frequency	Investment Target Territory	Investment Form	Exchange Rate Hedge*	Target Index	Special Type
Shares -Ordinary -Large -Small& Medium Bonds -Ordinary -Public -Corporate -Other -Credit Attributes ( ) Real Estate Investment Trusts Other Assets ( ) Composite Assets ( ) -Fixed asset distribution type -Fluctuating asset distribution type	1 per year 2 per year 4 per year 6 per year (alternate month) 12 per year (monthly) Daily Other ( )	Global Japan North America Europe Asia Oceania Central & South America Africa Middle and Near East (Middle East) Emerging	Family Fund Fund of Funds	Yes ( ) No	Nikkei225 TOPIX Other ( )	Bull/Bear Type Conditional Investment Type Long-Short Type/Absolute Return Type Other ( )

＊The exchange rate is hedged against the yen.

Among the classification of attributes in Chart 1-6, “investment target assets” is to be stated by making a selection from among the listed assets. When the investment target assets are a composite portfolio of differing assets, a statement is to be made in parenthesis of the particulars, such as “shares and bonds.”

The accounting period for an investment trust is stated as “closing frequency” because the accounting period may be one year, six months, three months, two months (alternate month closing), one month (monthly closing), and one day (daily closing type (MMFs and MRF)).

For “investment target territory,” multiple territories may be stated in some cases.

Where the fund corresponds to a “family fund” or “fund of funds” as described in “3-10. Others,” the appropriate selection is made under “investment form.”

Where a fund invests in foreign currency denominated assets, the fund’s investment purpose and the risk taken on by investors differs greatly depending on whether the exchange rate is hedged (taking as little exchange rate risk against the yen as possible) or not hedged (actively taking on exchange rate risk against the yen and aiming to enjoy a rise in the price of the foreign currency). This is indicated in the "exchange rate hedge" column, with the degree of exchange rate hedge being indicated in parentheses as "full hedge," "partial hedge," "timely hedge," etc.

Where the fund is an index fund or a special type,(Note 2) the applicable type is stated.

(Notes) 1. As stated in 3-5, because systemically there is a large difference in the practical handling of stock investment trusts and bond investment trusts, this classification continues to be important (for details, see "6. Sale of Securities Investment Trusts" and "7. Calculation of Base Value, Closing, Dividends, Cashing Out and Redemption of Securities Investment Trusts").

2. "Special type" refers to the following types of funds:

"Bull/Bear Type" – used other than for hedging derivative products, aims to invest actively together with linkage or reverse linkage to the various indexes (including linkage or reverse linkage index multiples).

"Conditional Investment Type" – by investing in structured bonds, etc., the investment outcome and maturity date, etc. are decided by the level of a market index (*e.g.*, stock price index) in accordance with certain conditions.

"Long-Short Type/Absolute Return Type" – by selling short (shorting) issues and assets that are expected to fall in price and by purchasing issues and assets (buying long) that are expected to rise in price the fund aims to have zero substantive additions to portfolio holdings, and seeks returns that would not be affected by the entire movement of a particular market (*e.g.*, Japan's stock market).

3 12 Monthly-Paid Type, Currency-Selected Type, Leveraged Investment Trusts, Complex Investment Trusts Similar to OTC Derivatives Transactions, and Knock-in Investment Trusts

(1) Monthly-Paid Type

As stated in 3-11 above, there is variety in the closing frequency of investment trusts, such as once, twice, four times or six times a year, on a bimonthly, monthly, or daily basis. A monthly-paid type fund is a scheme wherein a closing is made and a dividend is paid on a monthly basis. Although most monthly-paid type funds are managed under the policy of ensuring stable payment of the dividend, it is necessary to fully understand matters such as that there may be cases where there is no dividend payment, whereas a dividend may sometimes be paid beyond the profit obtained by the fund, and that such a dividend payment would cause a decline in the base value, and that all or part of the dividends may be regarded as partial refund of principal.

(2) Currency-Selected Type

A currency-selected type investment trust is designed to allow investors to select a currency other than the yen as the subject of exchange trade, in addition to selecting the investment target assets such as bonds and shares. For example, if a fund aims to enable investors to receive the investment results in Australian Dollars using assets denominated in US Dollars, the fund carries out exchange trade by selling US Dollars and buying Australian

Dollars, in addition to managing the investment target assets.

The sources of profit and loss arising in currency-selected type investment trusts are: (i) a rise or fall in the price of the investment target assets, and interest and dividend from such assets; (ii) income (premium) or expense equivalent to the difference in the interest rate between the currency in which the investment target assets are denominated and the selected currency, which arises from exchange transaction; and (iii) a rise or fall in the rate of the selected currency against the yen.

However, it should be noted that as a currency-selected fund is subject not only to the price fluctuation risk of the investment target assets but also the exchange fluctuation risk of the selected currency, a huge loss might occur in the event of a fall in the currency rate, and that profit from an exchange transaction does not always correspond to a difference between short-term interest rates but may possibly be far deviated from it. Those engaged in selling currency-selected type investment trusts should pay special attention to these points.[Note]

(Note) For the explanation of dividends that must be provided when selling investment trusts and the regulations, etc. concerning the sale of currency-selected type, check the description provided later (for details, see 6-2 "(4) Explanation on Expenses Payable by Customers and Dividends, and Measures to Confirm Customers' Understanding of Currency-Selected Investment Trusts").

(3) Leveraged Investment Trusts, Complex Investment Trusts Similar to OTC Derivatives Transactions, and Knock-in Investment Trusts

Leveraged investment trusts and complex investment trusts similar to OTC derivatives transactions (hereinafter referred to as "complex investment trusts") are subject to tighter regulations than those for other types of funds in terms of investment solicitation and sales due to their special characteristics as financial products (for details, see 6-2 "Regulations, Etc. Concerning Sales"). Knock-in investment trusts are a type of complex investment trust, and in addition to regulations on investment solicitation and sales, tighter disclosure rules under special provisions are imposed than those imposed on other types of funds with regard to the disclosure in materials used for sales, etc., investment management reports, and websites of investment trust settlor companies, etc.

(i) Leveraged Investment Trusts

"Leveraged investment trust" refers to an investment trust that is managed so that the change rate of the base value is consistent with the value that is calculated by multiplying the change rate of a specific indicator or price by a predetermined factor (limited to two times or more or minus two times or less) (excluding listed investment trusts) (JSDA Investment Solicitation Rules, art. 2, item 9).

(ii) Complex Investment Trusts

"Complex investment trust" refers to an investment trust that will be of the same nature of a product or effect as that of a complex structured bond similar to OTC derivatives transactions (hereinafter referred to as a "complex structured bond") by investing in such structured bond (JSDA Investment Solicitation Rules, art. 2, item 8).

"Complex structured bond" refers to a bond other than a Japanese government bond and a bond that has a structure to reflect the credit condition of a single entity, which falls under any of the following (JSDA Investment Solicitation Rules, art. 2, item 7):

(a) A bond for which the redemption price can be less than the face value (excluding those structured so that the change rate of the redemption price is consistent with the value that is calculated by multiplying the change rate of a specific indicator or price by a predetermined factor (limited to one time or minus one time);

(b) A bond subject to a condition that the redemption is made with other securities such as by the automatic exercise of rights in the derivatives transaction; or

(c) A bond which falls under any of the following, other than one structured so that the change rate of interest is consistent with the change rate of an interest indicator:

a. Interest is not determined at the time of issuance, and the currency used for redemption payment and that used for purchase payment are different;

b. Interest is not determined at the time of issuance, and the currency used for interest payment and that used for purchase payment are different; or

c. Interest becomes zero or very close to zero depending on the conditions.

(iii) Knock-in Investment Trusts

A knock-in investment trust is a type of complex investment trust, which has the features set forth in (a) to (c) below (JITA By-laws for the Complex Investment Trust Rules, art. 2):

(a) Derivatives transactions or structured bonds are used, and the target investment results (*e.g.,* redemption price, dividends, etc.) and the redemption date depend on a specific indicator or price;

(b) With the use of a knock-in option or any other similar economic effect, it has a product nature that could cause investors to incur a loss of principal or enjoy an unusual degree of profitability in cases such as when the specific indicator or price reaches a certain level during a certain period of time and the redemption price reflects such movements in the indicator or price; and

(c) A function or structure to secure principal (or to limit a loss) against movements in the indicator or price (excluding those relating to credits) under certain conditions is provided.

A typical example of a knock-in investment trust uses a stock index (Nikkei Stock Average). For example, if the Nikkei Stock Average does not fall below a certain price level (knock-in price) at all during a certain period of time, profit can be secured (but only up to a certain amount however high the Nikkei Stock Average may be), whereas, if the Nikkei Stock Average falls below the knock-in price even once, the investment result is linked with such movements. In the course of soliciting investors to invest in knock-in investment trusts, it was often the case that while it was emphasized that investors can receive dividends at a rate above the deposit interest rate if the Nikkei Stock Average does not fall below the knock-in price, investors were not fully informed of the possibility of incurring a loss if the Nikkei Stock Average fell below a certain level just once during a certain period of time (*e.g.*, a fall by 35% from the current stock price in five years). As a result, due to the lack of understanding of the nature of this product, there were cases such as investors incurring losses on a par with the fall in the Nikkei Stock Average. This led to the introduction of tighter disclosure rules for knock-in investment trusts under a special provision than those for other types of funds with regard to the disclosure in materials used for sales, etc., investment management reports, and websites of investment trust settlor companies. For example, the following statement must be clearly indicated on the cover or at the beginning of a prospectus, using 12-point or larger characters and be placed within a frame.

> Please consider carefully upon application that this investment trust has a risk that a considerable loss could occur in principal when the base indicator (*e.g.*, Nikkei Stock Average) reaches a certain predetermined level.

4 Structure of Securities Investment Trusts

Although the structure of a securities investment trust is described briefly in Chart 1-3, here we will take a more detailed look. In securities investment trusts under instructions from the settlor, the foundations for management are laid out in the basic terms and conditions. The parties involved in this type of investment trust are the asset management company (investment trust settlor company), the trustee (trust bank), the beneficiary (investor), and the distributor.

4 1 Investment Trust Contract

(1) Conclusion of an Investment Trust Contract

When an investment trust settlor company (*i.e.*, settlor or asset management company) proposes to enter into an investment trust contract with a trustee, the said basic terms and conditions of the investment trust must be filed with the Prime Minister (who, in practice, delegates its authority to the Commissioner of the Financial Services Agency) (ITA, art. 4, para. 1 and art. 225, para. 1). While the basic structure of investment trusts under instructions from the settlor is defined in the ITA, the detailed provisions governing their organization are set forth in the basic terms and conditions of an investment trust.

The main items included in an investment trust contract are as listed below (ITA, art. 4, para. 2).

(i) Trade names or names of the settlor and the trustee, and their business operations;
(ii) Types of the underlying assets and other matters concerning the management of the trust property;
(iii) Matters concerning the method, criteria and record date for the valuation of the investment trust property;
(iv) Matters concerning the redemption of trust principal and distributions of profit;
(v) Matters concerning the duration of the trust contract, extensions thereof, and early cancellation during the duration of the trust contract;
(vi) Matters concerning the accounting period of the trust;
(vii) Matters concerning the method of calculating the trust fees and other fees to be received by the trustee and the settlor
(viii) Classification as to whether the investment trust is offered through a public offering, private placement with qualified institutional investors, private placement with professional investors or private placement with general investors
(ix) Where the settlor entrusts another person with the authority to give instructions on investment, the trade name or name and other details of the person to whom the settlor entrusts such authority, and the costs of such entrustment;
(x) Matters concerning an amendment to the basic terms and conditions of the investment trust; and
(xi) Method of giving public notice to be used by the settlor.

The investment trust settlor company must provide any persons who are to acquire an investment trust with a written copy of the basic terms and conditions of the investment trust (ITA, art. 5, para. 1, main clause). However, this does not apply if (i) the basic terms and conditions of an investment trust are included in a prospectus, (ii) the investment trust is a privately placed investment trust to qualified institutional investors, (iii) in the case of private placement with general investors, the information on the content of the basic terms and conditions of the investment trust is provided or published as specified information on securities, etc., (iv) the desired investment trust property is the same as those of an already owned investment trust or (v) if an individual sharing the same household as the person to receive the said fund has already received the abovementioned document or it has been confirmed that the same will be received by such an individual and the said person agreed not to receive the said document (ITA, art. 5, para. 1, *proviso*; ITA Enforcement Ordinance, art. 10). Publicly offered investment trusts ordinarily include the contents of the basic terms and conditions of an investment trust in the prospectus, and thus, do not deliver a separate written document containing the same material.

(2) Amendments to an Investment Trust Contract

When the investment trust settlor company proposes to amend the basic terms and conditions of an investment trust, it must file a notice with the Commissioner of the Financial Services Agency in advance of that fact with the content of the proposed amendment (ITA, art. 16, item 1). In this case, where the amendment is a material amendment, for a fund established prior to September 30, 2007 when the new Trust Act came into force (an Old Law Trust), the procedures in (i) below must be followed; and for a fund established after the enforcement of the new Trust Act (a New Law Trust), the procedures in (ii) below must be followed:

(i) Material Amendment of the Basic Terms and Conditions of an Old Law Trust

Where a material amendment of the basic terms and conditions of an Old Law Trust is proposed, public notice of the fact of the amendment and the content thereof must be given in advance, and written notice stating these matters must be delivered to the beneficiaries (ITA prior to the September 30, 2007, amendment, art. 30). This public notice and written notice must include a statement to the effect that beneficiaries with an objection to the amendment may voice their objection within a certain period of time (which cannot be less than one month). If the number of units held by beneficiaries that state an objection within the specified period of time is greater than one-half of the total number of units held by all beneficiaries, no amendment is allowed.

On the other hand, where the number of such units is one-half or less, the amendment will take effect, but those beneficiaries who stated an objection within the fixed period of time may make a demand to the trustee that the portions of the fund owned by such beneficiaries be repurchased with the investment trust property at the fair value which they would have had if the amendment had not been made (ITA prior to the September 30, 2007, amendment, art. 30-2).

(ii) Material Amendment of the Basic Terms and Conditions of a New Law Trust

Where a material amendment of the basic terms and conditions of a New Law Trust is proposed, the amendment shall be made pursuant to the procedures for a written resolution of the beneficiaries.

In the case of a written resolution of the beneficiaries, the investment trust settlor company shall prepare a document stating the date of the said resolution, the contents of material amendments to the basic terms and conditions and reason thereof, matters to be stated on reference documents for written resolutions, deadline for exercise of voting rights and other matters, and dispatch the notice in writing to beneficiaries at least two weeks prior to the date of the resolution (if certain requirements are met, the notice may be made by electromagnetic method) (ITA, art. 17, paras. 1 through 4). Written resolutions shall be adopted by a majority of two-thirds or more of the voting rights of all beneficiaries who may exercise voting rights (ITA, art. 17, para. 8). The basic terms and conditions may provide that a beneficiary shall be deemed to have approved the resolution if it does not exercise its voting right (such provision shall be stated on the notice sent to beneficiaries (ITA, art. 17, para. 7)). If all beneficiaries have manifested their intent to consent to the proposal of the investment trust settlor company in writing (or when certain requirements are met, by electromagnetic method), the procedures for a written resolution do not need to be taken (ITA, art. 17, para. 10; ITA Enforcement Ordinance, art. 31).

A beneficiary voting against the material amendments to basic terms and conditions may request that the fund which it owns be repurchased with the investment trust properties at a fair price (ITA, art. 18, para. 1). However, this provision on the dissenting beneficiaries' right to request the purchase of their beneficial interest does not apply to an investment trust wherein a beneficiary's request for the redemption of the fund which is filed during the trust contract period may be satisfied by the partial cancellation of the investment trust contract (*e.g.*, a fund which allows cashing out every day except for holidays, etc. outside Japan) (ITA, art. 18, para. 2).

(3) Cancellation of an Investment Trust Contract (Redemption of the Fund)

When the investment trust settlor company intends to redeem the fund and cancel the investment trust contract, it must notify the Prime Minister to that effect in advance (ITA, art. 19) (for details, see "7-5 Redemption").

4 2 Parties Involved in Securities Investment Trusts

(1) Investment Trust Settlor Company

Only persons who are registered with the Commissioner of the Financial Services Agency for engaging in investment management business may become an investment trust settlor company (FIEA, art. 2, para. 8, item 14, art. 28, para. 4, item 2, art. 29, and art. 194-7, para. 1).

The main types of business that the investment trust settlor company conducts are as follows:

(i) Conclusion of investment trust contract, and filing of notification of the basic terms and conditions of an investment trust and amendments thereof;
(ii) Establishment of the investment trust property;
(iii) Giving instructions on management of the investment trust property (including the exercise of voting rights by instructions);
(iv) Calculation and publication of the base value of the fund;
(v) Preparation of disclosure documents such as prospectus and management report; and
(vi) Cancellation of the investment trust contract (redemption of the fund).

Among the principal business operations of investment trust settlor company mentioned above, (iii) through (v) will be discussed later (for details, see "5. Management of Securities Investment Trusts," "7. Calculation of Base Value, Closing, Dividends, Cashing Out and Redemption of Securities Investment Trusts" and "8. Disclosure for Securities Investment Trusts").

For many funds, investment trust settlor companies outsource the management of investment trust property to investment management companies as provided for by law (for details, see the note indicated at the beginning of "5. Management of Securities Investment Trusts").

There has also been an increase in investment trust settlor companies that outsource the calculation of the base value and the disclosure process.

It is necessary to be registered as a type II financial instruments business operator by the Commissioner of the Financial Services Agency where an investment trust settlor company conducts an offering of the beneficial interests in a fund which it issues itself (FIEA, art. 2, para. 8, item 7(a), art. 28, para. 2, item 1, and art. 29). In this case, the investment trust settlor company also performs the role of distributor, and thus the investment trust settlor company is said to be engaging in "direct sales functions."

(2) Trustee Companies

Trustees must be trust companies, etc. (trust companies or financial institutions that conduct trust businesses; hereinafter the same) (ITA, art. 3).

The main businesses that trustee companies conduct are listed below:

(i) Administration of investment trust property;
(ii) Calculation of the base value of the fund (verification with the value calculated by the investment trust settlor company); and
(iii) Approval/consent for the content of the basic terms and conditions of an investment trust and for amendments thereof.

The trustee company becomes the titleholder of the investment trust property and administers it in its own name while keeping such property separate from its own assets. When incorporating foreign securities into investment trust property, the trustee must establish a custody contract with a local financial institution so that the local financial institution can take custody of the foreign securities. The trust company independently calculates the base value of the fund, which is then verified by the investment trust settlor company.

At present, the trustee business for investment trusts is being carried out by re-entrustment companies. This entrustment is designed to improve efficiency in business operations by separating the trustee business from other businesses of trust banks and having the trustee business centrally managed at a re-entrustment company, and by allowing the re-entrustment company to conduct the trustee business in cooperation with other trustee companies. In this way, the role played by these re-entrustment companies in practice has taken on an increasing significance in the hierarchy of investment trust organization.

(3) Beneficiaries

A beneficiary is a holder of a beneficial interest that possesses the right to receive the earnings of the trust. Beneficial interests consist of the right to receive dividends and redemption proceeds, and to make fund requests for cashing out by cancellation or repurchase. Each beneficiary possesses an equal right, based on the number of units of beneficial interests held, to receive a contribution of the trust's principal as well as any dividends (ITA, art. 6, para. 3)

(4) Distributors

Except in the case of investment trust settlor companies that engage in direct sales functions, investment trusts are usually offered and sold through "distributors" such as financial instruments business operators and registered financial institutions (this refers to financial institutions that have been registered in accordance with FIEA Article 33-2 concerning the business of investment trusts offerings, etc., hereinafter the same). Therefore, distributors play an important role in the actual administration of investment trusts, although they are not a direct party to the trust contract.

Pursuant to the basic terms and conditions of an investment trust, the investment trust settlor company may appoint a specific distributor (this is called a designated distributor) to sell the investment trust, and the designated distributor conducts the following business as an agent of the investment trust settlor company:

(i) Handling of the offering of the investment trust and trading;
(ii) Handling of distribution of profits and payments of redemption proceeds;
(iii) Requesting cancellation to the investment trust settlor company for funds purchased from the beneficiary and relaying cancellation requests from the beneficiary; and
(iv) Delivery of prospectuses and management reports to clients, and exchanging necessary information with the investment trust settlor company concerning offerings and sales (*e.g.*, notifications from the designated distributor regarding the progress made in offering/sales, and notifications from the investment trust settlor company regarding the base value and other matters).

Distributors that are not designated distributors are usually called intermediary distributors, and they are required to interface with a designated distributor when conducting the abovementioned operations.

5 Management of Securities Investment Trusts

One characteristic of investment trusts is that they are managed by professionals. In Japan, a person who may direct investment as the settlor of an investment trust under instructions from the settlor is a financial instruments business operator who is registered as an investment management business(Note) (FIEA, art. 2, para. 8, item 14, art. 28, para. 4, item 2, and art. 29).

We will take a brief look at practices in connection with the management of an investment trust. However, the statements below are made in connection with publicly offered securities investment trusts (investment trusts under instructions from the settlor). It is necessary to take note that different rules apply in regard to the investment of other investment trusts and there are also many areas that differ widely in practice, etc.

(Note) A financial instruments business operator who conducts an investment management business may delegate all or a portion of its management authority to another financial instruments business operator who conducts an investment management business or to a corporation established under foreign laws and regulations who conducts an investment management business overseas (FIEA, art. 42-3, para. 1, item 2; FIEAEO, art. 16-12; ITA, art. 2, para. 1; ITA Enforcement Order, art. 2). Further, where management is conducted for investment only in assets other than rights related to securities or derivatives transactions, management may also be delegated to a trust company (ITA Enforcement

Order, art. 2, item 2); provided, however, that the relevant investment trust settlor company cannot delegate out all of its authority to give instructions on investments concerning all of the investment trust property that it manages (ITA, art. 12, para. 1).

5 1 Organization and Authority of Investment Trust Settlor Company

The investment trust settlor company (management company) has the authority to perform the following investment functions with respect to the management of an investment trust: (1) research functions; (2) determination and implementation functions of the investment policy; (3) trading functions; (4) risk management functions; (5) performance evaluation functions; (6) compliance functions, etc. How these functions are embodied in an organizational structure and what kinds of processes are implemented differ depending on the management policies and investment philosophy of each management company. The differences in these matters are what distinguish each asset management company.

(1) Research Functions

These functions involve researching and analyzing the factors that could cause the price of the assets to fluctuate such as economy, interest rates, and companies, etc. Experts such as economists, analysts(Note), or quants (quantitative analysis experts) are assigned to the division that heads the research function, and present the results of their analyses to the fund manager, etc. through meetings, etc. as described below.

(Note) Analysts at management companies are persons who conduct company research/analysis solely for the management of the investment trust. To distinguish them from the analysts at securities firms, etc. who conduct company research/analysis in order to provide information to customers (called “sell-side analysts”), these persons are sometimes referred to as “buy-side analysts” (similarly, analysts that work at institutional investors with investments in trust products or life insurance are also referred to as buy-side analysts).

(2) Determination and Implementation Functions of the Investment Policy

In the case of an investment trust, the major investment targets, investment methods, investment restrictions and other matters are set forth for each fund in the basic terms and conditions of the investment trust. The functions involved at this stage are utilizing the analyses provided by the economists, analysts and quants to construct and manage a portfolio that will satisfy the fund’s goals while keeping with the matters stated in the basic terms and conditions of the investment trust, determining the investment policy and the specific types of securities, etc. transactions to use. In many cases, determination of the actual transactions to be implemented by the fund is left to the investment expert known as the fund manager. It would not be an overstatement to say that these functions have the largest influence over the fund performance.

The management company will often set up a committee known as the “investment policy board” or some other title to deliberate on the company’s fundamental investment policy, while the fund manager is given decision-making authority over the specific transactions to be conducted by each fund according to such a policy. However, the extent to which a policy applies company-wide, and the scope of the fund manager's individual discretion varies with the management company or the fund. In addition, there are management companies and funds where the fund manager itself possesses the full assortment of research functions and the research organization is not independent. There are also management companies and funds where management is conducted not by an individual fund manager, but by a group of experts under a team management method.

(3) Trading Functions

These are functions to execute the securities, etc. transactions determined by the fund manager, and an expert known as the trader is assigned. Although there are management companies where the fund manager concurrently serves as the trader, in most management companies these posts are separated.

In order to execute trades on terms that are favorable to the investors, the trader chooses the counterparty and trading execution terms, accurately and properly executes the trade, and gives clear and appropriate instructions to the trust bank that is the trustee, which has the authority to manage and dispose of the investment trust property.

(4) Risk Management Functions

Investment trusts are constantly exposed to a multitude of risks, such as (i) market risk associated with the fluctuation of the price of the investment targets, interest rates, exchange rates, etc. (this includes the individual risks for the share or bond issues or industries that make up the portfolio); (ii) credit risk associated with changes in the creditworthiness of certain parties, such as the possibility of defaults by the issuer of the investment targets or the counterparty; (iii) liquidity risk that, due to a large volume of cancellation/monetization requests or turmoil in the markets, etc., it will not be possible to conduct transactions on the market or conduct transactions at economic terms.

The risk management function seeks to ascertain the various risks of each fund, and make the fund manager aware of the risks or insist on corrective measures in cases where the size of the risk grows larger than the level that is acceptable for the fund in light of its investment objectives. Because the expected return on the portfolio depends on how much risk is taken on, risk management functions play a vital role in fund performance.

Depending on the management company, the risk management functions could be housed in the same investment division as the fund manager, assigned to an independent management department, or both.

(5) Performance Evaluation Functions

These are functions that verify the investment trust's performance after the fact. An analysis is made of trends in the net asset value for each fund, the source of the trends, positive and negative factors, etc., and the results of this analysis are fed back to the investment desk. This partially overlaps with the risk management function described in (4) above, since the source of a fund's performance depends largely on the level of risks to which the fund is exposed, and it is necessary to verify after the fact whether the fund was appropriately taking on the proper types of risks.

(6) Compliance Functions

The FIEA charges the investment trust settlor company (management company) with a fiduciary duty and duty of care of a prudent manager, and prescribes certain prohibited activities for the benefit of beneficiary protection (for details, see "5-3 Duties of Investment Trust Settlor Company"). Based on the spirit of the ITA, the Investment

Trusts Association, Japan has also ratified detailed rules (various by-laws, etc.) which investment trust settlor companies must follow in complying with the ITA, the ITA Enforcement Order and ITA Enforcement Ordinance.

Additionally, the investment trust settlor company must establish various internal rules to comply with the law and regulations and the rules of the Investment Trusts Association, Japan. Naturally, the management company must conduct its investment activities in strict compliance with the law and regulations, the Investment Trusts Association, Japan rules, and its own internal rules.

Compliance functions involve providing guidance and training to the fund manager, etc. regarding these laws and regulations, etc., monitoring the status of compliance with the laws and regulations, etc., stopping any violations of and correcting any actions that have a high likelihood of violating the law and regulations, etc. Many management companies establish a compliance department separate from the divisions mentioned in (1) through (4) above, and in some cases even assign a compliance supervisor to each of those divisions. The hope is that greater internal control will be achieved in the investments and other business activities engaged in by the investment trust manager by having each division autonomously involved in compliance as well as an independent compliance division.

5 2 Investing Techniques of Securities Investment Trusts

(1) Index Investing (Passive Investing) and Active Investing

Index investing is an investing technique that tries to replicate as nearly as possible the performance of a benchmark (Note) such as the Tokyo Stock Price Index or the Nikkei Stock Average. In order to more closely track the performance of the index, the fund mirrors the industry categories, interest rate risk (sensitivity to changes in interest rates), exchange risk (sensitivity to changes in foreign exchange rates), etc. of the benchmark, and tries to minimize specific risk through diversification.

In contrast, active management takes on a different risk than the benchmark based on the analysis of economic conditions, interest rates, and company research, etc. in an attempt to beat the performance of the benchmark.

(Note) "Benchmark" refers to the criterion upon which a fund's investment goals and performance are judged. Stock indexes, bond indexes, etc. are used as benchmarks according to the major investment targets and the nature of the fund.

(2) Top-Down Approach and Bottom-Up Approach

Active investing is broadly classed into two methods on how to outperform the benchmark; the top-down approach and the bottom-up approach.

In the top-down approach to investing, the manager seeks to find sources of earnings that will outperform the benchmark based on macroeconomic research and analysis, and constructs a portfolio of issues most likely to take advantage of these trends.

The opposite is the bottom-up approach to investing, which compiles a portfolio based on the results of painstaking research and analysis of individual companies, and seeks to outperform the benchmark.

(3) Growth Stock Investing and Value Stock Investing

Active investing in shares can be categorized into a number of “investment styles” depending on how the sources of profits that surpass the benchmark are to be found. Growth stock investing and value stock investing are typical examples of such investment styles. In growth stock investing, the manager focuses on the future growth potential of the relevant company, whereas value investing involves comparing the value of the share with its price level, and organizing a portfolio of shares that are determined to be undervalued.

Growth stock investing and value stock investing are increasingly being researched as two different “investment styles,” and private economic research firms publish growth stock indexes and value stock indexes.

Other “investment styles,” in addition to the above, include large-cap investing and small-cap investing, etc., and by combining these with growth/value, investment styles can be further classified into “large-cap growth,” “large-cap value,” “small-cap growth,” and “small-cap value,” etc.

(4) Bond Fund Management

Bond prices fluctuate mainly due to interest rate risk, credit risk, and liquidity risk. There is also foreign exchange risk in cases where investment is made into foreign currency denominated bonds.

Therefore, in the management of a bond fund, interest risk is controlled on the basis of the duration of the portfolio.(Note) Attention is paid to the control credit risk of the issuer of the bonds that constitute the fund, while making changes to these bonds as necessary. Control is also put in place depending on the situation of foreign exchange exposure in the event of investing in foreign currency denominated bonds. Moreover, management is conducted by changing the maturity mix of the bonds in the fund, depending on whether the yield curve steepens or flattens.

(Note) The “duration” is the benchmark for the sensitivity of the bond price to changes in interest rates. In general, this increases in proportion to the maturity of bonds.

(5) Relationship Between the Investment Technique and the Basic Terms and Conditions of an Investment Trust

The basic terms and conditions for each fund set forth the major investment targets, investment techniques, investment restrictions, etc. of the fund. There are cases where the investment techniques described in (1) through (4) above are clearly written in the basic terms and conditions, and cases where they are not. Since the purpose of an index fund is to track an index, usually this is clearly stated in the basic terms and conditions. However, in some cases the basic terms and conditions for an actively managed fund will clearly state only that the fund aims to outperform a certain index, relegating to the fund manager the choice of investment approach and techniques, while in other cases the basic terms and conditions clearly describe the methodology of how the fund plans to beat the benchmark.

In addition, index funds that aim to track the performance of a growth stock or value stock index could be said to use passive investing techniques to manage an actively managed fund. Conversely, while so-called themed funds, which select issues that correspond to a certain theme (*e.g.*, XX-related stock funds, etc.), are generally classified as actively managed funds, since their aim is to manage issues in the chosen theme and not a quantifiable benchmark, they could be seen as passive investment funds.

In any case, each investment professional needs to exert his best efforts to see that the investment trusts under his control accomplish their performance goals in line with the matters set forth in the basic terms and conditions.

5 3 Duties of Investment Trust Settlor Company

(1) Fiduciary Duty, Duty of Care of a Prudent Manager

In Paragraph 1 of Article 42, the FIEA prescribes a fiduciary duty on the part of an investment trust settlor company, stating that "a financial instruments business operator, etc. shall engage in the investment management business faithfully on behalf of the holder of rights." Paragraph 2 states the duty of care of a prudent manager which investment trust settlor companies are bound to uphold: "A financial instruments business operator, etc. shall carry out the investment management business with the care of prudent manager on behalf of the holder of rights."

The fiduciary duty in Article 42, Paragraph 1, means that the investment trust settlor company must think solely of the welfare of the holder of rights, *i.e.,* the beneficiaries, in performing its management activities. In general, this provision is construed to prohibit the following kinds of conduct:

(i) Any action that would put it its own interests in conflict with the interests of the beneficiaries;
(ii) Any action that conflicts with the interests of the beneficiaries; and
(iii) Any action in furtherance of its own interests or the interests of a third party.

As stated in (2) below, the FIEA prescribes these prohibited acts as a concrete expression of the fiduciary duty.

The duty of care of a prudent manager laid down in Article 42, Paragraph 2, is the duty under which the investment trust settlor company must act as a professional. It can be understood that the ITA vests the investment trust settlor company with relatively unfettered discretion over the fund management, while at the same time requiring the investment trust settlor company to exercise a heightened degree of care as a professional.

(2) Prohibited Acts

The FIEA prohibits certain acts as a direct embodiment of the fiduciary duty. Below we take a look at the most representative acts thereof (for details, see the FIEA, art. 42-2):

(i) Engaging in self-dealing;
(ii) Entering into intra-transactions between the managed assets;
(iii) Entering into so-called scalping transactions; (Note)
(iv) Entering into a transaction on terms differing from an ordinary transaction and detrimental to the interests of the beneficiaries;
(v) Entering into transactions for its own account using information related to transactions conducted as management;
(vi) Compensation for loss occurring in transactions (excluding cases of compensation for loss due to incidents) conducted as management or provision of special profits;
(vii) Entering into a transaction that is detrimental to the interests of the beneficiaries in order to further the interests of a third party, etc.;
(viii) Entering into unnecessary transactions in light of market conditions, etc. in order to further

the interests of a third party, etc.;

(ix) Entering into transactions with the purpose of affecting the terms of primary offering of securities for which its parent corporation, etc. or subsidiary corporation, etc. is acting as lead manager, or acquisition of the so-called remains of offerings concerning securities which its parent corporation, etc. or a subsidiary corporation, etc. is underwriting, etc.; and

(x) Other prohibited acts.

(Note) An act of making an investment in investment trust property for the purpose of securing the interest of a party other than the beneficiary of the investment trust (including the investment trust company) by using fluctuations in the price indicator, etc. involved in the transaction managed based on the instructions on investment of securities, etc.

(3) Management in Accordance with the Management Plan

The regulations of the Investment Trusts Association, Japan, require that management be conducted by a method in accordance with the management plan, or by a method of putting in place a system for recording and reviewing matters such as the plan of management, the execution of management, and the reasons for the failure to execute management in accordance with the management plan in the event of such failure. In the case of conducting management in accordance with the management plan initially referred to above, if any change in the management plan is to be made in the conduct of management, an explicit statement of the reason of change is required (JITA Management Rules, art. 6; JITA By-Laws for the Management Rules, art. 1-3).

5 4 Investment Targets and Investment Restrictions of Securities Investment Trusts

(1) Investment Targets

(i) Investment Targets Specified in the ITA

The main investment targets of investment trusts (“specified assets”) specified in the ITA as assets in which it is necessary to facilitate investment are the following types of investments: securities, rights pertaining to derivatives transactions, real property, real estate leasehold rights, superficies rights, promissory notes, monetary claims, silent partnership equity interests, commodities, rights pertaining to commodity investment transactions, renewable energy power generation facilities, and rights to operate public facilities, etc. (ITA, art. 2, para. 1; ITA Enforcement Order, art. 3). They also include real estate investment trusts and investment trusts other than securities investment trusts.

In the case of a securities investment trust, securities and rights to trading in securities-related derivatives transactions (“securities” shall exclude rights deemed as securities as provided for in Article 2, Paragraph 2 of the FIEA pursuant to the said Paragraph, and “securities-related derivatives transactions” shall mean securities-related derivatives transactions for securities other than such rights) must, in principle, comprise more than one-half of the investment trust property (ITA, art. 2, para. 4; JITA Management Rules, art. 3).

(ii) Rules of the Investment Trusts Association, Japan

The provisions in the Investment Trusts Association, Japan rules regarding the investment targets of securities investment trusts are almost identical to the ITA provisions, except that shares are limited to listed shares or those that meet other prescribed requirements (JITA Management Rules, art. 11; JITA By-laws for the Management Rules, art. 2). Regarding securitization-related products, only those products for which market values can be readily obtained are allowed to be included, in consideration of their liquidity (JITA Management Rules, art. 13).

Furthermore, the rules of the Investment Trusts Association, Japan list the types of transactions in which an investment trust manager can engage (though certain limitations are imposed on the scope, etc. of each transaction type). The specified transaction types are:

A. Margin transactions; B. Share borrowing; C. Securities lending; D. Bond loan transactions, borrowing and short-selling; E. Repurchase transactions; F. Loans of money; G. Capital borrowing; H. Foreign exchange transactions; I. When-issued transactions (JITA Management Rules, art. 15).

(iii) Investment Targets Specified in the Basic Terms and Conditions of an Investment Trust

The basic terms and conditions of an investment trust list the investment targets of each fund in accordance with its objectives and within the scope described in (i) and (ii) above. For example, the basic terms and conditions for a bond investment trust might state that the fund will not include shares, etc. in the securities that it will target.

(2) Investment Restrictions

In order to secure the fiduciary duty regarding the underlying assets and to promote proper risk management in line with the trust purposes of each fund, there are several restrictions on investments prescribed by the law and regulations, the Investment Trusts Association, Japan rules, and the basic terms and conditions of an investment trust. Below we examine the most representative of these various restrictions.

(i) Regulations Concerning Diversified Investments

Under the amended FIEA effective as of December 1, 2014, a management company is prohibited from managing a fund, which is created on or after the said day, by a method contrary to a reasonable method for controlling credit risk properly that the management company has predetermined (FIBCOO, art. 130, para. 1, item 8-2).

Accordingly, the Investment Trusts Association, Japan, has established regulations concerning such “reasonable method” as referred to in Article 130, Paragraph 1, Item 8-2 of the FIBCOO (generally referred to as “regulations concerning diversified investments”). Under these regulations, the exposure in relation to the underlying assets or transactions is categorized into three categories, namely:

(a) Equity exposure;
(b) Bond exposure; and
(c) Derivatives exposure.

The ratio of each exposure and the total ratio of these exposures in relation to the total amount of net assets in the trust property for the same person are limited to 10% and 20%, respectively. If the ratio of any or the total of these exposures exceeds the respective limit due to the changes in the market conditions or an increase or decrease in the assets, an adjustment must be made within one month to keep the relevant exposure below the limit, and if it is difficult to make such an adjustment within one month by taking ordinary measures, the management company must make a necessary adjustment as soon as possible, while making such situation clear (JITA Management Rules, art. 17-2, para. 1). In the calculation of an exposure in relation to a secured transaction, the value of the security may be deducted, while an exposure is zero in relation to Japanese government bonds, public bonds, international organization bonds, short-term financial instruments, or forward exchange contracts, etc. for which the settlement date will come within 120 days (JITA Management Rules, art. 17-2, para. 2 and para. 3). If any issue is or is highly likely to be dominant in the fund's investment (accounting for a large percentage of the fund), certain measures must be taken, such as clearly indicating on the cover of a prospectus to be delivered a statement that the fund is specialized in a certain issue, and the abovementioned 10% and 20% exposure limits may be changed to 35% (JITA Management Rules, art. 17-3, para. 1, item 3).

The following funds are excluded from the prohibition under certain conditions (JITA Management Rules, art. 17-3, para. 1, item 1, item 2, and item 4).

(a) MMFs, MRF;
(b) Index-linked funds (including those linked at a certain multiplying factor); and
(c) Funds named after the name of the party subject to an exposure (excluding those incorporating structured bonds).

With regard to the application of the regulations concerning diversified investments to a fund of funds, if an exposure of the underlying fund or the ceiling thereof can be ascertained, any part of such exposure or ceiling which belongs to the fund of funds may be regarded as an exposure of the fund of funds, and the abovementioned 10% and 20%-exposure limits may be applied. However, if an exposure of the underlying fund or the ceiling thereof cannot be ascertained, an exposure of the underlying fund is treated as an "equity exposure," and the 10% exposure limit is applied (JITA Management Rules, art. 17-2, para. 5 and art. 23, para. 2).

(ii) Restrictions on Derivatives Transactions

In cases where a fund employs derivatives transactions, thorough risk management is required. Therefore, the laws and ordinances provide that in cases where the amount corresponding to the risk that may arise due to fluctuations in the interest rate, price of currencies, prices in the financial instruments markets or other index or other causes calculated in a reasonable method prescribed by a financial instruments business operator, etc. in advance shall exceed the total amount of net assets of the fund, the derivatives transaction (including warrants, investment equity subscription right certificates, transactions concerning certificates or instruments representing options, and trades in bonds with options) must not be conducted or continued (FIBCOO, art. 130, para. 1, item 8).

Funds that use derivatives transactions, etc. for purposes other than hedging must clearly describe their investment stance in the basic terms and conditions (JITA Management Rules, art. 18, para. 1).

(iii) Regulation for Liquidity Risk Management

From January 1, 2022, financial instruments business operators, etc. are required to take reasonable measures to prevent the situation where they will not be able to accept investors' requests for cancellation of publicly offered investment trusts (Amended FIBCOO, art. 130, para. 1, item 8-3; ITA Enforcement Ordinance, art. 271, para. 10).

Accordingly, the JITA has established rules providing for "reasonable measures" referred to in Article 130, Paragraph 1, Item 8-3 of the FIBCOO (rules for liquidity risk). Under the rules for liquidity risk, settlor companies of publicly offered investment trusts are required to develop a system for management of liquidity risk in light of factors such as the size of the investment trust from the product designing stage until the redemption process, the terms of sale and other characteristics of the asset holdings, the investment strategy, the attributes of sales outlets of the securities companies, registered financial institutions, etc., the attributes of prospective investors, the terms for establishment and cancellation, the product characteristics, market trends, and market environment, as well as the effects of these factors on liquidity risk and the results of the stress tests (JITA Management Rules, art. 2-4).

(iv) Other Investment Restrictions

Under the ITA, the investment trust settlor company may not instruct the trust company to acquire shares issued by a single corporation if the total number of voting rights pertaining to the shares in a corporation held as part of the investment trust property of all investment trusts under instructions from the settlor managed by such settlor company exceeds 50% of the total number of issued shares of that corporation (ITA, art. 9; ITA Enforcement Ordinance, art. 20).

In order for dividends, cancellation gains or redemption gains on the stock investment trust to be subject to the dividends exemption under the tax system (for details, see “7. Calculation of Base Value, Closing, Dividends, Cashing Out and Redemption of Securities Investment Trusts”), the basic terms and conditions of an investment trust must include the restrictions on investments in assets other than shares and in foreign currency denominated assets, and funds that invest mainly in domestic shares, etc. provide for such restrictions in their basic terms and conditions of an investment trust.

(Notes) A sample provision in the basic terms and conditions of an investment trust concerning the restrictions on investments in assets other than shares:

- Investments in assets other than shares shall generally be limited to 50% or less of the total trust property.

Sample provisions in the basic terms and conditions of an investment trust concerning the restrictions on investments in foreign currency denominated assets:

- No investment shall be made in foreign currency denominated assets.
- The settlor shall not give instructions on investments that would cause the total market value of the foreign currency denominated assets included in the trust property to exceed 50 percent of the total amount of the trust property.

The Investment Trusts Association, Japan only permits the inclusion of investment trust securities (referring to beneficiary certificates of investment trusts and foreign investment trusts, or investment securities of investment corporations and foreign investment corporations) where the said investment trust securities do not account for more than 5% of net assets, except those (a) which are listed or registered on a financial instruments exchange market or a foreign market, and which can be sold at any time; and (b) for which shares, etc. have been converted into investment trust securities (this restriction does not apply to a mother fund or a fund of funds). Also, the total amount that a single investment trust settlor company may invest in investment trust securities, to the extent that the investment trust settlor company has not entered into an agreement with the issuing fund of the said investment trust securities, cannot exceed 50% of the said fund’s total net assets.

Furthermore, in order to prevent conditions under which the overall expenses pertaining to the ultimate investment or fund cannot be ascertained, and in order to ensure the fair valuation of assets included in the fund portfolio, the Investment Trusts Association, Japan does not permit investment in fund of funds investment trust securities (unless the fund of funds is a mother fund or a listed investment trust), and prohibits reciprocal and circular holdings between or among investment trusts (JITA Management Rules, art. 12).

The Investment Trusts Association, Japan imposes various restrictions with respect to MMFs and MRF, such as requiring at least a certain rating for the assets, including public and corporate bonds, etc. in the fund or setting the upper limits for the average remaining term to maturity of the assets, in order to heighten the stability of these investments. An investment trust management company dealing with MMF and MRF must formulate a contingency plan concerning events such as a loss on principal, and must verify the validity of the plan as appropriate and consider introducing additional response measures if necessary (JITA MRF Management Rules).

(v) Duty to Have Assets Appraised, Etc.

When an investment trust settlor company conducts transactions in certain securities such as unlisted share certificates, etc.; transactions in real property, etc. (meaning real property, rights to lease real property and superficies rights); and over-the-counter derivatives transactions using the investment trust property, the investment trust settlor company is required to have an uninterested lawyer, legal professional corporation, certified public accountant, auditing firm, or real estate appraiser that meets certain criteria appraise the value or investigate the other terms of the transaction (ITA, art. 11, para. 1; ITA Enforcement Order, art. 18).

These provisions do not impose restrictions on the assets for which an appraisal, etc. is necessary, but their practical effect is to make it harder to use the trust property to conduct over-the-counter derivative transactions, etc.

5 5 Transactions in Securities, Etc. in Securities Investment Trusts

When a transaction in securities in a securities investment trust is conducted, it is necessary to endeavor to conduct the transaction on terms that maximize the advantages to the fund in view of an overarching consideration that includes the market conditions and price at the time of making the transaction (*i.e.*, "best execution"). In order to make this effective, it is necessary to clarify the record of relevant decisions made in connection with transactions requiring negotiations, such as those that are not conducted through an exchange (JITA Management Rules, art. 4).

Moreover, most asset management companies separate the roles of fund manager (management division) and trader (division placing orders) (for details, see "5-1 Organization and Authority of Investment Trust Settlor Company"), so that the management division can issue order instructions to the division which places orders. In this event, order instructions involving multiple investment trusts can be combined when placing the order (*i.e.,* pooled ordering). In order to ensure the best possible execution of pooled ordering, the Investment Trusts Association, Japan, determines the securities to be covered by pooled ordering, the transaction unit prices, and the method of allocation of contract results, and also requires an asset management company that conducts pooled ordering to put in place internal rules as well as control divisions such as a compliance division, and to monitor the condition of execution operations (JITA Management Rules, art. 8-2).

5 6 Execution of Instructions Regarding Voting Rights, Etc.

The investment trust settlor company shall give instructions to the trustee company regarding the exercise of voting rights and other shareholder rights relating to the securities incorporated in the investment trust property (ITA, art. 10, para. 1; ITA Enforcement Order, art. 14; ITA Enforcement Ordinance, art. 21).

The investment trust settlor company exercises the voting rights in connection with shares held as investment trust property, by making an explicit statement to the trustee and instructing the trustee by making one of the following statements of intention for each of the items set forth on the agenda stated in the notice of a shareholders meeting (JITA Full Members' Business Rules, art. 2, para. 1), by:

(a) Voting in favor of the agenda item;

(b) Voting against the agenda item;

(c) Giving a *carte blanche* proxy to the investment trust settlor company; or

(d) Abstaining from voting.

The exercise of voting rights relating to foreign shares shall be made according to the prevailing local laws and customs of the domicile country of the said shares (JITA Full Members' Business Rules, art. 2, para. 3).

In addition, the Investment Trusts Association, Japan provides that each investment trust settlor company should prescribe internal rules regarding its fundamental approach concerning the exercise of voting rights to shares and the authority, etc. to declarations of intent (JITA Full Members' Business Rules, art. 2, para. 2). Some investment trust settlor companies post their fundamental approach concerning instructions for voting rights and the result of the exercise of voting rights of domestic stocks (the exercise result, in principle, in the shareholders meetings held in May and June) on their websites, etc.

The Council of Experts on the Stewardship Code under the FSA publicized the "Principles for Responsible Institutional Investors: Japan's Stewardship Code" (Note). In this Code, the Council requires institutional investors to publicly disclose the voting records for each investee company on an individual agenda item basis. Investment trust settlor companies which have accepted the Code disclose company-specific voting in addition to aggregating the voting records for each agenda item.

(Note) Japan's Stewardship Code was first formulated on February 26, 2014. Intended to promote the sustainable growth of companies, the Code presents the principles necessary to encourage a wide range of institutional investors to appropriately discharge their stewardship responsibilities through constructive dialogues with the investee companies. Although the Code, which consists of eight principles following the two revisions made as of May 29, 2017, and March 24, 2020, is not legally binding, institutional investors are required to either comply with the code or give the reasons if they do not comply with it ("Comply or Explain" approach).

5 7 Customer-Oriented Business Conduct (Fiduciary Duty)

In order to ensure stable asset building for people, it is important for all financial institutions and other business operators (hereinafter referred to as "financial business operators") engaging in sale of financial instruments, advisory services, product development, asset management and investment to endeavor to conduct their business in a customer-oriented manner. From this perspective, the Financial Services Agency published the "Principles of Customer-Oriented Business Conduct" consisting of seven principles in March 2017. Financial business operators are required to conduct general practice and business activities in light of the purport and spirit of these Principles.

Principle 1: Establishment and publication, etc. of policy for customer-oriented business conduct
Principle 2: Pursuit of customer's best interest
Principle 3: Appropriate management of conflict of interests
Principle 4: Clarification on commissions, etc.
Principle 5: Provision of material information in a comprehensible manner
Principle 6: Provision of services suitable for the customer
Principle 7: Framework, etc. for appropriate motivation for employees

In accordance with Principle 1, financial business operators that have adopted the principles must:

・Establish and publish clear policies for ensuring their customer-oriented business conduct;
・Periodically publicize the status of their initiatives in accordance with their policies; and
・Periodically review these policies.

With regard to the content of Principles 2 to 7, financial business operators must specify the following matters with easy-to-understand explanations about their policies:

・If they implement these Principles: their policies regarding each of the Principles; and
・If they do not implement these Principles: the reasons for not doing so and alternative measures.

The "Principles of Customer-Oriented Business Conduct" were revised in January 2021 to further promote customer-oriented business conduct by providing, for example, that when proposing financial products that involve investment risks to customers, it is desirable for financial business operators to provide customers with reference materials (a "key information sheet") (Note) prepared to enable them to compare these products with the same type of product.

(Note) For details about a key information sheet, see 6-2 (10) Use of the "Key Information Sheet" under the "Principles of Customer-Oriented Business Conduct."

6 Sale of Securities Investment Trusts

6-1 Proliferation of Investment Trusts, and Basic Approach to Sales

Although investment trusts are designed to lower the risks involved with investment in securities, etc. to the greatest extent possible, the investment principal is not guaranteed and the dividends are not fixed. Some among the many types of investment trusts pursue returns while retaining an equal or even higher level of risk than for regular stock investments.

Pursuing higher returns always involves higher risks. Explaining these features accurately so that non-institutional investors can fully understand them is very important in order to promote the healthy spread of investment trusts. It is also important to have such investors understand the basic scheme of investment trusts, such as that when a dividend is paid, the base value will drop by an equivalent amount, and that all or part of the dividends may be regarded as a partial refund of principal. In addition, the product characteristics of investment trusts vary with each fund. Therefore, the distributor must provide sufficient information in order for investors to make independent investment decisions. These are the most important functions of the distributor.

Below, we will take a concrete look at the regulations and practices, etc. regarding the sale of investment trusts. However, the statements below are made in connection with publicly offered securities investment trusts (investment trusts under instructions from the settlor) (partially mentioning matters pertaining to foreign investment trusts), and it is necessary to take note that different rules apply in regard to the sale of other investment trusts and there are also many areas that differ widely in practice, etc.

6-2 Regulations, Etc. Concerning Sales

In the sale of investment trusts, in order to firmly establish the principle of investor self-responsibility, it is absolutely vital that investors are given a full explanation of the product characteristics of the investment trusts and make an informed decision to invest. Solicitations and advertisements must also be conducted in an appropriate manner. For this reason, the following regulations have been established with respect to the sale of investment trusts:

(1) Preparation of Investment Trust Explanatory Documents (Prospectuses)

When selling an investment trust, the investment trust settlor company, which is the issuer of the beneficiary certificates, must prepare a prospectus (FIEA, art. 13, para. 1; for details, see 8-1 “(1) Issuance Disclosure Under the FIEA”).

(2) Delivery of the Investment Trust Explanatory Document (Prospectus) and Document to Be Delivered Prior to Conclusion of Contract

There are two types of investment trust explanatory documents (prospectuses); one that must delivered in advance of, or at the time of, the purchase of units in an investment trust (**investment trust explanatory document (delivery prospectus)**) (FIEA, art. 15, para. 2), and one that must be delivered immediately if a demand is made at or before the time of purchase (**investment trust explanatory document (demand prospectus)**) (FIEA, art. 15, para. 3). If the advance consent of the investor is obtained, a document containing the said prospectus can be provided through methods employing a computer or other media provided for by Cabinet Office Ordinance in lieu of delivering a physical prospectus (Internet homepage, electronic mail, etc.). In this case, the said prospectus is deemed to have been delivered (FIEA, art. 27-30-9).

In addition, as the sale of investment trusts falls under the execution of a contract for a financial instruments transaction as provided for in the FIEA, the distributor shall prepare a document to be delivered prior to conclusion of a contract and deliver the document to be delivered prior to conclusion of a contract to an investor upon having such investor acquire investment trusts (FIEA, art. 37-3, para. 1, main clause); provided, however, that in practice, because the sale of investment trusts requires the delivery of a prospectus, the prospectus stating all or part of the matters to be stated in the document to be delivered prior to conclusion of a contract is delivered together with a supplementary document stating matters to be stated in the document to be delivered prior to conclusion of a contract that are not covered in the prospectus (FIEA, art. 37-3, para. 1, *proviso*; FIBCOO, art. 80, para. 1, item 3, and para. 8).

(3) Duty to Explain Under the Act on the Provision of Financial Services

The Act on the Provision of Financial Services (hereinafter the “APFS”) imposes on financial instruments distributors the duty to explain to customers material matters such as the risks, etc. pertaining to financial instruments, and the same law also applies to investment trusts (for details, see Volume 1, “Chapter 3, Laws Relating to Solicitation and Sales of Financial Instruments”).

The following are examples for reference of investment trust explanatory documents based on the APFS.

<Example of an investment trust with main investment targets ranging from shares to ordinary bonds, both on a yen basis and a foreign currency basis>

- **This investment trust invests mainly in domestic and foreign shares and bonds. Because the base value of this investment trust rises and falls depending on the effect of the price fluctuations of the included shares and bonds and exchange rate fluctuations, etc., it is possible that it will fall below the invested principal. Also, it is possible that it will fall below the invested principal due to changes in the management and financial circumstances of the issuers of the included shares and bonds and changes in external evaluations of these matters, etc.**
- **This investment trust mainly targets domestic and foreign shares and bonds for investment. A loss may be incurred as a result of a decline in the base value due to the effect of price drops in the included shares and bonds (concerning foreign currency based securities, there will also be effects from fluctuations in exchange rates), and deterioration, etc. of the credit circumstances of the issuers of these shares and bonds (from the Investment Trusts Association, Japan’s “Guidelines Concerning Investment Trust Settler Companies’ Obligation to Explain in Accordance with the ‘Act on the Provision of Financial Services’”).**

If it is a fund with a closed period (no cash out period), in addition to the above, it is necessary to explain, "please note that during the closed period, it is not possible to cash out of the fund," etc.

The APFS states that regarding the timing of explanations of material matters, the explanation is to be made "during the period until the sale of the financial instruments is made," and in the case of a sale of an investment trust it is appropriate to interpret this as meaning during the period until entering into the contract. It would appear that if a customer continues to make purchases into the fund after an explanation of material matters has been given, and the customer appears to continue to maintain an awareness of the material matters, it would not be necessary to make an explanation at the time of selling a fund for which the material matters to be explained to a customer are the same. Nevertheless, an explanation should be given if requested by that customer. Also, it is desirable that sales of funds that are not well known or that are thought to have a complicated and high-level structure be handled cautiously, and it is thought that consideration should be given to providing an explanation that corresponds to the nature of the product, such as by providing a more meticulous explanation.

(4) Explanation on Expenses Payable by Customers and Dividends, and Measures to Confirm Customers' Understanding of Currency-Selected Investment Trusts

Given that investment trusts are instruments that are solicited and sold to a broad range of customer groups, including ordinary customers who do not have sufficient expert knowledge and experience, it is important to conduct solicitation that is appropriate according to the customer's knowledge, experience and investment intention. Therefore, distributors of investment trusts must pay particular attention to the following points (Comprehensive Guidelines for Supervision of Financial Instruments Business Operators, etc., IV-3-1-2(4)):

(i) With respect to expenses payable by customers (excluding professional investors; the same applies in (ii) and (iii)) such as sales commissions, the distributors must explain the following matters in an easily understandable manner upon soliciting them to purchase investment trusts:

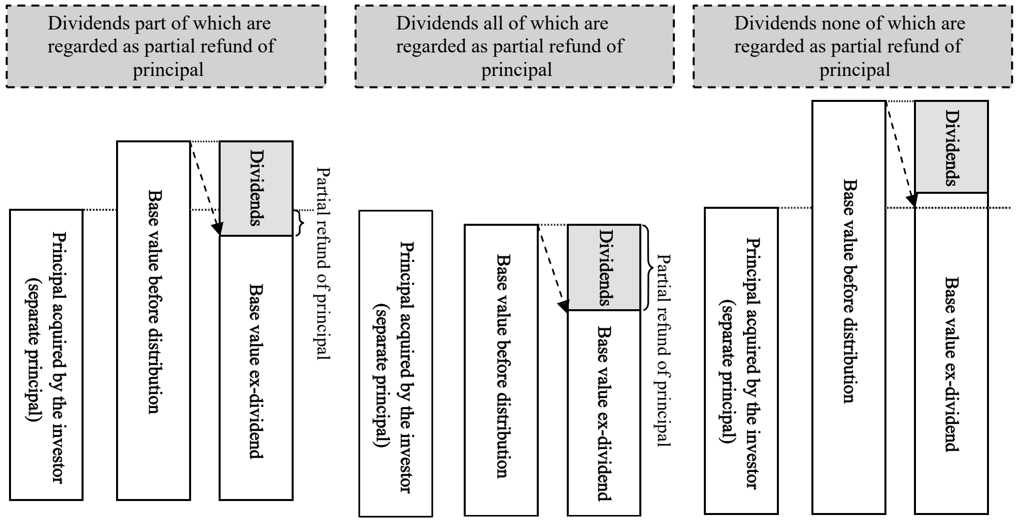
(a) The rate of sales commissions for the investment trust for which customers are solicited, and the amount of sales commissions in accordance with the purchase price (if such amount cannot be fixed at the time of the solicitation, an estimate thereof); and

(b) Expenses payable by customers after purchasing the investment trust for which they are solicited (trust fees (in the case of an investment trust managed in the form of a fund of funds, the actual rate of expenses payable including the management costs for the underlying fund), the amount of a load, etc.).

(ii) With respect to dividends on investment trusts, the distributors must explain to customers, in an easily understandable manner, that all or part of the dividends may be regarded as a partial refund of principal.

(iii) Given that currency-selected investment trusts involve not only a risk that the price of the invested asset will fluctuate but also the complex risk of currency fluctuation, when entering into a contract with a customer who has no experience in investing in currency-selected investment trusts, the distributors must take measures, such as receiving a written confirmation from the customer to the effect that he/she has understood the product characteristics and risk profile and keeping such confirmation.

Chart 1-7 Dividends Regarded as Partial Refund of Principal, and Dividends Not Regarded as Such



* The dashed arrow represents the dividend drop.

** When an investor of an additional offering type stock investment trust receives an amount as partial refund of principal, the investor's separate principal for the future will be as calculated by deducting such amount of partial refund from the investor's previous separate principal (for details, see 7-6 "(1) Separate Principal, Ordinary Dividends, and Refund of Principal (Special Dividends) of Additional Offering Type Stock Investment Trusts").

When soliciting customers to invest using the NISA program, it is necessary to provide an appropriate explanation in a timely manner where necessary regarding the fact that refunds of principal (special cash distributions), which are paid as dividends from investment trusts, are originally tax-exempt and do not stand to benefit from the NISA program (Points of Attention upon the Opening of Account, Solicitation or Sale, etc. under the NISA Program (Guideline)" (NISA Promotion and Liaison Association).

(5) Notification of Total Return to Customers

As repeatedly mentioned earlier, because the base value is always fluctuating, the dividend level does not represent the investment trust's earning. When investors intend to ascertain the profit and loss they have gained or incurred from investments in investment trusts, they need information regarding the total return. The total return can be calculated by taking into account various factors such as the base value at the time of acquisition of investment trusts by the investors, the base value at the time of cashing out if the investment trusts are partially cashed out, the base value as of the base date for calculation of profit and loss, and the total amount of dividends received. From this standpoint, the Japan Securities Dealers Association introduced a system whereby companies which are Association Members and sell investment trusts are required to notify their customers of the total return on the investment trusts they have purchased. This total return notification system was put into effect as of December 1, 2014, and has been applicable to publicly offered stock investment trusts (including foreign investment trusts and foreign investment corporations, with some exceptions) to be purchased by customers since the same day. The total return is indicated in terms of the amount of money, instead of the percentage. The notification should be made at least once each year on a base date as determined by the distributors.

(6) Duty to Explain upon Soliciting a Switching of Funds

In the event of soliciting offers to make acquisitions in a fund at the time of cashing out another fund (excluding MMFs, MRF, etc.) (soliciting a switching of funds), a financial instruments business operator, etc. must explain material matters pertaining to the said switching of funds (FIEA, art. 40, item 2; FIBCOO, art. 123, para. 1, item 9). Solicitation of short-term switching of investment trusts does not always help customers to build their assets stably and efficiently because such switching requires an additional payment of sales commissions, while it could lead to cashing out regarding a number of investment trusts within a short period of time, hindering efficient management and resulting in a decline in the investment results (Comprehensive Guidelines for Supervision of Financial Instruments Business Operators, Etc., IV-3-1-2(5)).

A “switching of funds” here means to cancel in part, or withdraw or sell the investment equity of an investment trust that is currently held, or to order the same, etc., and also commit an act of soliciting a customer to acquire, purchase or order, the same, etc. in another investment trust, etc. Acts of soliciting the cashing out and acquisition as a combined set would constitute this type of activity.

It is necessary to provide detailed explanations to customers on the characteristics of investment trusts related to switching between them and the advantages and disadvantages associated with switching even when there is a rationale for switching in light of customers’ investment goals, market trends, etc., to enable customers to judge whether there is the need to make a switch after they have fully understood the pros and cons of making a switch. In addition to the general matters for explanation regarding the sale of investment trusts, etc., the matters that are necessary for the customer to judge whether switching is rational include a rough estimate of profit or loss of investment trusts, etc. to be cancelled and the characteristics and fees of the investment trust, etc. to be cancelled and those of the investment trust, etc. to be acquired; however, these could differ depending on the customer knowledge, customer experience, the state of customer assets, the purpose of investment, and the nature of the investment trust, etc. on a case-by-case basis.

Using the NISA program, income tax, etc. is not imposed on the dividend income or capital gains, etc. arising from listed shares, etc. purchased by investors within the annual investment limit (consisting of JPY1.2 million as the installment investment quota and JPY2.4 million as the growth investment quota) and the maximum amount of tax-exempt holdings (JPY18 million for the total of the installment investment quota and growth investment quota, of which the maximum amount for the growth investment quota is JPY12 million). When an investor sells the listed shares, etc. held in the NISA account, the maximum amount of tax-exempt holdings is reduced only for the portion consumed by those listed shares, etc. that are sold, and the investor can use the investment quota up to the annual investment limit again for the next year and onwards. Therefore, users of the NISA program may not be able to fully enjoy the benefits of the program if they intend to employ investment techniques such as the switching of financial products at short intervals. With this in mind, when soliciting customers to invest under the NISA program, it is necessary to explain the investment scheme and propose appropriate financial instruments in light of the purpose of the program (NISA Promotion and Liaison Association, “Points of Attention upon the Opening of Account, Solicitation or Sale, etc. under the NISA Program (Guideline)”).

(7) Regulations on Solicitation and Sale of Leveraged Investment Trusts and Complex Investment Trusts

The meaning of the terms “leveraged investment trusts” and “complex investment trusts (including knock-in investment trusts; hereinafter the same applies in (7))” are as defined in 3-12 “Monthly-Paid Type, Currency-Selected Type, Leveraged Investment Trusts, Complex Investment Trusts Similar to OTC Derivatives Transactions, and Knock-in Investment Trusts.”

Leveraged investment trusts and complex investment trusts are subject to stricter regulations than other types of investment funds in terms of investment solicitation and sale due to the special characteristics of the products. When soliciting the sale of these types of trusts to customers who are individuals, an Association Member must establish certain solicitation commencement standards, and must not solicit customers who do not meet such standards (JSDA Investment Solicitation Rules, art. 5-2).

In addition, an Association Member must deliver a notification regarding the associated risks and information on the relevant dispute resolution organization to the customer and provide an explanation on the content of the notification in a manner and to an extent necessary to enable the customer to understand such matters in light of the knowledge, experience, and assets of the customer and the purpose of entering into the contract. Furthermore, when dealing with complex investment trusts, the Association Member must obtain a document from the customer confirming certain specified matters (JSDA Investment Solicitation Rules, art. 6-2 and art. 8, para. 3).

Knock-in investment trusts, which are a type of complex investment trusts, are subject to tighter disclosure rules than those for other types of funds with regard to the disclosure in materials used for sales, etc., investment management reports, and websites of investment trust settlor companies, in addition to the regulations on solicitation and sale (for details, see 3-12 “Monthly-Paid Type, Currency-Selected Type, Leveraged Investment Trusts, Complex Investment Trusts Similar to OTC Derivatives Transactions, and Knock-in Investment Trusts”).

(8) Measures to Prevent Mistaking Investment Trusts for Savings Accounts, Etc.

If financial institutions that handle savings accounts, etc. which guarantee the principal will sell investment trusts, an explanation must be provided to the customer by delivering written materials and through other appropriate means based on the customer’s knowledge, experience, and assets, in order to prevent investment trusts being mistaken for savings accounts. Specifically, it is necessary to explain the following matters (JSDA Investment Solicitation Rules, art. 10, para. 1 and para. 2):

(i) An investment trust is not a savings account, etc. or an insurance policy;
(ii) An investment trust is not subject to protection of the Deposit Insurance Organization of Japan and the Non-Life Insurance Policyholders Protection Corporation;
(iii) Investment trusts (that are not purchased at a financial instruments business operator) are not covered by an investor protection fund;
(iv) Investment trusts do not guarantee return of principal;
(v) Parties to the relevant contracts (*i.e.,* the contracts under which the bank or insurance company conducts a sale of the investment trust while the investment trust settlor conducts the establishment and management of the investment trust, and investment of the investment trust property, etc.); and
(vi) Other matters that may be deemed to be helpful in preventing mistaking investment funds for savings accounts, etc.

Furthermore, when handling investment trusts in its business outlet or office, the financial institution must display the matters set forth in (i) to (iv) above at a place where the customers who use the counter for investment trusts can easily see these displayed matters from that counter. However, such matters may be displayed at a place other than the place specified above if the financial institution provides the explanation mentioned above to the customer before handling the investment trusts and delivers or presents a document containing the explanation (including showing such document on the screen of a tablet or other device) by the time of executing the contract (JSDA Investment Solicitation Rules, art. 10, para. 3).

(9) Regulations Concerning Advertising

A distributor or investment trust settlor company shall clearly and accurately represent the following matters upon making advertisements or similar acts regarding investment trusts (FIEA, art. 37, para. 1; FIEAEO, art. 16; FIBCOO, art. 72, art. 73, para. 1 and para. 2, and art. 76):

(i) Trade name or firm name of the distributor and/or investment trust settlor company;
(ii) Registration number of the distributor and/or investment trust settlor company;
(iii) Matters concerning fees, remuneration and other consideration;
(iv) That the customer may suffer a loss of principal, the reason thereof and the index as the cause thereof (to be represented in a size not extremely different from the letters or numbers of the largest size);
(v) Facts that are disadvantageous to customers with respect to material matters; and
(vi) That the distributor and/or investment trust settlor company are members of the financial instruments firms association (which is related to the content of the relevant business) and the name of the said association.

Premiums and other goods shall display the following or shall be offered together with other goods displaying the following (FIBCOO, art. 72, item 3):

(i) Name of the fund (ordinary name) or the type thereof;
(ii) Trade name, firm name or ordinary name of the distributor and/or investment trust settlor company (to be represented clearly and accurately);
(iii) That the customer may suffer a loss of principal, the reason thereof and the indicator as the cause thereof (to be represented clearly and accurately in a size not extremely different from the letters or numbers of the largest size); and
(iv) That the document to be delivered prior to conclusion of a contract or the prospectus (in cases a document is delivered together with the prospectus, the prospectus and such document) shall be read sufficiently (to be represented clearly and accurately).

In addition, the Japan Securities Dealers Association has established provisions stipulating conduct that is prohibited for Association Members who are distributors with respect to advertising, etc., and requires the mandatory appointment of an advertising examining officer when producing advertising, etc. with such officer being responsible for examining whether or not the said advertising in fact violates the prohibition provisions (JSDA Advertising Rules, art. 4, para. 1 and art. 5, para. 1).

(10) Use of the "Key Information Sheet" under the "Principles of Customer-Oriented Business Conduct"

Although the Principles of Customer-Oriented Business Conduct (Note) are not laws or industry rules, it is desirable for financial business operators that have adopted these Principles to actively use a "key information sheet" in which information is provided in an easy-to-understand manner and with due consideration to enable customers to compare various types of products across areas under the jurisdiction of different industry laws.

(Note) For details on customer-oriented business conduct, see 5-7 “Customer-Oriented Business Conduct (Fiduciary Duty).”

There are two versions of this “key information sheet,” *i.e.*, “Financial Business Operator” version and “Product” version, in which the following information is specified respectively.

“Financial Business Operator” version

1. The Company’s basic information
2. The products the Company handles
3. Policy on product lineup
4. Contact point for complaints and consultation

“Product” version

1. Details of the product
2. Risks and investment results
3. Costs
4. Conditions for payout and cancellation
5. Possibility of conflict of interest
6. Outline of taxation
7. Other reference information

6 3 Unit-Type Investment Trusts

(1) Offerings

Unit-type investment trusts raise funds for limited periods of time ranging from approximately two weeks to one month. The distributor receives application money from investors during the offering period, and on the investment trust establishment date (fund establishment date), the collected funds are entrusted all together as investment trust property to the trustee company.

(2) Offering (Application) Price, Offering (Application) Unit

While the principal price per unit (face value) is decided on a per fund basis, in the case of unit-type investment trusts, it is generally JPY10,000 per unit. Acquisition applications are raised from investors at this principal price per unit. The offering (application) unit is, in principle, set by the distributor (thus, even if it is the same fund, if the distributor is different there are cases in which the offering unit is different; however, for funds that are exclusively for large-scale investors, there are cases where the offering unit is provided for in the basic terms and conditions of an investment trust). The offering unit is decided, for example, as being “in increments of one unit of at least 10 units" (if it is JPY10,000 per unit, the offering units would be in JPY10,000 units with the minimum being JPY100,000).

(3) Offering (Sales) Commissions

The distributor determines the offering (sales) commission. (Even with respect to the same fund, if the distributor differs, there are cases where the offering commission will differ.)(Note) In the case of funds where the primary investment target is shares, it is normal for the offering commission to be approximately JPY100 to JPY300 per each JPY10,000 of principal.

Collecting the offering commission can take the form of an inclusive or separate method.

In the case of the separate method, if a two percent commission is levied on each JPY10,000 of principal, and then consumption tax, etc. (national and local consumption taxes; hereinafter the same; the consumption tax rate is set at 10% as a numerical example in this (3)) is added to the said offering commission, JPY220 per JPY10,000 of principal is paid by the investor aside from the investment amount.

In the case of the inclusive method, an amount that is the offering commission with consumption tax, etc. added is levied on the sales price. Although the distributor determines the offering commission, if the upper limit of the offering commission that is determined by each distributor is JPY330 per JPY10,000 of principal, JPY324 per JPY10,000 of principal, which corresponds to the said upper limit amount and the consumption tax, etc. on that amount, is deducted from the trust assets on the date that the trust is established and is paid to the distributor. Thus, the funds which are the basis of the investment are in this case JPY9,670 per JPY10,000.

(Note) Concerning management fees (trust fees):

It is necessary to note that fees on investment trusts, aside from offering (sales) fees, include management fees (trust fees). Management fees (trust fees) are fees for carrying out the investment and management of the investment trust property, and are received by the investment trust settlor company and the trustee company from the investment trust property. From the point of view of the investor, they have the same economic effect as commissions.

The management fees (trust fees) are provided for in the basic terms and conditions of an investment trust, and they are calculated at a fixed rate on a per diem basis and are deducted daily from the investment trust property.

Investment trust settlor companies pay one part of their own fees to the distributors as commissions for acting as the investment trust settlor company's agent in carrying out administrative work such as the distribution of earnings and the payment of cancellation money (**administrative agent commission**).

6 4 Additional Offering Type Stock Investment Trusts

(1) Initial Offering and Additional Offering

In offerings for additional offering type stock investment trusts, there are **initial offerings** and **additional offerings (continuous offerings)**. The initial offering is an offering carried out in order to newly establish the fund, and as with unit-type investment trusts, funds are raised for a limited period of approximately two weeks to one month. The distributor receives application money from investors during the offering period, and on the investment trust establishment date (fund establishment date), the collected funds are entrusted all together as investment trust property to the trustee company. This point is also exactly the same as with unit-type investment trusts.

As opposed to this, additional offerings (continuous offerings) are offerings carried out in the form of adding capital to the fund after the fund is established, and after the fund's establishment date, in principle, additional funds are raised every business day during the **trust period** (the continuing period of the fund). However, concerning funds that invest in foreign assets, etc., where the market on which most of the investment target assets are traded is closed, there are cases where applications for acquisition will not be accepted for the same date as the date on which the said market is closed.(Note) Also, there are funds that limit the additional offering period to a specific period of time (limited additional offering type).

Because the trust is added to by additional offerings and new beneficiary certificates are issued, legally it is an "offering," but because it is easy to distinguish from the initial offering and because from the point of view of economic practice it is similar to the buying and selling of shares on a secondary market, in practice, it is called "buying" or "purchase." Likewise, a request to cash out by cancellation of the trust or a repurchase of the beneficiary certificates, in practice, is called "selling" or a "sale."

(Note) This kind of day is provided for because even if additional establishments are accepted, there is the possibility that the investment purpose will not be achieved and that the blind system cannot be adequately maintained on the date the market is closed and it is not possible for the fund to purchase assets that reflect the value of the added capital (for details, see 6-4 "(7) Significance of the Blind System").

(2) Offering (Application) Price, Offering (Application) Unit

Although the principal price (face value) per one unit is decided on a per fund basis, in additional offering type stock investment trusts, most are JPY1 per unit. In the case of additional offering type investment trust, although the initial offering raises funds at, for example, JPY10,000 per 10,000 units, because additional offerings are offered at the offering (application) price that is based on the base value, offering (application) units are determined by either:

(i) The investor specifying the number of units it will apply for;
(ii) The investor specifying the amount of application money; or
(iii) The investor specifying the application proceeds (the aggregate amount of the application price, sales commission and consumption tax, etc. levied on the sales commission).

In principle, it is the distributor that determines offering units. (Thus, even if it is the same fund, if the distributor is different, there are cases in which the offering unit is different. However, for funds that are exclusively for large-scale investors, there are cases where the offering unit is set forth in the basic terms and conditions of an investment trust.) The offering unit is decided, for example, as being "in one unit increments of at least 100,000 units or in one yen increments from at least JPY100,000."

(3) Offering (Application) Price for Additional Offerings

While the offering (application) price for additional offerings stock investment trusts is normally the base value, for funds that collect a **load** upon additional establishments, it is the **sales base value**, which is the base value to which the amount of load is added.(Note) The previous day's base value (for funds that collect a load at the time the additional offering is made, the sales base value) is published in the Nikkei's morning edition.

In normal cases, the base value that is applicable to the offering price is the base value on the application date for funds that primarily target domestic assets for investments, and the base value on the business day that follows the application date for funds that include foreign assets it is the base value on the business day that follows after the application date (for details, see 6-4 "(7) Significance of the Blind System"). In the case of a fund of funds, the base value is determined as being that of two business days after the application date or thereafter. The computation date for the base value that is applicable to the offering price is sometimes called the **base value application date**.

(Note) Where additional establishments are carried out in a fund or where there is a request to cash out, the fund will purchase assets that correspond only to the additional funds or will comply with the investor's request to cash out by selling held assets. In addition to the costs generated by such transactions, where the liquidity of the included target assets is low, such transactions have an impact on the market and it is possible that the fund will end up bearing a large risk. In this type of fund, in order to maintain the fairness of the cost and risk burden between investors who have purchased additional establishments and beneficiaries who already hold the fund or between investors who cease being beneficiaries due to withdrawal from the fund and the beneficiaries who continue to hold the fund, upon additional establishments or cashing out, the fund will use a system of collecting a load that is added to the trust assets, in which an additional sum is collected or the amount discharged from the fund is reduced at the time of additional establishment or cancellation.

(4) Offering (Sales) Commissions

The offering (sales) commission is set by the distributor (even if it is the same fund, if there are different distributors, there are cases where the offering commission will differ). For funds that mainly invest in shares, it is normal to levy approximately two to three percent of the offering price as the offering commission. However, recently, funds that do not charge any offering commissions (no-load funds) have been increasing. No load is a requirement of funds for the installment investment quota under the NISA program.

(5) Application Closing Time

In an additional offering type stock investment trust, the investment trust settlor company must require the distributor to comply with a closing of receiving customer application requests (buy orders), of no later than 3:00 p.m. The same is true for cancellations (including repurchases) (JITA Full Members' Business Rules, art. 8, item 1; for details, see 6-4 "(7) Significance of the Blind System"). The application closing time is set for each fund. For most funds it is the same time as the time that trading ends for the exchange's trading session. However, it is necessary to note that some funds, which have a special structure such as the bull/bear type or funds that include assets that have low liquidity (*i.e.,* that include assets that are difficult to turn into cash), have an even earlier acceptance closing time (*e.g.,* by 2:00 PM). Applications that are made after the acceptance closing time has passed will be handled the next business day.

(6) Delivery of Additional Offerings

For funds that include foreign assets, because the offering (application) price in an additional offering is usually based on the base value for the day following the application date, it is not clear on the application date. Also, the offering price for funds that mainly target domestic assets for investment is not clear at the time of application. This is because, while the application closes on or before the end of trading for the securities exchange's trading session, the offering price for such funds are based on the base value for the application date, which is calculated based on the closing prices of the exchange for that day. This system is called the blind system.

For this reason, in the case of additional establishments for a stock investment trust, when taking buy orders (applications for additional establishments), the application payment is received based on a rough estimate and the payment is adjusted on the delivery day. An example of how the application payment is calculated is described below. The delivery for funds that mainly target domestic assets for investment is often the third business day after the contract date, and for funds that include foreign assets it is often the fourth business day. In addition, in a case of a fund of funds, this is deferred by a further one or two business days.

Some distributors do not take an estimated payment from customers who have a certain amount of deposited assets. Some securities companies that handle money reserve fund accounts allocate MRF cancellation money to the acquisition application payment.

<Example of calculation of the acquisition application price>

The case where there is an additional establishment of 50,000 units of an additional offering type stock investment trust (without a load at the time of establishment) with a base value (per 10,000 units) of JPY12,000 (offering commission rate and consumption tax rate are respectively set at 2% and 10% as numerical examples):

Acquisition application amount = JPY12,000 × 50,000 units / 10,000 units = JPY60,000
Commission = acquisition application amount × commission rate = JPY60,000 × 2% = JPY1,200
Consumption tax, etc. = commission × consumption tax rate = JPY1,200 × 10% = JPY120
Acquisition application price = acquisition application amount + commission + consumption tax, etc. = JPY60,000 + JPY1,200 + JPY120 = <u>JPY61,320</u>

(7) Significance of the Blind System

The base value of an investment trust, for domestic assets, is calculated based on that day's domestic exchanges' closing prices. Thus, for example, for an index fund that aims to link to a share price index for domestic shares, investors can calculate the approximate base value at the time when trading ends on the domestic exchanges. In such circumstances, suppose that applications for the acquisition of and cashing out of investment trusts were allowed even after the domestic exchanges close. It would then likely be impossible to purchase the share except by paying an elevated price, because participants in the share market would not be able to trade on the market until the morning of the next day. Nevertheless, by purchasing an index fund it would be possible to participate indirectly in the market at the base value calculated on the basis of the lower price that was available prior to the news becoming known, and then cashing out the fund at the higher base value on the following day to gain a profit. On the contrary, if it were bad news, although participants in the market would only be able to sell shares only at a share price that has fallen, holders of an index fund would be able to cash out the investment trust at the base value calculated on the basis of the higher price that was available prior to the news coming out.

Also, in calculating the base value of investment trusts, foreign assets are calculated based on the closing price of the previous day's foreign markets. Thus, if the date used to apply the base value for funds that include foreign assets were to be the application date itself, this would enable investors to purchase investment trusts at the base value calculated on the basis of a lower price and cash out investment trusts at the base value calculated on the basis of a higher price than by participating in the market, since investors can calculate an approximate base value at the time of application.

The profit obtained through this kind of trading is called a free lunch (eating for free), and it harms the fairness of securities trading. Investment trusts have established systems such as base value application dates, application closing times, and the suspension of the acceptance of applications on days when foreign markets, etc. are closed, and the blind system was adopted in order to prevent this kind of trading and to maintain the fairness of trading on the securities and financial markets.

When selling investment trusts, it is necessary to fully understand these points and not to neglect consideration so that the fairness of trading is not harmed.

6 5 Additional Offering Type Bond Investment Trusts

Initial offerings of additional offering type bond investment trusts are also the same as unit-type investment trusts, so the following demonstrates the handling of additional offerings.

(1) Offering Period

For additional offering type bond investment trusts, additional establishments are accepted only at the base value of the closing date (for details, see "3-5 Stock Investment Trusts and Bond Investment Trusts"). Unlike the case of additional type stock investment trusts, therefore, a specific offering period is established that ends on the closing date and funds are raised during that period in the same manner as with the original offering. The distributor receives subscription payments from investors during the offering period, and on the additional trust establishment date (the day after the closing date), the collected funds are entrusted all together as investment trust property to the trustee company.

However, in the case of funds that close on a daily basis (MMFs and MRF), because closing is carried out every day, offerings are carried out continuously every business day. Although the business day following the day on which the acquisition application is received is the fund acquisition day in a normal case, for MMFs and MRF, the fund acquisition day for acquisition applications that were received before a specific time (*e.g.,* noon) is the same as the day on which the application was received. As of the end of September 2023, there was no MMF on the market.

(2) Offering (Application) Price, Offering (Application) Unit

The principal price (face value) per unit of a bond investment trust is decided on a per fund basis and in the normal case is JPY1 per unit.

The offering (application) price is the base value on the closing date (the last day of the offering period). For bond investment trusts, where the base value on the closing date exceeds JPY10,000, because all of the portion that exceeds JPY10,000 must be distributed, as long as the principal does not suffer a loss, the base value of JPY10,000 is the offering (application) price.

However, the offering (application) price for the daily closing type is the base value of the day before the acquisition day, but because closing is carried out every day and all proceeds are distributed, and moreover, because the separate principal system has not been introduced (for details, see “7-6 Taxation of Dividends, Cashing Out and Redemptions”), the result is that offering price will always be JPY10,000, and the offering cannot be made if the base value falls under 10,000.

The offering (application) units are normally determined separately for each fund. The offering unit is decided, for example, as being “increments of 10,000 units and a minimum of 10,000 units, or increments of JPY10,000 and a minimum of JPY10,000.” The offering unit for daily closing funds is one unit (yen) at a minimum of one unit (yen).

(3) Offering (Sales) Commissions

Until now, there have been no funds that levy an offering (sales) commission. However, the so-called long-term bond trusts that were launched in 1961 levy a cashing out commission at the time of cashing out.

6 6 ETF

The manner in which ordinary investors acquire ETFs (listed investment trusts) differs from that described up to here, and is done in the same manner as for listed shares. Purchase orders can be made as limit orders or market orders, and listed investment trusts can be bought on margin. The transaction unit is decided on a per fund basis, such as 10 units or one unit. Commissions are determined independently by each distributor.

In the case of in-kind contribution type ETFs, large investors such as securities firms and institutional investors can contribute a portfolio of physical shares to the fund selected so that the performance of the underlying shares of the ETF mirrors the relevant stock index in the case of an ETF that is linked to the stock index, and acquire (establish) beneficiary certificates.

6 7 Handling of Foreign Investment Trusts

Foreign investment trusts are established and managed according to foreign laws and regulations. There are two types of foreign investment trusts: contractual type and corporate type. When a foreign investment trust is sold in Japan, it is governed by the FIEA and the ITA, and it is subject to the same restrictions and regulations as investment trusts established in Japan. Like Japanese investment trusts, the handling of primary and secondary offerings of foreign investment trusts must be accompanied by a prospectus.

When an order from an investor is first received to trade foreign investment trust securities, the agreement pertaining to foreign securities transaction accounts must be delivered, and an application to establish a transaction account must be received from the investor pursuant to the same (JSDA Foreign Securities Rules, art. 3, para. 2). The agreement pertaining to foreign securities transaction accounts shall set forth matters concerning the commissioned execution and processing of orders, custody of securities, and payment/receipt of monies, etc. (*id.,* art. 3, para. 5).

Of course, at the solicitation, whether the investment matches the investor's intention, investment experience, funds available, etc. must carefully be taken into account (*id.,* art. 5). Like Japanese investment trusts, investment management reports must be delivered to investors at the end of each fiscal year for foreign investment trusts (ITA, art. 59).

7 Calculation of Base Value, Closing, Dividends, Cashing Out and Redemption of Securities Investment Trusts

Next, let us turn to the calculation of base values, closings, dividends, cashing out and redemptions of investment trusts. Please note that the following description concerns a publicly offered securities investment trust (investment trust under instructions from the settlor). Differing regulations apply to the calculations of the base value, closings, dividends, cashing out and redemptions of other investment trusts, and caution is necessary because there are many areas that are broadly different in practice, etc.

7 1 Calculation of Base Value

(1) What Is the Base Value?

The base value is the value of the investment trust (for details, see "2 Concept of Investment Trusts"), and, in principle, purchases of investment trusts and cashing out of investment trusts are conducted at the base value.

In principle, the shares and bonds, etc. that are included in the portfolio of the investment trust are assessed at market value to obtain the total value of the assets. The total liabilities are then deducted from the total assets. This remainder is then divided by the number of units of beneficial interests (which in many cases is represented in units of 10,000), to obtain the base value. As a general rule, the base value is calculated on a daily basis. The method of calculating the base value is stipulated specifically in the JITA Investment Trust Accounting Rules. In practice, to ensure reliability of the base value, the investment trust settlor company and the trustee company respectively calculate the base values and compare these values in units of JPY 1 (verification). As this practice is unique to Japan, it has recently been criticized as being one of the barriers to entry to both Japanese and foreign business operators. In addition, most investment trust settlor companies outsource the calculation of the base value to enhance business efficiency. Under such circumstances, discussion is underway about changing this practice and requiring the calculation of the base value to be performed only by one party: either the investment trust settlor company or the trust company.

(2) Valuation of Assets in Portfolio

(i) Principle Regarding Valuation of Assets in Portfolio

In principle, the assets in the portfolio are to be valued at the market price (meaning the price to be received from the sale of the assets or the price to be paid for the transfer of liabilities as of the calculation date in a transaction between market participants that is assumed to be conducted orderly) in accordance with the Accounting Standard for Fair Value Measurement, etc. (JITA Investment Trust Accounting Rules, art. 3, item

1). The method of valuing the assets is, in principle, to be conducted in a consistent manner (JITA Investment Trust Accounting Rules, art. 3, item 2). Amendment of the method of valuing assets that seeks to a more favorable result is not permitted.

The most significant feature of investment trusts as a prominent product of market oriented indirect finance is that investors engage in transactions at a base value which has been calculated based on the market value that is determined in the market. For this reason, when evaluating the assets in a portfolio, the investment trust settlor company has a fiduciary duty to beneficiaries and is required to exercise the care of a prudent manager (JITA Investment Trust Accounting Rules, art. 2).

(ii) Valuation of Shares

In principle, domestic shares that are listed on a financial instruments exchange are evaluated at the closing price on that exchange on the calculation date of the base value. If there is no closing price on the calculation date, then, in principle, the evaluation will be made at the closing price on the date that is closest to the calculation date (provided that if the quotation price on the calculation date has fallen at least 10 percent when compared to the closing price on the most recent date, then the quotation price shall be used) (JITA Investment Trust Accounting Rules, art. 6, para. 1, art. 8, para. 1 and para. 2).

Shares that are listed on a foreign exchange are, in principle, to be evaluated at the closing price on the most recent date for which it is possible to obtain knowledge on the calculation date of the base value on the relevant foreign exchange (JITA Investment Trust Accounting Rules, art. 15).

Consequently, in the case of shares that have a continuous market price, in principle, for domestic shares the final price on the calculation date of the base value is to be reflected in the base value, while in the case of foreign shares the final price on the previous business day to the calculation date of the base value is to be reflected in the base value.

(iii) Valuation of Bonds, Etc.

Bonds, etc. are to be valued at one of the prices of (a) the reference statistical prices for trading (average values) that are published by the JSDA, (b) the price offered by a financial instruments business operator or a bank, etc. (excluding a sell quotation price), or (c) the price suggested by a price information company (JITA Investment Trust Accounting Rules, art. 21, para. 1). Nevertheless, if a valuation amount cannot be obtained or if it is recognized that cause exists as a result of which the valuation amount obtained cannot be accepted as a market price, the investment trust settlor company shall make the evaluation at a valuation amount that it deems on the basis of reasonable grounds to be the market price, or shall consult with the trustee and make the evaluation at a valuation amount that both parties deem on the basis of reasonable grounds to be the market price (JITA Investment Trust Accounting Rules, art. 21, para. 2).

Bonds, etc. that will be redeemed or will approach maturity within one year can be evaluated at the amortized cost method (accumulated amortization method) (JITA Investment Trust Accounting Rules, art. 22, main text). In this event, if a discrepancy occurs between the market price and the price evaluated at the accumulated amortization method and if it is determined to be necessary in order to calculate an appropriate base value, the evaluation is to be promptly changed to the market price (JITA Investment Trust Accounting Rules, art. 22, *proviso*).

(iv) Foreign Exchange Rate Used in Converting Foreign Currency Denominated Assets Into Yen

Normally, the base value of a Japanese investment trust is expressed in yen, and consequently, in order to calculate the base value, it is necessary to make a yen conversion of the valuation amount obtained pursuant to (i) or (ii) above, with respect to foreign currency denominated assets that are included in the portfolio. The foreign exchange rate that is used in this yen conversion is the rate that is calculated based on the mid-rate of the telegraphic transfer customer spot rate on the calculation date of the base value (JITA Investment Trust Accounting Rules, art. 32, para. 1). In unavoidable situations such as if the customer rate is not announced, the rate will be determined using a valuation by the Self-Regulation Committee of the Investment Trusts Association (JITA Investment Trust Accounting Rules, art. 32, para. 2). The customer rate is normally announced on the basis of the spot rate at 10:00 a.m., Japan time, but in cases in which there is substantial fluctuation in a single day the customer rate itself may ultimately be changed.

Consequently, in the case of foreign currency denominated shares and bonds that have a continuous market price, the final market price on the business day prior to the base value calculation date converted into yen at the customer rate on the base value calculation date is to be used in calculating the base value.

(v) Valuation of Mother Fund and Cautions in the Case of a Fund of Funds

In the case of a family type fund, the valuation of a mother fund that includes a subsidiary fund (baby fund) is to be made at the base value on the base value calculation date (JITA Investment Trust Accounting Rules, art. 25).

Funds that are included in the portfolio of a fund of funds are to be calculated using the same method as shares (only in the event that the component funds included are listed on an exchange), or the base value that is announced by the asset management company, etc. of the relevant fund included in the portfolio, etc. (JITA Investment Trust Accounting Rules, art. 24). For most funds of funds, the base value is calculated using the base value of the component funds on the business day preceding the base value calculation date. In this event, the base value of the fund of funds shall be the value that reflects the market price on the day which is two business days before the calculation date.

Thus, it is necessary to be aware that even in the case of funds that invest in the same investment targets, the market prices that are reflected in their base values, which are calculated on the same date, may differ in the time that these prices are included depending on whether the fund invests directly into shares or bonds, or through a mother fund, or through a component fund of a fund of funds.

7 2 Closing

The accounting period of an investment trust is prescribed for each fund in the basic terms and conditions of an investment trust. Accounting periods comprise various lengths, such as one year, six months, three months, two months (bi-monthly closing), one month (monthly closing), and one day (daily closing (MMFs and MRF)). The investment trust settlor company closes the fund accounts on the last day of each closing period.

Similar to closing of the books for an ordinary company, fund account closing involves the preparation of a balance sheet, statements of income and retained profits, and accompanying notes (hereinafter the “financial statements”) for each fund as of the end of each accounting period, with the objective of clarifying the financial condition of the investment trust and the profit or loss for the term. In addition, funds that have a one year accounting period have an interim closing six months after the start of the period and must prepare the interim financial statements. Also, financial statements for funds with an accounting period of less than six months must be prepared every six months.

Based on the information contained in the financial statements, the investment trust settlor company then prepares an investment management report as required under the ITA (an investment management report must be prepared every six months for funds with an accounting period of less than six months).

The financial statements (or interim financial statements) prepared by the investment trust settlor company shall be audited by a certified public accountant or auditing corporation. The auditor will verify the market price of the securities as well as the fund's securities transactions, interest income, dividends, etc. The audit will also focus on whether the investment trust settlor company's internal control systems for all of its operations are functioning, and whether the fund is being managed in line with its objectives and investment policies.

The investment trust settlor company must submit its securities report together with these audited financial statements (or semi-annual securities report in the case of the interim financial statements) to the Director-General of the Local Finance Bureau within three months after the closing or interim closing is finished (for details, see "8. Disclosure for Securities Investment Trusts").

7 3 Dividends Distribution

(1) Method of Determining Dividends

The maximum amount allowed for dividends is prescribed as follows in the rules of the Investment Trusts Association, Japan (JITA Investment Trust Accounting Rules, Book 5):

(i) For a unit-type investment trust, at the end of an accounting period if the net asset amount after subtracting expenses (hereinafter, the sum of management fees (trust fees) and other expenses) is equal to or larger than the principal, a dividend can be made up to the larger of the excess, or the amount of dividends, etc., and other income received during the term. If the net asset amount after expenses is less than the principal, dividends can be made up to the amount of dividends and other income received during the term.

(ii) For an additional offering type stock investment trust, the amount that may be distributed is the amount that is the sum of the total amount of dividends, etc. received after expenses plus the realized gains/losses during the term plus the valuation profit/loss at the end of the term minus expenses, and where a deficit has been carried forward from the preceding period, after compensating for the said deficit. In the case of an additional offering type stock investment trust, upon each additional establishment, an adjustment of gains/losses is carried out so as not to dilute the gains/losses per 1 unit.

(iii) In the case of an additional offering type bond investment trust, the entire amount of any excess over principal at the end of term is distributed.

Furthermore, in cases under (i) and (ii) above, the investment trust settlor company may determine the amount of any dividend, within the range of the distributable amount, in accordance with the fund's dividend policy stated in the basic terms and conditions of an investment trust. When a distribution is made, the base value decreases by the dividend amount (**dividend drop**). In the case of government and corporate bond investment trusts, there are no distributions where the post-dividend drop base value results in a loss of principal. However, in the case of stock investment trusts (including those whose main placements are in government and corporate bonds), a cautious eye must be kept on distributions where the post-dividend drop base value may result in a decrease in principal (distributions that are equivalent to a repayment of principal).

(2) Payment of Dividends

The dividend amount is determined each closing date, and the investors receive this through the distributor.

The date on which dividend payments commence is normally stipulated in the basic terms and conditions of an investment trust as a day designated by the investment trust settlor company within one month from the closing date, but payments are actually made four business days after the closing date, or thereafter. However, there are also many funds that allow investors to elect to reinvest their dividends, and in the case that an investor chooses to reinvest dividends, the distributor signs a cumulative investment contract with such investor. In this case, payment of the dividend is deemed to be the next business day, and after taxes are deducted from the said dividend, it is possible to reinvest by an additional entrustment at the base value of the day preceding payment (in other words, in principle, the closing date) (for details, see “7-6 Taxation of Dividends, Cashing Out and Redemptions”).

Finally, the statute of limitations for dividends is five years (ten years for redemption proceeds).

(3) Dividends and Fund Structure of Bond Investment Trusts

As mentioned above, in an additional offering type bond investment trust, all amounts exceeding the base value on the closing date are distributed as dividends. Let us review this practice in relation to the structure of the fund.

In a long-term bond investment trust, new offerings are made once every month for the first year after initial inception, thereby creating twelve different funds. From the second year following establishment, monthly additions are made to each of the twelve funds. Additions are made on the day (generally the 20th day of each month) after the closing date of each month (generally the 19th day of each month). For each monthly closing, the full amount of income less expenses for the term is distributed, so that the base value immediately after closing will be the same as the initial principal, as long as there has not been a loss of principal. Thus, all subsequent additions can be made at the base value (JPY10,000), which is equal to the initial principal.

Next, let us look at MMFs and MRF.

The distinct feature of these funds is that they are closed every day (daily closing). With daily closing, all daily gains such as interest from bonds in the portfolio and trading gains are distributed as the profit for the day, so that the base value following the closing will be equal to principal. This closing process is similar to that used for long-term bond investment trusts, except that it occurs daily and the fund can be offered each day at its principal amount. However, dividends are not paid to the beneficiaries daily. Instead, the dividend is accumulated as accrued dividends and is automatically re-invested at the end of each month. These funds invest mainly in medium-term bonds and short-term financial instruments in order to avoid the influences of market fluctuations as much as possible. As of the end of September 2023, there was no MMF on the market.

7 4 Cashing Out

(1) Cancellation and Repurchase

There are two methods by which an investor (beneficiary) who holds an investment trust may cash out money from the fund during the trust period: cancellation and repurchase.

Cancellation involves cashing out money by directly having trust assets liquidated for cash. Repurchase involves having the distributor buy back the fund (the beneficiary transfers the beneficiary certificate to the distributor), and it is carried out once the investor makes a repurchase request.

(2) Cancellation Acceptance Date/Closed Period

Japanese investment trusts accept cancellations every business day, in principle. However, for funds that invest in foreign assets, etc., where the market on which most of the target investments are traded is closed, there are cases where an acquisition application dated the same day as the said market holiday will not be accepted.(Note 1)

Also, some investment trusts fix a closed period ahead of time in the basic terms and conditions of the investment trust, during which time cancellations are prohibited. The time during which cancellation is prohibited is called the **closed period**. Closed periods are intended to stabilize the invested funds.(Note 2) Examples of the length of closed periods are the first six months or one year following inception, or throughout the entire life of the trust, except at final closing.

(Notes) 1. This kind of day is stipulated because even if an attempt is made to sell the assets included in the fund in order to deal with investors' requests for cashing out, if the market is closed and the assets cannot be sold, there is a possibility that a harmful effect on the fund's assets will be unavoidable or it will not be possible to adequately maintain the blind system (for details, see 6-4 "(7) Significance of the Blind System").

2. Even if it is a fund that provides for a closed period, basic terms and conditions of an investment trust will allow the beneficiaries to make cancellation or repurchase requests even during the closed period in certain circumstances. These circumstances include when the beneficiary dies, loses the greater part of its assets due to force majeure, becomes bankrupt, or becomes unable to maintain a livelihood due to illness. These basic terms and conditions of an investment trust also provide that the distributor will buy back the fund for reasons that correspond to the above.

(3) Limitations on Cashing Out, Deadlines for Accepting Requests to Cash Out

Where there are unavoidable factors such as a halt to trading on the financial instruments exchange or a halt to foreign exchange trading, it is possible for investment trust settlor companies to suspend acceptance of cashing out (provisions in the basic terms and conditions of an investment trust and prospectus). This is because it would be impossible to handle an investor's request to cash out when the market is halted, even if an attempt was to be made to sell assets that are included in the fund. In this sense, these limitations on cashing out seek to defend the fund when the market is in turmoil or other unforeseen events occur.

Requests to cash out sent to distributors of stock investment trusts shall not be accepted later than 3:00 p.m. (JITA Full Members' Business Rules, art. 8, item 1). This is for the purpose of maintaining the blind system (for details, see 6-4 "(7) Significance of the Blind System").

Moreover, in many cases exposing investment trust property to a significant increase or decrease in net assets over a short period of time will affect the investment management and may cause adverse consequences to the remaining beneficiaries. From this perspective an investment trust settlor company is required to determine for each fund additional offering type investment trust a limit of the amount of cancellations that will be accepted at one time by a large subscriber as well as a certain amount that will require prior notice, in sufficient consideration of the size of the fund and its product characteristics, etc. With regard to a cancellation of a certain amount or more which requires a prior notice, such notice must be made to the distributor by 12:30 p.m. of the contract date (JITA Full

Members' Business Rules, art. 9).

(4) Cashing Out Price

In the case of cashing out by cancellation request, in principle, the investment trust's cashing out price is the base value. However, for funds that levy a back-end load, the cashing out price will be the balance after deducting the load. Further, there are also funds that upon cashing out levy a performance fee (a management fee (trust fee) that is proportional to investment performance), and in this case, the said performance fee is also deducted. The price after these deductions is called the cancellation amount.

In the case of cashing out by repurchase request, for bond investment trusts it is the cancellation amount less the withholding tax. Although the situation is similar for stock investment trusts, an exemption from withholding at the source applies to stock investment trusts in normal circumstances (excluding cases such as when the distributor cannot immediately cancel the repurchased fund), and consequently, the cash value is the cancellation amount (for details, see "7-6 Taxation of Dividends, Cashing Out and Redemptions").

The base value applicable to the cashing out price is usually the base value of the application date for funds that primarily invest in domestic assets, and for funds that primarily invest in foreign assets, it is the base value of the business day following the application date. In the case of a fund of funds, the base value is determined as of two business days after the application date or thereafter. As with offerings, the base value settlement date that is applied to the cashing out price is sometimes called the base value application date.

Regardless of the above, for funds that close daily (MMFs and MRF), it is the base value of the day before the next business day after the date of receipt of the cashing out application (because closing is carried out also on holidays, the expression is not "the day of," but "the day before the next business day"; this is the same in (5)) (provided that for some types of MRF, when the cashing out is received in the morning, it is the previous day's base value).

(5) Payment of the Cashing Out Proceeds

For funds that invest primarily in domestic assets, payment of the proceeds cashed out from the fund by cancellation or repurchase normally occurs on the third business day after the date of receipt of the cashing out application. By contrast, for funds that include foreign assets, payment of the proceeds cashed out from the fund by cancellation or repurchase normally occurs on the fourth business day after the date of receipt of the cashing out application. However, in cases such as where the assets included in the fund cannot be easily liquidated, there are also funds that even further delay the payment period.

Regardless of the above, MMFs make payment from the following business day, and MRF makes payment on the day itself only in the case where the cancellation is accepted in the morning and the investor desires payment on that day (same day cancellation), but in all other cases payment is made from the following business day (provided, some types of MRFs make all payments on the following business day). For MMFs, simultaneously with the payment of cashing out proceeds, there is a payment of the dividends prior to re-investment that have been reported up to the day prior to the business day following the acceptance date of the request for cashing out.

Further, for MMFs and MRF, "cashing" (meaning same day withdrawal) is allowed (depending on the distributor, there are also cases where cashing out is not handled). To cash out of MMFs, in order to make payment possible on the same day as the request to cash out, until payment of the cashing out proceeds is made on the following business day, it is possible for the distributor to lend an amount that corresponds to the cashing out proceeds (this is called a cashing out). Also, for MRF, cashing out is possible with respect to requests for afternoon cashing out that will be paid the next business day (all requests to cash out MRF that makes all payments on the next business day). The upper limit for cashing out is JPY5,000,000 per fund (this may differ depending on the distributor) (the borrowing interest on cashing out is normally one day's net distribution amount, and the cashing out proceeds are automatically allocated on repayment). As of the end of September 2023, there was no MMF on the market.

7 5 Redemption

Investment trusts are redeemed upon the expiration of the trust term prescribed in the basic terms and conditions of the investment trusts (redemption at maturity). However, it is also possible for the investment trust settlor company to renew the trust term at its discretion (extend the trust term).

Many investment trust funds, under the basic terms and conditions thereof allow redemption during the trust term when the investment trust property falls below a certain level (*e.g.,* cases such as where the surviving number of units falls below 3 billion) (early redemption). Some funds allow early redemption after the fund management becomes stable subject to certain conditions (*e.g.,* the base value exceeds JPY12,000 even once) (compulsory redemption).

When the investment trust settlor company proposes to cancel the investment trust contract, bringing redemption, it must notify the Commissioner of the Financial Services Agency in advance of such fact (ITA, art. 19). In the case of early redemption, it is necessary to carry out the procedures described in (i) below for Old Law Trusts, and the procedures described in (ii) below for New Law Trusts. However, where it is difficult to carry out the procedures below in the case that genuinely unavoidable circumstances arise, or where it is provided in advance in the basic terms and conditions of the investment trust that it will be redeemed in the case that certain conditions are met, this shall not apply where those certain conditions are met and redemption is carried out (ITA, art. 20, para. 2; ITA Enforcement Ordinance, art. 43; ITA prior to the amendment on September 30, 2007, art. 32, para. 3, *proviso*; ITA Enforcement Ordinance prior to the amendment on September 30, 2007, art. 51).

(i) Early Redemption of Trusts Under Old Law

When early redemption of the fund of trust under old law is to take place, the investment trust settlor company must give advance public notice of the fact that it will make such redemption, and deliver a written statement to that effect to the beneficiaries (ITA prior to the amendment on September 30, 2007, art. 32, para. 1). This public notice and written statement must note the fact that beneficiaries opposed to cancellation may voice any objections to the investment trust settlor company within a certain period of time (and such period cannot be less than one month). If the beneficial interests held by beneficiaries who stated an objection within the fixed period exceed one-half of the total beneficial interests, redemption is not possible. On the other hand, if they do not exceed one-half of the total beneficial interests, redemption is possible; provided, however, in this case, beneficiaries who stated an objection within the objection period may demand that the trustee repurchase the beneficiary certificates held by them, using the investment trust property, at the fair value the fund would have had if the redemption had not occurred (ITA prior to the amendment on September 30, 2007, art. 30, art. 30-2, and art. 32).

(ii) Early Redemption of Trusts Under New Law

Where early redemption of the fund of trust under new law is to be carried out, it is done by the procedure of a written resolution of the beneficiaries.

In the case of a written resolution of the beneficiaries, the investment trust settlor company prepares a document stating the date of the relevant written resolution, the reason for early redemption, the matters that should be stated in the written resolution reference materials, the time limit for exercise of voting rights, and other details, and notifies the known beneficiaries of this in writing no later than two weeks prior to the resolution date (where certain conditions are met, this may be done by electromagnetic means). A resolution in writing is passed by a majority of two-thirds or more voting rights of all beneficiaries who may exercise voting rights (ITA, art. 17, para. 8, applied *mutatis mutandis* through ITA, art. 20, para. 1). It is possible to set forth in the basic terms and conditions of the investment trust a provision to the effect that where a beneficiary does not vote it will be deemed to have voted in favor of the redemption (it is necessary to state that provision in the notification sent to the beneficiaries). Where all of the beneficiaries indicate their consent in writing to the investment trust settlor company's proposal (where certain conditions are met, this may be done by electromagnetic means), the written resolution procedure is not required (ITA, art. 17 and art. 20, para. 1; ITA Enforcement Ordinance, art. 31).

Beneficiaries who were against early redemption may demand that the fund that they own themselves be repurchased at a fair price using investment trust property (ITA, art. 18 and art. 20, para. 1). However, this provision on the dissenting beneficiaries' right to request the purchase of their beneficial interest does not apply to an investment trust wherein a beneficiary's request for the redemption of the fund which is filed during the trust period may be satisfied by the partial cancellation of the investment trust contract (*e.g.,* a fund which allows cashing out every day except for holidays, etc. outside Japan) (ITA, art. 18, para. 2 applied *mutatis mutandis* through ITA, art. 20, para. 1).

Payment of redemption proceeds commences within five business days from the date of redemption.

Regarding taxation of redemption proceeds, please check the description below (for details, see "7-6 Taxation of Dividends, Cashing Out and Redemptions").

If the beneficiary decides to purchase another fund with the redemption proceeds, depending on the distributor, there may be preferential treatment for redemption switching or pre-redemption switching under certain circumstances.(Note)

(Note) Preferential treatment for switching refers to measures which allow an investor to move assets from one fund to another with no charge for or with a discount on the offering (sales) commission on the said fund purchase, if made within a certain period of time and with the redemption proceeds from another fund. Also, preferential treatment for pre-redemption switching means, where a different fund is purchased using the proceeds from cashing out of the fund within a certain period prior to redemption, there is no charge for or a discount on the offering (sales) commission on the said fund purchase.

7 6 Taxation of Dividends, Cashing Out and Redemptions

Readers should note that the treatment of the items described below is based on the system as of the end of

November 2023, and it subsequently may have changed depending on tax law revisions, etc. Regarding the tax system for investment trusts other than publicly offered securities investment trusts, please check the description below (for details, see Volume 3, "Chapter 5, Taxation of Securities Transactions").

(1) Separate Principal, Ordinary Dividends, and Refund of Principal (Special Dividends) of Additional Offering Type Stock Investment Trusts

In order to understand the taxation of the dividends, cashing out proceeds and redemption proceeds for additional offering type stock investment trusts, it is necessary to understand the separate principal method and the distinction between regular dividends and refund of principal (special dividends).

Separate principal means each investor's average acquired net asset value,(Note) which is the weighted average of the number of units acquired each time that investor acquires that fund, and is adjusted each time there is a dividend distribution.

The taxation of dividends depends on each investor's separate principal and the relationship between the ex-dividend net asset value, and dividends are further broken down into ordinary dividends and refunds of principal (special dividends). Ordinary dividends are subject to taxation; however, special dividends are tax-free, as they are deemed to be a return of the investor's separate principal, instead of taxable income:

(i) If the ex-dividend net asset value is equal to or greater than the investor's separate principal, the entire amount of the dividend is classified as an ordinary dividend; and

(ii) If the ex-dividend net asset value is less than the investor's separate principal, the portion of the dividend that corresponds to the shortage is classified as a refund of principal (special dividend), with the remaining amount being classified as an ordinary dividend.

Furthermore, when an investor receives the payment of a refund of principal (special dividend), the amount of his separate principal on the dividend date (closing date) minus the amount of the refund of principal (special dividend) becomes the investor's separate principal going forward.

A specific example of the separate principal method is shown in Chart 1-8.

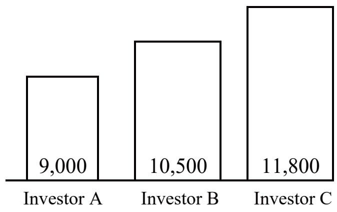
(Note) Additional offering type stock investment trusts shifted to the separate principal method on April 1, 2000. For investors who held a fund (additional offering type stock investment trust) at the time of the shift, the fund's average trust money (the average purchase value of all of the fund's investors) as of March 31, 2000, was treated as the separate principal of each investor.

Dividends from a unit-type stock investment trust are subject to tax on the full amount of the dividend, without any distinction for ordinary dividends and refund of principal (special dividends).

Chart 1-8 Structure of Taxation of Dividends from Additional Offering Type Stock Investment Trust (Sample)

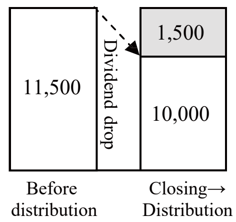
1. Separate Principal of Investor

Investor	Date of Acquisition	Separate Principal
A	June 20	JPY 9,000
B	Aug. 10	JPY10,500
C	Oct. 1	JPY11,800



2. Status on the Closing Date (Oct.15)

Base Value (B.V.)	JPY11,500
Dividend	JPY 1,500
B.V. Ex-Dividend	JPY10,000



3. Computation of the Ordinary Dividend and Refund of Principal (special dividend)

Investor Separate Principal.

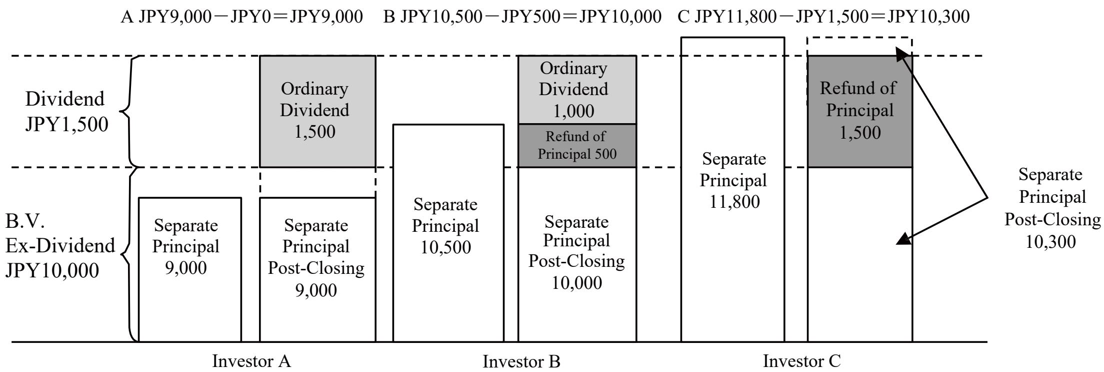
A JPY9,000 < JPY10,000 B.V. ex-dividend is higher than the separate principal → Entire JPY1,500 is an "Ordinary Dividend"

B JPY10,500 > JPY10,000 B.V. ex-dividend is lower than the separate principal →Difference of JPY500 is a "Refund of Principal" (special dividend) Remaining JPY1,000 is an "Ordinary Dividend"

C JPY11,800 > JPY10,000 B.V. ex-dividend is lower than the separate principal →Difference of JPY1,500 is a "Refund of Principal (special dividend)"

4. Calculation of Post-Closing Separate Principal

The investor's separate principal after the closing (distribution) will be as calculated by deducting the amount of partial refund (special dividend) from the investor's previous separate principal.



Investor	Separate Principal	B.V. Ex-Dividend	Dividend	Ordinary Dividend	Refund of Principal (special dividend)	Separate Principal Post-Closing
A	JPY 9,000	JPY10,000	JPY1,500	JPY1,500	JPY 0	JPY 9,000
B	JPY10,500	JPY10,000	JPY1,500	JPY1,000	JPY 500	JPY10,000
C	JPY11,800	JPY10,000	JPY1,500	JPY 0	JPY1,500	JPY10,300

(2) Taxation of Dividends for Stock Investment Trusts

Dividends from a stock investment trust are treated as dividend income (Income Tax Act, art. 24, para. 1).

(i) Individual Investors

Ordinary dividends from unit-type investment trusts and from additional offering type investment trusts, under the system that does not require the filing of a tax return, are subject to separate withholding tax at the rate of 20.315% (15% as income tax, 0.315% as special income tax for reconstruction, and 5% as inhabitant tax). An investor may also choose, however, to file a tax return for dividend income under the comprehensive taxation system or the separate self-assessment taxation system. In the case of some funds a tax credit on dividends is allowed if comprehensive taxation is selected[Note 1], while if separate self-assessment taxation is selected, the dividend income from taxable dividends can be netted against the capital gains or loss from sale of shares, etc.[Note 2]

It is possible to have dividend income on taxable dividends and the capital gains or loss from the sale of listed shares, etc. netted within the special account.

(Notes) 1. In order to eliminate double taxation with respect to individual beneficiaries receiving share dividends, which are subject to corporate taxes and income taxes, tax credits for dividends can be applied, allowing for the deduction of 10% of the dividend income amount from income tax, and 2.8% of the same amount from inhabitant tax (if total taxable income, including dividend income, exceeds JPY10 million, the tax credit rates applicable to the portion of dividend income equal to the amount of total taxable income that exceeds JPY10 million are 5% and 1.4%, respectively), but a dividend credit may also be applied to a part of the dividends of stock investment trusts that include domestic shares. For taxation purposes, however, 50% of stock investment trust dividends are deemed to be attributable to share dividends, and furthermore, tax credit rates for dividends decrease as per Chart 1-9 in line with increases in the non-stock ratio (the proportion of assets other than shares, as prescribed in the basic terms and conditions of an investment trust, within total trust assets,) or in the foreign currency denominated asset ratio (the proportion of foreign currency denominated assets, as prescribed in the basic terms and conditions of an investment trust, within total trust assets).

2. Where there is a loss that has arisen according to the calculation of capital gains, etc. for that year from listed shares, etc., or where there is a transfer loss for listed shares, etc. that has arisen in each year within the preceding three years (excluding that which was already deducted in the preceding years), the amount of these losses shall be deducted from the amount of dividend income from listed shares, etc. and other income.

Chart 1-9 Ratios Regarding Dividend Tax Credits for Individual Investors

Non-stock ratio / Foreign currency-denominated asset ratio	50% or less	Over 50% up to and including 75%	Over 75%
50% or less	Half of shares		
Over 50% up to and including 75%		Quarter of shares	
Over 75%			Not applicable

(ii) Corporate Investors

Ordinary dividends from unit-type stock investment trusts and from additional offering type stock investment trusts are subject to having only income tax withheld at the source, and not inhabitant tax. Consequently, the tax rate is 15.315% (15% as income tax and 0.315% as special income tax for reconstruction). The taxation rule that excludes such dividends from the revenue of corporate investors does not apply to stock investment trusts in the business year that starts on April 1, 2015, and thereafter, except for specified stock investment trusts such as ETFs that invest in Japanese shares (Act on Special Measures Concerning Taxation, art. 3-2).

Furthermore, under the corporation tax, refund of principal (special dividends) is not subject to tax, and only amounts pertaining to such refund of principal (special dividends) are accounted for as reductions in book value. Also, corporations may deduct the full amount of any withholding taxes imposed on taxable dividends (provided, however, in cases where the corporation acquired its beneficiary certificates through purchase, the deduction is prorated for the corporation's holding period during the year in which the purchase occurred).

(iii) Foreign Tax Credit (Adjustment for Double Taxation)

Taxpayers investing in foreign bonds or shares by means of investment trusts, etc. sold by securities companies, etc. were subject to taxation in a foreign country on the interest or dividend they received from these bonds or shares, and then further subject to taxation in Japan on the distribution of profits they received from the securities companies, etc. In order to adjust such double taxation, *i.e.* taxation in Japan and taxation in a foreign country, a new system has been introduced so that the amount of income tax levied in a foreign country will be credited against the amount of tax levied in Japan, up to the amount of withholding tax, when the taxpayers receive the distribution of profit from the investment trusts, etc. from the securities companies, etc., starting from 2020 (this tax credit does not apply to inhabitants tax). As a result, if this adjustment is made, the amount of tax may differ from the amounts mentioned in (i) and (ii) above at the time of distribution of profit.

(3) Taxation of Cancellation Gains/Redemption Gains from Stock Investment Trusts

(i) Individual Investors

Cashing out gains or redemption gains received from cancellation or repurchase of a stock investment trust, or received from the redemption of a stock investment trust will be treated as a capital gain, and the difference between the cashing out price or redemption price and the acquisition price (including the offering (sales) commissions and other expenses required for the acquisition) will be subject to separate self-assessment taxation and taxed as a capital gain after being netted with the income or loss on sale of listed shares, etc. The tax rate is 20.315% (15% as income tax, 0.315% as special income tax for reconstruction, and 5% as inhabitant tax).

The special account for withholding at source may also be used for netting with the income or loss on sale of listed shares, etc.

<Example calculation>

An individual investor has 200,000 units in a publicly offered stock investment trust (back-end load upon cancellation equivalent to 0.2% of base value) for which its separate principal (10,000-unit basis) is JPY10,000 (2% commission at the time of purchase, 10% consumption tax thereof). Calculate the proceeds received and the capital gain/loss that arises in the cases where the investor cashes out its units, when the net asset value (10,000-unit basis) is JPY10,500.

Expenses for Acquisition = Base Value × (1 + Fee Rate × (1 + Consumption Tax Rate)

× No. Units Purchased/10,000
= JPY10,000 × (1 + 0.02 × 1.10) × 200,000/10,000
= JPY 204,400

Cashing out Price = Base Value − Back-end Load
= JPY10,500 − JPY10,500 × 0.2%
= JPY10,479

Proceeds Received = Cashing out Price × No. Units Held/10,000
= JPY10,479 × 200,000 units/10,000
= JPY209,580

Capital Gain/Loss = Income from Sale − Expenses for Acquisition
=JPY209,580 − JPY204,400
=JPY5,180 (capital gain)

(ii) Taxation of Corporate Investors

Unlike in the case of individual investors, the stock investment trust cancellation or redemption gains received by corporate investors are treated as dividend income.

Accordingly, for the amount that the cancellation price or redemption price exceeds the investor's separate principal, for stock investment trusts, the excess is subject to the withholding rate of 15.315% (15% as income tax and 0.315% as special income tax for reconstruction).

When a corporate investor cashes out from a stock investment trust through a repurchase request rather than cancellation, the net proceeds for the corporate investor will be the balance of the amount by which the repurchase price exceeds the separate principal, minus the amount equivalent to income tax withheld, giving rise to a capital gain or loss.

(4) Taxation on Government and Corporate Bond Investment Trusts

Dividends from government and corporate bond investment trusts(Note) are treated as interest income (Income Tax Act, art. 23, para. 1), and are subject to withholding tax at the rate of 20.315% on the full amount of the dividend (comprised of a 15% income tax, 0.315% special income tax for reconstruction and 5% inhabitant tax) if the investor is an individual (as in the case of dividends for stock investment trusts, such individual investors can complete the taxation procedure by paying withholding tax without filing a tax return or netting dividend income with the capital gains or losses on listed shares, etc. if they choose to file a tax return for dividends under the separate self-assessment taxation system). Cancellation or redemption gains from such trusts are treated as capital gains and subject to separate self-assessment taxation as in the case of stock investment trusts. They are netted with the trading profits and losses on listed shares, etc. and are subject to capital gains taxation at the rate of 20.315% (comprised of a 15% income tax, a 0.315% special income tax for reconstruction and a 5% inhabitant tax).

Where the investor is a corporation, the full amount of government and corporate bond investment trust dividends is counted as profits and are subject to corporation tax. Also, the withheld income tax, special income tax for reconstruction, and local income tax are deducted from the corporation tax.

(Note) As to additional offering type stock investment trusts, the separate principal method has also been applied to additional offering type bond investment trusts (excluding daily closing funds). In the case of additional offering type bond investment trusts, if the base value exceeds the price per unit of principal (usually JPY10,000; hereinafter referred to as JPY10,000), an amount equivalent to the whole of such excess must be paid as dividends, and additional establishment may be carried out only at the base value on the closing date. As a result, separate principal necessarily equals to or falls below JPY10,000, and because a distribution of earnings is not allowed if the base value before distribution falls below JPY10,000, there would be no dividend to be paid as refund of principal.

(5) Application of the Tax-Exempt Systems

The following are tax-exempt systems that are related to investment trusts:

(i) NISA Program

As of January 1, 2024, the new NISA program was launched by fundamentally consolidating and reforming the conventional NISA programs and establishing the new program as a permanent one. The section below provides details of the new NISA program.

Under the NISA program, income from dividends, capital gains from cancellations and redemptions from investment trusts invested via NISA accounts (tax-exempt accounts) are exempt from taxation.

The new NISA program has two investment quotas: an installment investment quota and a growth investment quota. Investment trusts eligible for investment using the installment investment quota are publicly offered stock investment trusts and ETFs that are suitable for long-term installment investments or diversified investments and that satisfy the predetermined requirements (Note). On the other hand, investment trusts eligible for investment using the growth investment quota are publicly offered stock investment trusts, ETFs and listed REITs; however, investment trusts where the trust period is less than 20 years, monthly dividend investment trusts, and certain investment trusts using derivatives transactions are excluded from the scope of eligible products.

The installment investment quota and the growth investment quota can be used concurrently but not at different financial institutions.

(Note) The requirements for investment trusts covered by the installment investment quota are prescribed in detail in the Order for Enforcement of the Act on Special Measures Concerning Taxation and the relevant public notice issued by the Cabinet Office. The major requirements are as indicated below.

(Common requirements)
- The trust contract is valid for an indefinite period or for 20 years or more.
- Dividends are not paid monthly.
- The investment is not made through derivatives transactions, except for an investment for hedging purposes.
- A notification is made to the Prime Minister to report the products handled by the investment trust.

(Requirements for designated index investment trusts)
- The investment trust is linked with any of the indexes designated by the public notice.
- The shares are included in the major investment targets.
- No sale commission, cancellation fee or account management fee is charged.
- The trust fee does not exceed the designated level.

(Requirements for investment trusts other than designated index investment trusts)
- The investment trust has net assets of JPY5 billion or more.
- At least five years have passed since the trust was created.
- No sale commission, cancellation fee or account management fee is charged.
- The trust fee does not exceed the designated level.
- The shares are included in the major investment targets.

(ETFs)
- The ETF is linked with any of the indexes designated by the public notice.
- The investment target assets are shares.
- The trust fee does not exceed the designated level.
- In the case of an ETF listed on a domestic market, it is designated by the exchange as an ETF for which measures to ensure smooth distribution have been implemented.
- In the case of an ETF listed on a foreign market, it has net assets of JPY1 trillion or more.

(ii) Defined Contribution Pension System

Investment trusts are used as a means of investing pension assets in the defined contribution pension system, and income that arises due to the investment of pension assets is, in principle, tax-exempt under tax law (although it is subject to the special corporations tax, imposition of the special corporations tax (the tax rate is approximately 1% of the reserve funds) has been halted until March 31, 2026).

In a corporate-type defined contribution pension plan, the corporation contributes funds to the employee's pension account, and since January 2012 it has become possible for the employee to contribute funds to his/her pension account as well (this is called "matching contributions"). The funds contributed by corporations are eligible for inclusion in deductible losses in the calculation of corporation tax, while the funds contributed by employees as matching contributions and the funds contributed by individuals in individual-type defined contribution pension plans (iDeCo) are eligible to be used as income deductions (deductions for small-sized enterprise mutual aid premiums).

Also, although taxed at the payment stage, there is preferential treatment under the tax system, such as being exempted as retirement income when taken as a lump sum payment or being exempted as a public pension, etc. when taken as a pension.

(iii) Worker's Asset Formation System

So-called long-term bond investment trusts and "asset formation stock funds" are exempt from tax on their dividends (including amounts in excess of principal at the time of cancellation or redemption) under the asset formation pension savings or asset formation residential savings systems.

(iv) Tax Exemption System for Interest Income, Etc. from Small Savings of Persons with Disabilities, Etc. (so-called *Maru Yu* System for Disabilities, Etc.)

The tax exemption under this system is granted for persons who meet certain requirements, such as the wives who are eligible to receive survivor's pensions and persons who have physical disability certificates, with regard to their interest income from government and corporate bond trusts, up to JPY3.5 million in combination with interest income from savings and other financial instruments covered by this system.

7 7 ETF

The methods of dividend distribution and cashing out by ordinary investors for ETFs differ from that mentioned up to this point, and are carried out in the same manner as with listed shares. In other words, cashing out from ETFs by ordinary investors is carried out by selling (transferring) at the market price on the exchange in the same way as with a listed share.

Also, income distributions are paid to beneficiaries who are recorded in the list of beneficiaries as of the closing date.

The tax treatment of a capital gain or loss on sale of an ETF, as well as distributions of earnings, is handled essentially in the same manner as for listed shares, and there is no distinction between ordinary dividends and refund of principal (special dividends).

8 Disclosure for Securities Investment Trusts

It is vital to the sound development of the investment trust system that investors are provided with sufficient information and materials that will allow them to make an independent and informed decision regarding their investments. Based on this necessity, both the FIEA and the ITA contain disclosure systems that apply to investment trusts, and require investment trusts to provide material information concerning their operations.

The disclosure for investment trusts is comprised of issuance disclosure and continuous disclosure. In the remainder of this section, we will look at the rules and practice, etc. of disclosure for investment trusts.

The following statements concern publicly offered securities investment trusts (investment trusts under instructions from the settlor) (although in some cases statements are made concerning privately offered securities investment trusts (investment trusts under instructions from the settlor)). It is necessary to take note that different rules apply for disclosure of other investment trusts, and there are also many areas that widely differ in practice, etc.

8 1 Issuance Disclosure

Issuance disclosure refers to the disclosures that must be made to investors when they purport to acquire a new issue of securities; in the case of investment trusts, both the FIEA and the ITA prescribe the content of the disclosure.

(1) Issuance Disclosure Under the FIEA

Upon an offering or sale of a publicly-offered investment trust, the investment trust settlor company, which is the issuer, must file a securities registration statement with the Director-General of the Local Finance Bureau (FIEA, art. 4, para. 1). The filed securities registration statement is made available for public inspection (FIEA, art. 25, para. 1), thus being disclosed to investors.

When having an investor acquire an investment trust, an explanation on the investment trust (a prospectus) must be delivered in advance of or simultaneously (in the case of an investment trust explanatory document (delivery prospectus)) with having the investment trust purchased, or when a request for delivery is made on or before the time of having the investment trust acquired, immediately (in the case of an "investment trust explanatory document (request prospectus)") at the request (for details, see "6. Sale of Securities Investment Trusts"), and consequently, the investment trust settlor company also prepares investment trust explanatory documents (prospectuses) as disclosure information, simultaneously with securities reports.

The main content of a delivery prospectus is as set forth below:

1. Cover Page, Etc. of a Delivery Prospectus (From the Cover Page Through the Statement of Matters in the Main Text):
- **(1) Statement to the effect of being a delivery prospectus;**
- **(2) Statement of being a prospectus under the FIEA;**
- **(3) The name of the fund and the product classification;**
- **(4) Information on the settlor company, etc.;**
- **(5) Information on the trustee company;**
- **(6) Method of obtaining detailed information;**
- **(7) Date of commencement of use;**
- **(8) Matters in connection with effect of notification;**
- **(9) Product classification and table of attribute categories; and**
- **(10) Other matters that are to be stated.**

2. Main Text of a Delivery Prospectus (in the Following Order):
- **(1) Purposes and features of fund;**
- **(2) Investment risk;**
- **(3) Investment performance; and**
- **(4) Procedures and commissions, etc.**

3. Additional Information (If Necessary):
(The above is from art. 2 through art. 4 of the "Regulations Concerning Preparation of Delivery Prospectuses.")

(2) Issuance Disclosure Under the ITA

In cases where the investment trust settlor company purports to execute an investment trust contract, it must file the contents of the basic terms and conditions of an investment trust pertaining to the investment trust contract with the Commissioner of the Financial Services Agency (ITA, art. 4, para. 1), and must deliver written documents containing a description of the basic terms and conditions of an investment trust to those persons who wish to acquire the investment trust (ITA, art. 5, para. 1, main clause); provided, however, this does not apply when the investment trust explanatory document (prospectus) sets forth the contents of the basic terms and conditions of an investment trust (ITA, art. 5, para. 1, *proviso*). In the case of a publicly offered investment trust, ordinarily an investment trust explanatory document (prospectus) that includes a copy of the basic terms and conditions of an investment trust is delivered in lieu of these written documents.

Since no prospectus is prepared or delivered with respect to a privately placed investment trust, a document called a "Product Explanation" or other name is prepared, and includes the details of the basic terms and conditions of an investment trust.

8-2 Continuous Disclosure

Continuous disclosure is a system to provide investors with decision-making information by requiring a fund to make periodic disclosures to its investors after securities are issued. In addition to the continuous disclosure prescribed by the FIEA and ITA, there is also the periodic disclosure under the Investment Trusts Association, Japan Agreement (for details, see “8-4 Timely Disclosure”); however, here we will only look at disclosures that are required by law.

(1) Continuous Disclosure Under the FIEA

The investment trust settlor company must submit a securities report for each fund it establishes to the Director-General of the relevant Local Finance Bureau within three months after the closing of the said fund for each of the relevant fund’s accounting periods (FIEA, art. 24, para. 1 and para. 5); provided, however, when the accounting period of the fund is less than six months, the securities report must be submitted every six months (Cabinet Office Ordinance on Disclosure of Information, etc. on Regulated Securities, art. 23, *proviso*).

Additionally, for a fund with a closing period of one year, an interim securities report (FIEA, art. 24-5, para. 3), or when a movement occurs in the fund’s related corporations, etc., an extraordinary report (FIEA, art. 24-5, para. 4) must also be submitted to the Director-General of the Local Finance Bureau. The securities report, the semi-annual report and the extraordinary report are likewise subject to public inspection (FIEA, art. 25).

The securities report must include the financial reports for the two most recent periods. These financial statements, as well as the annual and interim financial statements included in the securities registration statement, securities report, and interim report must be accompanied by the audit certification prepared by a certified public accountant or an auditing company that has no special interest in the issuer (FIEA, art. 193-2).

(2) Continuous Disclosure Under the ITA

The investment trust settlor company must prepare an **investment management report** for each investment trust property at the end of each closing period (six months for funds in which the closing is less than six months) without delay and deliver the report to beneficiaries (ITA, art. 14, para. 1).

The system for disclosure via investment management reports has been reformed with regard to such reports to be prepared at the closing on or after December 1, 2014. The new system will require both the summary of an investment management report containing extremely important matters and the whole body of the investment management report to be prepared and delivered to beneficiaries. Under the new system, investment trust settlor companies must prepare such summarized versions of investment management reports and deliver them to known beneficiaries via the distributors (ITA, art. 14, para. 4). If investment trust settlor companies provide customers the whole body of the investment management report by electromagnetic means, as provided in the basic terms and conditions, they are deemed to have delivered the investment management report (ITA, art. 14, para. 2). However, even in such a case, they must deliver the whole body of the investment management report upon request of a beneficiary (ITA, art. 14, para. 3; JITA Investment Management Report Rules, art. 10, para. 1).

An investment management report (the summary and the whole body thereof) is not required to be prepared or delivered in cases such as the following: (i) where funds are privately offered by qualified institutional investors and the investment trust contract prescribes that the delivery of investment management reports is unnecessary; (ii) where it is anticipated that an individual sharing the same residence as the beneficiary will receive the said report and the beneficiary has agreed by the report drafting date not to receive the same (excluding where a request for delivery was made by the report drafting date); and (iii) where the funds in question are MRF or funds listed on a financial instruments exchange.

Matters that should be stated in investment management reports are prescribed in the ITA. Among these matters, the following are considered important and required to be included in the summary of an investment management reports to be delivered to customers (Regulation on Accountings of Investment Trust Property, art. 58-2):

1. **The investment policy for the investment trust property;**
2. **Developments in the investment of the assets during the accounting period for the investment trust property;**
3. **Changes in the investment status;**
4. **Remuneration, etc. for the investment trust settlor company and the trustee company and other expenses borne by the beneficiaries in relation to the investment trust property during the accounting period for the investment trust property, as well as the details of the services for which such remuneration and expenses are paid;**
5. **The ratio of the total market value of each of the major issues of shares to the amount of net assets in the investment trust property, as of the end of the current term;**
6. **The ratio of the total market value of each of the major issues of public and corporate bonds to the amount of net assets in the investment trust property, as of the end of the current term;**
7. **The ratio of the total market value of each of the major issues of beneficiary certificates of investment trusts (excluding beneficiary certificates of the parent investment trust), beneficiary certificates of the parent investment trust, and investment securities of investment corporations to the amount of net assets in the investment trust property, as of the end of the current term;**
8. **The ratio of the appraised value of each of the major types of derivatives transactions to the amount of net assets in the investment trust property, as of the end of the current term;**
9. **The division that will receive inquiries from the beneficiaries and its telephone number;**
10. **In the case of an investment trust for which it is provided in the basic terms and conditions that the items of information to be contained in the whole body of an investment management report may be provided by electronic and magnetic means, a statement to that effect, and information necessary for inspecting such matters to be contained in the whole body of an investment management report; and**
11. **A statement to the effect that the whole body of an investment management report is delivered at the request of the beneficiary, and information necessary for making such request.**

The matters enumerated above are those basically assumed for securities investment trusts.

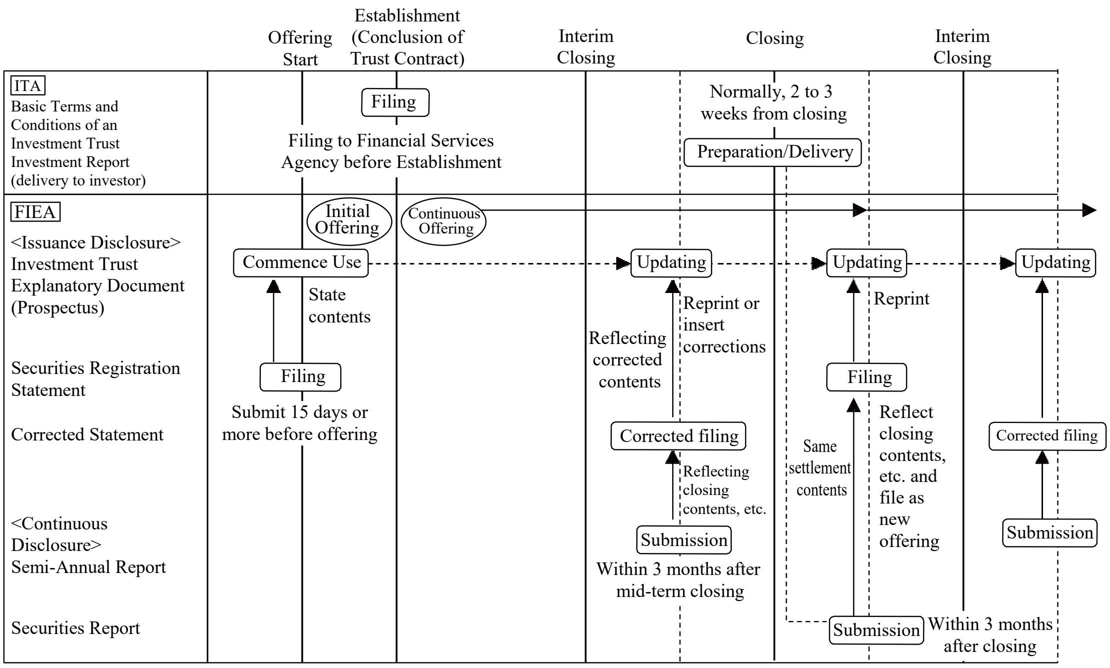
The matters that should be stated in investment management reports for real estate investment trusts and infrastructure investment corporations are also prescribed.

In addition, investment management reports are supposed to be prepared in such a way as to make them easy for investors to understand (See Financial Services Agency, "Comprehensive Guidelines for Supervision of Financial Instruments Business Operators, Etc." VI-3-2-3(2)). Based on this, the Investment Trusts Association, Japan specifies, in the JITA Investment Management Report Rules , the matters to be set forth in an investment management report and the presentation order of these matters. In doing so, the Investment Trusts Association, Japan aims to standardize the format of disclosure through investment management reports.

8-3 Schedule for Preparation and Updating of Legally Required Disclosure Materials

In 8-1 and 8-2 above we looked at the contents of disclosures for publicly offered securities investment trusts under the FIEA and the ITA. Here, we will look at the schedule by which these legally required disclosure materials are prepared and updated in practice. Chart 1-10 provides an example of the schedule for preparing and updating legally required disclosure materials in connection with a publicly offered additional offering type investment trust that has closing on an annual basis.

Chart 1-10 Legally Required Disclosure Schedule in Connection with Publicly Offered Additional Offering Type Investment Trusts (Fund with annual closing, and where there are no extraordinary correction filings)



First, where the fund is to be established, it is necessary to raise funds with an initial offering. In that case, as already noted the investment trust settlor company that is the issuer must file a securities registration statement with the Director-General of Local Finance Bureau (FIEA, art. 4, para. 1), and because it takes effect from the 15th day after the filing is accepted (FIEA, art. 8, para. 1), the filing must be made 15 days or more before beginning the initial offering.

When the filing is accepted, it is possible to solicit applications for the new fund (provisional offering). However, it is not possible to accept acquisition applications unless 15 days have passed and the filing has taken effect.

On the other hand, under the ITA, when concluding an investment trust contract, the content of investment trust contract that pertains to the said basic terms and conditions of an investment trust must be filed in advance with the Commissioner of the Financial Services Agency (ITA, art. 5, para. 1), and because the investment trust contract is executed on the fund's initial establishment day, the basic terms and conditions of an investment trust is to be filed by the day before the initial establishment day. It is also necessary to attach the basic terms and conditions of an investment trust to the securities registration statement, and normally, the content of the basic terms and conditions is stated in the investment trust explanatory document (prospectus) as well. In practice, therefore, the basic terms and conditions of an investment trust are also prepared at the time of the filing of the securities registration statement.

Once the initial offering period of approximately two weeks to one month is over, the trust agreement is executed and investment commences.

Once six months elapse after commencement of investment, the investment trust settlor company carries out an interim closing, prepares interim finance statements, and after an audit by a certified public accountant or an auditing firm (FIEA, art. 193-2), an interim report must be submitted within three months from the date of the interim closing (FIEA, art. 24-5, para. 3). Because it is also necessary to have the securities registration statement reflect the contents, etc. of the interim closing that is included in the semi-annual report, a filing of an amended registration statement is made at the same time. Moreover, when an amendment is made to the content of a registration statement, the investment trust explanatory document (prospectus) must also be corrected, and is to be updated by a revised printing of the investment trust explanatory document (prospectus) that was initially used or by inserting documents on which the corrected matters are stated.

After six more months have passed, leading up to closing, the investment trust settlor company carries out closing processing, prepares the investment management report, and delivers it to the investors through the distributor. There is no legally stipulated time limit for delivery, but the normal practice is for delivery to be made to the investors within approximately two to three weeks from closing.

After that, the investment trust settlor company must submit the annual securities report within three months after the closing date after receiving an audit of the closing by a certified public accountant or an auditing firm. The contents, etc. of the closing that are included in the annual securities report are also reflected in the securities registration statement, but as a different public offering from the previous public offering, this case differs from the interim closing in that it is not a corrected filing but a submission of a new securities registration statement. This is because the effective period is set at 16 months or less for the securities registration statement and the prospectus (one month initial offering + one year closing period + three months submission deadline for the annual securities report) (JITA Full Members' Business Rules, art. 7), and subsequently a new securities registration statement is submitted each year.(Note)

Chart 1-10 describes a fund that has a one-year closing period, but the finance reports and investment management report preparation period is every six months for funds for which the closing period is not more than six months such as those with six months, three months, two months (every other month), one month (every month), and one day (daily closing types) closing periods, including monthly-paid funds. In the legally stipulated disclosure schedule for these types of funds with a closing period of not more than 6 months, the "interim closing" indicated in Chart 1-10 becomes the "(full year) closing" and the "interim report submission" becomes the "securities report submission," and the preparation of investment management reports is done twice a year, every six months.

Also, where it is necessary to amend important matters that should be stated in the filings or correct other contents in order to protect the public interest or investors, the investor trust settlor company must submit an extraordinary corrected filing regardless of the closing period (FIEA, art. 7), and in such case, the investment trust explanatory document (prospectus) is updated (by reprinting or in the form of inserting documents stating the corrected matters in the already existing investment trust explanatory document (prospectus)).

(Note) Where a new securities registration statement is submitted, in the same way as with the time of the initial offering, the legal principle is that it takes effect after 15 days have passed (FIEA, art. 8, para. 1). Thus, it is necessary to file for new offering periods at least 15 days before the offering period based on this principle. However, in consideration of the special characteristics of the continuing nature of offerings in the case of securities investment trusts, from the second year, as long as they meet certain conditions, filings take effect from the next day (published by the FSA, "Points to be Considered regarding Disclosure of Details, Etc. of Specified Securities" (Guideline for the Specified Securities Disclosure System), 8-1). Normally, in order to meet the relevant certain conditions, the normal business practice is carried out on the schedule indicated in Chart 1-10.

8 4 Timely Disclosure

To assist investors, the Investment Trusts Association, Japan has rules requiring investment trust settlor companies to provide timely disclosures to investors, in addition to the legally required disclosure documents, on their homepages (JITA Investment Management Report Rules, Chapter 5).

Subject to these rules are privately placed investment trusts, ETFs, unit-type investment trusts that are in the closed period (for details, see 7-4 "(2) Cancellation Acceptance Date/Closed Period") and all but a few of the funds managed according to the instructions given by investment trust settlor companies, and funds for which timely disclosure is not mandatory may, at the investment trust settlor company's discretion, provide timely disclosure (Same regulations, art. 20). The frequency of disclosure is monthly or quarterly (as disclosure is usually made on a monthly basis, the disclosure materials generally go by the title "monthly report"), and the matters that must be disclosed are (i) an overview of the fund; (ii) disclosure concerning expenses; (iii) trends in dividends and yields; and (iv) the status of assets in the fund portfolio. This timely disclosure is now the disclosure means that is most familiar to investors because it is easy to access via the Internet, information is updated frequently, and investment trust settlor companies have devised various ways of disclosing the information in a compact manner that is more useful to investors.

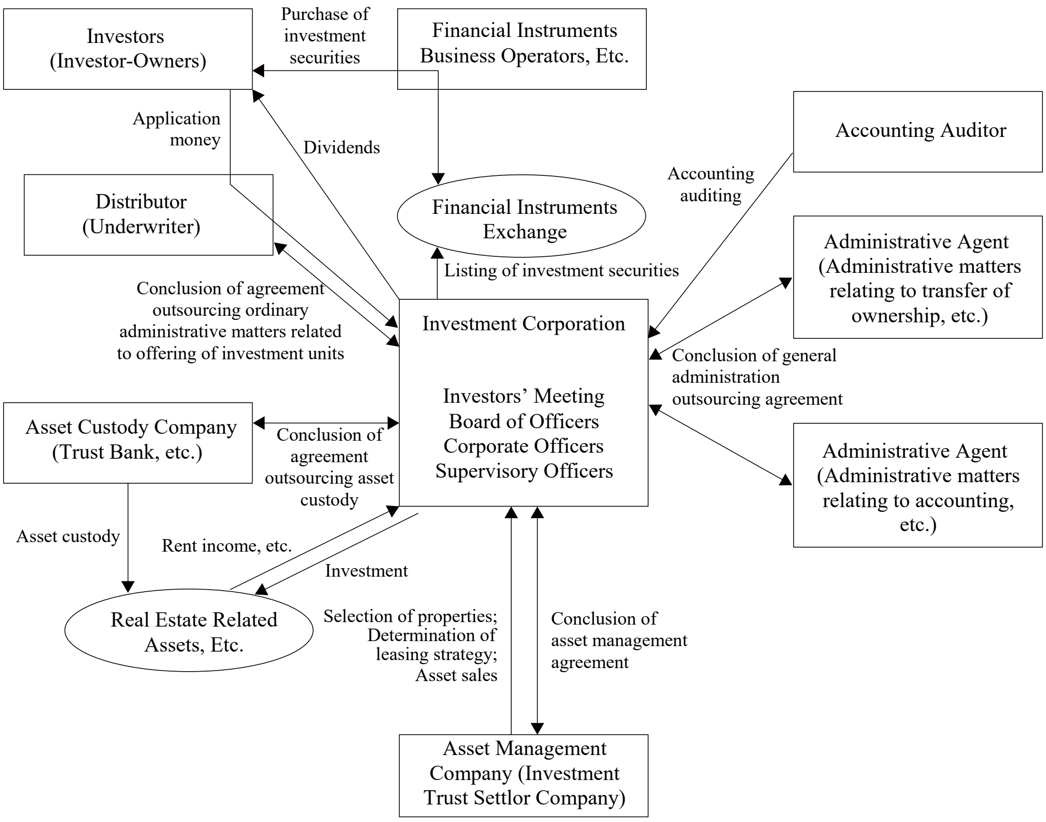
9 Investment Corporations

In the investment corporation system, a special corporation similar to a stock company (*Kabushiki Kaisha*, K.K. or KK; an association established under the ITA for the purpose of investing assets mainly in specified assets) is established, and this corporation itself becomes the fund (*kikin*) in the same collective asset investment scheme as a (contractual type) investment trust. The pool of contributions (funds) gathered from investors is granted corporate status, and this corporation becomes subject to certain rights and obligations. The management resembles that of an ordinary corporation (self-governance structures), and the needs of investors (investor-owners who are granted legal status similar to that of shareholders of a corporation) are reflected in management through the decision-making process at the investors meeting, etc. As is clear from Chart 1-11, it is necessary for investment corporations to outsource all operations such as asset management, asset custody, management of investors meetings and board of officers meetings and calculations. An investment corporation must use the term "*tōshi hōjin*" (which means "investment corporation") in its trade name (ITA, art. 64, para. 2).

In Japan, the investment corporation scheme is used primarily by real estate investment trust corporations (J-REIT). Funds for investing in infrastructure equipment (renewable energy power generation facilities, and rights to operate public facilities, etc.) have been introduced as a new type of investment target under the ITA upon its amendments as of December 1, 2014. In Japan, such funds were created by the investment corporation scheme. This scheme is considered to be suitable for creating a fund which includes assets such as real property with lower liquidity than the ordinary type of securities and for liquidating such assets by listing securities issued by the fund (**investment securities**).

Below we will take a look at the operations of an investment corporation, focusing on a real estate investment corporation as an example.

Chart 1-11 Structure of an Investment Corporation



9 1 Establishment of Investment Corporations and Offering of Investment Equity

(1) Establishment

To establish an investment corporation, the organizers first prepare the certificate of incorporation and file a notification of establishment of an investment corporation with the Prime Minister, and upon completion of certain procedures and registering, the investment corporation will be formally established (ITA, art. 66 through art. 74).

The following is a summary of the establishment procedures:

(i) The organizer must satisfy the statutory qualification requirements, such as that at least one of the organizers must have experience in carrying out tasks for the management of the same kind of assets as the specified assets which are to be the main subject of investment of the investment corporation to be established (ITA, art. 66, para. 3 and para. 4 and art. 98, items 2 through 5; ITA Enforcement Order, art. 54).

(ii) The certificate of incorporation sets out the basic items of the investment corporation and is equivalent to the basic terms and conditions of an investment trust used in the contractual type investment trust, or the articles of incorporation of a stock company. The ITA stipulates the matters to be stated in the certificate of incorporation. The major matters are as follows (ITA, art. 67, para. 1 and para. 2, art. 86, para. 1, and art. 93, para. 1):

(a) Whether an investor can have his/her investment equity in the company redeemed upon request (*i.e.,* open-end) or not (*i.e.,* closed-end);

(b) The total number of units of investment equity that the investment corporation is authorized to issue;
(c) Minimum net asset amount which must be maintained by the investment corporation at all times (cannot fall below JPY50 million (ITA, art. 67, para. 4));
(d) Asset management targets and strategy;
(e) Policy for distribution of money
(f) Amount of compensation which will be paid to the corporation's corporate officers, supervisory officers, and accounting auditors, or the standard used in deciding the said amounts;
(g) Amount of asset management fees which will be paid to the asset management company, or the standard used in determining the amount of the said asset management fees; and
(h) Name and address of the organizer(s).

Under the ITA, the following matters can be prescribed in the certificate of incorporation:
(a) That under certain circumstances, redemption may be suspended in the case of open-end type (ITA, art. 67, para. 2);
(b) That investment securities will not be issued in the case of open-end type until there is a request on the part of the investor (ITA, art. 86, para. 1); and
(c) That the voting rights of all investors who do not attend the investors meeting and who do not vote will be deemed affirmative (Deemed affirmative) (ITA, art. 93, para. 1).

The notification of establishment of an investment corporation that the organizers submit to the Prime Minister in advance must be accompanied by the certificate of incorporation and other necessary documents. The certificate of incorporation becomes effective when this notification is accepted by the Prime Minister (ITA, art. 69). An investment corporation is formed upon the registration of its establishment (ITA, art. 74).

(iii) The total capital amount of the investment corporation at the time of establishment is the total amount to be paid in for the investment equity issued upon establishment, which is set at an amount equal to or greater than JPY100 million by the ITA (ITA, art. 68; ITA Enforcement Order, art. 57). The organizer conducts an offering for subscription of investment equity to be issued at establishment. The organizer must, upon each solicitation of persons to subscribe for investment equity issued at establishment, prescribe the number of units of investment equity, the amount of money to be paid for the investment equity and the date or period for payment of money (ITA, art. 70-2), and notify persons who apply for subscription of the investment equity to be issued at establishment of the requisite matters (ITA, art. 71, para. 1). The candidates for the position of the corporate officer at establishment, the supervisory officer at establishment and accounting auditor at establishment listed on the investment equity application form are formally appointed when the allotment of the investment equity is completed (ITA, art. 72).

(2) Registration of Investment Corporations

Although a notification system is adopted with respect to the establishment of an investment corporation (ITA, art. 69), a registration system is adopted with respect to its operations. Therefore, in order to engage in asset trading, an investment corporation must register with the Prime Minister in advance (ITA, art. 187). The ITA provides for the necessary procedures for such registration (ITA, art. 188 through art. 190).

The types of transactions in specified assets that a registered investment corporation may perform are: the acquisition and assignment of securities; borrowing and lending of securities; acquisition and assignment of real estate; leases of real estate; and entrustment of the administration of real estate. A registered investment corporation is not allowed to conduct transactions in which the corporation itself engages in land development or building construction, those in which the corporation itself engages in production, manufacture, or processing of commodities or any other acts specified by Cabinet Office Ordinance as being similar thereto, or those in which the corporation itself engages in manufacturing and installation of renewable energy power generation facilities or any other acts specified by Cabinet Office Ordinance as being similar thereto (ITA, art. 193, para. 1; ITA Enforcement Order, art. 116).

(3) Offering of Investment Equity for Subscription

Investment corporations may make an offering of investment equity for subscription up to the total number of units of investment equity prescribed in the certificate of incorporation. However, as the operations concerning an investment corporation shall be delegated, the corporate officers of an investment corporation must not conduct administrative affairs concerning the offering, etc. of investment securities (ITA, art. 196, para. 1).

On each offering of investment equity for subscription, the board of officers must approve the number of units of investment equity for subscription, the amount to be paid for the investment equity for subscription or its calculation method and the date or period of payment of money (ITA, art. 82, para. 1).

The investment corporation must notify persons who apply for subscription of the investment equity for subscription of the matters referred to in (1) (ii) (a) through (h) (the main items included in the certificate of incorporation) and other requisite matters (ITA, art. 83, para. 1). The subscriber of the investment equity for subscription becomes an investor on the payment date or the date payment was made (ITA, art. 84, para. 1; Companies Act, art. 209).

9 2 Organs of Investment Corporations

An investment corporation has, as its organs, the investors meeting, corporate officers, supervisory officers, and the board of officers, which are equivalent to the shareholders meeting, directors, auditors, and the board of directors of a stock company, respectively.

(1) Investors Meeting

The items for resolution by the investors meeting are the matters prescribed by the ITA and the matters prescribed by the certificate of incorporation (ITA, art. 89).

The principal items for resolution by the investors meeting are as follows:

(i) Election of corporate officers, supervisory officers, and accounting auditors (ITA, art. 96);
(ii) Removal of corporate officers, supervisory officers, and accounting auditors (ITA, art. 104);
(iii) Amendments of the certificate of incorporation (ITA, art. 140);
(iv) Approval of asset management entrustment agreement (ITA, art. 198, para. 2);
(v) Consolidation of units of investment equity (ITA, art. 81-2, para. 2);
(vi) Approval of an absorption-type merger or a consolidation-type merger agreement (ITA, art. 149-2, para. 1, art. 149-7, para. 1, and art. 149-12, para. 1); and
(vii) Dissolution (ITA, art. 143).

Among the above, the election or removal of the corporate officers, supervisory officers, and the accounting auditor, and the approval of the asset management entrustment agreement must be determined through an ordinary resolution (the owners of a majority of the total number of units of issued investment equity attend the meeting, and decisions are made with the approval of a majority of the voting rights of those in attendance) (ITA, art. 93-2, para. 1; provided, however, where the certificate of incorporation provides for a percentage that is higher than a simple majority, for the removal of corporate officers and accounting auditors, that percentage applies (ITA, art. 106)). Also, changes to the certificate of incorporation, the consolidation of units of investment equity, the approval of merger agreements, and dissolution must be determined through a special resolution (the owners of a majority of the total number of units of issued investment equity must attend the meeting, and decisions are made with the approval of at least two thirds (where a percentage that is greater than two thirds is provided for in the certificate of incorporation, that percentage applies) of the voting rights of those in attendance) (ITA, art. 93-2, para. 2).

In principle, investors meetings are convened by the corporate officers (ITA, art. 90, para. 1). Because the term of office for corporate officers is no more than two years, meetings are held usually once every two years to appoint new officers. To convene an investors meeting, the company must make a public announcement of the meeting at least two months prior to the proposed dated of the meeting, and it must send all investors notice of the meeting at least two weeks before the meeting date, with reference documents for the investors' meeting and voting forms attached (ITA, art. 91, para. 1 and para. 4).

Also, the certificate of incorporation may provide that the voting rights of all investors who do not attend the investors meeting and who do not exercise their voting rights shall be deemed to be affirmative votes for the resolutions proposed at the investors meeting (where multiple resolutions are proposed and from among those resolutions there are resolutions that conflict with each other, excluding any of the conflicting resolutions) (ITA, art. 93, para. 1).

At an investors meeting of an investment corporation, voting rights may be exercised by a document or electromagnetic means.

(2) Corporate Officers, Supervisory Officers, and the Board of Officers

There are two types of officers in an investment corporation: corporate officers and supervisory officers. The corporate officers execute the investment corporation's business and act as representatives of the corporation (ITA, art. 109, para. 1). They are equivalent to the representative directors in an ordinary joint stock company. The supervisory officers supervise the corporate officers' performance of their duties (ITA, art. 111, para. 1). Corporate officers and supervisory officers are elected by the investors meeting (ITA, art. 96), there must be at least one or two corporate officers, and the number of supervisory officers must be at least one greater than the number of the corporate officers (ITA, art. 95). The term of office for corporate officers may not exceed two years (ITA, art. 99). Although the term of office for supervisory officers is four years, it is possible to provide a shorter term by the certificate of incorporation or by a resolution of the investors meeting (ITA, art. 101, para. 1).

Because of the nature of their duties, supervisory officers must maintain their independence. Therefore, organizers, corporate officers, the officers and employees of a corporation that is an organizer or its subsidiaries, etc., corporate officers of an investment corporation, officers or employees of financial instruments business operators, etc. that handled the offering or its subsidiaries, etc., and other persons who may have a problem carrying out their duties as supervisory officers due to circumstances such as a conflict of interest with the organizers or corporate officers of the investment corporation may not become supervisory officers (ITA, art. 100).

In an investment corporation, a board of officers comprised of the supervisory officers and corporate officers is installed, and when a corporate officer wishes to conduct any important business function (conclusion or amendment of entrustment agreements concerning the investment and custody of assets, entrustment of general administrative matters, convocation of investors meetings, etc.), the executive officer must obtain the approval of the board of officers (ITA, art. 109, para. 2). Executive officers must also make a report on the state of the company's business operations to the board of officers at least once every three months (ITA, art. 109, para. 3).

9 3 Asset Investment of Investment Corporations

An investment corporation only functions as a vehicle for asset management (also known as a "conduit"), and is required to outsource the actual asset management operations, asset custody operations and other general administrative affairs.

For the purpose of conducting asset investment, a registered investment corporation must enter into an agreement with an asset management company to entrust its asset investment business to that company (ITA, art. 198, art. 1). From the standpoint of self-execution obligations, asset management companies are prohibited from re-entrusting the whole of the authority concerning asset investment entrusted thereto, as in the case of securities investment trusts (ITA, art. 202, para. 1), but may be allowed to re-entrust a portion of such authority under the agreement with the investment corporation (FIEA, art. 42-3; ITA, art. 202, para. 2).

(1) Duty of Loyalty and Duty of Care of a Prudent Manager of the Management Company

Asset management companies must be financial instruments business operators engaged in the investment management business, and if the subject of investment includes real estate, the license/authorization under the Building Lots and Buildings Transactions Business Act is required (ITA, art. 199). Asset management companies which are financial instruments business operators engaged in the investment management business have the duty of loyalty and the duty of care of a prudent manager toward right holders (i.e., investment corporations), as in the case of management companies handling securities investment trusts (FIEA, art. 42, para. 1 and para. 2).

(2) Investment Targets of Real Estate Investment Corporations (J-REIT)

Real estate investment corporations (J-REIT) invest principally in real estate, etc. and asset-backed securities, etc. that primarily target investments in real estate, etc., and distribute rent proceeds, etc. and other investment management profits generated to investors.(Note) Each fund has its own management characteristics, such as concentrating on urban properties or diversified regional holdings, and such as focusing on industrial facilities, office buildings, residential buildings, logistic facilities, hotels, and healthcare facilities.

The management of real estate investment trusts is carried out by asset management companies that are experts in real estate management. The asset management company chooses and invests in the real estate, decides the leasing strategy, which is the conditions under which the real estate investments will be leased, and manages the real estate. Also, the asset management company draws up long-term repair plans necessary to maintain the value of the real estate and executes such plans in a timely manner.

Real estate investment corporations are listed on the financial instruments exchange, providing investors with a market upon which to trade their investments. Under the rules of the financial instruments exchange, listed real estate investment corporations must meet certain requirements, such as the requirement that at least 70% of the total assets under management consist of real estate, etc.

(Note) Under the JITA Real Estate Investment Corporations Rules, "real estate, etc." and "asset-backed securities, etc. that primarily target investments in real estate, etc." are defined as follows:

"Real estate, etc." means (i) real property, (ii) real estate leasehold rights, (iii) superficies rights, (iv) assets (i) through (iii) under foreign laws and regulations, (v) beneficial interests of a trust in which assets (i) through (iv) are entrusted, (vi) beneficial interests in a money trust established for the purpose of managing investments in assets (i) through (iv), (vii) contribution shares in a silent partnership concerning real estate, (viii) beneficial interests in a money trust established for the purpose of managing investments mentioned in (vii) as the primary trust asset, and (ix) assets having the same characteristics as those of assets of (v) through (viii) that are formed based on foreign laws and regulations, and (x) shares or capital contributions issued by a foreign real property holding corporation.

"Asset-backed securities, etc. that primarily target investments in real estate, etc." mean (i) preferred equity investment certificates, (ii) parent investment trust beneficiary certificates (an investment trust that is established for the purpose of causing acquisitions in other investment trusts, (iii) parent investment securities (investment securities of an investment corporation that is established for the purpose of causing acquisitions of other investment corporations), (iv) special purpose trust beneficiary certificates, (v) silent partnership contribution share certificates, and (vi) assets that have the same characteristics as those set forth in (i) through (iv) and which are formulated in accordance with the laws and regulations of a foreign country, for the purpose of investing more than one half of its assets in real estate, etc.

(3) Asset Investment According to the Asset Management Plan for Real Estate Investment Corporations (J-REIT)

When carrying out asset investment for a real estate investment corporation, an asset management company must prepare an asset management plan which specifies the following matters for each fund and try to carry out asset investment according to such plan (JITA Real Estate Investment Corporations Rules, art. 9):

(i) Management period scheduled under the asset management plan;
(ii) Investment policy of the real estate investment corporation;
(iii) Attributes of the real property, etc. and asset-backed securities, etc. assumed as the investment targets;
(iv) Valuation method for the assets held;
(v) Criteria for shuffling of the real property, etc. held and asset-backed securities, etc. held;
(vi) Policy for formulating a long-term repair plan for the real property, etc. held, the total amount of reserve based on the long-term repair plan, etc. for the real property, etc. held as estimated for the accounting period concerned, and the amount of reserve planned for each accounting period; and
(vii) Policy for formulating a plan on borrowing and repayment of funds (including a plan on the issuance and redemption of investment corporation bonds (including book-entry transfer investment corporation bonds; the same applies hereinafter); the same applies hereinafter).

An immediate plan on borrowing and repayment of funds must also be included as reference information.

(viii) If any amendment is made to the asset management plan, the date of amendment and the specific reason for the amendment; and

(ix) Other matters as may be deemed necessary for the protection of investors.

(4) Investment Restrictions on Real Estate Investment Corporations and Requirements for Management Systems

Since real property, etc. is one of a kind of assets with greater individuality than securities, etc., investment restrictions exist in accordance with the characteristics and types of real property, while asset management companies are required to have in place appropriate management systems.

(i) Investment Restrictions and Systems Required for Overseas Real Estate, Etc.

When a real estate investment corporation (J-REIT) seeks to acquire overseas real estate, etc., the country or region in which the relevant estate is located must meet the following conditions (JITA Real Estate Investment Corporations Rules, art. 24-2):

(a) The country or region has in place a law and other systems necessary for properly securing rights to use, profit and dispose of real estate, etc.;

(b) The country or region has in place a registration system and other systems necessary for ensuring the perfection of rights concerning real estate, etc. against third parties;

(c) The country or region has in place a law and other systems necessary for ensuring the proper conclusion and performance of agreements for transactions involving real estate, etc.;

(d) The country or region properly publicizes exchange rates for the currency to be used in transactions and ensures that the currency can be converted into Japanese yen without delay when necessary;

(e) The country or region sets in place conditions for properly conducting payment settlements and transfers; and

(f) The country or region has in place a litigation system and other dispute resolution systems.

When an asset management company gives instructions regarding the acquisition of overseas real estate, etc., it must, from the perspective of investor protection, conduct an investigation and collect information to the same extent as when acquiring property located in Japan, and take the measures necessary to manage and recover the leased property, etc. appropriately (*e.g.,* appointing a local agent depending on the situation in the country or region in question) (JITA Real Estate Investment Corporations Rules, art. 24-3). An asset management company is also required to have in place an internal system which enables the company to perform the following duties appropriately when giving instructions regarding the acquisition of overseas real estate, etc. (JITA Real Estate Investment Corporations Rules, art. 24-4).

(a) Disclosure of information concerning the overseas real estate, etc. and the country or region in which the relevant property is located;

(b) Retention of records, etc. in Japan regarding the communications with the local asset administration company, etc.;

(c) Acquisition of information from the country or region in question and timely and appropriate response based on such information; and

(d) Timely disclosure in the event of a disaster, etc.

(ii) Systems Required for Healthcare Facilities

If a real estate investment corporation seeks to acquire a healthcare facility (*e.g.,* a serviced residence for the elderly, fee-based home for the elderly, or a group home for the elderly with dementia), the asset management company must have in place an internal system which enables the company to perform the following duties appropriately according to the size and characteristics of the relevant services (JITA Real Estate Investment Corporations Rules, art. 24-5):

(a) Proper response when obtaining the necessary information from the party operating the healthcare facility (hereinafter referred to as the "facility operator") as needed in the course of investing in the healthcare facility, in light of the actual conditions, etc. of the facility operator;

(b) Provision of information, etc. to the facility users so as not to make the users feel insecure due to the fact that their facility becomes the investment target of the real estate investment corporation; and

(c) Disclosure to investors of the circumstances specific to the healthcare facility in addition to the general disclosure items.

(5) Investigation of the Value, Etc.

When the acquisition or transfer of land or buildings, or rights or assets relating thereto has been carried out with regard to an investment corporation for which the asset management company is managing assets, the asset management company must have a real estate appraiser who does not fall within the scope of interested persons, etc. appraise the real property pertaining to the relevant assets (ITA, the main clause of art. 201, para. 1). However, this shall not apply if the asset management company has such appraisal conducted prior to the acquisition or transfer (*id*., *proviso*).

When an OTC derivatives transaction has been conducted with regard to an investment corporation for which the asset management company is managing assets, the asset management company shall have an attorney, legal professional corporation, certified public accountant, audit corporation, or real estate appraiser that has no interest in that transaction and meets certain requirements investigate the value and other matters of the relevant assets (ITA, the main clause of art. 201, para. 2). However, this shall not apply if the asset management company has such investigation conducted prior to the said transaction (*id*., *proviso*).

(6) Transactions with Interested Persons, Etc.

Where an asset management company invests assets of a registered investment corporation under its entrustment, and the acquisition or assignment of securities, borrowing and lending of securities, acquisition or assignment of real estate or lease of real estate is to take place between the registered investment corporation and an interested person, etc. of the asset management company, the asset management company is required to obtain consent of the board of officers of the registered investment corporation in advance, in principle (ITA, art. 201-2).

An asset management company must deliver to the investment corporation statutory matters in writing at least once every three months (ITA, art. 203). At the time, the asset management company is required to clarify whether the asset management company has been trading for its own account in the same issues of securities or same types of commodities, etc. as the asset management of the investment corporation or whether the asset management company has conducted trades in real estate for its own account, etc. when the specified assets invested in by the investment corporation include real estate (ITA, art. 203, each item of para. 1; ITA Enforcement Order, art. 125, para. 3).

In addition, if specified assets are traded, etc. between the investment corporation managed by the asset management company and the asset management company or its directors or corporate officers, other investment corporations managed by the asset management company, interested parties, etc., the asset management company must deliver a document stating matters concerning the transaction to the said investment corporation and such other investment corporations, etc. (ITA, art. 203, para. 2; ITA Enforcement Order, art. 126; ITA Enforcement Ordinance, art. 248).

9 4 Sales of Investment Equity of Real Estate Investment Corporations

When general investors trade in investment securities issued by a listed real estate investment corporation, they must conduct such transactions on the exchange, similar to listed shares, via a securities firm that is a trading participant of the said financial instruments exchange. Limit orders and market orders are both possible. Commissions are independently determined by each distributor.

Because the following types of risks are associated with real estate investment corporations, it is necessary to have investors understand these types of issues:

(i) It is not a product for which the principal is guaranteed. The trading price will fluctuate on the market;

(ii) Dividends will fluctuate depending on changes in income from the real estate, etc. The amount of dividends predicted by the asset management company is no more than a prediction that is based on a specific set of premised conditions, and it is not guaranteed;

(iii) Due to the effects of various economic conditions such as the real estate leasing and sales markets and the interest rate environment, there is the possibility that dividends will decrease and the price will fall. For example, if the amount of rent from the owned real estate falls and there is a decrease in income or if interest rates rise and financing costs increase, it is possible that dividends will decrease;

(iv) If the investment target real estate is subject to an earthquake or fire, etc., it is possible that the dividends and price will fall due to such unpredictable situations; and

(v) If it conflicts with the standards set by the financial instruments exchange and is delisted, it is possible that trading in the fund will become extremely difficult.

9 5 Custody of Assets, Accounting, Etc., Dividends, and Financing of Real Estate Investment Corporations

(1) Custody of Assets

A registered investment corporation cannot place assets in its own custody and must entrust the custody functions to an asset custody company (ITA, art. 2, para. 22) (ITA, art. 208, para. 1). Therefore, the investment corporation concludes an entrustment agreement for custody of assets with an asset custody company which is to carry out the custody services for the investment corporation’s assets. The asset custody company assumes the duty of loyalty and the duty of care of a prudent manager in relation to the investment corporation (ITA, art. 209, para. 1 and para. 2).

Since persons who may serve as an asset custody company are limited to persons such as trust companies, etc. or financial instruments business operators engaging in the securities, etc. management business (ITA, art. 208, para. 2; ITA Enforcement Ordinance, art. 252), trust banks usually provide the asset custody services as in the case of investment trusts.

(2) Entrustment of Administrative Affairs

Because of its required role of a "conduit" as mentioned above, an investment corporation must outsource its asset investments to an asset management company, and the custody of its assets to the asset custody company. Furthermore, it must entrust its administrative affairs other than these to the administrative agent. The scope of administrative affairs that an investment corporation must entrust to another include: accounting; offering of investment equity and investment corporation bonds; preparation, etc. of the investors registry, investment equity subscription right registry and investment corporation bonds registry; and the operation of a board of officers meeting (ITA, items of art. 117). Accordingly, it is often the case that the trust bank that serves as the asset custody company also assumes some of these administrative affairs, or that an accounting firm assumes accounting affairs.

An administrative agent also assumes the duty of loyalty and the duty of care of a prudent manager in relation to the investment corporation (ITA, art. 118, para. 1 and para. 2).

(3) Accounting, Etc.

An investment corporation must prepare accurate accounting books in a timely manner and preserve such accounting books and other important materials related to its business for ten years from the day of the closing of the accounting books (ITA, art. 128-2). An investment corporation must also prepare financial statements (a balance sheet, income statement, statement of changes in investors' equity and explanatory notes), an asset management report, statement related to the distribution of money, and annexed detailed statements thereof, and submit these materials to an accounting auditor to have them audited (ITA, art. 129 and art. 130; ITCO, art. 34, para. 1).

Accounting of a real estate investment corporation must be processed in accordance with the Regulation on Accountings of Investment Corporations, the Real Estate Investment Corporations Regulations and other regulations of the Investment Trusts Association, Japan, and business accounting standards generally accepted as fair and appropriate (JITA Real Estate Investment Corporations Rules, art. 4). To comply with this, an asset management company must properly retain and manage the sales contracts and a third party's appraisal reports with regard to the properties held by the real estate investment corporation in which management operation is entrusted, service contracts concluded with the service providers, and other documents necessary for carrying out the entrusted business properly (JITA Real Estate Investment Corporations Rules, art. 4-2).

An investment corporation must also prepare books and documents related to its business and preserve them for ten years (ITA, art. 211; ITA Enforcement Ordinance, art. 254).

(4) Valuation of Properties, Etc. Held and Calculation of the Base Value

As the valuation method to be used to calculate the fair value of the real property, rights of lease to real property and superficies rights held by a real estate investment corporation, a method that is considered to be appropriate for each asset must be selected from the following and be prescribed in the certificate of incorporation, and valuation must be made by such method; provided, however, that this does not apply to a real estate investment corporation established through private placement (JITA Real Estate Investment Corporations Rules, art. 5, para. 1):

(i) Valuation based on an appraisal by a real estate appraiser;
(ii) Valuation based on the actual transactions of similar properties in the vicinity;

(iii) Valuation as amended through reduction based on the price assumed for acquiring the property in question again at the relevant time (limited to the valuation of buildings);
(iv) Value calculated by the income approach (DCF method or direct capitalization approach); or
(v) A combination of (i) through (iv).

In accordance with the principle of continuity, the valuation method prescribed in the certificate of incorporation shall, in principle, not be changed (JITA Real Estate Investment Corporations Rules, the main clause of art. 5, para. 2).

Beneficial interests in trusts created by entrusting therein real property, rights of lease to real property and superficies rights (including these assets under foreign laws and regulations), beneficial interests in money trusts created for the purpose of investing in these assets, and contribution shares in a silent partnership shall basically be valued based on the price offered by the trust company of the assets or the operator or the final price quoted on the listed market (JITA Real Estate Investment Corporations Rules, art. 6 and art. 7).

Assets other than real property that are held by a real estate investment corporation shall be valued by a method provided in the JITA Investment Trust Accounting Rules and Regulations on Infrastructure Investment Trusts and Infrastructure Investment Corporations, and if this is difficult, valued according to the business accounting standards generally accepted as fair and appropriate (JITA Real Estate Investment Corporations Rules, art. 8).

The amount of depreciation of real property held shall be calculated by the straight-line method in the case of buildings (excluding attached facilities) or by either the straight-line method or the declining balance method which is prescribed in the certificate of incorporation in the case of facilities, etc. (JITA Real Estate Investment Corporations Rules, art. 12, para. 1). The calculation method applicable to facilities specified in the certificate of incorporation shall not be changed in principle (JITA Real Estate Investment Corporations Rules, art. 12, para. 2).

A management company shall correct the book value of the real property, etc. held at the end of each accounting period by deducting the amount of depreciation calculated by the abovementioned method from the book value at the beginning of the relevant accounting period (JITA Real Estate Investment Corporations Rules, art. 13). If there has been any capital expenditure during each accounting period with regard to the real property, etc. held (expenditure for extending the life of the asset or increasing the value of the asset), an amount equivalent to the expenses incurred as such capital expenditure shall be added to the book value at the beginning of the relevant accounting period (JITA Real Estate Investment Corporations Rules, art. 23). With regard to trading securities held, a management company shall correct the book value thereof through fair value adjustments, and add any securities valuation profit to the securities trading profit, and any securities valuation loss to the securities trading loss, respectively (Real Estate Investment Corporations Regulations, art. 14, para. 1). A management company shall also calculate any adjustment in the value of other securities held and record it as fair value adjustment or record the balance as valuation and translation adjustments at the end of each accounting period (JITA Real Estate Investment Corporations Rules, art. 14, para. 2).

The amount calculated by deducting the liabilities from the total amount of assets after such depreciation, capital expenditure adjustment, and fair value adjustment of securities, etc. and then dividing the result by the number of units of investment equity shall be publicized as the amount of net assets per unit (base value) (JITA Real Estate Investment Corporations Rules, art. 26 applied *mutatis mutandis* through the same regulations, art. 41). This base value is used as a benchmark for the trading price on the exchange.

(5) Distribution of Money

For tax purposes, if investment corporations seek to include the amount paid as dividends in the amount of deductible expenses, that is, to make their profit tax-exempt, they are generally required to pay out in excess of 90% of their distributable profit as dividends (Act on Special Measures Concerning Taxation, art. 67-15, para. 1, item (ii), (e)). Following this provision, the Investment Trusts Association, Japan (JITA) has a rule to allow real estate investment corporations to distribute the whole amount of profit they gained during the current period (JITA Real Estate Investment Corporations Rules, art. 42). If the amount of profit calculated under the ITCO falls short of the amount of income under tax law (inconsistency between taxation and accounting; ITCO, art. 2, para. 2, item 29), the real estate investment corporation may take either of the following measures in order to meet the requirements for exemption from corporation tax: distribute money in an amount equivalent to the amount of increase in an allowance for temporary difference adjustment (ITCO, art. 2, para. 2, item 30), or set up a voluntary reserve in an amount equivalent to a reserve for temporary difference adjustment (ITCO, art. 2, para. 2, item 31) (JITA Real Estate Investment Corporations Rules, art. 42, para. 2). If the real estate investment corporation records an allowance for temporary difference adjustment or a reserve for temporary difference adjustment, it must, for subsequent periods, add an amount of reduction from the reserve for temporary difference adjustment to, or subtract an amount of reversal of the allowance for temporary difference adjustment from, the amount of unappropriated retained earnings which is part of the amount of profit (JITA Real Estate Investment Corporations Rules, art. 43-2). Furthermore, the real estate investment corporation is required to state, in the notes to financial statements, matters such as the cause of the allowance, reversal, reserve or reduction, the assets generated from the allowance or reversal, the amount of allowance, reversal, reserve or reduction, and the specific methods for making a reversal or reduction (JITA Real Estate Investment Corporations Rules, art. 43-3 and art. 43-3-2).

Investment corporations are also allowed to pay money to investors as a refund of contributions that constitutes a distribution accompanying a decrease in contributions, etc. under tax law, up to 60% of the amount that remains after deducting the total amount of accumulated depreciation recorded as of the last day of the preceding accounting period from the total amount of accumulated depreciation calculated as of the last day of the current accounting period (ITA, art. 137, para. 1; JITA Real Estate Investment Corporations Rules, art. 43). When real estate investment corporations make a refund of contributions that constitutes a distribution accompanying a decrease in contributions, etc. under tax law, except in the case of making such refund of contributions continuously at every closing, they should give full consideration to matters such as the disclosure of distinction between a distribution of profit and a refund of contributions, the decision-making process, policy for making a refund of contributions, and matters that may have an impact on medium to long-term cash flow required for financing (*e.g.,* long-term repair plan). They are also required to clearly state in an asset management report that the amount paid is not a payment of distribution of profits but a refund of contributions that constitutes a distribution accompanying a decrease in contributions, etc. under tax law, and put notes in the relevant parts of the report regarding the objective grounds or reasons for the validity of the amount of refund of contributions (JITA Real Estate Investment Corporations Rules, art. 43-5).

If investment corporations make refunds of contributions that constitute distributions accompanying a decrease in contributions, etc. under tax law continuously at every closing, they must announce the refund and disclose the refund policy in their certificates of incorporation, securities registration statements, annual securities reports, prospectuses, websites and other media, and put notes in the relevant parts of asset management plans. In addition, when disclosing the refund policy and putting notes in asset management plans and reports, they must present objective grounds therefor based on reasonable data, etc. (JITA Real Estate Investment Corporations Rules, art.

43-4).

(6) Financing

Real property was included in the scope of investment targets under the ITA through the 2000 amendments, and accordingly, financing by means of investment corporation bonds was also introduced as a new financing method (only in the case of closed-end investment corporations; ITA, 139-2, para. 1). This is to meet the need of flexible financing means such as borrowings available for investing in real property, which has greater individuality than securities.

In an offering of investment corporation bonds, the total amount of investment corporation bonds for subscription, the amount of money for each investment corporation bond, the interest rate, the method of redemption and due date for redemption, the method and due date for interest payments, etc. must be determined by the meeting of the board of officers (ITA, art. 139-3, para. 2).

The JITA Real Estate Investment Corporations Rules provide that investment corporations are allowed to borrow funds only to the extent necessary for the purpose of asset management, etc. and they must give consideration to the soundness of their property when borrowing funds. The JITA's Real Estate Investment Corporations Regulations further require management companies to state in their asset management reports such matters as the reason for each borrowing, the amount borrowed, the lender, security, the interest rate, and the repayment method and due date (JITA Real Estate Investment Corporations Rules, art. 18).

The issuance of investment corporation bonds takes time, and borrowings require time for examination, etc. To solve these problems and ensure more prompt financing, the issuance of short-term investment corporation bonds (CPs) has been introduced in the 2007 amendments. The issuance of short-term investment corporation bonds is permitted under certain conditions such as that the investment corporation bonds are issued for the purpose of procuring the funds necessary to acquire certain specified assets, etc., and that the maximum issue amount thereof is fixed by the certificate of incorporation, etc. (ITA, art. 139-13). The amendment in 2014 introduced an investment equity subscription right system as a new financing and capital policy method for investment corporations. The new system now enables financing through allocation to the existing investors (rights offering).

9 6 Disclosure by Real Estate Investment Corporations

(1) Disclosure by Listed Real Estate Investment Corporations

Listed real estate investment corporations (J-REIT), which are categorized as listed companies, are subject to the disclosure regulations under the FIEA, including issuance disclosure (securities registration statements, prospectuses) and continuous disclosure (annual securities reports). They are also required to disclose the details of their investment management by way of asset management reports as referred to in the ITA. In addition, for each accounting period, the corporate officers of an investment corporation must prepare an asset management report (ITA, art. 129, para. 2), and have such report, as well as the balance sheet and other financial statements, audited by an accounting auditor. After these materials are approved by the board of officers, the investment corporation must notify the investors of such approval without delay.

(2) Main Items of Asset Management Reports of Real Estate Investment Corporations

The following are the main items to be contained in an asset management report (ITCO, art. 71 through art. 75):

(i) Process of asset investment during the business period;

(ii) Changes of the business performance and status of property over the most recent three business periods;

(iii) Information on the real property, etc. held, including:

- (a) Location, lot number, etc.;
- (b) Prices of each property at the end of the current accounting period (appraised price, posted price, road price rating, published price for sale, etc.);
- (c) For each property with tenants, the occupancy rate and the total number of tenants at the end of the current accounting period, as well as the total rent income during the business period; and
- (d) Total sales during the business period;

(iv) Issues that the investment corporation should cope with;

(v) Material events that have occurred after the closing in relation to the status of the investment corporation;

(vi) Other matters necessary for clarifying the status of asset investment by the investment corporation during the business period;

(vii) Matters concerning officers, etc. of the investment corporation (*e.g.* name, position, duty, and the total amount of remuneration for corporate officers, supervisory officers or accounting auditors);

(viii) Matters concerning a liability insurance contract for officers of the investment corporation (the name of the insurer, the scope of the insured persons, and the outline of the terms of the contract); and

(ix) The names of the major investors (top ten investors), and the number of units they hold and their holding ratios.

(3) Disclosure on Management of Real Estate Investment Corporations

(i) Disclosure of Changes in the Valuation of the Real Property Held

The valuation method for the real property held by an investment corporation is prescribed in the certificate of incorporation, and in accordance with the principle of continuity, the method once adopted shall not be changed, except when it becomes no longer appropriate due to justifiable grounds and replacing it with another method is reasonably judged not to be detrimental to the protection of investors (JITA Real Estate Investment Corporations Rules, art. 5, para. 2). When changing the valuation method, it is necessary to clearly state the reasons for the change, the value calculated by the former method and that calculated by the new method at the end of the accounting period when the change has taken place, etc. in the asset management report for the said period (JITA Real Estate Investment Corporations Rules, art. 5, para. 3).

(ii) Disclosure on Long-term Repair Plans, Etc.

An asset management company must state in an asset management report for five accounting periods or more the amount of reserve set aside at the end of each accounting period based on the long-term repair plan, etc. for the real property, etc. held (JITA Real Estate Investment Corporations Rules, art. 11).

(iii) Disclosure of Borrowings

If an asset management company borrows any funds for a real estate investment trust, etc., it must state in the asset management report for the relevant accounting period the reason for each borrowing, the amount borrowed, the lender, security, the interest rate, and the repayment method and due date, etc. (JITA Real Estate

Investment Corporations Rules, art. 18).

(iv) Disclosure of Capital Expenditure

When an implementation plan for capital expenditure (excluding deductible capital expenditure such as a reserve for repair) has been determined, it is necessary to state the name and location of the subject real property, the purpose of the capital expenditure, the scheduled period and expected amount, and an estimated amount of increase in the book value of the real property in the asset management report and prospectus to be delivered to investors prior to the implementation of the capital expenditure (JITA Real Estate Investment Corporations Rules, art. 24, para. 1). The same matters must be disclosed on the basis of the actual figures after the capital expenditure plan has been completed (JITA Real Estate Investment Corporations Rules, art. 24, para. 3). If capital expenditure is necessary for any real property held due to a natural disaster or similar event, it is necessary to give public notice of this fact promptly by the method prescribed in the certificate of incorporation or disclose it by electronic or magnetic means and state the same in the asset management report (JITA Real Estate Investment Corporations Rules, art. 24, para. 2).

(v) Disclosure of Distribution of Money as a Refund of Contributions That Constitutes Distribution Accompanying Decrease in Contributions, Etc. Under the Tax Law

Investment corporations are allowed to pay money to investors as a refund of contributions that constitutes a distribution accompanying a decrease in contributions, etc. under tax law, up to 60% of the amount that remains after deducting the total amount of accumulated depreciation recorded as of the last day of the preceding accounting period from the total amount of accumulated depreciation calculated as of the last day of the current accounting period (ITA, art. 137, para. 1; JITA Real Estate Investment Corporations Rules, art. 43). When real estate investment corporations make a refund of contributions that constitutes a distribution accompanying a decrease in contributions, etc. under tax law, except in the case of making such refund of contributions continuously at every closing, they should give full consideration to matters such as the disclosure of distinction between a distribution of profit and a refund of contributions, the decision-making process, policy for making a refund of contributions, and matters that may have an impact on medium to long-term cash flow required for financing (*e.g.,* long-term repair plan). They are also required to clearly state in an asset management report that the amount paid is not a payment of distribution of profits but a refund of contributions that constitutes a distribution accompanying a decrease in contributions, etc. under tax law, and put notes, etc. in the relevant parts of the report regarding the objective grounds or reasons for the validity of the amount of refund of contributions (JITA Real Estate Investment Corporations Rules, art. 43-5).

If investment corporations make refunds of contributions that constitute distributions accompanying decrease in contributions, etc. under tax law continuously at every closing, they must announce the refund and disclose the refund policy in their certificates of incorporation, securities registration statements, annual securities reports, prospectuses, websites and other media, and put notes, etc. in the relevant parts of asset management plans. In addition, when disclosing the refund policy and putting notes, etc. in asset management plans and reports, they must present objective grounds therefor based on reasonable data, etc. (JITA Real Estate Investment Corporations Rules, art. 43-4).

Chapter 2 Incidental Businesses

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1 Businesses Other Than Financial Instruments Business

Operators of Type I financial instruments business or investment management business (hereinafter referred to as the “financial instruments business operators”) are unable to realize their full potential by engaging solely in the financial instruments business.

Therefore, under the Financial Instruments and Exchange Act (the “FIEA”), businesses that are difficult to separate, or cannot be reasonably separated from the financial instruments business are permitted as businesses that financial instruments business operators may conduct as long as there is no damage to the interests of society overall or the protection of investors.

Businesses other than the financial instruments business can be divided broadly into the following three categories:

(1) Business activities that may be conducted without notifying or obtaining the approval of the Prime Minister, as activities incidental to the financial instruments business (incidental business; FIEA, art. 35, para. 1);
(2) Specified business activities such as the money lending business or the real estate (building lots and buildings) transaction business that may be conducted by notifying the Prime Minister (notified business; FIEA, art. 35, para. 2, each item thereof); and
(3) Business activities, other than the financial instruments business, incidental business, and notified business, that may be conducted by obtaining approval from the Prime Minister (approved business; FIEA, art. 35, para. 4).

(for details, see Volume 1, Chapter 2, 2.2 “(3) Business Other Than Financial Instruments Business”).

This Chapter discusses those business activities that are incidental to the financial instruments business (incidental business).

Article 35, Paragraph 1 of the FIEA presents a list of business activities that are incidental to the financial instruments business. These business activities include:

(1) Borrowing or lending of securities, or intermediary or agency services therefor;
(2) Money loan incidental to a margin transaction;
(3) Money loan secured by securities that are deposited for safe custody from customers (limited to those specified by Cabinet Office Ordinance);
(4) Agency services for customers concerning securities;
(5) Agency service of the business pertaining to payment of earnings, redemption money or cancellation money with regard to the beneficiary certificates of an investment trust or foreign investment trust issued by an investment trust settlor company, or pertaining to delivery of the securities or other assets included in the trust property involving the said securities;
(6) Agency service of the business pertaining to distribution of money, distribution of refunds or residual assets, or payment of interest or redemption money with regard to securities (investment securities, investment equity subscription rights certificates, investment

corporation bond certificates, or foreign investment securities) issued by an investment corporation;

(7) Conclusion of a contract for cumulative investment (limited to those specified by Cabinet Office Ordinance);

(8) Provision of information or advice related to securities (excluding such advice provided under an investment advisory contract);

(9) Agency service of the business of financial instruments business operators, etc.;

(10) Custody of assets of registered investment corporations;

(11) Consultation to any other business operator with regard to the business transfer, merger, company split, share exchange, share transfer or share delivery, or intermediation therefor;

(12) Consultation to any other business operator with regard to the management;

(13) Sale and purchase of currencies and other assets (excluding crypto-and other assets; the same applies in (15)) prescribed by Cabinet Order as being related to derivative transactions (excluding transactions of securities-related derivatives), or intermediary, brokerage or agency service therefor;

(14) Sale and purchase of negotiable deposits and other monetary claims (excluding those that fall under the category of securities), or intermediary, brokerage or agency service therefor;

(15) Management of investment property as an investment in the following assets:

(i) Specified assets as provided for in the Act on Investment Trusts and Investment Corporations (excluding real estate and other assets specified by Cabinet Order); and

(ii) In addition to those provided for in (i) above, assets as prescribed by Cabinet Order;

(16) Provision of customer information acquired from the customer to a third party with the consent of the customer or any other provision of information held by the financial instruments business operator to a third party, which contributes to advancement of the financial instruments business that the financial instruments business operator conducts or to improvement of convenience for users of the financial instruments business operator (excluding an act that falls under (viii) above); and

(17) Acts to be performed by mainly utilizing the human resources, information and communications technology, equipment, and any other management resources retained by the financial instruments business operator pertaining to the financial instrument business conducted by the financial instruments business operator, which is specified by Cabinet Office Order as an act that contributes to the establishment of a sustainable society, such as an act for regional revitalization or improvement of industrial productivity

An agreement in connection with incidental business will not constitute a “contract for financial instruments transaction” (FIEA, art. 34), and consequently will not be covered by the duty of delivery of document prior to conclusion of a contract (FIEA, art. 37-3) or other duties.

2 Contents of Businesses Incidental to Financial Instruments Business

2 1 Securities Borrowing and Lending, or Intermediary or Agency Services Therefor

This business refers to conducting borrowing and lending transactions for consumption of securities wherein one party (lender) lends securities to the other party (borrower), and upon the expiration of an agreed period of time, the borrower returns to the lender securities of the same type, quality, and quantity as those borrowed, as well as providing the intermediary or agency services for such transactions. There are several types of borrowing and lending transactions for consumption of securities depending on the type of underlying securities, such as borrowing and lending transactions of share certificates, etc. and borrowing and lending transactions of bond certificates. Among them, the section below explains borrowing and lending transactions of share certificates, etc. These transactions are conducted, for example, in cases where a customer intends to sell share certificates, etc. in a standardized margin transaction and the financial instruments business operator needs to procure the share certificates, etc. from a securities finance company (for details, see Volume 2, Chapter 3, “10.1 Outline of Margin Transaction System”), or where a financial instruments business operator needs to procure share certificates, etc. from the existing shareholders for an additional secondary distribution by the over-allotment (for details, see Volume 2, Chapter 1, “4.5 Shares Related Matters”).

The following stipulations concerning borrowing and lending transactions of share certificates, etc. (*e.g.*, share certificates, share option certificates, bonds with share options, equity investment certificates, preferred equity investment certificates, and listed beneficiary certificates of investment trust, etc.) are prescribed in the “Rules Concerning Handling for Borrowing and Lending Transactions of Share Certificates, Etc. , which is a Self-Regulatory Rule of the JSDA (hereinafter referred to as the “Rules”).

(1) Explanation to and Confirmation with Individual Investors, Etc. (Rules, art. 4)

Prior to borrowing share certificates, etc. from an individual investor, etc., a financial instruments business operator must explain the basic structure of the borrowing and lending transaction of share certificates, etc. and risks associated with such transaction, and must try to make the individual investors, etc. understand the risks involved in such transactions, and confirm that the individual investor, etc. will engage in such transactions based on its own judgment and at its own risk.

(2) Conclusion of Agreements, Etc. (Rules, art. 5)

When conducting a borrowing and lending transaction of share certificates, etc., the financial instruments business operator must in advance enter into a master agreement concerning borrowing and lending transactions of share certificates, etc., which sets forth matters concerning, *inter alia*, the method of entering into individual agreements on borrowing and lending transactions of share certificates, etc., the method of paying lending fees, and deposit of collateral money, etc., as well as keep organized and retain these agreements.

An “individual transaction statement,” must also be delivered, etc. to the customer at the time of an individual borrowing and lending transaction of share certificates, etc., setting forth matters such as the contract date, the name of the issue(s), the lending volume, the lender, the borrower, the lending period, the lending fees, etc.

(3) Acceptance and Substitution of Collateral Money, Etc. (Rules, art. 6 and art. 7)

Before conducting a lending transaction of share certificates, etc. as the lender, a financial instruments business operator decides, by agreement with the customer (the borrower), whether the contract to be concluded is a lending transaction of share certificates, etc. with collateral in which the lender will receive collateral money or securities, etc. as the substitute for collateral money (hereinafter referred to as "securities substitute for collateral money"), or a lending transaction of share certificates, etc. without collateral in which the lender will not receive collateral in exchange for the delivery of the share certificates, etc.

(i) Cases Where a Financial Instruments Business Operator Lends Share Certificates, Etc.

A financial instruments business operator receives the collateral money or securities substitute for collateral money according to its agreement with the customer.

The financial instruments business operator may pay interest on the collateral money deposited by the customer.

If securities substitute for collateral money are deposited in lieu of collateral money, their price cannot exceed the amount obtained by multiplying the previous day's market price by a prescribed percentage.

(ii) Cases Where a Financial Instruments Business Operator Borrows Share Certificates, Etc.

A financial instruments business operator must provide collateral money or securities substitute for collateral money to the customer according to its agreement with the customer.

Furthermore, if the said customer is an individual investor, etc., the financial instruments business operator is required to deposit collateral (including collateral equivalents) except in cases where it receives prior or simultaneous written confirmation from the said individual investor, etc. that collateral does not need to be deposited.

In addition, whenever a financial instruments business operator engages in unsecured transactions, then regardless of the customer's attributes, it must adequately explain to the customer the risk factors involved in the said unsecured transactions.

(4) Acceptance, Etc. of Additional Collateral Money, Etc. (Rules, art. 8)

When the financial instruments business operator lends share certificates, etc. to a customer, the total market value of those share certificates, etc. is marked to market on a daily basis, compared to the total amount of the customer's collateral money and securities substitute for collateral money (multiplied by the applicable haircut), and if a shortage or excess results, the financial instruments business operator will receive additional collateral or return the excess collateral to the customer, according to its agreement with the customer.

(5) Return of Collateral Money, Etc. (Rules, art. 10)

Upon the expiration of the loan period, after the financial instruments business operator receives the return of the loaned share certificates, etc., it must promptly return the collateral money, etc. deposited by the customer.

(6) Receipt and Payment of Lending Fees (Rules, art. 11)

The lending fees that the financial instruments business operator receives from the customer when it makes a loan of share certificates, etc., and the lending fees paid to the customer when the financial instruments business operator borrows share certificates, etc. are determined according to its agreement with the customer.

(7) Reconciliation of Outstanding Amount of Lending, Etc. (Rules, art. 12)

When the financial instruments business operator engages in a borrowing and lending transaction of share certificates, etc., it must reconcile the outstanding balance of the share certificates, etc. subject to lending, collateral money, etc. with the customer at least once every three months.

(8) Enhancement of Internal Control Systems (Rules, art. 15 and art. 16)

Prior to commencing borrowing and lending transactions of share certificates, etc., financial instruments business operators must establish internal rules concerning borrowing and lending transactions of share certificates, etc. in order to ensure sound business management.

In addition, financial instruments business operators are required to have their internal administration supervisor periodically check under his/her responsibility whether borrowing and lending transactions of share certificates, etc. are being appropriately carried out in accordance with the internal rules.

2 2 Money Loan Incidental to Margin Transactions

This business refers to the business activity wherein a financial instruments business operator loans funds to a customer who will engage in margin transactions (for details, see Volume 2, Chapter 3, “10 Margin Transactions”).

(1) Content of Operations

A margin transaction shall mean a trade or other transaction in securities that is conducted with a financial instruments business operator extending credit to a customer (FIEA, art. 156-24).

A financial instruments business operator may itself provide the funds to be lent to the customer who seeks to engage in margin transactions, or may use a loan transaction with a securities finance company to procure the same.

The monetary amount that the financial instruments business operator lends to the customer is not the difference between the margin deposit that the customer has deposited and the contract price, but rather is the total amount of the contract price (TSE Brokerage Agreement Standards, rule 41, para. 1). Cash equivalent to the total amount of the contract price is not delivered directly to the customer, but rather the financial instruments business operator delivers the contract price of the customer directly through Japan Securities Clearing Corporation, a financial instruments clearing organization designated by the financial instruments exchange (settlement), on the delivery date of the transaction, thereby making the loan (TSE Clearing and Settlement Regulations, arts. 3 and 4).

As a result of this settlement through delivery, the financial instruments business operator receives the share certificates, etc. that have been purchased, but does not deliver them to the customer. Rather they are retained by the financial instruments business operator to secure the proceeds on the loan (TSE Agreement for Setting up Margin Transaction Account, art. 4). Consequently, a margin transaction between a customer and a financial instruments business operator is secured by both the margin deposit and the share certificates, etc. of the purchase.

(2) Customers Eligible for Loans

Since the loan is incidental to a margin transaction, customers who have submitted the “Margin Account Agreement” to a financial instruments business operator and have opened a “margin account” are eligible for loans.

(3) Clear Statement of Loan Conditions

When providing money loan to a customer, a financial instruments business operator shall appropriately present to the customer the terms and conditions of the loan, such as the loan interest rate, the term of the agreement or the loan and the repayment procedures.

(4) Repayment Procedures

Customers repay the purchase price from the proceeds received by reselling the share certificates, etc. that they have purchased in margin transactions, or they can simply hand over money equal to the purchase price that the customer borrowed to the relevant financial instruments business operator and receive the share certificates, etc. (delivery of cash on hand).

Margin deposits that a customer deposits with a financial instruments business operator are to be managed separately from the assets of the financial instruments business operator itself, but the share certificates, etc. purchased or the proceeds for share certificates, etc. sold (hereinafter "unsettled balances") are not held in separate custody from the financial instruments business operator's own assets.

Thus, if the financial instruments business operator were to go bankrupt, the customer may not be able to repay the margin loan by such means as physical delivery of cash or shares. In such cases, the customer must settle the deal in cash using the share price, etc. published by a financial instruments exchange in lieu of the ordinary repayment methods for margin transactions.

In this case, the customer's claim against the financial instruments business operator for the amount of money involved in the unsettled balances is not given any priority whatsoever, so even if a computational profit results from the transaction, there is a possibility that the customer will not be able to recover the same.

In addition, claims for payment of unsettled balances are not covered by the Investors Protection Fund.

2 3 Money Loan Secured by Securities Deposited for Safe Custody from Customers

This business consists of two types of business activities; the cashing business and the secured lending business (lending money to customers by accepting securities as collateral in order to meet their financing needs). The scope thereof is set forth in Article 65 of the Cabinet Office Ordinance on Financial Instruments Business (hereinafter referred to as "FIBCOO"). The section below explains the cashing business of a money reserve fund (MRF), which is major service in this business.

(1) Cashing Business

The cashing business refers to the activity of lending money to a customer who has requested cancellation of his/her beneficiary rights in an MRF, so that the customer will be paid the amount equal to the cancellation money on the date of cancellation request. Specifically, a money loan is provided to the customer in an amount equal to the cancellation money using the securities related to the cancellation request as collateral until cancellation money is paid on the day following the date of cancellation request.

(2) Terms and Conditions of the Loan, Etc.

(i) Lending Limits

This is the amount that each financial instruments business operator determines for the MRF based on whichever is less of the amount that can be returned that is calculated on the basis of the balance of each fund or JPY5 million (FIBCOO, art. 65).

(ii) Loan Interest

The loan interest is the net dividends of the MRF made up until the cancellation date from the date of cancellation request.

(iii) Loan Term

The term is the period from the day when the loan is made until the next business day.

(iv) Collateral

The collateral is the MRF subject to the cancellation request.

(v) Method of Repayment

The cancellation amount to be paid to the customer on the next business day following the loan is appropriated to the repayment.

(vi) Applications for Cashing

A written application is unnecessary. It is necessary, however, to confirm that the customer wishes to use the “cashing” system.

(3) Other

(i) Clear Statement of Loan Terms and Conditions, Etc.

When cashing is accepted, a document setting forth the loan limit and other lending conditions must be issued to the customer (if cashing via an ATM is used, it is also possible to divulge the loan terms and conditions, etc. on the ATM display screen, and make the agreement, etc. available to customers by placing copies near the ATM). The application can be accepted after confirming the customer’s intent. This can also be done through a comprehensive agreement concluded at the beginning of the transaction, etc. with the loan terms and conditions being clearly stated in the customer agreement, etc.

Additionally, the methods of lending and repayment and other major lending conditions must be posted in an appropriate location at the offices of the financial instruments business operator that handles such lending.

(ii) Preparation of Books, Etc.

Documents required for the cashing businesses such as books, etc. must be prepared, kept organized and retained.

(iii) Compliance Matters

When conducting cashing businesses, care is to be exercised with respect to the amount, the interest rate and the period in connection with lending and funding, in order to ensure the protection of customers, the credibility of the financial instruments business operator and the soundness of its operations, and there must be compliance with the various laws and regulations, etc. required from the perspective of protecting investors and the public interest.

2 4 Agency Service for Customers Concerning Securities

The agency service for customers concerning securities consists specifically of the following businesses: (1) acting as agent in receiving payments for and paying principal and interest on bonds; (2) introducing brokerage for share-related administrative tasks, (3) acting as the customer's standing agent concerning securities; and (4) acting as agent, etc. in receiving various payments to be made to customers. The section below explains the agency service regarding bonds and shares, etc. issued in Japan.

(1) Acting as Agent in Receiving Payments for and Paying Principal and Interest on Bonds

(i) Acting as Agent in Receiving Payments for Bonds

This business refers to the activity wherein a financial instruments business operator will receive payments (the purchase price) for those bonds as a designated payment-handling institution pursuant to its agreement with the issuer of the bonds, and pay the amounts it receives to the designated location on the payment date.

(ii) Acting as Agent in Paying Principal and Interest on Bonds

This business refers to the activity of paying principal and interest on the bond on behalf of the bond issuer or the payment agent (banks, trust companies) upon the request of the bondholder, etc.

Overall, the payment of principal and interest is made in succession as follows:

Issuer → Payment Agent → Account Management Institution → Owner of the Bonds

To facilitate the chain above, the owner of the bonds delegates to the account management institution the authority to demand and receive the principal or interest and the account management institution further delegates the same to entities such as the JASDEC and the Bank of Japan.

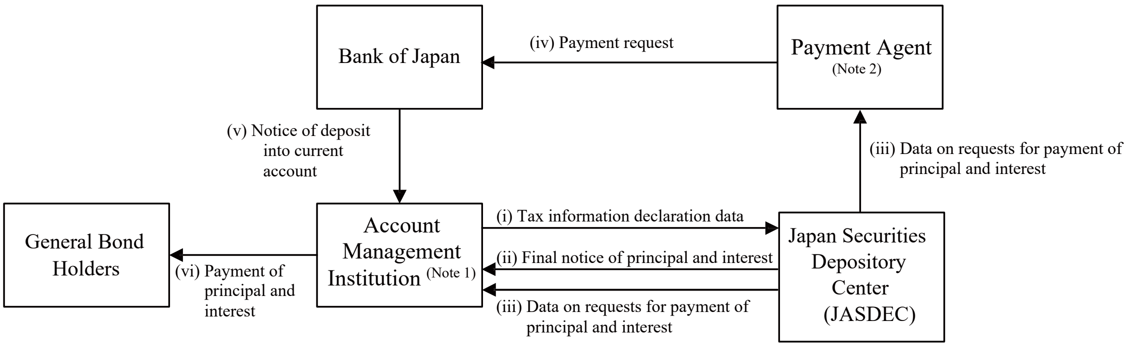
The following is an explanation of the agency service for paying principal and interest on bonds under the General Bond Book-Entry Transfer System and the Government Bond Book-Entry Transfer Clearing System.

(a) General Bond Book-Entry Transfer System

The general bond book-entry transfer system makes the transfer of rights in general bonds, namely, corporate bonds, municipal bonds, public corporation bonds and yen-denominated foreign bonds, completely paperless, instead of having to issue bond certificates in paper form, pursuant to the "Act on Book-Entry Transfer of Corporate Bonds, Shares, Etc." (hereinafter the "Book-Entry Transfer Act").

Under this system, a newly issued bond shall be issued as a book-entry transfer bond of the Japan Securities Depository Center upon the issuer's agreement to the issuance of the bond as a book-entry transfer bond.

The payment of principle and interest under this system (involving the Japan Securities Depository Center, Inc. (JASDEC)) is processed as follows.



(Notes) 1. "Account Management Institution" refers to financial instruments business operators, banks, etc.
2. "Payment Agent" refers to those designated by the Japan Securities Depository Center as a payment agent (Ordinarily, this is a bank that has been entrusted by the corporate bond issuer with administrative functions such as managing the bond register)

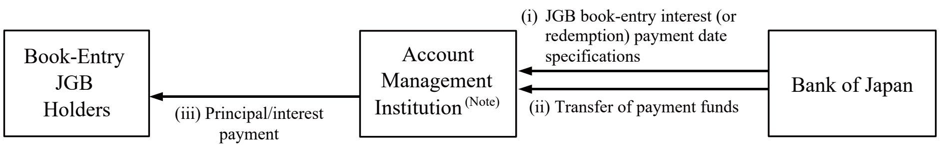
(b) Government Bond Book-Entry Transfer System

The government bond book-entry transfer system is a system wherein the delivery (clearing) of government bonds traded via financial instruments business operators, banks, etc. (account management institution) is carried out through book-entry transfer, that is, by transferring those bonds on the transfer account books kept at the Bank of Japan (book-entry transfer institution).

Pursuant to the Book-Entry Transfer Act, no bond certificate is issued for Japanese government bonds, and consequently persons wishing to acquire a new issue of book-entry government bonds must open an account with an Account Management Institution prior to the purchase in order to process the book-entry transfer of the bonds.

Principal and interest payments for book-entry government bonds are paid from the Bank of Japan to the account management institutions and finally to the government bond holders.

The clearing for book-entry transfer government bonds is processed as follows.



(Note) Account Management Institution: financial instruments business operators, banks, etc.

(2) Introducing Brokerage for Share-Related Administrative Tasks

This business refers to the activity wherein a financial instruments business operator introduces brokerage for the share-related administrative tasks listed below to the issuing company or the JASDEC at the request of a customer.

(i) Forwarding the request for purchase or additional purchase of odd-lot shares

A shareholder's request filed with a financial instruments business operator is forwarded to the JASDEC and then to the issuing company (the administrator of the shareholder registry).

(ii) Handling a request for notice to individual shareholders (for the exercise of the right of minority shareholders)

The right of minority shareholders covers the right to request inspection and copying of the articles of incorporation, share handling regulations, minutes of shareholders meeting

and other documents, and the right to submit proposals for shareholders meetings.
(iii) Processing the exercise of share options (including bonds with share options, share options, etc.)
(iv) Acting as agent for filing a notification of change of address and conducting other share-related administrative tasks

(3) Acting as the Customer's Standing Agent Concerning Securities

This business refers to conducting all or a portion of the administrative tasks enumerated below as the agent or proxy of an investor residing outside of Japan ("foreign investors") based on the contract of entrustment concluded with the investor. As companies issuing shares or bonds request that foreign investors appoint a standing agent or select a provisional address in Japan, foreign investors who make an investment in Japan appoint a standing agent who is a resident in Japan and entrust the agent with management of securities they acquired.

Also, the financial instruments business operator must collect a document from a customer evidencing the entrustment (power of attorney) when the business operator is entrusted by the customer with administrative tasks relating to standing proxy service concerning securities (JSDA Rules Concerning Acceptance, Etc. of Deposit of Securities, art. 7). Moreover, an entrusted financial instruments business operator may collect a standing agent fee from the customer in the amount determined by the financial instruments business operator.

The contents of the major operations include:

(i) Investor Account Management Required to Conduct Standing Agent Functions
(ii) Agent for Transferring Title to Securities and Receiving Deposits
(iii) Agent for Receipt and Management of Dividends, Interest, Redemption Money, Etc.
(iv) Exercise of Rights to Share Options and Bonds with Share Options, Etc.
(v) Execution of a Voting Right by Proxy
(vi) Agent for Administrative Procedures Concerning the Acquisition, Disposition or Transfer/ Assignment of Securities Under the Laws Including the Foreign Exchange and Foreign Trade Act
(vii) Agent in Applying for Reduction of or Exemption from Withholding Tax Under a Tax Treaty
(viii) Agent in Repurchase Requests for Odd-Lot Shares
(ix) Report

(4) Acting as Agent in Receiving Various Payments to Be Made to Customers

This business refers to the activity wherein a financial instruments business operator receives money to be paid to a customer from the issuing company, etc. on behalf of the customer through the bank account held in the name of the financial instruments business operator, and then remits such money to the securities account held by the customer:

(i) Dividends on shares;
(ii) Proceeds on repurchase associated with a repurchase request that is made in connection with odd-lot shares;

(iii) Adjustment payments in association with exercise of share options;
(iv) Cash to be paid as a result of the consideration for a merger, etc., which became permissible by relaxation of consideration regulation; and
(v) Cash to be paid as consideration in a buyback request on shares with put options, or as consideration in shares subject to call.

All of these activities are limited to receiving cash in connection with the portion of shares (and in connection with (iii) the portion involving share options) that a financial instruments business operator holds in safe custody on the account of the relevant customer.

2 5 Agency Service of the Business Pertaining to Payment of Earnings, Redemption Money or Cancellation Money with Regard to the Beneficiary Certificates of an Investment Trust or Foreign Investment Trust or Delivery of Securities or Other Assets in the Trust Property Relevant to the Securities

This service refers to cases where a financial instruments business operator, under an agreement concluded with the settlor (settlor company) for each issue of investment trust, receives payment of earnings, redemption money or cancellation money, or receives delivery of securities or any other assets in the trust property relevant to the investment trusts, and pays over these amounts or delivers these assets to the trading accounts of the customers, etc. (beneficiaries). The same applies to foreign investment trusts (for details, see Chapter 1, "3-3 Investment Trusts Under Instructions from the Settlor and Without Instructions from the Settlor").

2 6 Agency Service of the Business Pertaining to Distribution of Money, Distribution of Refunds or Residual Assets, or Payment of Interest or Redemption Money with Respect to the Securities (Investment Securities, Investment Equity Subscription Rights Certificates, Investment Corporation Bond Certificates, or Foreign Investment Securities) Issued by an Investment Corporation

An investment corporation only functions as a vehicle for asset management, and is required to outsource the actual asset management operations, asset custody operations and other general administrative affairs.

This service refers to the activity wherein a financial instruments business operator conducts, with respect to the securities issued by an investment corporation, distribution of money, distribution of refunds or residual assets or payment of interest or redemption money to the investors on behalf of the investment corporation (for details, see Chapter 1 "Investment Trusts and Investment Corporations Business").

2 7 Conclusion of the Cumulative Investment Contracts

This business refers to concluding a cumulative investment contract wherein "a financial instruments business operator (limited to those engaged in the securities, etc. management business) receives deposit money from a customer, and in exchange of the said money, sells securities to the customer continuously on dates designated in advance" (FIEA, art. 5, para. 1, item 7) so as to have them acquired by the customer.

(1) Structure of a Cumulative Investment Contract

Under a cumulative investment contract, a financial instruments business operator temporarily purchases securities for the amount of money paid in by a customer or the returns or redemption money derived from the securities deposited by the customer (hereinafter referred to as the "amount paid in, etc."), and then sells the securities thus purchased to the customer in proportion to the amount paid in, etc., thereby having the customer acquire the securities.

In the event of a joint purchase such as cumulative stock investment and in the case where the total amount paid in, etc. is less than the purchase price (or a whole integral multiple thereof; in the case of cumulative stock investment, the market value at the financial instruments exchange, multiplied by the share unit number) for the securities that are to be purchased by the customer, the purchase will be made with funds that are combined with payments made by other customers or those of the financial instruments business operator, and ownership of the securities will be shared with other customers, etc. (in the name of the financial instruments business operator).

In this event, if the quantity increases, the portion shared by the customer will also increase on each occasion. When the aggregate of the cumulative paid in amount reaches the purchase price of a trading unit of securities (or 100 shares in the case of cumulative stock investment), securities to be owned by the customer will be identified, and the customer shall have sole title thereto (in the name of the customer).

<<Example of purchase>>

Cumulative Investment Contract for Purchasing Company A's shares for 10,000 Yen Each Month

(i) A customer purchases 100 shares (share unit number) jointly with other customers, etc., and (ii) when the number of shares allocated to the customer among the shares thus jointly purchased reaches the share unit number, the customer acquires sole ownership for those shares.

	Amount paid in	Company A's share price	Number of shares acquired	Number of shares in joint ownership	Number of shares in sole ownership
1st month	JPY10,000	JPY250	40 shares	The total number of shares acquired is 40 shares, which is less than the share unit number. → All shares are in joint ownership	0 shares
2nd month	JPY10,000	JPY200	50 shares	The total number of shares acquired is 90 shares (40 shares (acquired in the 1st month) + 50 shares), which is less than the share unit number. → All shares are in joint ownership	0 shares
3rd month	JPY10,000	JPY400	25 shares	The total number of shares acquired is 115 shares (90 shares (acquired by the 2nd month) + 25 shares), of which 100 shares constitute the share unit number and are allocated to sole ownership of the customer. The remainder (115 shares – 100 shares = 15 shares) is in joint ownership.	100 shares
4th month	JPY10,000	JPY300	33.3 shares	The total number of shares acquired is 48.3 shares (15 shares (acquired by the 3rd month) + 33.3 shares), which is less than the share unit number. → All shares are in joint ownership	100 shares

(Fees, etc. are disregarded)

(2) Details of a Cumulative Investment Contract

A cumulative investment contract must provide for the following matters.

(i) Eligible Securities

The types of securities that may be handled as part of the financial instruments business operator's cumulative investment businesses include bonds such as government bonds and local government bonds, investment trust beneficial certificates such as unit-type and additional offering type investment trusts, foreign investment trust beneficiary certificates, investment securities, foreign investment securities, listed share certificates, listed investment trust beneficiary certificates (ETFs) and listed investment securities (J-REIT).

(ii) Method of Purchasing Securities

The securities purchased are, in principle, limited to new issues (except for share certificates, listed investment trust beneficiary certificates and listed investment securities), and the type of securities as well as how to allocate the customer's deposit among the securities purchased must be determined in advance under the agreement.

Nevertheless, in cases where there is no new issue on the predetermined issue date under the agreement and another suitable new issue cannot be located, the financial instruments business operator may purchase securities of the same type that have already been issued, as set out in advance in the agreement.

The financial instruments business operator purchases the securities without delay once the amount paid in, etc. reaches the purchase price (or an integral multiple thereof) of the new securities to be purchased for the customer.

Customers can pay the whole or part of the purchase price at any time and cancel a purchase of securities at any time by so instructing the financial instruments business operator.

The purchase price is basically determined by the type of securities as follows:

(a) For bonds, the price for public offering or secondary distribution;
(b) For investment trust beneficiary certificates, the price set forth below:
  (i) for a unit-type investment trust, the price for public offering;
  (ii) for an additional offering type bond investment trust, the net asset value as of the purchase date or the day immediately preceding the purchase date;
  (iii) for an additional offering type investment trust other than those mentioned in (ii) above, the net asset value as of the day immediately preceding the purchase date (in the case of an additional offering type investment trust in which the partial redemption charge is collected at the time of purchase, the amount obtained by adding the said partial redemption charge to the net asset value); and
(c) For foreign investment trust beneficiary certificates, the net asset value on the date immediately preceding the purchase date;
(d) For investment securities or foreign investment securities, the price prescribed in the certificate of incorporation or any other document equivalent thereto; and
(e) For listed share certificates, listed investment trust beneficiary certificates or listed investment securities, the market price at the financial instruments exchange designated in advance in the contract (where there are several contract prices at the exchanges of the issue concerned, their weighted average price).

(iii) Management Method for Amounts Paid-in, Etc.

The amounts paid in, etc. shall be managed separately as cumulative investment deposits, and no payment will be made to customers of interest or other gains on these deposits.

(iv) Transfer of Ownership

In the case of joint purchases such as cumulative stock investment, when the serial codes and numbers of the securities purchased by a customer are identified, these securities which have been jointly owned in the name the financial instruments business operator come under sole ownership of the customer (in the case of cumulative stock investment, these securities are held in the name of the customer).

(v) Method of Custody

Deposit balances, etc. for securities received under cumulative investment businesses must be held in custody separately from other securities. In this case, securities that are held jointly by the financial instruments business operator and customers must be further segregated.

(vi) Cancellation

Under a cumulative investment contract, the customer may make a cancellation request at any time.

(3) Cumulative Stock Investments

Cumulative stock investment is a system whereby investors deposit funds with the financial instruments business operator, and the financial instruments business operator uses that pool of funds in order to purchase a predetermined issue of shares, etc. on a certain date each month (cumulative investment through joint purchases).

The investor signs a cumulative stock investment contract, etc. with a financial instruments business operator and selects a share from the list of shares pre-selected by the financial instruments business operator. Using the amount paid in, etc. by each of the investors who selected the same issue, on a predetermined date every month, the financial instruments business operator will acquire the said shares, etc. in a joint purchase.

This enables investors to purchase shares, etc. periodically and continuously with a fixed amount of money (dollar-cost averaging method): even a relatively small amount. At the point at which the cumulative stocks purchased become a round-lot, the investor can become an ordinary shareholder by changing the cumulative stock investment account into a custodial account (for details, see Volume 2, Chapter 3 “7 Cumulative Stock Investments”).

(i) Exemption from the Insider Trading Regulations

If a predetermined amount is paid periodically for the automatic purchase of a certain shares under a cumulative stock investment program, this will be covered under the Cabinet Office Ordinance on Restrictions on Securities Transactions, Article 59, Paragraph 1, Item 9, and the regulations concerning insider trading (FIEA, art. 166 and art. 167) will not apply (for details, see Volume 1, Chapter 2, “12.4 Insider Trading”).

Thus, even if a corporate insider who has knowledge of material facts (insider information) purchases shares before the information becomes publicly available, as long as the transaction is a part of the periodic purchases under a cumulative stock investment program entered into before the information became known to the party, the transaction will not violate the insider trading regulations.

Exemption is allowed only when the purchase of shares under the cumulative stock investment program satisfies all of the following conditions:

a. The purchase is made according to a predetermined plan;
b. The purchase is not based on an individual investment decision;

c. The purchase is part of a series of continuing purchases; and
d. The customer's total paid-up amount for a single issue is less than JPY1 million per month.

(ii) Non-Exempted Transactions

An exception to the rule would be "automated purchases" that are exempted from the insider trading regulations.

However, the following transactions are not exempted from the insider trading regulations and thus need to be monitored diligently:

- **Sale of a customer's shares in the said issue;**
- **Purchases made with irregular payments; and**
- **Conclusion or amendment of a cumulative stock investment contract after learning of material facts, and making a purchase under the said contract before the facts are publicly announced.**

(iii) Customer Payment Amounts

Only customer payments of less than JPY1 million per month for a single issue are exempted from the insider trading regulations. When the said customer has cumulative stock investment contracts with multiple financial instruments business operators designating the same issue, the total of all payments made by the investor for the shares must be less than JPY1 million in order to be exempted from the insider trading regulations.

Because a financial instruments business operator cannot check the investor's transactions with other financial instruments business operators, it must without fail notify the investor at the time of concluding the contract that "if the total amount of the amount paid in under the contract with the financial instruments business operator and the amount paid in, etc. under any other contracts with any other financial instruments business operators for the purchase of the same shares becomes JPY1 million or more, it will be subject to the insider trading regulations".

2 8 Provision of Information or Advice Related to Securities

This business covers the following activities in which a financial instruments business operator provides a customer with expertise and know-how in connection with securities. Providing advice, etc. under a contract for receiving remuneration by giving advice on the value of securities (investment advisory contract) constitutes the investment advisory business, and requires registration.

(1) Provision of Information, Advice, Etc. Related to Business Pertaining to Securities or Other Financial Instruments Businesses

A business that offers, *inter alia*, information or advice on financial instruments businesses, and provides information and know-how, etc., which specifically refers to information and advice on financial strategies, etc. and asset management, etc. that the financial instruments business operator has accumulated through its operations in the financial instruments business.

(2) Provision of Information and Advice, Etc. Regarding the Procedures for Applications to Various Institutions in the Case of the Issuance of Securities, Etc.

Offering, *inter alia*, information and advice on various procedures for the issuance and listing, etc. of securities (note that there is a potential conflict with the Administrative Scrivener Act if application documents are prepared for submission to administrative agencies on behalf of an issuer), specifically, offering information and advice on the issuance of new shares and public offerings, etc., and regarding other finance issues.

2 9 Agency Service of the Business of Any Counterparty Financial Instruments Business Operator, Etc.

This business refers to the agency services (excluding 2-5. above) for the financial instruments business and the incidental business (excluding the business activities involved in the agency service mentioned herein) of another financial instruments business operator, etc. (including the registered financial institution business conducted by a registered financial institution), which such principal financial instruments business operator is permitted to conduct.

For example, a financial instruments business operator may engage in the cumulative investment business as an agent of another financial instruments business operator, etc.

(1) Agency Service Relating to Cumulative Investment Business

This business refers to the brokerage service for introducing customers (the introduced customer) to a financial instruments business operator that carries out a cumulative investment business (hereinafter a “delegating financial instruments business operator”), or carrying out administrative work on behalf of a delegating financial instruments business operator, such as delivering purchase proceeds between the business operator and the introduced customer.

The major agency services relating to cumulative investment business are as follows:

- **Receiving of applications for cumulative investment and other related documents;**
- **Receiving applications to purchase securities;**
- **Receiving payments;**
- **Receiving applications to cancel cumulative investment contracts; and**
- **Returning securities or paying refunds in association with return sales of securities.**

Moreover, a financial instruments business operator that engages in agency activities relating to cumulative investment business must explicitly state to customers requesting a cumulative investment contract that the agreement will be entered into with the delegating financial instruments business operator, and obtain the customer’s consent to the same.

(2) Relationship with Delegating Financial Instruments Dealer

The financial instruments business operator providing the agency services relating to the cumulative investment business must enter into an agreement with the delegating financial instruments business operator which explicitly states that the agency services shall be limited to those involving intermediary activities and clarifies who has responsibility to the introduced customer.

A system must also be implemented in order to have delivery and receipt of money, etc. with the delegating financial instruments business operator conducted accurately and in a timely manner.

2 10 Custody of Assets of a Registered Investment Corporation

This business refers to the activity wherein a financial instruments business operator or a trust company, etc. acts as an asset custody company and keeps in custody the assets of a registered investment corporation which is restricted from retaining its own assets (Act on Investment Trusts and Investment Corporations, art. 208, para. 2).

Since the financial instruments business operators mentioned here are limited to those that carry out securities, etc. management business, this business can be said to constitute an incidental business concerned only with a Type I financial instruments business operator that carries out management business of securities, etc. (for details, see Chapter 1 "Investment Trusts and Investment Corporations Business").

2 11 Other Incidental Businesses

In addition to the above businesses, (i) the provision of consultation to any other business operator with regard to a business transfer, merger, company split, share exchange, share transfer or share delivery, or intermediation in connection with the same (activities in connection with mergers and acquisitions, etc.); (ii) the provision of consultation to any other business operator with regard to management (management consultant activities, etc.); and (iii) sale and purchase of currencies, etc. have been prescribed in the FIEA (FIEA, art. 35, para. 1).

The Act Partially Amending the Banking Act, etc. for Ensuring Reinforcement and Stability of Financial Functions in Response to Socioeconomic Changes due to the Impact of the COVID-19 Infection (Act No. 46 of May 26, 2021), which was enacted in 2021, has additionally introduced the following acts as incidental business activities: acts to be performed by mainly utilizing the human resources, information and communications technology, equipment, and any other management resources retained by the financial instruments business operator pertaining to the financial instrument business conducted by the financial instruments business operator, which are specified by Cabinet Office Order as acts that contribute to establishment of a sustainable society, such as regional revitalization or improvement of industrial productivity (*e.g.*, consulting and business matching, registration-based staffing services, sale of apps and IT systems developed for internal use, data analysis, marketing and advertising, and monitoring services for the elderly) (FIEA, art. 35, para. 1, item 17; FIBCOO, art. 66-2).

Moreover, as well as these explicitly listed business activities, a financial instruments business operator can engage in other business incidental to the financial instruments business including (1) safe-deposit box business, and (2) agency business for receiving payment of public utility charges, etc., as "any other business incidental to financial instruments business," as prescribed in the FIEA, the main paragraph of art. 35, para. 1 (discussed later).

(1) Safe-Deposit Box Business

This business refers to the business of providing customers of financial instruments business operators with a safe and convenient place to store customers' assets. Under the agreement of service, the prescribed fees are collected and safety-deposit boxes are lent out.

(2) Agency Service for Receiving Payment of Public Utility Charges, Etc.

This business refers to the business in which pursuant to the contracts of a financial instruments business operator with a customer and a service provider company, the financial instruments business operator, on behalf of the service provider company, collects cash from the customer by means of automatic cancellation of MRF of a cash management account (*shōken sōgo kōza*) of the customer, or through physical receipt of cash at a counter for the purposes of payment of the public utilities charge or the credit card bill, etc. and then distributes the cash to the service provider company.

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1 Introduction

1 1 Business Organizations

Business can be conducted as a sole proprietorship. A fairly large-scale business can probably be operated if employees are hired and funds are borrowed. However, there are limits. A form of joint enterprise is required if one intends to operate a significantly large-scale business by concentrating capital and labor, and diversifying risks. A partnership (Civil Code, art. 667, *et. seq*.) would be one option.(Note) Because all the partners are tied together by the partnership agreement, the mutual relationships become complicated if the number of partners increases. Also, each partner must assume unlimited liability if the business fails, as would the owner of a sole proprietorship.

(Note) Cooperative associations, such as agricultural cooperatives and consumers cooperatives, are juridical persons and not partnerships in the meaning discussed in this section.

[1] Laws Concerning Companies

Before the current Companies Act (Act No. 86 of 2005) was enacted, companies in Japan were governed by Part II of the Commercial Code (Act No. 48 of 1899), which delineated general partnership companies (*gōmei kaisha*), limited partnership companies (*gōshi kaisha*), and stock companies (*kabushiki kaisha*). In addition, the former limited liability company structure was governed by the Limited Liability Companies Act (Act No. 74 of 1938). Other relevant laws had also been enacted concerning companies, including the Act on Special Provisions on the Commercial Code Concerning Audits, Etc. of Stock Companies (Act No. 22 of 1974).

In June 2005, the Companies Act was enacted. This Act has been in force and effect from May 2006, and with its enforcement all of the above mentioned laws have been abolished. While the laws enacted prior to the Second World War were all written in literary language with Katakana characters, the Companies Act is written in normal vernacular Japanese, which is the result of progress that has been achieved in modernizing forms as well as the content of the Companies Act.

Since an effort was made to provide stipulations that would be as easy to understand as possible, the Companies Act became a voluminous code extending to almost 1,000 Articles. Nevertheless, it contains a number of clauses under which the detailed provisions are left to stipulation by ministerial ordinances of the Ministry of Justice. While amendments to laws require the decisions of the Diet, ministerial ordinances do not and thus are amended frequently. As of the present time, the following are the three ministerial ordinances that the Ministry of Justice has released which cover this new Act (with their abbreviated titles used in this Manual stated in parentheses):

1. Ordinance for Enforcement of the Companies Act (Companies Ordinance) (Ministry of Justice Ordinance No. 12 of 2006)
2. Regulation on Corporate Accounting (Accounting Regulation) (Ministry of Justice Ordinance No. 13 of 2006)

3. Electronic Public Notice Rules (Ministry of Justice Ordinance No. 14 of 2006)

The Companies Act underwent major amendments in 2014 and 2019. This Chapter also covers the details of these amendments.

1 2 Companies

In the current economic world, companies are the prevailing form of business organization. The Companies Act gives legal sanction to the following four forms: stock companies (*kabushiki kaisha*); general partnership companies (*gōmei kaisha*); limited partnership companies (*gōshi kaisha*); and limited liability companies (*gōdō kaisha*) (Companies Act, art. 2, item 1).(Note) Each type has its own characteristics such as, for example, how liabilities are assumed when the business fails, the complexity of the organization, etc.

(Note) Under the Commercial Code prior to the enactment of the Companies Act, a limited liability company (*yūgen kaisha*) also existed as a corporate vehicle (for details, see Column [2] below).

The "mutual company" seen in the insurance industry is an organization that is similar to a cooperative association, and is not classified as a "company."

(1) Types of Companies

(i) Stock Companies (*kabushiki kaisha*)

A member (shareholder) does not assume any responsibility for liabilities of the company. In principle transfer of equity interest (shares of stock) is unrestricted. In exchange, the law intervenes to regulate the internal relationship of the company in detail.

(ii) General Partnership Companies (*gōmei kaisha*)

The partners (Note) not only assume responsibility for investing in the company but also assume direct, joint and unlimited liability to creditors (Companies Act, art. 576, para. 2 and art. 580, para. 1). For instance, if a general partnership company with 2 partners, Member A and Member B, is unable to pay a debt of JPY10 million, the creditor may demand payment for the debt from either A or B. If A receives the claim, A must pay JPY10 million from his/her personal assets (A has the right to demand reimbursement from B.).

(Note) In everyday language, a '*shain*' means an employee of a company, but in legal terminology a '*shain*' refers to a member (equity holder) in a company. In a stock company, the shareholder is a '*shain*.'

(iii) Limited Partnership Companies (*gōshi kaisha*)

At least one partner (unlimited partner) assumes the same liabilities as a partner in a general partnership company. In addition, there must be at least one equity investor (limited partner) whose liability to creditors of the company is limited to the amount registered (Companies Act, art. 576, para. 3 and art. 580, para. 2).

(iv) Limited Liability Companies (*gōdō kaisha*)

All of the partners of this type of company are limited partners (Companies Act, art. 576, para. 4). This corporate vehicle has been introduced as a new vehicle with the enactment of the Companies Act, and is modeled after the limited liability company (LLC) in the United States of America. This vehicle allows for freedom in operation of a company with only a small number of partners, while at the same time holding them harmless from unlimited liability in the event that the business fails. For these reasons the limited liability company is well suited for a venture business or a joint venture company.

(2) Membership Companies

The companies enumerated in (ii), (iii) and (iv) above are collectively referred to as “membership companies” (Companies Act, art. 575, para. 1). An equity interest would be the equivalent of a share of stock in a stock company, but unlike shares of stock the size of the interests need not be the same. These three corporate vehicles share the same characteristic of the equity interests normally being owned by only a small number of members of the company. In principle any of the members of the company may represent the company and execute its business, but this work may be delegated to certain members (*ibid*., art. 590 and art. 591). Also, individuals will not go into business with absolutely anyone since competence or incompetence in management will have a direct impact on all members of the firm, and consequently consent from all other members of an equity interest is required in order to transfer an equity interest (although an equity interest of a limited liability partner who does not participate in execution of the business may be assigned as long as consent is obtained from all members who do participate in the execution of the business (*ibid*., art. 585)).

A relatively large degree of discretion is possible in determining the articles of incorporation concerning the internal relationships of a membership company. By entry into the articles of incorporation it is possible to prescribe that, in connection with an assignment as mentioned above, for example, that consent of all members is required, that no consent is required, or that consent from certain specified members is required. Moreover, although a limited partner is only permitted to make the contribution in the form of cash or other property (Companies Act, art. 576, para. 1, item 6), but unlimited partners are not encumbered by this restriction and may make their contribution in the form of services or their name (contribution of reputation).

Distribution of company property to a member is also at the free discretion of a general partnership company or limited partnership company that has unlimited liability partner, and is not prohibited when the company is running at a loss. Since a limited liability company has no unlimited partners, however, it is not permitted to distribute assets or refund equity interests unless the company is earning a profit (Companies Act, art. 628, *et seq*.).

[2] Limited Liability Companies (*yūgen kaisha*)

Limited liability companies (*yūgen kaisha*) existed in a form of mini stock companies where the members enjoyed preferential treatment of limited liability (2-2 below) and great freedom was allowed in relation to internal matters. Limited liability companies (*yūgen kaisha*) were outnumbering stock companies, and some of the limited liability companies (*yūgen kaisha*) were of a very large scale owing to the fact that accounting auditors were not required to be placed.

With the enactment of the Companies Act, it is no longer possible to incorporate limited liability companies (*yūgen kaisha*) in the form that they previously existed. Nevertheless, former limited liability companies (*yūgen kaisha*) may continue to exist as exceptional limited liability companies (*tōkurei yūgen kaisha*). They are stock companies but must contain the words “limited liability company (*yūgen kaisha*)” within their corporate trade name ("Act on Arrangement of Relevant Acts Incidental to Enforcement of the Companies Act"; hereinafter referred to as the "Arrangement Act"; Act No. 87 of 2005; art. 2, para. 1 and art. 3, para. 1). By including these words, they will be treated in the same manner as the previous limited liability company (*yūgen kaisha*) in most respects, including, for example, that they will not have a fixed term of office for their directors (Arrangement Act, art. 18), nor will they be required to make public notice of their financial statements (*ibid*., art.28).

Exceptional limited liability companies become ordinary stock companies when they amend their articles of incorporation to change their trade names to ones that includes the characters spelling out stock companies (*kabushiki kaisha*) and register to that effect (Arrangement Act, art. 45 and art. 46). Upon such changes, the treatments they received as limited liability companies (*yūgen kaisha*) will no longer be allowed. The directors' terms of office will be two years and although companies that restrict the transfer of all shares may extend such terms of office to ten years, they still need to amend their articles of incorporation (Companies Act, art. 332, para. 1 and para. 2; some companies are not allowed to extend the directors' terms of office). Moreover, they will be required to make public notice of their financial statements (*ibid*., art. 440).

(3) Juridical Personalities of Companies

The above-mentioned four types of companies, stock companies, general partnership companies, limited partnership companies, and limited liability companies, are all juridical persons (Companies Act, art. 3). In other words, rights are held and obligations are owed under the name of a company, and therefore, the company engages in transactions as a separate entity from the members. Although juridical person also includes foundations ("*zaidan hōjin*"), companies are classified as an incorporated association ("*shadan hōjin*") because they are associations of people. Also, since it is a company's objective to generate profits for itself and then distribute the generated profits to the company's members, a company is a for-profit incorporated association.

Juridical personality is a technique for handling legal relationships simply and conveniently. It would be very complicated to handle the rights and obligations arising from transactions conducted by the company if they were to be apportioned to each of the members in the company. The system of juridical person must also be utilized in good faith. If an individual establishes a company and misuses it in order to avoid seizure, or commingles assets, or handles the books and the like without separating the company from the individual, the individual may be subject to personal liability (denial of juridical personality).

2 Characteristics of a Stock Company

2 1 Stock

The status of a '*shain*' (equity interest) in a stock company takes the form of stock. Stocks are equally divided units, and a shareholder investing a large amount of funds into a company holds a large number of shares of stock, while if the price for a share of stock is low, a person with only a small amount of funds available will also be able to invest. Collecting funds from a wide range of people in this way facilitates operating a business on a large scale. Also, the relationship between the company and the shareholders (such as dividend of surplus, allotment of new shares, voting rights, and so forth) can be handled in proportion to the number of shares held, which is very simple and convenient.

Shares of stock generate various rights for the shareholders against the company. The shares represent the status of the shareholders. Since shares can be transferred by physical delivery or by changing the registered ownership in the registry of shares, distribution is an extremely easy thing to accomplish. Since shares can be sold at any time, people feel comfortable when investing in shares.

2 2 Limited Liability of Shareholders

A shareholder subscribing to 500 shares of stock at JPY10,000 per share has no obligation once the shareholder has paid in JPY5 million (Companies Act, art. 104). The shareholder has no obligation to make any additional contributions even if the company is in need of funds. The shareholder has no obligation to pay debts to creditors of the company even if the company fails to pay its debts. This is the principle that shareholders have limited liability. It should be noted that, differing from a limited partner in a limited partnership company, or a member of a limited liability company (who as stated in 1-2 above have a liability to creditors to the extent of the monetary amount that is registered), a shareholder has absolutely no obligation to outsiders of the company.

In a sole proprietorship or a general partnership company, failure of the business causes significant personal liabilities. In contrast, if one invests in stocks and conducts business as a stock company, and the company goes bankrupt, the stocks would be worthless but one's personal assets would be intact. A stock company has the advantage of allowing an entrepreneur to foresee and disperse risks, and facilitates rebuilding of the entrepreneur's business. Also, an existing company which plans to launch a new business can do so by establishing a separate company and proceed with the new business, thereby keeping the risks within a certain limit.

2 3 Stated Capital

Since shareholders do not assume any responsibility for the liabilities of a company, the assets of a company are the only source of repayment for a company's creditors. The stated capital functions as the target for maintaining the assets of the company. In reality, a company's assets exist in a variety of forms (such as personal property, real estate, receivables, and patents), and are constantly increasing or decreasing according to the activities of the company. However, the stated capital is a publicly announced figure reached through calculation, and is constant unless specific procedures for the change are taken. In addition, because setting a target would be meaningless if the amount of stated capital could be decreased freely, any decrease in the amount of stated capital must follow procedures instituted to protect creditors (for details, see 9-4).

A company must strive to maintain assets corresponding to the announced amount of stated capital (this is called the principle of capital maintenance or capital adequacy). For instance, a company must not pay dividends of surplus or purchase its own shares if the company has deficit (Companies Act, art. 461).

At the time of incorporation, a company must state in its articles of incorporation the amount of contribution that it intends to obtain (Companies Act, art. 27, item 4). There is no minimum amount of stated capital, and a corporation with only JPY1 in stated capital may be established.

The amount of stated capital is calculated, as a rule, by multiplying the subscription price per share by the number of shares issued, provided that an amount of up to half of the subscription price does not have to be included in the stated capital if determined at the time of issue (Companies Act, art. 445, para. 1 through 3). The amount of stated capital must be registered (*ibid*., art. 911, para. 3, item 5), and stated on the balance sheet (Accounting Regulation, art. 76, para. 2, item 1).

2 4 Differing Types of Stock Companies

There is tremendous diversity among the entities incorporated as stock companies. They range from huge monoliths like Toyota Motor Corporation and Hitachi, Ltd., to small stock companies that are operated only by members of the same family. The Companies Act has folded the former limited liability company structure into that of a stock company, resulting in many more small stock companies than was previously the case. Below we will look at several important categories for which regulation differs under the Companies Act.(Note)

(Note) Companies discussed throughout this Chapter basically refer to large, public companies.

(1) Large Companies

A stock company with a stated capital of JPY500 million or more or total liabilities of JPY20 billion or more is referred to as a large company (Companies Act, art. 2, item 6). The total liability standard has also been adopted because of the significant impact on society of a company that engages in a large scale of business by using debt, even if it only has a small amount of stated capital. These companies are subject to stricter regulation than other companies since they involve a large number of people and as a bankruptcy on their part will have a particularly significant impact on society at large.

One example is that a large company must have an accounting auditor (Companies Act, art. 328). Moreover, a large company that is a public company must have a strong management organization. It must choose whether to have either an audit and supervisory committee, nominating committees, etc. (nominating, audit, and compensation committees), or a board of auditors, and must in any case have a board of directors (*ibid*., art. 327, para. 1, and art. 328, para. 1). A public company must publish not only its balance sheet but also its profit and loss statements (*ibid*., art. 440, para. 1).

[3] Timing of Category Change

An increase or decrease in the amount of stated capital does not necessarily occur at the end of a fiscal year, and changes in total liabilities occur even more frequently. Having the regulations over a large company apply or no longer apply the instant a change occurred in these amounts would cause considerable disruption, and consequently the determination of whether a company is a large company is to be made on the basis of the amounts stated in the balance sheet approved at the most recent annual shareholders meeting (Companies Act, art. 2, item 6 and item 24). In the case of a company that approves its March settlement in June, if this company reduced its amount of stated capital from JPY600 million to JPY300 million on October 1, it would continue to be treated as a large company until the close of annual shareholders meeting in June of the following year.

(2) Public Companies

Prior to the enactment of the Companies Act, we understood a public company to be a company that is publicly listed or that is covered by the Financial Instruments and Exchange Act (previously the Securities and Exchange Law). The Companies Act uses the term "public company" in a very different sense. A company is a public company under the Companies Act if its articles of incorporation do not require the company's approval for the acquisition of any part of its shares by transfer (Companies Act, art. 2, item 5).

Even if the company does not presently issue shares that can be freely transferable it is not possible to deny the possibility that shares in a company in which these can be issued may be traded widely among unknown persons, and consequently different policies are required than that which would be the situation of a company that is run privately among a small group of individuals. For example, a public company must have a board of directors (Companies Act, art. 327, para. 1, item 1), and shares with restricted voting rights must not be more than half of all shares issued (*ibid*., art. 115).

The regulations on companies that are not public company are somewhat more lenient. For example, they do not need to treat their shareholders equally and may specify different treatments for each shareholder (Companies Act, art. 109, para. 2).

(3) Companies with Committees or Boards

This term is used frequently in the Companies Act, including for example "a company with board of directors." Organs of a stock company include its shareholders meeting, directors, a board of directors, company auditors, a board of company auditors, accounting auditors, accounting advisors, audit and supervisory committee, nominating committee, etc. (nominating, audit, and compensation committees) as well as executive officers. The only institutions that all stock companies must have among these organs are a shareholders meeting and directors (Companies Act, art. 295, para. 3 and art. 326, para. 1). In principle, a company is free to determine within its articles of incorporation any of the other organs (*ibid*., art. 326, para. 2), which takes into account the fact that the former limited liability company structure has also been included into the stock company structure.

In some circumstances, however, certain organs are required under the Companies Act, including that a public company must have a board of directors, and that a large company must have accounting auditors (see (1) and (2) above). Regardless of whether an organ is actually established, a company which must establish such organ is referred to as a "company with XXX." Executive officers, however, are always accompanied by a nominating committee, etc. and are not created independently. Consequently, the term company with executive officers is not used.

2 5 Ensuring Appropriate Operation of a Company

It goes without saying that appropriate operation of companies must be ensured, and the Companies Act strives to provide a structure of companies to achieve this goal. As mentioned above, stock companies are tremendously diverse in scale and characteristics. Therefore, it is not easy to set a uniform goal concerning what type of appropriate operation should be ensured, or to provide for a uniform method for achieving that goal.

If a high standard is set as a goal, and companies are uniformly required to achieve that goal, the cost of regulation will be excessively large, causing many companies to drop out. On the other hand, if the goal is set low, it will not be easy for companies to gain internal consent concerning incurring costs for pursuing a higher goal even if they have the potential to aim higher. Both cases are detrimental to society.

The desirable practice for companies is to aim at a goal slightly higher than the level required by law, and there has been a growing social tendency in many industrialized countries to highly evaluate such efforts as *best practices*. This concept is expressed in various forms including rules or declarations of economic organizations, rules of stock exchanges, and reports of governmental institutions. The principles released by the Organisation for Economic Co-operation and Development (OECD) as a summary of these rules, etc. carry substantial weight.

The substantial owners of a stock company are the shareholders who invested in the company, whereas the people who directly steer the company are the management. Thus, the starting point of ensuring appropriate operation of a company would be to determine the appointment of the management and its behavior so as to maximize the shareholders' interests. This framework is applied to diverse matters, and the entirety of the framework is often referred to as *corporate governance*. The corporate governance mainly focuses on the way management should conduct itself, but it covers more than that. Shareholders include not only those who invest their own money, but also institutional investors such as funds that invest other people's money, and such institutional investors are required to behave in a manner that differs from that of ordinary shareholders (best practices sought in institutional investors are sometimes referred to as a stewardship code, deeming the person who manages funds as the steward of a manor).

[4] Japan's Corporate Governance Code

This set of rules established by the Tokyo Stock Exchange came into effect on June 1, 2015, (it also came into effect on the same date for the Sapporo Securities Exchange and other stock exchanges). There had been cases where stock exchanges applied severer rules than those prescribed in laws and regulations on listed companies (such as the requirement of capital increase through third-party allotment and independent directors). This Code was established in accordance with the "Japan Revitalization Strategy Revised in 2014" which is a growth strategy of the Cabinet. It has incorporated the recommendations by a council of experts (related to the Ministry of Economy, Trade and Industry and the Financial Services Agency) as-is, although being strongly influenced by the abovementioned principles of the OECD.

The Code starts off by stating that shareholder rights and equal treatment of shareholders should be secured, while stressing the importance of cooperation with stakeholders other than shareholders (such as employees, customers, business partners, creditors and local communities). As the role of the board of directors, emphasis is placed on carrying out effective oversight of the management etc., from an independent and objective standpoint. For this purpose, the Code states that companies listed on the Prime Market should appoint independent directors for one-third or more of their director positions (or appoint at least two independent directors in the case of companies listed on other markets).

Even if an appropriate goal could be set, it would be necessary to secure the power to steadily push forward toward achieving that goal. As a means to do so, the Code places emphasis on dialogue and disclosure. Although companies are not forced to comply with the policy indicated by the Code (as a matter of course, they will be sanctioned by the stock exchange if they violate specific listing rules such as the reporting obligation), if they intend to take a different position, they must state the reason therefor (comply or explain). Companies may adopt varied directions or place varied emphasis on which goal they consider important and how they pursue that goal. However, since the path to ensuring appropriate operation of companies would be for each company to squarely face the matters emphasized by the Code, the Code requires companies to indicate their attitude periodically through Corporate Governance Report. The Code places emphasis on disclosure of the company's attitude including its philosophy, apart from financial information expressed by numerical figures.

The Code is expected to be periodically reviewed and has already been revised twice: once in June 2018 and then in June 2021.

The Code is neither long nor difficult to read. Readers are advised to refer to the contents of the Code on the Japan Exchange Group's website.

3 Incorporation of a Stock Company

3-1 Procedures for Incorporation

(1) Preparation of the Articles of Incorporation

In order to incorporate a stock company, the incorporators (only one incorporator is required, and this may be a juridical person) prepare and sign (or affix his or her name and seal on) the articles of incorporation (Companies Act, art. 26). Articles of incorporation of a stock company must specify or record matters set forth by law such as the purpose, the corporate name, and the location of the head office, which are referred to as mandatory matters (*ibid*., art. 27). The omission of only one of the mandatory matters makes the whole of the articles of incorporation invalid.

On the other hand, some matters need to be included in the articles of incorporation in order to be valid but the omission thereof has no impact on the validity of the whole of the articles of incorporation, only resulting in the omitted matters being treated as not being included in the articles of incorporation. Examples of these non-mandatory matters include the reduced quorum of the shareholders meeting (Companies Act, art. 309, para. 1 and para. 2), contribution in kind and assignment of properties after formation. These items are of material importance thus they are required to be specified and changed in a prudent manner (for details, see Column [5] below).

[5] Contributions in Kind and Undertaking of Properties After Formation

If contributions in kind, wherein the person who contributes properties other than money and receives shares, are overvalued, capital adequacy will be lost. Companies are required to include such matters in the articles of incorporation and are subject to investigation by court-appointed inspectors in order to prevent overvaluing from occurring (Companies Act, art. 28, item 1 and art. 33, para. 1 through 9). The same procedures are required for undertaking of properties after formation where contributions are made in money by the owner of property but the company makes a commitment to such owner who made the contributions that it will buy the relevant property at the time of incorporation of the company, as such undertaking has the same risk as the contributions in kind (*ibid*., art. 28, item 2 and art. 33, para. 1 through 9). However, a certificate from an attorney or other specialists can be substituted for this investigation by inspector, and if the contribution in kind consists of securities with a market value, then an investigation is not needed if they are valued at or below market value for the purposes of their contribution in kind. Moreover, regardless of the type of property, investigations are not necessary if the aggregate value of the property represents no more than JPY5 million (*ibid*., art. 33, para. 10).

In addition, the articles of incorporation often stipulate a record date to determine the shareholders who have rights, the number of directors, executive directors, and so forth (optional provisions).

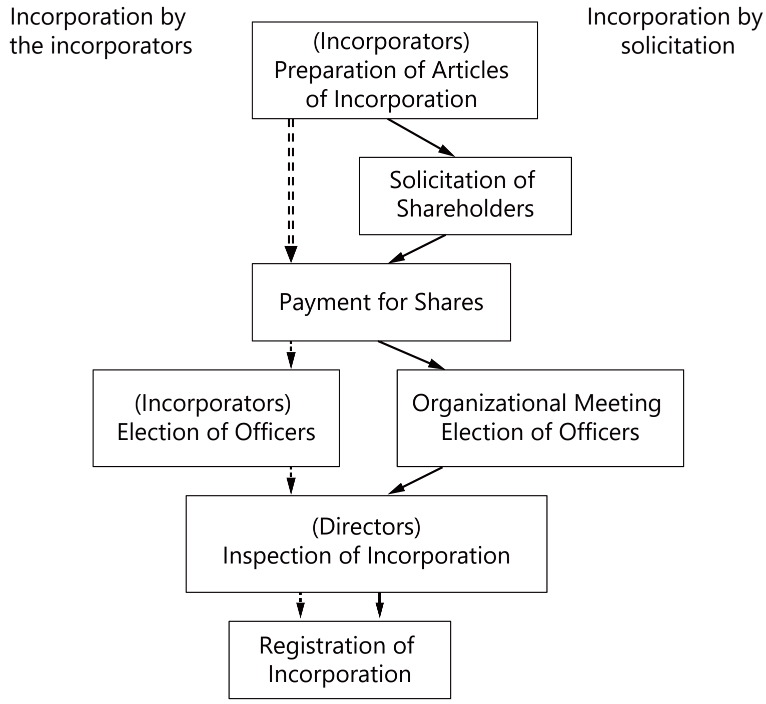
The articles of incorporation must be certified by a notary public (Companies Act, art. 30, para. 1).

(2) Issuance of Shares and Election of Officers

If all of the shares of stock are subscribed by incorporators only, the incorporation is referred to as incorporation by the incorporators. If a portion of the shares of stock is subscribed by incorporators and the remainder is offered to investors, the incorporation is referred to as incorporation by solicitation (Companies Act, art. 25 and art. 57).

Once the entire amount of the contribution has been made, the company will elect its directors (at the organizational meeting in case of incorporation by solicitation) (Companies Act, art. 34, para. 1, art. 38, para. 1, art. 63, para. 1 and art. 88, para. 1), and an examination will be made as to whether or not incorporation has been properly completed (*ibid*., art. 46 and art. 93).

Chart 3-1 **Incorporation Procedures of Stock Companies (Case where there are no contributions in kind)**



(3) Registration

Once the aforementioned procedures have been completed, the incorporation must be registered (Companies Act, art. 911, para. 1 and para. 2). By this registration, the company is formed (*ibid*., art. 49). The existence of the company is not recognized until then, even if it has operated under the same name. Because whether or not the company is a juridical person could affect the interests of a large number of people, this matter is determined in every case by registration.

The items to be registered are stipulated (Companies Act, art. 911, para. 3). If there are changes in any of these items, the alteration must be registered (*ibid*., art. 915). If a company fails to do so such company may not assert that the facts are different from what appears on the registration (*ibid*., art. 908).

(4) Freedom to Incorporate

Anyone can incorporate a company without restrictions, as long as the legally prescribed procedures are followed (the normative system). However, a license from or registration with the regulating authorities is required to commence business in an industry involving the public interest (such as finance, securities, transportation, and the like).

Since a company can be incorporated by only one incorporator, it is possible to incorporate a company that has only one shareholder. Also, after incorporation of a company, all shares of the stock may be concentrated in one person and consequently, the company may end up with only one shareholder. This sort of company is called a one-person company. Also, a parent company in some cases will hold all the shares of stock of its subsidiary (a wholly owning parent and a wholly-owned subsidiary) (for details, see Column [7]).

3 2 Illegal Incorporation

(1) Invalidation of Incorporation

Invalidation of the incorporation of a company becomes an issue if there is material violation of laws and regulations during the incorporation procedures (such as omitting mandatory provisions from the articles of incorporation, the failure to hold an organizational meeting, and so forth). However, shareholders and directors (and depending on the company, the company auditors, executive officers and liquidators) are the only persons entitled to file a claim seeking invalidation (Companies Act, art, 828, para. 1, item 1 and para. 2, item 1). Also, the claim can be made only if filed in a court within two years after the registration date of the incorporation. Even if the court rules to invalidate the incorporation of a company, it does not establish the *nunc pro tunc* invalidation of the existence of the company, and thus the judgment will not affect legal issues created before the judgment was rendered. Upon invalidation of the incorporation, the company is deemed to be dissolved, and liquidation proceedings are initiated (*ibid*., art. 839).

(2) Borrow-and-Deposit and Pretense Money

Payments for shares of stock must be made at the bank designated for payment (Companies Act, art. 34, para. 2 and art. 63, para. 1). Incorporators sometimes make payments by appropriating borrowed money from the bank designated for payment and promise such bank not to withdraw the said deposits of the company until the loan is repaid. This commits an offense called borrow-and-deposit (*ibid*., art. 965). Also, incorporators sometimes make the payment for shares of stock by obtaining loans from a third party, obtain a certificate of deposit of paid money from the bank (*ibid*., art. 64, para. 1), complete the registration of the incorporation, and then quickly withdraw the money from the bank to repay the loan to the third party (so called pretense money). In such case, a valid payment has not been made (judicial precedent) and the incorporated company is not backed by capital.

In order to prevent these types of disguised payments, banks designated for payment are not allowed to claim that no payment was made of the amount for which the bank issued the certificate of deposit of paid money (Companies Act, art. 64, para. 2). The amendment of 2014 states that an incorporator or subscriber for shares for subscription who disguised payment or other performance of contributions shall bear the obligation to make payments for shares and shall not be exempted from this obligation without the consent of all shareholders and that the shareholder’s rights for such shares may not be exercised until the payments have been made (*ibid*., art. 55-2, para. 1 and para. 4, art .55, art. 102, para. 3, and art. 102-2). Any incorporator or director involved in disguising payment shall also bear the obligation to make payment (*ibid*., art. 52-2, para. 2 and art. 103, para. 2 and para, 3), and shareholders may enforce liability for such conduct (*ibid*., art. 847).

4 Numbers, Denominations and Features of Shares

4-1 Share Split, Consolidation of Shares and Cancellation of Shares

(1) Share Split

Dividing one share into multiple shares is called a share split. A share split increases the number of outstanding shares of the stock but not the assets and thus decreases the substantive value per share.

If the stock price is too high, it becomes difficult for investors to buy the stock. If the shares are split, they will become easier to buy at an affordable price. Share splits are determined by a resolution of the board of directors, or by a resolution of a shareholders meeting if a company does not have a board of directors (Companies Act, art. 183, para. 2). The number of shares may only be increased up to the limit on total number of authorized shares prescribed in the articles of incorporation (Authorized Capital System) (for details, see 10-1). However, in the case of a share split, this limit may be raised by amendment of the articles of incorporation without a resolution of a shareholders meeting (*ibid*., art. 184, para. 2). The limit may be doubled in the case of a two for one share split, tripled in the case of a three for one share split and so on, but only in the case of companies that have issued only common shares.

(2) Allotment of Shares Without Contribution

Allocating shares of stock to a shareholder without any payment for the shares is referred to as an allotment of shares without contribution. In the case of a company that only issues common shares, this would have the same result as a stock split. Nevertheless, since a share split is made in connection with shares that have already been issued, the number of treasury shares owned by the company will also increase at the same ratio, while an allotment of shares without contribution uses newly issued shares of stock, and consequently these are not allocated to the company itself (Article 186, Paragraph 2 of the Companies Act provides “shareholders other than the relevant stock company”).

In a company that issues class A shares and class B shares, it was understood that in a one-to-two share split the shares of stock of both classes would double in number. If the class A shares were to be shares with a preferred right to dividends (4-4(1) below), the amount of surplus available for dividends to class B shareholders would be reduced below that of the case prior to the share split. By using the method of allotment of shares without contribution, class A shares can be allocated to class B shareholders, or class B shares can be allocated to class A shareholders.

If the articles of incorporation do not stipulate what organ of the company should resolve to issue an allotment of shares without contribution, this resolution is to be determined by the board of directors (or by the shareholders meeting in the event of a company that does not have a board of directors (Companies Act, art. 185 through art. 187).

(3) Consolidation of Shares

The amalgamation of a certain number of shares into a smaller number of shares (*e.g.*, two shares into one share) is referred to as a consolidation of shares. By making a consolidation of shares, the company will reduce its number of shares outstanding, but will increase the substantive value per share. Consolidation of shares is carried out frequently in the case of a capital reduction or a merger. Without limitation to the aforementioned cases, if it seems that the size of the stock is too small, a consolidation of shares may be carried out in order to make it larger. This requires explanation of the reasons for the need to consolidate shares and obtaining special resolution of the shareholders meeting (Companies Act, art. 180 and art. 309, para. 2, item 4). According to the ratio of the consolidation of shares, shareholders holding fractional shares or less than minimum trading lots may emerge. The consolidation of shares may be carried out in an attempt of driving an opposition group of shareholders out of the company.

The 2014 amendments introduced detailed provisions concerning the consolidation of shares which generates fractions less than one share. A company must disclose the ratio of consolidation, the effective day and other matters to shareholders (Companies Act, art. 182-2 and art. 182-6). Shareholders may request the company not to consolidate its shares if the consolidation violates laws and regulations or the articles of incorporation and is likely to cause detriment to them (*ibid*., art. 182-3). Shareholders may exercise appraisal rights to demand that the company purchase such fractional shares (*ibid*., art. 182-4 and art. 182-5). However, in the case where a company adopting the share unit system consolidates its shares and fractional shares would be generated only from shares of less than one unit, those provisions regarding strict disclosure procedures or regarding the shareholders' right to demand that the company either purchase their shares or not effect the consolidation do not apply because shares of less than one unit do not carry voting rights anyway.

(4) Cancellation of Shares

Eliminating shares that have already been issued is referred to as the cancellation of shares. The number of shares outstanding in a company will be reduced by cancellation. Traditionally the cancellation of shares could be conducted not only through the cancellation of treasury shares held by the company, but also through the cancellation of shares held by shareholder. The Companies Act abolished the latter procedure so that now all cancellations of shares take the form of the company first acquiring the shares of stock and then cancelling them.

The board of directors will determine how many of what class of shares will be cancelled. If a company does not have a board of directors this is to be determined by the director (Companies Act, art. 178). Since the issues of not undermining equality among shareholders or the maintenance of capital will have already been addressed at the time that the company acquires its own shares (6-2 below), there are no stringent requirements for the cancellation of shares in and of themselves.

4 2 Treatment of Fractional Shares

Share splits, consolidation of shares, capital increases by allotment of shares to shareholders (10-1 and 10-2 below), and so forth generate fractional shares of less than one full share of the stock, depending on the ratio. When such fractional shares arise, they shall be consolidated and sold by the company, or purchased by the company, with the proceeds distributed to the shareholders (Companies Act, art. 234 and art. 235). There are detailed regulations on the price at which shares may be sold (Companies Ordinance, art. 50). Since this procedure is taken each time fractional shares come into existence, the fractional shares will not continue to exist thereafter. As mentioned earlier, shareholders have appraisal rights with respect to fractional shares generated as a result of the consolidation of shares (4-1(3) above).

4 3 Unit Share System

If a company issues shares in small denominations, one could possibly be left with an impression of imbalance if even shareholders making small contributions were able to exercise important rights over the management of the company. Also, considerable expenses would be required for tasks such as sending notices of convening of shareholders meetings to every shareholder holding even a single share. A company wishing to avoid this can adopt the unit share system and only grant voting rights to shareholders holding (an integral multiple of) a set number of shares.

The adoption of the unit share system, and the number of shares that constitutes a unit, are provided in the articles of incorporation. If the number of shares in one unit is too large, there will be many shareholders without important rights, so the limit is set at 1,000 shares and 0.5 percent of the total number of issued shares (Companies Act, art. 188; Companies Ordinance, art. 34). The number of shares that constitutes one unit is referred to as the share unit, which is determined for each class of shares (Companies Act, art. 2, item 20 and art. 188, para. 3). For listed companies, the share units have been standardized as 100 as a result of the initiatives by the stock exchanges.

Once the share unit is determined, a change in the articles of incorporation to reduce the number of shares in share unit or abolish the unit share system can be made without a resolution of a shareholders meeting, since a change in this nature will only increase the number of shareholders that are treated like all other shareholders (Companies Act, art. 195). A resolution by the shareholders meeting is also not required to amend the articles of incorporation in order to increase the number of shares in a unit or to enact a new unit share system, as long as it is made at the same time as a share split, and the number of units per shareholder will not be reduced (*ibid*., art. 191).

Shareholders of companies using the unit share system have one voting right for each unit they hold (Companies Act, art. 308, para. 1, *proviso*). That is to say, shareholders who hold shares less than one unit have no voting rights, and are not entitled to receive notices of shareholders meeting (*ibid*., art. 189, para. 1). Since many important rights relating to management of the company are minority shareholder rights, and the shareholders having such rights are determined by the percentage of the voting rights that they hold, shareholders holding shares less than one unit are not eligible to exercise such rights (shareholders' right to propose, etc.).

Shares less than one unit do come with other rights. They will not lose their right to receive property converted from the shares, such as the residual assets in the event of dissolution of the company, or shares of stock in the event of a split or a consolidation, but other rights such as the right to demand dividend of surpluses will not be granted to shareholders holding shares less than one unit if so specified in the articles of incorporation (Companies Act, art. 189, para. 2; Companies Ordinance, art. 35). A share certificates-issuing company may choose not to issue share certificates for shares less than one unit (Companies Act, art. 189, para. 3).

A shareholder wishing to collect its investment can request the company to purchase the shares less than one unit (Companies Act, art. 192 and art. 193). If the articles of incorporation so prescribe, the shareholder may also have the company sell the shareholder shares less than one unit and combine these with the shares less than one unit that the shareholder has to make a unit (*ibid*., art. 194).

4 4 Classes of Shares

The feature of the rights attached to a share will not change regardless of who owns the shares (for details, see Section 5-2). In contrast to bonds, shares of stock do not carry a maturity date, and include a right to receive a distribution of surpluses as well as a right to vote at a shareholders meeting until such time as a company is dissolved and its residual assets distributed (Companies Act, art. 105, para. 1). This is the basic rule for shares, although certain changes may be made in the articles of incorporation. Changes may be made to all of the shares that the company issues (*ibid*., art. 107) or may prescribe different rights to certain of the shares (*ibid*., art. 108). In the latter case, there will be more than one class of shares existing at the same time, and a company of this nature is referred to as a company with class shares (*ibid*., art. 2, item 13).

This discretionary latitude in the articles of incorporation is permitted in order to accommodate needs such as to facilitate financing or to create a relationship of control that fits the actual makeup of the shareholders. It is necessary to limit amendments to the extent of this purpose, and it is not permissible to make amendments to the extent that denies the nature of a stock company (Companies Act, art. 105, para. 2). It is also true that amending the articles of incorporation to add new classes of shares or to change the total number of authorized shares, share split and consolidation of shares, or changes in organization such as a merger or company split, will have a different impact on shareholders depending on the class of shares that they hold, and it is, therefore, necessary to come to an accommodation between the right of shareholders of different classes. An attempt is made to adjust these rights by having resolutions by a general meeting of class shareholders consisting of members who may be injured by an action of the company, in addition to a general shareholders meeting in which all shareholders may participate (*ibid*., art. 2, item 14 and art. 321 through art. 325). In some cases, it is possible to omit this resolution by a general meeting of class shareholders by so specifying in the articles of incorporation (*ibid*., art. 322, para.2 and para. 3), and it is also possible to add cases when a general meeting of class shareholders would be required (*ibid*., art. 323).

Ordinary shares which are the general standard are referred to as common shares in contrast to shares of stock that have special rights. In a company with class shares, common shares are treated as being one type of classes of shares.

(1) Class Shares with Respect to Dividend of Surpluses

Shares of stock for which dividends are to be paid out of the remaining surplus following the payment of a certain amount of dividends to other classes of shares of stock are referred to as (dividend) preferred shares. Deferred or subordinated shares are a type of stocks that are paid dividends from profits left after dividends are paid to common stockholders. Ordinary shares that are regarded as the standard are referred to as common shares. A company may issue these different classes of shares if so specified in the articles of incorporation (Companies Act, art. 108, para. 1, item 1).

Even though preferred shares have a preferential right to dividends on earnings, it is not possible to determine indiscriminately the extent to which these shares offer an advantage, since this will vary depending on whether a certain amount of dividends are paid for two years or more (cumulative preferred stock), or whether an additional dividend is distributed, when dividends for common stockholders are distributed, in a profitable fiscal year (participating preferred stock).

The manner in which the class shares differ from the common shares must be prescribed in the articles of incorporation. However, the amount of preferred dividends depend on economic conditions at the time the preferred stock is issued, so it is possible to stipulate the method of determining the amount of dividend or the type of dividend property in the articles of incorporation, and to have the board of directors (or a shareholders meeting in the event of a company that does not have a board of directors) determine the specific amount within these limits, at the time of issuance (Companies Act, art. 108, para. 2, item 1 and para. 3; Companies Ordinance, art. 20, para. 1, item 1).

(2) Class Shares with Respect to Distribution of Residual Assets

A company may issue classes of shares that differ in their treatment of the distribution of residual assets at the time of dissolution of the company. The terms to be stipulated in the articles of incorporation are similar to those discussed in (1) above (Companies Act, art. 108, para. 1, item 2 and para. 2, item 2; Companies Ordinance, art. 20, para. 1, item 2).

(3) Shares with Restricted Voting Rights

In addition to shares of stock with no voting rights, a company may also issue shares of stock that only have the rights to vote in relation to certain items to be resolved at a shareholders meeting (Companies Act, art. 108, para. 1, item 3 and para. 2, item 3; Companies Ordinance, art. 20, para. 1, item 3). All shares except shares of stock with full voting rights are shares with restricted voting rights.

If the shares with restricted voting rights exceed one-half of the total shares issued (if the company adopts unit share system, if the number of units with restricted voting rights exceeds one half of the total number of units) in the case of a public company, the company must take action to reduce the number of shares with restricted voting rights to less than one-half of the total shares issued (Companies Act, art. 115). This is because, in principle, a shareholder’s right to have a voice in a company must be in proportion to the amount of its contribution in the risk capital, and any significant deviation from this principle cannot be viewed as being a healthy situation.

(4) Shares with Restriction on Transfer

These are shares that require the approval of a company in order to be transferred. Restrictions may be imposed on all shares in a company (Companies Act, art. 107, para. 1, item 1), or only on certain classes of shares (*ibid*., art. 108, para. 1, item 4 and para. 2, item 4). The methods of transfer of shares will be discussed below (for details, see 6-1).

(5) Shares with Put Option

These are shares for which a company makes a commitment at the time of issuance to acquire on request by the shareholder (Companies Act, art. 2, item 18). This commitment may be made for all shares issued (*ibid*., art. 107, para. 1, item 2 and para. 2, item 2) or only some classes of shares (*ibid*., art. 108, para. 1, item 5 and para. 2, item 5; Companies Ordinance, art. 20, para. 1, item 5). Normally, the consideration for redemption is cash, but since it is also possible for the company to acquire these shares using another class of shares, or shares in another company, or bonds or other properties as consideration, the word “acquisition” is used instead of “purchase.”

If a stipulation is made that shareholders may request acquisition by the company only after a certain period of time has elapsed since the shares were issued, the company will be able to acquire capital for that period and thereafter reduce its cost of dividend (these were previously referred to as “redeemable shares”). If common shares are to be used as the consideration for acquiring dividend preferred shares, the preferred shares with share option will be converted to common shares, thereby reducing the cost of dividends (these were previously referred to "convertible shares"). If the consideration is in the form of bonds, this would be the reverse of a convertible bond, and would enable the company to gradually reduce the number of its shares in the event that the company wishes to downsize. If share options, shares in a parent or subsidiary or commodity such as manufactured products are used for the consideration, these may be used according to the purpose.

Except in the case where the consideration is another class of shares of the same company, if a company acquires its own shares, where the consideration is money, etc., then property of the company will flow out (or if bonds are used as consideration then the debt of the company will increase). From the perspective of maintaining capital, it is not possible to ignore this situation (2-3 above), and even if a shareholder holds shares with put option, the shareholder cannot demand that the company acquire the shares if the company does not have distributable amount (Companies Act, art. 166, para. 1, *proviso*).

(6) Shares Subject to Call

Shares subject to call are shares for which the company has the initiative in acquisition, rather than the shareholder (Companies Act, art. 2, item 19). A company may attach a clause of this nature to all of its shares (*ibid*., art. 107, para. 1, item 3 and para. 2, item 3) or only some classes of shares (*ibid*., art 108, para. 1, item 6 and para. 2, item 6; Companies Ordinance, art. 20, para. 1, item 6). When the date as specified by the articles of incorporation or the resolution of the board of directors (or the shareholders meeting in the event of a company that does not have a board of directors), or date on which the grounds provided for in the articles of incorporation have arisen comes, the company may acquire the shares even if the shareholder does not want to transfer the shares to the company. When the date of acquisition has been determined by the above resolution, the company will notify the shareholders and registered pledgees of shares at least two weeks prior to the said date, and if only some of the shares will be acquired, the company will give the same notice after determining in the same resolution which shares the company will acquire (Companies Act, art. 168 and art. 169).

Other aspects of the acquisition clause are the same as for shares with put option, such as that a variety of properties may be used for the consideration and not just cash, or that the company is not permitted to acquire the shares if it does not have distributable amount (Companies Act, art. 170, para. 5).

(7) Class Shares Subject to Wholly Call

If a company wishes to reduce its capitalization completely at the time of a corporate reorganization, it must not have a situation in which it does not have any shares at all even for an instant. If it has classes of shares, however, then the existence of the company will not be affected even if all of these classes of shares are extinguished. Consequently, a classification for this type of share has been added (Companies Act, art. 108, para. 1, item 7 and para. 2, item 7). The law requires that an explanation be given to the shareholders by directors of the reason for which issuing of these shares is necessary, and that the acquisition date and acquisition price must be determined by a special resolution (*ibid*., art. 171 and art. 309, para. 2, item 3; Companies Ordinance, art. 20, para. 1, item 7). When the acquisition date falls due, the company must automatically acquire all of the shares of this class (Companies Act, art. 173).

Since this measure may be used as a means to drive minority shareholders out of the company (cash-out), the 2014 amendment introduced a system that takes this respect into consideration.

More specifically, the amendment enhanced the ex ante or ex post facto disclosure of information to shareholders (Companies Act, art. 171-2 and art. 173-2) and prescribed shareholders' right by which shareholders may demand the company not to acquire such class shares if they are likely to suffer disadvantage due to illegal acquisition (*ibid*., art. 171-3). The period during which shareholders who are dissatisfied with the acquisition price may file a petition with the court to determine the price has been revised from within 20 days from the day of shareholders meeting to the period until the day immediately preceding the acquisition date (*ibid*., art. 172).

(8) Class Shares with Veto Power

It is possible to stipulate in the articles of incorporation that a resolution by a general meeting of class shareholders of a certain class of shares is required in connection with matters for which a resolution of a shareholders meeting or the board of directors (or the liquidators committee after dissolution) is necessary even if the shareholders of that class will not be adversely affected (Companies Act, art. 108, para. 1, item 8 and para. 2, item 8; Companies Ordinance, art. 20, para. 1, item 8). Shareholders of this class would have veto power because the relevant step cannot be taken, whether it is a distribution of surplus, a merger or a company split, without first obtaining the approval of a majority of the shareholders of that class.

This enables a situation in a joint venture or venture business company or the like in which the shareholders in this specified class do not need to be worried about a decision being made that they do not like, even if these shareholders constitute a minority of all voting rights in the company. Recently, there has been discussion of whether it is appropriate to issue shares of this class as a defensive measure against a hostile takeover, or whether issuing of these shares is suitable for a listed company. There is no restriction on the quantity of these shares or the amount for their issue.

(9) Class Shares in Connection with Election of Officers

It is possible for example to stipulate in the article of incorporation that class shareholders of one class will appoint two out of the three directors of a company, while the class shareholders of another class will appoint the other director (Companies Act, art. 108, para. 1, item 9 and para. 2, item 9; Companies Ordinance, art. 20, para. 1, item 9). This class shares would be used in cases in which the family of the founder of the company wishes to obtain outside investment but also seeks to retain control, or where a corporate group wishes to prescribe the number of directors to be allocated from within the group.

In the above example, if the holders of the relevant class of shares with the right to elect one director have a minority of all voting rights, then there would be no meaning in allowing these holders to elect a director if the director can be immediately dismissed by a shareholders meeting, and consequently, the law prescribes that, in principle, dismissal of a director in this case requires a resolution by a general meeting of class shareholders of that class (Companies Act, art. 347).

5 Shareholders' Rights

5 1 Sole Shareholder's Rights and Minority Shareholders' Rights

Rights that can be exercised by shareholders holding even just one share are called sole shareholder's rights, and rights that can only be exercised by shareholders (or a group of shareholders) who hold not less than a certain percentage (or, rarely, a certain number) of voting rights (or not less than a certain percentage of shares) are called minority shareholders' rights. If the percentage or the number of shares held is not specifically stipulated by law, the rights are sole shareholder's rights. Examples of minority shareholders' rights include the right to propose (Companies Act, art. 303), the right to seek the removal of directors, accounting advisors, and company auditors (*ibid*., art. 854), and the right to inspect account books (*ibid*., art. 433). These rights have considerable significance in restraining arbitrary actions by major shareholders and, therefore, can only be exercised by shareholders holding a defined bundle of shares in order to prevent abuse.

Most minority shareholders' rights are prescribed on the basis of the ratio and number of voting rights. Holders of shares less than one unit do not have these rights as they do not have voting rights.

[6] Rights to Self-Interest and Rights for Common Benefit

A variety of rights arises for shareholders vis-à-vis the company. Rights which benefit only the individual shareholder, such as the right to receive distributions of surplus or residual assets, are called rights to self-interest. By way of contrast, rights that, if exercised, influence shareholders' interests overall are called rights for common benefit. These rights include voting rights and various rights to bring litigation. As mentioned above, holders of shares less than one unit do not have a voting right (above 4-3 "Unit Share System").

5 2 Principle of Shareholder Equality

Each and every share of stock has rights with the same feature, and the shareholders have rights against the company that are proportional to their respective shareholdings (Companies Act, art. 109, para. 1). If a company treats specific shareholders favorably or unfavorably, such action violates the principle of shareholder equality and the law, and any resolution based on this sort of preferential treatment is null and void. Although an exception to this principle is allowed for companies with class shares, equal treatment is required in the same class.

In a company that is not a public company (see 2-4(2) above), different treatment among shareholders holding the same class of shares is permissible if this is specified in the articles of incorporation with the shareholders consent, since normally there are only a few shareholders in this type of company and they are well acquainted with each other. If the stipulation is made that a certain shareholder has a right to twice the dividends or voting rights of another shareholder then this would be the same as if the first shareholder held class shares of that nature (Companies Act, art. 109, para. 2 and para. 3). Nevertheless, this treatment will only apply while the shares remain in the hands of that shareholder, and if they are assigned to another person the shares would be stripped of their preferential treatment.

5 3 Prohibition Against Giving of Benefits

A company must not give monetary or any other benefits to shareholders who hint at harassment in a shareholders meeting, or who threaten to file a lawsuit against the company in exchange for their withdrawal from their actions. Those who receive any benefits in violation of this provision must return the said benefits to the company. If the company does not demand to return, other shareholders may file a lawsuit on behalf of the company. If a company provides benefits to specific shareholders without compensation, or if the benefits provided are booked as newspapers or magazine subscriptions, advertising fees or in other ways that do not conform to the actual situation, this is presumed to be an illegal provision of benefits. It is also illegal to provide benefits on the account of a subsidiary (Companies Act, art. 120, para. 1 through para. 3). The relevant provisions can be read as including such persons who have lost shareholder's status as a result of reorganization (*e.g.*, merger, share exchange) or who are shareholders of the parent company in the scope of shareholders who have a right to bring an action.

Not only are the recipients of the benefits subject to penalties, but the directors or employees of the company providing such benefits are as well (Companies Act, art. 968 through art. 970). The directors are obligated to repay to the company the amount of the benefits illegally provided. Only the directors other than those who provided the benefits can prove that he or she was without negligence and be exempted from responsibility (*ibid*., art. 120, para. 4; Companies Ordinance, art. 21). These provisions are intended to eliminate extortionists at shareholders meetings (so-called "*sōkaiya*").

6 Transfer of Shares

6-1 Unrestricted Transfers and Restricted Transfers Under the Articles of Incorporation

(1) Unrestricted Transfers and Restrictions on Transfer

A shareholder wishing to stop investing in a company cannot simply quit the company and recover the investment (see 2-2 above). Collection of investments can be made only by transferring shares, so shares are permitted to be highly transferable. On the other hand, some stock companies have only a few shareholders, and do not wish to include strangers. The Companies Act has also made all former limited liability companies into stock companies, and thus the vast majority of stock companies would now probably be considered to be closed companies.

With the 1966 revision, it became permissible for a company to impose a restriction on the transfer of shares by requiring the approval of the board of directors, if this restriction is stated in the articles of incorporation. Introducing this clause created a distinction between companies that allowed all of their shares to be transferred freely, and those that imposed restrictions on the same. Companies which added this clause to their articles of incorporation were referred to as companies that restricted transfer, and the financial instruments exchanges prescribed in their regulations that they would not allow companies with this restriction to be listed.

The Companies Act treats transferability as one of the rights of a share. It has now become possible for a company to restrict the transfer of only certain classes of shares, in addition to restricting transfer of all of its shares (see 4-4(4) above). The approval of a shareholders meeting is required to transfer the shares of a company that does not have a board of directors (although different procedures can be stipulated in the articles of incorporation; Companies Act, art. 139, para. 1).

(2) Restrictions on Transfer

Restrictions on transferring shares will inconvenience shareholders in the collection of their investment. While a shareholder would not have grounds for complaint if a company has stipulated a restriction on transfer of shares in its articles of incorporation at the time of incorporation (the original articles of incorporation), and the shareholder became a shareholder with knowledge of that fact. It is extremely problematic for restrictions of this nature to be imposed on shares that formerly could be freely assigned. It will be impossible to list the company (or the company will be delisted if it was formerly listed), and valuation of shares will decline (in calculation such as for inheritance tax purposes this results in a deduction of 30 percent in the evaluation).

Consequently, the procedures are extremely strict for amending the articles of incorporation to add restrictions on the transfer of shares. In order to pass a resolution for restriction, the affirmative votes of two-thirds of the voting shares and a majority of the shareholders who are eligible to vote at a shareholders meeting is required. This requirement may be made more stringent if so specified in the articles of incorporation, but may not be made more lenient (Companies Act, art. 309, para. 3). If a company will introduce restrictions on the transfer of a certain class of shares, the same resolution is required by the general meeting of class shareholders of such class shares (*ibid*., art. 324, para. 3).

Shareholders who are against the restriction may demand that the company purchase their shareholdings (Companies Act, art. 116 and art. 117). A provision restricting share transfers must be publicized by registration (Companies Act, art. 911, para. 3, item 7) and also endorsed on share certificates (*ibid*., art. 216, item 3 and item 4).

If company P and company Q will merge and shareholders in company P will be given shares with restrictions on transfer in company Q in exchange for shares in P without restrictions on transfer, the same stringent resolution requirements as discussed above is required at company P side for approval of the merger (Companies Act, art. 309, para. 3, item 2). If a new company R will be incorporated through the merger of company P and company Q, and if shares in R are shares with restriction on transfer while shares in P and Q are freely transferrable, these stringent requirements will also apply to the merger resolutions of P and Q (*ibid*., art. 309, para. 3, item 3). The same shall apply in the event of share exchange (*kabushiki kōkan*) or share transfer (*kabushiki iten*).

(3) Transfer of Shares with Restrictions on Transfer

Let us assume that shareholder A of company P who holds the shares with restrictions on transfer wishes to sell those shares to another person B. In that case, (i) Shareholder A requests that P make a determination as to whether or not approve the transfer (Companies Act, art. 136); and (ii) shareholder A may also demand that P purchase the shares or designate another purchaser if P will not approve the transfer to B (*ibid*., art. 138, item 1).

If approval of the transfer is granted by the board of directors of the company (or the shareholders meeting in the event of a company that does not have a board of directors), or by the organ that is designated by the articles of incorporation of P (Companies Act, art. 139, para. 1), then shareholder A may transfer the shares to B. The same applies if P does not give shareholder A an answer within two weeks from the date of the request (*ibid*., art. 145, item 1). If approval is denied, and shareholder A has only made a request described in (i) above, shareholder A will have no alternative but to relinquish its intention to transfer the shares.

If shareholder A has also made a request described in (ii) above, and P notifies shareholder A within two weeks that P or another person C designated by P will purchase the shares (Companies Act, art. 145, item 1), the transfer will be made between shareholder A and P or C. In this case, P or C must deliver a document to shareholder A certifying that an amount equivalent to the book value of the relevant shares in P has been deposited (*ibid*., art. 141, para. 2 and art. 142, para. 2; Companies Ordinance, art. 25). If this certificate of deposit is not delivered by P within 40 days from the date of the first notice, or within 10 days by C, Shareholder A may transfer the shares to B (Companies Act, art. 145, item 2 and item 3; Companies Ordinance, art. 26).

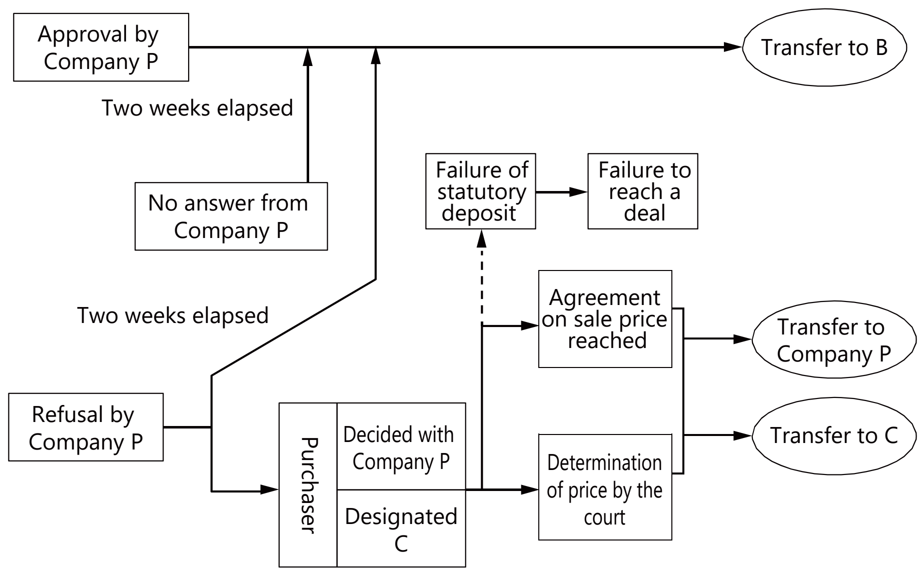
The price of sale between shareholder A and P will be the price agreed by negotiation between the parties. If they cannot agree on a price, then the price is to be decided by a court. If neither shareholder A nor P makes a petition to a court within 20 days from the purchase notice by P, the purchase price shall be the book value that has been deposited (Companies Act, art. 144).

B who acquires the shares from shareholder A may also request approval from company P (Companies Act, art. 137, para. 1). This would be the only option in a case such as when B acquires the shares through a public auction. The process for determining the price would follow the same procedures as discussed above, but since B is not listed on the shareholders registry, in principle the request to the company must be made jointly with shareholder A (*ibid*., art. 137, para. 2; Companies Ordinance, art. 24).

If P is a company issuing share certificates, then A or B who request the purchase must deposit the share certificates. If share certificates are not deposited within one week from the delivery of the certificate of deposit of the book value of shares, then P or designated purchaser C may cancel the sale agreement (Companies Act, art. 141, para. 3 and para. 4, art. 142, para. 3 and para. 4).

If shareholder A transfers shares to B without obtaining approval, the transfer is null and void vis à-vis company P, and B cannot request registration of the transfer. However, the said transfer is valid between the parties (between A and B) (judicial precedent).

Chart 3-2 Transfer of Shares with Restrictions on Transfer (Shareholder A requests (i) approval of the transfer to B and (ii) designation of purchaser)



6 2 Treasury Shares and Parent Company Shares

(1) Regulations on Treasury Shares (Shares of a Company That Are Owned by the Company Itself)

If a company acquires shares issued by the company, the result is the same as repayment of an equity contribution. This action is also utilized to manipulate share prices, for insider trading or to protect the status of directors. This may cause inequality among shareholders depending on the price. In order to prevent this type of abuse, there are provisions governing procedures, sources of funds, method of acquisition and liability of directors in relation to acquisition and disposition of company's own shares (Companies Act, art. 155 through art. 178). Any wrongful acquisition under any name is punishable by law if company funds are used for the acquisition (*ibid*., art. 963, para. 5, item 1).(Note)

(Note) Previously acquisition of treasury shares was completely prohibited. A small number of exceptions were established by the 1938 reforms, and the business community had long pushed for further liberalization. The 1994 amendments to the Commercial Code greatly broadened the exception, and liberalization has continued since then. The 2001 reforms abolished the in principle prohibition and introduced the procedural and financial regulations. Because holding of such shares without disposing of them was also allowed, these reforms have been called "lifting of the ban of treasury shares." The Companies Act maintains this general trend but has gathered the regulations from their various locations and consolidated them into one place. In some cases, procedures have been liberalized, such as not always requiring an annual shareholders meeting to authorize the scope of shares that may be acquired, or simplification of acquisition from specified shareholders of shares that have a market price. On the other hand, new systems have been added such as shares with put option, and a right to demand sale against an heir. With the narrow application of cancellation of shares (see 4-1(4) above), these regulations on treasury shares have in some respects become even more important.

(2) Procedures for Acquisition

(i) General Procedure

There is a provision listing situations in which a company can acquire its own shares (Companies Act, art. 155; Companies Ordinance, art. 27; in all 20 categories are listed, and 24 separate subcategories are included). Although a company is not allowed to acquire its own shares in a situation that is not included in the list, it is important to recognize that one of the situations mentioned above covers the general rule. That is the following procedural provision.

If a resolution is passed at a shareholders meeting specifying the number of shares, the total price and the period (which shall be not more than one year), the company may acquire its own shares (Companies Act, art. 155, item 3 and art. 156, para. 1). There are no restrictions on the purpose or situation, etc., in which the resolution may be made. An ordinary resolution is sufficient as long as the shareholder from whom the acquisition is to be made is not stipulated (*ibid*., art. 309, para. 2, item 2). The resolution by the shareholders meeting will delegate the acquisition of shares within the extent prescribed above to the board of directors (or the directors in the event of a company that does not have a board of directors). It is possible for the permitted period to expire without a single share being purchased. The board of directors will determine particulars such as the numbers of shares to be acquired, the price and the offering date, regardless of whether the total number of shares allowed is to be acquired at one time, or in several installments (*ibid*., art. 157), and notify the shareholders of that effect (although public notice is sufficient in the event of a public company (*ibid*., art. 158)). The shareholders shall apply for acquisition by the company, stating the number of shares they wish to be acquired. If the total number of shares offered for acquisition exceeds the total number to be acquired by the company, the number of shares to be purchased from each shareholder shall be determined by proportional allocation (with fractions discarded; *ibid*., art.159).

(ii) Acquisition by Market Trade or Tender Offer

If the shares are to be acquired through a market transaction or a tender offer, the respective rules for that transaction must be followed rather than the procedures prescribed above. In case of the tender offer, notification or public notice and proportional allocation are required, but in case of the market trade, issuing a purchase order to a financial instruments business operator is sufficient. Particulars such as the date of acquisition, the number of shares and the price are to be determined by the board of directors (or a shareholders meeting in the event of a company that does not have a board of directors), but in order to acquire shares in this manner a company is required to have made a stipulation to that effect in advance in its articles of incorporation (Companies Act, art. 165).

(iii) Acquisition from Specified Shareholders

More stringent requirements apply in the event that a company will acquire shares from certain specified shareholders (which would always be the case in the event of a non-public company, but would also apply in cases such as when a listed company will acquire the shares from a major shareholder), since it is necessary to be careful that there is no undermining of equal treatment of shareholders. In this event, a special resolution by a shareholders meeting is required (Companies Act, art. 309, para. 2, item 2), and the shareholders who will be the sellers are not permitted to exercise their voting rights (*ibid*., art. 160, para. 4). It is also necessary to take procedures so that other shareholders may be added as sellers at their request (*ibid*., art. 160, para. 1 through para. 3; Companies Ordinance, art. 28 and art. 29).

In some cases, the above procedures do not need to be followed even if the shares are to be acquired from certain specified shareholders. One example would be when shares with a market price are to be purchased for a price that does not exceed the market price (Companies Act, art. 161). In the event of a company that is not a public company (see 2-4(2) above), if the shares are to be acquired from a person such as an heir, the procedures do not need to be followed to add other shareholders as sellers (*ibid*., art. 162). Also, in the event that a parent company will acquire shares in the parent that are held by a subsidiary, the board of directors (or a shareholders meeting in the event of a company that does not have a board of directors) may make the decision to acquire the shares (*ibid*., art.163). Moreover, a company is permitted to specify in its articles of incorporation that additional procedures will not be taken to add shareholders to the sellers, but an amendment of the articles of incorporation to add this clause requires the consent of all shareholders (*ibid*., art.164).

(iv) Others

Not all of the 24 categories referenced in (i) above are explained in this Manual. Please see the relevant sections concerning shares with put option (4-4(5) above), shares subject to call (4-4(6) above), and class shares subject to wholly call (4-4(7) above).

Below we have provided a simplified explanation only of a demand for sale against a person such as an heir. In the example discussed above, P is entitled to determine whether or not to approve a B who has acquired shares in P that are encumbered with a restriction on transfer (6-1(3) above). For a general succession such as an inheritance or a merger, the company is not entitled to deny this acquirer's status as a shareholder even if the company does not want that person to be a shareholder. Nevertheless, if the company finds this unacceptable, under this system, the company may, with a special resolution at a shareholders meeting within one year from the date that the company became aware of the inheritance or similar event, demand that B sell the shares to the company (Companies Act, art. 174 through art. 177 and art. 309, para. 2, item 3). Particulars such as the method of determining the price are almost the same as when a company refuses to approve a transfer.

(3) Funds Used for Acquisition

There must be funds available to acquire shares. In principle, only surpluses that would otherwise be used to pay dividends can be used (Companies Act, art. 461, para. 1, item 1 through item 7 and para. 2; Accounting Regulation, art. 156 through art. 158). Acquiring company's own shares without having these funds is a violation of law, and the directors as well as the sellers will be jointly liable to return the consideration to the company (*ibid*., art. 462). If it is likely that there will be a deficit in terms of surpluses that would otherwise be used to pay dividends at the end of the period, the company's own shares must not be acquired even if the company has these funds available, or even within the number of shares prescribed by the shareholders meeting or the board of directors. If they are acquired and a deficit actually arises, the directors, etc. will be liable to pay compensation unless they can prove they exercised due diligence (*ibid*., art. 465).

There are some cases in which the restrictions on funds do not apply. If, for example, company P acquires company Q, then the shares in P that were held by Q would naturally be transferred to P as a result of the merger. In addition, if shareholders dissenting from the merger exercise their right to demand that the company purchase the shares that they hold, the company is not entitled to refuse this purchase request on the grounds that it does not have the funds to make the purchase (see 6-6 Appraisal Rights below).

(4) Holding and Disposition of Treasury Shares

A company may cancel or otherwise dispose of treasury shares that it has acquired, or may continue to hold them. If the company holds its shares, the company itself is a shareholder, but will not be entitled to exercise voting rights or to receive dividends of surplus (Companies Act, art. 308, para. 2 and art. 453). If it sells treasury shares the purchaser will become a shareholder, which would be the same result as issuing new shares. The same procedures as in the case of a new issuance of shares are required to be followed in order to prevent improprieties in the method of determining the acquirer or the price (*ibid*., art. 199 through art. 213).

If company P acquires company Q, normally, P will issue its shares to shareholders of Q. A company also issues shares if a holder of share options exercises the share options. In cases such as these if the company holds treasury shares it may use these treasury shares instead of issuing new shares.

(5) Acquisition of Shares by a Subsidiary in Its Parent

If company P controls the financial or business policy decisions of company Q by holding a majority of the total voting shares of stock of company Q or by appointing numerous directors of company Q, P is called the parent company and Q is called the subsidiary (Companies Act, art. 2, item 3 and item 4; Companies Ordinance, art. 3). Q's subsidiary company R is also a subsidiary of P. The parent is capable of causing the subsidiary to act according to the parent's intentions, and the financial situation of the subsidiary will also impact that of the parent.

In principle, the acquisition by subsidiaries Q and/or R of shares in P is prohibited. There are some exceptions in cases of mergers or company split, etc., but even in such cases, a disposition of the parent company shares that have been acquired must be made within a reasonable period of time (Companies Act, art. 135; the acquisition of the parent company's shares is allowed in the case of acquisition without consideration and other cases as set forth in Paragraph 2 of the said Article and Article 23 of the Companies Ordinance; see also Article 800 concerning cases where the retaining of such shares is permitted as an exception) (for details, see Column [21]).

[7] Parent Companies and Subsidiaries

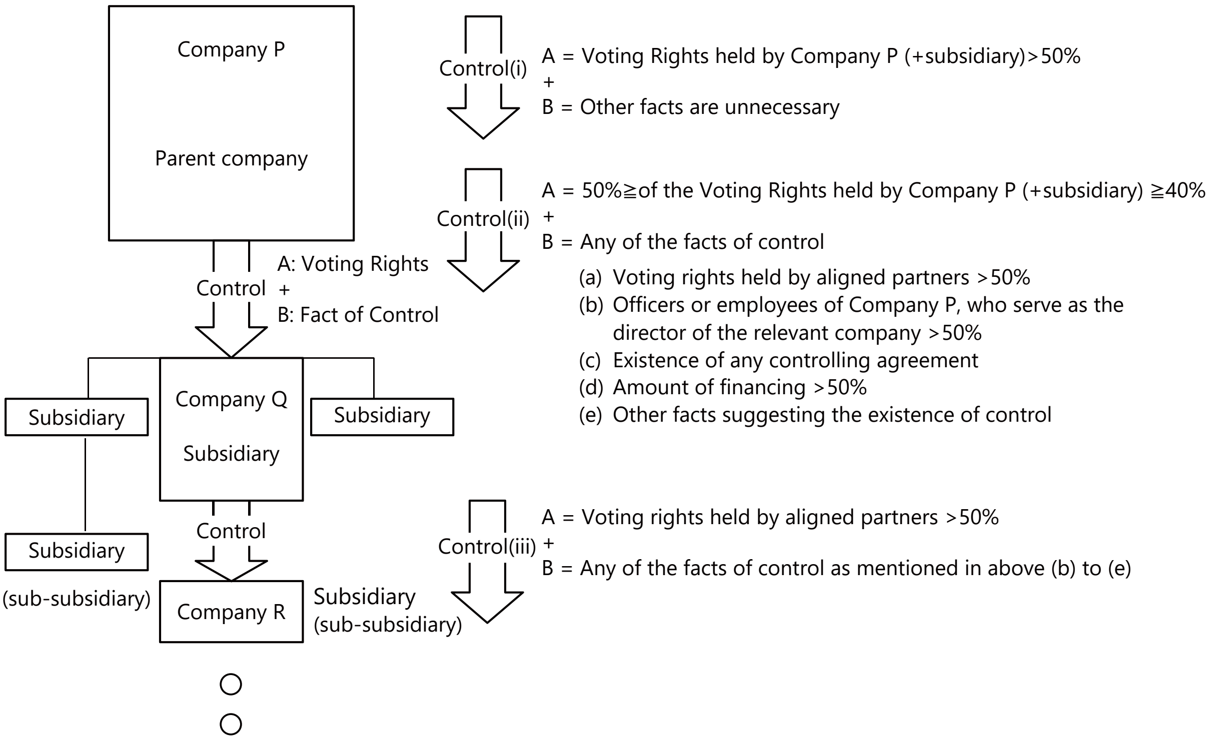
In cases where company P controls the management of company Q, company P is called the parent company and company Q is called the subsidiary (Companies Act, art. 2, item 3 and item 4). The details of the cases where the above mentioned definition applies are stipulated in the Ordinance of the Ministry of Justice (Companies Ordinance, art. 3). As shown in Chart 3-3, there are three ways of controlling the management: (i) If P holds the majority of the voting rights of Q, P will be deemed to be controlling Q, and a parent/subsidiary relationship will be found between the two companies. In addition to the case where holds the majority of such voting rights by itself, the voting rights of Q held by the companies under P's control will be included. Regardless of the names shown, voting rights held for the accounts of P or its affiliates (such as shares held in trust) shall be included; (ii) If the voting rights of Q held by P and its affiliates are less than the majority but not less than 40%, any of the facts mentioned in (a) through (e) of Chart 3-3 above will enable P to be found to have control over Q. Such facts include additional facts such as that the majority of directors of Q consists of officers or employees of P, or financing from P and its affiliates represent more than half of the liabilities of Q; and (iii) Under the fact that the total number of voting rights of Q held by P, companies under the control thereof, and the partners aligned with P amounts to the majority, together with the fact of control such as the majority of directors of Q consists of any officers or employees of P, P is deemed to be the parent company of Q. In this case, the voting rights held by any person who has agreed to exercise their voting rights in step with P will be included, and thus, to an extreme, there are cases where P does not directly hold any shares.

When a parent/subsidiary relationship is found between P and Q, specific regulations is applied to both companies. One of such specific regulations is that Q is not allowed to acquire the shares of P (6-2(5) above). In addition, expansion of regulations exceeding the framework of individual companies can be found such that the directors or employees of a subsidiary are not allowed to serve concurrently as the company auditors of the parent company (Companies Act, art. 335, para. 2), and that the minority shareholders of the parent company are allowed to request for the inspection of account books of subsidiaries (*ibid*., art. 433, para. 3). Moreover, consolidated accountings play an important role, but this will be described separately below (for details, 9-5).

In cases where company P holds all of the issued shares of company Q, company P is called the wholly owning parent company and company Q is called the wholly owned subsidiary company. Although the two companies have separate juridical personality, their economic substance is one and company Q can be considered to be an alter ego of company P. Share exchange and share transfer (12-3 below) are procedures that generate this kind of relationship.(Note)

(Note) A company's management can be controlled by a juridical person other than a company or by an individual by holding a large number of shares in that company. Accordingly, the parent company (Companies Act, art. 2, item 4) and others including a controlling individual are collectively referred to as the "parent company, etc." (*ibid*., item 4-2), and the subsidiary company (*ibid*., item 3) and a juridical person whose management is controlled by a juridical person other than a company or by an individual are collectively referred to as the "subsidiary company, etc." (*ibid*., item 3-2). Similarly, "wholly-owning parent company, etc." (*ibid*., art. 847-3, para. 2) is defined with a broader meaning than "wholly-owning parent company" (*ibid*., art. 847-2, para. 1). This somewhat cumbersome terminology has been developed in order to establish a system for enabling shareholders of the company at the top of the corporate group pyramid to file an action to enforce the liability of an officer of a member company of the group even in a corporate group controlled by the ultimate wholly-owning parent company, etc. and involving a controlling intermediary that is not a stock company (*ibid*., art. 847-3, para. 1) (for details, see Column [12]).

Chart 3-3 Scope of Parent Company and its Subsidiaries



6 3 Other Restrictions on Share Transfers

Shares of stock do not exist before registration of the incorporation of the company or validation of new share issues. Although a transfer of the rights to become a shareholder at this stage (potential shares) would constitute a valid transfer, it cannot be asserted against the company (Companies Act, art. 35 and art. 50, para. 2). Thus, the purchaser cannot demand that the company treat the purchaser as a shareholder.

If a company issues share certificates, a transfer of its shares prior to the issuing of the certificate will not be effective against the company (Companies Act, art. 128, para. 2). Judicial precedents, however, have held that if the company has neglected to issue share certificates for a long period, shares can be transferred and this transfer will be effective against the company. This provision is becoming less important since at the present time no issuance of share certificates is the default rule.

In addition, the Antimonopoly Act places some restrictions on the acquisition of stocks from the viewpoint of competition (Antimonopoly Act, art. 10, para. 1 and art. 14). In particular, a financial institution is, in general, prohibited from holding over 5% of the total voting stock of any domestic company (*ibid*., art. 11, para. 1).

6 4 Method of Transfers of Shares

Shares of stock can be transferred simply by agreement between the parties, but registration of the transfer in the shareholders registry is necessary in order to perfect the transfer against third parties (Companies Act, art. 130, para. 1 (see 7-4 below)). Book-entry shares are transferred by an entry in the transfer account (see 7-6 below).

Shares in the companies with share certificates can be transferred by delivery of the share certificates (Companies Act, art. 128, para. 1). Delivery of the share certificates is sufficient to assert against third parties, but registration of the transfer is required in order to assert against the company (*ibid*., art. 130, para. 2).

6 5 Good Faith Acquisition of Shares

A party that has possession of share certificates is presumed by that fact alone to be the lawful owner (Companies Act, art. 131, para. 1). If the person who purchased the share certificates from another person who stole it, believed such other person to be the lawful owner (in good faith), and the belief was not based on significant lack of caution (gross negligence), the original owner of the share certificates will loss his/her rights (good faith acquisition; *ibid*., art. 131, para. 2).

Currently, as listed companies are not allowed to issue share certificates and it is expected that not many companies will issue share certificates, the detailed explanation of this system shall be omitted.

Although the book-entry transfer system also allows for good faith acquisition, the meaning of this is different from what was discussed above. Under this system, if a record is made of a larger number of shares than was actually the case, the person who made the error in entry will be liable for the error (Act on Book-Entry Transfer of Corporate Bonds and Shares, art. 145 and art. 146; see Column [10] below).

[8] "deemed" and "presumed"

If the letter of law stipulates "shall be deemed to be ***," although the facts are different from ***, treatments shall be made as if *** was the case and no contestation shall be allowed. In contrast to this, if it provided that "shall be presumed to be ***," there is room for persons, who will be troubled if *** were considered to be true, to show evidence contrary to that and convince the judges.

6 6 Demand for Purchase or Sale of Shares

(1) Demand for Purchase of Shares

Shareholders who dissent from a merger or assignment of business may have the company purchase their shares at a fair price following certain procedures (Companies Act, art. 469, art. 785 and art. 797). This is to avoid situations in which, for example, shareholders can sell their shares only at lower prices due to a decision to merge under unfavorable conditions. Similarly, shareholders who dissent from an amendment to the articles of incorporation to restrict share transfers or from a consolidation of shares (*ibid*., art. 116), shareholders who dissent from a company split (*ibid*., art. 806) or shareholders who dissent from share exchange, share transfer or share delivery (*ibid*., art. 797, art. 806 and art. 816-6) may request that the company purchase their shares (except for the case of simplified proceedings and a special controlling company in short-form proceedings; *ibid*., art. 469, para. 2, art. 785, para. 2, art. 797, para. 2, and art. 806, para. 2; see 12-1(3) below). Requests for purchases of shares less than one unit or fractional shares have been described above (4-1(3) and 4-3 above).

When exercising appraisal rights for the shares for which share certificates have been issued, the shareholders must submit the share certificates (Companies Act, art. 116, para. 6, art. 469, para. 6, art. 785, para. 6, art. 797, para. 6, and art. 806, para. 6). In the case of book-entry shares, shareholders must apply for the transfer of their shares to the book-entry account opened at the company's request (Act on Book-Entry Transfer of Corporate Bonds and Shares, art. 155, para. 3; see Column [10] below).

Shareholders who have exercised their appraisal rights may not withdraw such exercise of rights unless approved by the company (Companies Act, art. 116, para. 7, *et al*.). This is to prevent shareholders from engaging in speculative trading of shares with an eye on the fluctuation of share prices. The purchase of shares based on shareholders' exercise of appraisal rights becomes effective as of the effective day of each matter from which they have dissented, such as an amendment to the articles of incorporation or a consolidation of shares (*ibid*., art. 117, para. 6, art. 470, para. 6, art. 786, para. 6, art. 798, para. 6, art. 807, para. 6, and art. 816-7, para. 6).

If the company and shareholders do not reach an agreement by the time limit with regard to the price at which the company should purchase the shareholders' shares, the court shall determine the price based on a petition by either party. Since interest payable to shareholders would increase as this price determination procedure drags on, the company may provisionally pay an amount that it considers fair even before the court makes a determination (Companies Act, art. 117, para. 2 and para. 5, art. 470, para. 2 and para. 5, art. 786, para. 2 and para. 5, art. 798, para. 2 and para. 5, art. 807, para. 2 and para. 5, and art. 816-7, para. 2 and para. 5).

(2) Demand for Sale of Shares (Cash-out)

It has already been described above that a company can demand the heir of shares with restriction on transfer to sell such shares (6-2(2)(iv) above) and that a holder of shares of less than one unit can demand the company sell shares of less than one unit to constitute a unit by combining them with his/her shares less than one unit (4-3 above). Shares subject to call and class shares subject to wholly call (4-4(6) and (7) above) shall be acquired by the company without its demand for sale.

The 2014 amendment has further introduced a new system for permitting a special controlling shareholder to demand the sale of shares, which is generally called a "cash out." If X acquires 90% or more of the voting rights (including those held via its wholly-owned subsidiary company/corporation) of company P (the subject company) and becomes its special controlling shareholder, X will be granted the right to demand all the other shareholders to sell all of the shares of company P thereto (Companies Act, art. 179, para. 1). This would enable X to remove the burden of minor shareholders that abuse their rights. If company P has issued share options, the special controlling shareholder may also demand a cash-out regarding such share options (*ibid*., art. 179, para. 2 and para. 3).

When X makes a demand for a cash-out, it shall determine the amount of consideration for the shares to be sold, the acquisition day and other matters and then notify company P of these matters to obtain its approval (Companies Act, art. 179-2, para. 1 and art. 179-3, para. 1). A demand for a cash-out does not require a resolution of company P's shareholders meeting but requires a resolution of approval of its board of directors (*ibid*., art. 179-3). Having approved such demand, company P must perform the ex ante and ex post facto disclosure procedures (*ibid*., art. 179-5 and art. 179-10) and give notice to the shareholders subject to the cash-out and the registered pledgees of shares subject to the cash-out (*ibid*., art. 179-4; while public notice may be used to substitute the notice in general, notice to shareholders subject to the cash-out is mandatory; *ibid*., art. 179-4, para. 2).

Shareholders subject to the cash-out may file a petition with the court to determine the sale price of their shares subject to the cash-out (Companies Act, art. 179-8; for provisional payment prior to the court's determination, *ibid*., art. 179-8, para. 3). Shareholders or holders of share options who are likely to suffer a disadvantage due to an illegal or extremely unjust demand for cash-out may demand the special controlling shareholder not to acquire the shares subject to the cash-out (*ibid*., art. 179-7). An action to seek invalidation of the acquisition of shares subject to the cash-out may be filed within six months (or one year if the subject company is a private company) from the acquisition day (*ibid*., art. 846-2 through art. 846-9).

6 7 Pledging Shares

Shares of stock are favored as collateral in obtaining financing. The Companies Act specifies pledging as a method for collateralizing shares (Companies Act, art. 146 through art. 154). Registration of a pledge in the shareholders registry is required to perfect against the company and other third parties (*ibid*., art. 147, para. 1). A pledge of shares of a company issuing share certificates (7-1 below) will not be effective unless the share certificates are delivered, and unless the pledgee continues to keep the share certificates in its possession the pledgee will not be able to assert the pledge against either the company or a third party (*ibid*., art. 146, para. 2 and art. 147, para. 2).

If a shareholder who has created a pledge makes a request to the company for recordation in the shareholders registry of particulars such as the name and address of the pledgee, the pledgee will become a registered pledgee, and will be able to receive notices and demands from the company to that address (Companies Act, art. 150, para. 1). A pledge that is not recorded in the shareholders registry is referred to as an informal pledge.

When shares generate dividends on surplus or turn into different forms as a result of a split or consolidation of shares or a merger or dissolution of the company, pledges existing on the shares shall also be effective with respect to such variations of shares (Companies Act, art. 151, para. 1). Therefore, when a special controlling shareholder demands a cash-out (6-6(2) above), any pledge on the shares subject to the cash-out shall also be effective with respect to the money to be paid to the shareholders subject to the cash-out (*ibid*., art. 151, para. 2).

7 Share Certificates and the Shareholders Registry

7 1 Dematerialization of Share Certificates

Share certificates have played a major role in the distribution of shares. Nevertheless, the handing over of share certificates is a burden for companies in which shares are frequently distributed in large volumes, and moreover, there is the danger of fraud. Automated processing by computer is much simpler. The shares listed on financial instruments exchanges consist solely of book-entry shares with no underlying certificate (7-6(1)(i) below).

Even during the days when issuing of share certificates was required, it was not unusual in the case of a small company in which shares were transferred only very infrequently that the company would not issue share certificates, since loss of the certificate would result in a danger of good faith acquisition by another party (see 6-5 above), and the procedures for having certificates reissued also constituted an onerous burden (see 7-3 below).

The Companies Act stipulated that, in principle, companies will not issue share certificates, and stipulated that instead companies which will issue share certificates should stipulate this in their articles of incorporation (Companies Act, art. 214). A company with this type of clause in its articles of incorporation is referred to as a "company issuing share certificate" (*ibid*., art. 117, para. 7).

A company issuing share certificate must issue share certificates without delay following the date of issuance of shares (Companies Act, art. 215, para. 1). Nevertheless, a non-public company (see 2-4(2) above) is not required to issue share certificates until a request is made by a shareholder (*ibid*., art. 215, para. 4). Consequently, if a request is not made by a shareholder it is possible for a company issuing share certificate to exist without issuing a single share certificate.

A shareholder may notify a company if the shareholder does not want to hold the share certificates, regardless of whether or not the company is a public company. If the company retrieves the share certificates from these shareholders and records that fact within its shareholders registry, the share certificates will be null and void (Companies Act, art. 217). If all shareholders make this notification then in this situation as well the company would constitute a company issuing share certificate that does not issue a single share certificate.

Even if share certificates have not been issued for either of the above reasons, delivery of the share certificates is required for transfer or pledging of the shares, as long as the company is a company issuing share certificate.

7 2 Statements on Share Certificates and Their Effect

A share certificate must state legally stipulated items such as the trade name of the corporation and the number of shares, as well as the signature or name and seal of the representative director (or the representative executive officer in the event of a company with nominating committee, etc.) (Companies Act, art. 216).

There is judicial precedent that a share certificate becomes valid at the time that it is delivered to the shareholder. Nevertheless, the certificate will not change its color immediately on being delivered, and it would be dangerous to treat this as simply being a scrap of paper until it is delivered. The safest course is to view it as becoming a share certificate from the time that it is prepared.

7 3 Share Certificates That Are Lost or Found

A shareholder who has lost a share certificate will want it to be reissued, but for a company reissuing is dangerous unless the company can verify that another person does not have the share certificate, and makes the certificate invalid even if it exists somewhere. For this reason, procedures have been established in the form of registration of lost share certificates (Companies Act, art. 221 through art. 233). Completing these procedures requires around one year.

The procedures can be completed somewhat earlier if the method of public notice to lodge an objection can be used. In cases such as when a company issuing share certificate will carry out a consolidation of shares or will merge, the company will ask for submission of the previous certificates to be replaced with the new share certificates or cash (Companies Act, art. 219). Shareholders who are unable to submit these certificates may petition to the company and have the company give public notice. If a person lodging an objection does not appear, the shareholder will be eligible to receive the new certificates or cash. The period of public notice must be at least three months (*ibid*., art. 220).

If an individual who finds share certificates and submit them to the police and receives such share certificates back after the 3-month public notice period in accordance with the Lost Property Act (Civil Code, art. 240), views are split on whether the individual who found the share certificates acquires the shareholder's rights or merely acquires pieces of paper.

7 4 Entry of a Name Change

A transfer or inheritance of shares will not be apparent to those who are outside of the situation. Consequently, a company cannot instantly start treating a new owner of shares as a shareholder. A person cannot assert that the said person is a shareholder until the transfer of title in the shareholders registry is completed (Companies Act, art. 130, para. 1). In the event of a company issuing share certificate, only the relationship with the company is determined in this manner, while the relationship with other parties will in principle be determined on the standard of who has possession of the share certificates (*ibid*., art. 130, para. 2).

If B has not requested the entry of a name change after A has transferred shares to B, the company may continue to pay dividends to A. Whether or not the transferee B can claim the dividends back from the transferor A is a separate matter (for details, see Column [9]).

In principle, a request for the entry of a name change is to be made jointly by both the transferor (*i.e.*, shareholders appearing in the shareholders registry, their heirs, etc.) and the transferee. For a request solely from the person acquiring the shares, it is necessary to submit appropriate documentation, such as a court judgment, proving that the shares were indeed transferred as claimed (Companies Act, art. 133; Companies Ordinance, art. 22). In the event of a company issuing share certificate, the acquirer shall on its own present the shares and make the request. Entry of a name change for book-entry transfer shares is made based on notice of all shareholders (7-6(1)(iii) below).

[9] Forgotten Shares

Shares which do not allow the shareholder to exercise its right to the company for reasons such that the shareholder has not completed the entry of a name change although he/she acquired the shares (it is often the case that such shareholders have forgotten to make such entry, but in some cases the shareholders do not make such entry on purpose due to the fact that the relevant shares are scheduled to be transferred again very soon), are called forgotten shares. In a narrower definition, forgotten shares refer to new shares which have been allotted to the transferor included in the shareholders registry upon the capital increase by allotment to shareholders, because the entry of a name change has not been completed.

It may be unfair for the transferor, who is no longer a shareholder, to receive any dividends or new shares just because his/her name is still on the register. Based on this viewpoint, the transferee should be entitled to claim the delivery of such dividends or new shares against the transferor (if the transferor has already made the payments for new shares, exchange shall be made thereby). Nevertheless, the Supreme Court has held that claim for delivery of new shares could not be approved because it was caused by transferee's failure not to demand the entry of a name change. If both the transferor and transferee are financial instruments business operators that are members of the Japan Securities Dealers Association, both parties divide the shares pursuant to the uniform practice rules of the JSDA.

7 5 Shareholders Registry and Record Date

Shareholders change constantly. Notices of calling of shareholders meetings, dividends of surplus, and notices of new share allotments are sent to the shareholders listed in the shareholders registry. Further mailings are not necessary if mail, like notices to a shareholder, addressed to the listed address does not reach the shareholder for 5 consecutive years (Companies Act, art. 196). Shares held by these shareholders may also at times be sold by the company (*ibid*., art. 197 and art. 198; Companies Ordinance, art. 38 and art. 39). The shareholders registry may also be prepared in the form of an electronic record (file).

A company may prescribe the shareholders stated in the shareholders registry on a certain date (record date) as the person who may exercise shareholder rights, in order to determine the shareholders who are entitled to exercise rights. However, the period between the date of record and date stipulated for the exercise of rights cannot exceed 3 months. At least two weeks prior public notice is required if a record date which is not specified in the articles of incorporation is to be established (Companies Act, art. 124).

7 6 Digitization of Share Certificates

[10] Progress of Paperless Shares

In order to simplify the delivery or receipt of share certificates, as a first step, the "Act Governing Custody and Transfer of Share Certificates, Etc." was enacted in 1984 and came into effect in October 1991 for the purpose of gathering the share certificates in one place, and enabling transfer solely by entry into a ledger (this depository and transfer system was referred to as the "*hofuri*" system). Physical share certificates still existed under this system, but it allowed for the transfer of coownership in the share certificates held on deposit at the depository organization by an endorsement of the name change on the account register.

Finally, since there is no need for share certificates which will not change their physical location, a new mechanism was created in which share certificates are never issued from the start. Although a law had already been made in 2001 in relation to bonds, the law was amended in 2004 and the name was changed to the "Act on Book-Entry Transfer of Corporate Bonds and Shares" to bring shares within the purview of the statute (this

Act was amended along with the 2014 amendment to the Companies Act; hereinafter referred to as the "Company Bonds and Shares Book-Entry Act").

Article 2, Paragraph 1 of the Company Bonds and Shares Book-Entry Act defines 23 types of securities such as shares, bonds, share options and government bonds as "bonds, etc."

Normally, shareholders open an account with the financial instruments business operator which the shareholder normally carries out transactions with, notifies the same to the issuer company, and the issuer company notifies the same to the book-entry transfer organization. Increase of shares through issuance of new shares, etc. is represented in the account in this way (Company Bonds and Shares Book Entry Act, art. 130). Since this treatment cannot be taken with respect to shareholders not making such notice, the company shall request the book-entry transfer organization to open a special account for the shareholder (*ibid*., art. 131). In order to transfer book-entry transfer shares deposited in a special account, the shareholder must transfer such shares to a normal account under the name of the shareholder before transferring the same to the account of the transferee (*ibid*., art. 133).

(1) Book-Entry Transfer Shares and Shareholder's Rights

(i) Book-Entry Transfer Shares

Shares meeting the three requirements below are "book-entry transfer shares" (Company Bonds and Shares Book-Entry Act, art. 128, para. 1): (a) The articles of incorporation of the issuer company does not provide that the company shall issue share certificates, (b) the transfer of shares is not restricted, and (c) the issuer company has given its prior consent to the handling of shares by the book-entry transfer organization (*ibid*., art. 13, para. 1). Book-entry transfer shares are mainly shares listed on financial instruments exchanges.

(ii) Transfer of Book-Entry Transfer Shares

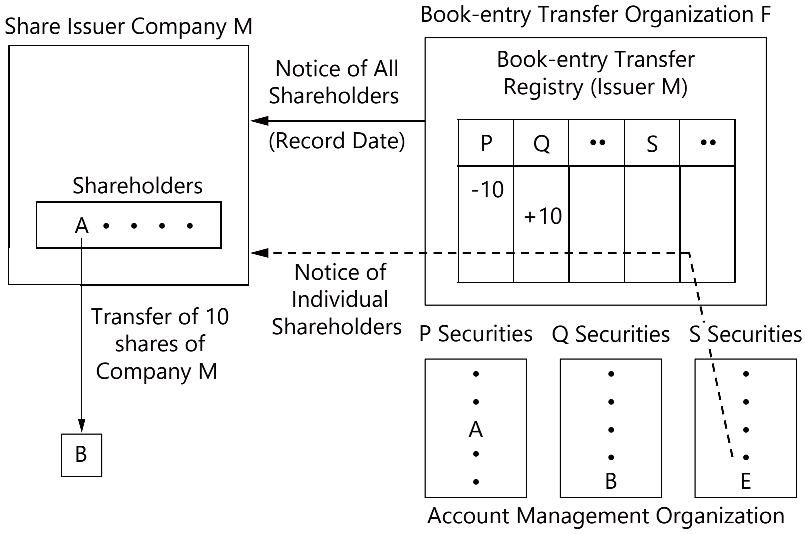
If A wishes to transfer 10 shares of company M to B, the transferor A shall apply for the book-entry transfer, and when 10 shares of company M in A's account with securities company P are deleted, and the increase of 10 shares of company M are entered in B's account with security company Q via Book-entry Transfer Organization F in which P has its account, the transfer of shares become effective (Company Bonds and Shares Book-Entry Act, art. 140). The creation of security interest on shares of company M by C in favor of its creditor D is similar to the case above, and becomes effective by the entry of the same in the pledge column of D's account (*ibid*., art. 141).

(iii) Administration of Shareholders - Notice of All Shareholders and Notice of Individual Shareholders

The book-entry procedures above are taken independent from the issuer company M. If company M shall hold a shareholders meeting, it must give a notice of calling in accordance with its shareholders' registry. As the book-entry transfer organization F has information of the book entry transfer registry, it shall notify the issuer company how many shares are held by who as of the record date, and when company M amends its shareholders' registry in accordance with this notice of all shareholders, it shall be deemed that the change of titleholder was made as of the record date (Company Bonds and Shares Book-Entry Act, art. 151).

Shareholder E of company M who wishes to exercise minority shareholder rights (see 5-1 above) shall request, via the financial instruments business operator with whom it has its account, that book-entry organization F gives notice of the number of shares of company M held by E and when E acquired such shares through the individual shareholder notice from F to company M (Company Bonds and Shares Book-Entry Act, art. 154).

Chart 3-4 Outline of the Book-entry Transfer System



8 Organ in Stock Companies

8-1 Shareholders Meeting

(1) Roles of the Shareholders Meeting

Since a shareholder invests in a company, a shareholder can be considered an owner of the company. However, shareholders in general are not experts in management. Moreover, a company would make little progress if numerous shareholders collectively made decisions. Therefore, even if directors are delegated everyday management of the company, a structure is required which allows decision making based on the intention of the shareholders on important matters concerning the basics of the company, for instance, who is to be appointed as a director.

Certain matters stipulated under the law require a resolution at a shareholders meeting (Companies Act, art. 295, para. 3) while allowing petty demands to restrict management on the part of directors would interfere with effectiveness and functionality. At a company that has a board of directors, the priority of its deliberation is recognized, and except for those matters prescribed by law the resolutions of a shareholders meeting are not recognized as valid. If shareholders wish to have the authority to decide other issues they must have the articles of incorporation include further stipulations on matters requiring their resolution (*ibid*., art. 295, para. 2). In a company that does not have a board of directors, the shareholders meeting is authorized to resolve on all matters (*ibid*., art. 295, para. 1).

The shareholders meeting is a deliberative body that comprises all shareholders. The meetings are held in accordance with the procedures prescribed below, at which resolutions are made or certain matters are reported. In some cases, however, it is possible to handle a situation without holding a meeting. If consent in writing or in an electronic record (such as a disk) is obtained from all shareholders with voting rights, the matter will be deemed to have been approved by a shareholders meeting (Companies Act, art. 319, para. 1). Also, if all shareholders are notified of issues that are to be reported and state in writing or in an electronic record that they believe this is sufficient, the report to the shareholders meeting will be deemed to have been made (*ibid*., art. 320).

(2) Call for a Shareholders Meeting and Shareholders' Right to Propose

An annual shareholders meeting is held following the end of each fiscal year to review the results of the fiscal year. Extraordinary shareholders meetings are held as needed (Companies Act, art. 296, para. 1 and para. 2).

In either case, the board of directors determines the date, place, and agenda of a meeting, and the representative directors shall dispatch a notice of the shareholders meeting to shareholders two weeks prior to the day of the meeting (this is performed by a director in the event of a company that does not have board of directors). A non-public company may give this notice at least one week in advance, and this period may be shortened by stipulation in the articles of incorporation (Companies Act, art. 299, para. 1 and para. 2). If all shareholders with voting rights agree, a meeting may be held without taking the procedures for calling the same (*ibid*., art. 300).

If the company does not call a shareholders meeting, a shareholder may demand the directors that they call a shareholders meeting and if this demand is refused, the shareholder may call the meeting with a court approval. This right is available to minority shareholders holding at least three percent or more of the total voting rights (and in a case of a public company with the further condition that these voting rights have been held for at least six months) (Companies Act, art. 297).

Shareholders may, without calling for a separate shareholders meeting, place additional matters on the agenda by exercising their right to propose (Companies Act, art. 303 through art. 305) at shareholders meetings called by the company.(Note) If the company is a company with a board of directors, this right is granted to shareholders who hold one percent or more of all voting rights or 300 voting rights or more (or 300 units for a company adopting the unit share system) (for a continuous period of six months or longer in the case of a public company). The proposals must be submitted in writing no later than eight weeks prior to the date of the shareholders meeting (and may be made by means such as email if permitted by the company). The company must state the agenda that have been proposed in the notice of calling, except in certain situations where refusing to do is permitted. This mechanism has considerable value in situations in which a shareholder wishes to make a proposal that the directors does not desire, such as a proposal to dismiss a director.

Recently, there have been cases of extreme misuse of the exercise of the right to propose; such as where one shareholder proposes a vast number of matters on the agenda. In order to prevent such abusive exercise of rights, the 2019 amendment limits the number of matters that one shareholder may propose on the agenda for the same shareholders meeting to ten (Companies Act, art. 305, para. 4 and para. 5).

(Note) The agenda would state what is to be deliberated, such as "partial amendment to the articles of incorporation." The Companies Act refers to this as "the matter that is the purpose of the shareholders meeting," or "that will be the purpose of the shareholders meeting." The proposal is what states the content to be delivered, such as what section of the articles of incorporation is to be amended, and in what manner. Companies Act, Article 303 governs the agenda, and Article 304 and Article 305 govern the presentation of proposals.

(3) Voting Rights

In a shareholders meeting, shareholders have voting rights in proportion to the amount of each shareholder's equity investment, not in proportion to the number of shareholders (in principle one voting right per share, and if the company adopts the unit share system, then one voting right per unit (Companies Act, art. 308, para. 1). It should be noted that there are certain exceptions to this rule (see 4-4(3) and 6-1(2) above)).

Treasury shares held by a company do not have voting rights (Companies Act, art. 308, para. 2). Also, if company X holds more than one-quarter of the voting shares issued by company Y, shares issued by company X that are held by company Y will not have voting rights (*ibid*., parenthetical statement in art. 308, para. 1; Companies Ordinance, art. 67 and art. 95). This provision has been enacted in order to discourage excessive cross holdings of shares between companies. Consequently, a subsidiary (6-2(5) above) normally cannot exercise voting rights at a meeting of its parent.

Voting rights can be exercised by proxy so there is no need for a shareholder to attend a shareholders meeting. A provision in the articles of incorporation that states a proxy must be a shareholder is also valid (judicial precedent). A proxy must submit a document certifying the right of proxy (a power of attorney, which may be in the form of email if permitted by the company) to the company. A power of attorney is required for each shareholders meeting (Companies Act, art. 310). A listed company is required to be in compliance with the provisions of the Financial Instruments and Exchange Act for soliciting proxy statements from shareholders (Financial Instruments and Exchange Act, art. 194; Cabinet Office Ordinance on Solicitation of the Exercise of Voting Rights by Proxy on the Part of Listed Companies).

(4) Written Votes, Electronic Voting and Reference Documents

A shareholder who will not be present at the shareholders meeting can participate in voting by entering the shareholder’s approval or opposition on the voting ballot (written voting ballot form) and sending this ballot to the company (this differs from a proxy statement in that a proxy is not necessary). Reference documents will be furnished with the notice of convening of the shareholders meeting, which will provide information that is necessary to make decisions as to whether to attend the meeting, whether to agree or oppose proposals, and what questions to ask, and will also present the reasons for proposals by the shareholders and the opinion of management with respect to the same (Companies Act, art. 301 and art. 311; Companies Ordinance, art. 65, art. 66, art. 69, art. 73 through art. 93, and art. 95). This method may be used by a normal sized company if prescribed by the board of directors (or the directors in the event of a company that does not have a board of directors) (*ibid*., art. 298, para. 1, item 3), but is required for a large company that has more than 1,000 shareholders with voting rights (*ibid*., art. 298, para. 2, main clause). A listed company may use a solicitation for proxy statements instead of a written ballot (*ibid*., art. 298, para. 2, proviso; Companies Ordinance, art. 64 and art. 95).

If the board of directors so determines, means such as email or posting on a website may be used for voting (electronic voting; Companies Act, art. 298, para. 1, item 4, art. 302, and art. 312).

[11] System for Electronically Providing Materials for Shareholders Meetings

If a company is allowed to provide to its shareholders materials for a shareholders meeting such as reference documents by making these materials available on the internet instead of providing them to the shareholders in print, it can save costs for printing and postage, and at the same time, the shareholders can obtain substantial information at an early date. From this viewpoint, the 2019 amendment has introduced a new system wherein a company is not required to provide its shareholders with materials for shareholders meetings in print if the directors post these materials on the company’s website or any similar medium and notify the shareholders of the URL or other necessary information on the website, etc. in writing (Companies

Act, art. 325-2). Companies that issue book-entry transfer shares such as listed companies (7-6 (1) above) will be required to use this system (Act on Book-Entry Transfer of Corporate Bonds and Shares, art. 159-2, para. 1).

However, there are some shareholders who find it difficult to use the internet, such as those who are elderly. In order to protect the interests of such shareholders, it is provided that even when a company uses this system, the shareholders may demand that the company deliver materials for a shareholders meeting in print (the shareholders' right to demand delivery in print; Companies Act, art. 325-5, para. 1).

(5) Proceedings and Resolutions

The chairperson maintains order at the meeting. The chairperson may order an individual out of the room if he/she does not obey the chairperson's orders (Companies Act, art. 315). If a shareholder asks a question regarding a proposal, the directors, company auditors, accounting advisors or executive officers must provide an explanation (*ibid*., art. 314).

A shareholder has a right but does not have a duty to attend a shareholders meeting. The shareholder will probably determine whether to attend on the basis of factors such as the agenda, and consequently, resolutions cannot be made suddenly on a matter that is not stated in the notice. It is true, however, that in companies that do not have a board of directors there would be a close relationship between the shareholders and the directors, and many of these companies also dispense with the notice of calling. Accordingly, there is no restriction on the matters that can be resolved at a shareholders meeting (Companies Act, art. 309, para. 5).

Resolutions include ordinary resolutions (*fūtsu ketsugi*), special resolutions (*tokubetsu ketsugi*), and extraordinary resolutions (*tokushu ketsugi*). An ordinary resolution is passed if shareholders holding a majority of the voting rights attend the shareholders meeting (quorum) and a majority of the voting rights of the attending shareholders are cast in favor of the proposal (Companies Act, art. 309, para. 1). However, these requirements can be modified by the articles of incorporation and, therefore, many companies have eliminated the quorum provision in order to avoid the risk of an adjournment. However, the quorum must not be reduced below one-third of the outstanding shares in the articles of incorporation if the resolution involves the selection and appointment of directors and company auditors, accounting advisors or the dismissal of a person other than a company auditor, even though this is an ordinary resolution (*ibid*., art. 341).

Special resolutions are required for resolving any particularly important matter.(Note) Passing a special resolution requires the attendance of shareholders holding a majority of the voting rights (which the articles of incorporation may reduce to one-third) as well as a vote in favor by a two-thirds majority of the voting rights of the attending shareholders (Companies Act, art. 309, para. 2).

(Note) The following are the items covered by Article 309, para. 2 of the Companies Act: (i) and (ii) - acquisition of treasury shares from specified shareholders (*ibid*., art. 140, para. 2, para. 5 and art. 160, para. 1); (iii) - acquisition of class shares subject to wholly call (*ibid*., art. 171, para. 1), as well as the right to demand that heirs, etc., sell shares to the company (*ibid*., art. 175, para. 1); (iv) - consolidation of shares (*ibid*., art. 180, para. 2); (v) - new issue of shares by a company without a board of directors (*ibid*., art. 199, para. 2, art. 202, para. 3, item 4, and art. 204, para. 2), as well as delegation of matters concerning the offering of new issues of shares on the part of a non-public company (*ibid*., art. 200, para. 1); (vi) - same matters concerning share options (*ibid*., art. 238, para. 2, etc.); (vii) - dismissal of a company auditor or a director who is an audit and supervisory committee member (*ibid*., art. 339, para. 1 and art. 343, para. 4); (viii) - reducing of liability of directors, auditors, accounting advisors, accounting auditors and executive officers (*ibid*., art. 425, para. 1); (ix) - reduction of the amount of stated capital (*ibid*., art. 447, para. 1); (x) - dividends in kind (*ibid*., art. 454, para. 4); (xi) - amendment to the articles of incorporation, assignment of business, dissolution and liquidation (*ibid*., Part II, Chapter 6 through Chapter 8); and (xii) - changes in organization, merger, company split, share exchange, shares transfer and share delivery (*ibid*., Part V).

The requirements for resolutions such as those concerning amendment to the articles of incorporation to restrict share transfers are even more severe (Companies Act, art. 309, para. 3 (see 6-1(2)) above).

Minutes of the shareholders meetings are maintained at the company's principal office (for 10 years) as well as at branches (copies of the minutes for five years), and are shown to shareholders and creditors of the company at their requests (Companies Act, art. 318). They may also be stored on a disk or similar medium and made available for viewing on a screen or printed out.

(6) Illegal Resolutions

If the proceedings violate law and regulations, or if the contents of a resolution violate the articles of incorporation or are significantly unfair due to participation of specially interested persons, shareholders, directors, company auditors, or executive officers may file a lawsuit demanding revocation of the resolution. A motion to revoke must be filed within three months after the date on which the resolution was passed, or the validity of even this kind of resolution cannot be challenged (Companies Act, art. 831).

If the contents of a resolution are illegal (for instance, dividend payments without surplus, or a violation of the principle of shareholder equality), the resolution is null and void. If violations during the proceedings are so blatant that the shareholders meeting can be said to have not been held (for instance, some shareholders colluded and passed a resolution, minutes of a shareholders meeting were prepared for appearance sake without a meeting actually being held, etc.), the resolution is absent. In either case, anyone may allege that the resolution is invalid at any time by any method. One can also seek a judgment by a court to confirm the invalidation (Companies Act, art. 830).

8 2 Directors

(1) Status of Directors

A company with board of directors must have three or more directors (Companies Act, art. 331, para. 5). Only one director is required for a company that does not have a board of directors (*ibid*., art. 326, para. 1). Directors are elected by resolution of the shareholders meeting (*ibid*., art. 329, para. 1). The term of office is in general up to two years. This may be shortened, and a non-public company may extend this term up to 10 years if so specified in the articles of incorporation (*ibid*., art. 332, para. 1 and para. 2). As for a company with audit and supervisory committee, the term of office of directors who are not audit and supervisory committee members is one year (*ibid*., art. 322, para. 2), while the term of office is one year for all directors of a company with a nominating committee, etc. (*ibid*., art. 322, para. 6). The term of office of directors must also be one year if dividends of surplus are to be paid solely on the authority of the board of directors (*ibid*., art. 459, para. 1; except for directors who are audit and supervisory committee members). The term of office of directors may end earlier due to a change in the type of company, *e.g*., establishment of a committee (*ibid*., art. 332, para. 7).[Note]

(Note) The text of the law frequently states "until the conclusion of the annual shareholders meeting." For example, the term of office of directors who have been elected at an annual shareholders meeting on June 25 of two years ago should expire on June 24 of this year, but if the annual shareholders meeting for that year is held on June 28, then their term would be extended until the conclusion of that shareholders meeting.

A person who has been convicted of specific crimes is not entitled to become a director (Companies Act, art. 331, para. 1). The election of a person with such a background is deemed invalid. If a person falls into any of the said categories while serving his/her term as director, he/she loses the position of director.

A director may be dismissed by an ordinary resolution at a shareholders meeting even during the director's term (Companies Act, art. 339, para. 1; dismissal of a director who is an audit and supervisory committee requires a special resolution; *ibid*., art. 309, para. 2, item 7). If the resolution to dismiss a director who has committed a wrongdoing is not passed, minority shareholders with three percent or more of voting rights of the issued and outstanding shares (and in the case of a public company who have held these voting rights or shares for a continuous period of at least six months) may file a claim in court seeking dismissal of said director (*ibid*., art. 854).

If there is a shortfall in the number of directors, the retiring director must continue his duties until a new director assumes his/her post. If necessary a temporary director may be appointed by a court (Companies Act, art. 346). In some cases, a court will suspend the performance of duties by a director, and appoint a person who performs the duties, for instance, when the validity of a resolution to select and appoint the director is pending in a court (Civil Provisional Remedies Act, art. 23, para. 2; Companies Act, art. 352).

(2) Outside Director

In order to prevent a company's president or executive team from abusing their position and to ensure proper management, it is important for the company to have directors who are capable of making decisions from a fair standpoint and speaking without reserve to the executive team. Such directors are appointed from persons outside the company. The criteria for choosing outside directors have changed from only requiring that they have no ties with the company (being outside the company) to also attaching importance on having no interest in the company (not only the outside directors themselves but also their relatives should be independent of the company).

The following persons are not eligible to be outside directors of a company (Companies Act, art. 2, item 15): (a) a person who is an executive director (8-4(1) below), executive officer or employee of the company or its subsidiary company or has been in such position over the past ten years; (b) a person who has been a director, accounting advisor or company auditor of the company or its subsidiary company over the past ten years, and had been an executive director, executive officer or employee of the company or its subsidiary company within ten years prior to assuming the first-mentioned position; (c) a controlling shareholder of the company who is a natural person or a director, executive officer or employee of the company's parent company, etc. (see (Note) in Column [7] above); (d) an executive director, executive officer or employee of the company's sister company (meaning a company whose parent company is the same as that of the company in question); and (e) the spouse or relative within the second degree of kinship of the company's directors, executive officers, or important employees (*e.g*., corporate officer) or of the company's controlling shareholders who are natural persons.

One of the roles that outside directors are expected to play is negotiating a transaction from an independent position when there is a conflict of interests between the company and its representative directors. It would be unfavorable if a person is disqualified from becoming an outside director on the grounds of having engaged in such an act. To avoid this, the 2019 amendment clearly provides that the engagement in such an act does not constitute a ground for disqualification as an outside director (Companies Act, art. 348-2).

A company with nominating committee, etc. (8-9 below) or a company with audit and supervisory committee (8-10 below) must appoint a majority of its directors who are committee members from among persons outside the company. If a company with audit and supervisory committee substitutes special directors for a board of directors (8-3 (Note) below), it must have outside directors (Companies Act, art. 373, para. 1, item 2).

Furthermore, based on the notion that it is desirable for a company owned by a number of shareholders or a company whose shares are traded widely to have outside directors, the 2019 amendment has made it obligatory for a large, public company with a board of company auditors which must submit an annual securities report to appoint outside directors (Companies Act, art. 327-2; and, for outside auditors, see 8-5(4) (Note) below).

(3) Competing Business Transactions; Conflict-of-Interest Transactions; and Remuneration for Directors

A director must work in the interest of the company and must not give priority to his or her personal interests (fiduciary duty; Companies Act, art. 355). The following restrictions are provided to prevent a director entrusted with management of the company from abusing his/her status as director.

If a director operates a business or engages in transactions that are similar to that of the company or conducts transactions as a representative of a competitive company, the director must explain the material facts of the transactions and obtain approval from the board of directors (or the shareholders meeting in the event of a company that does not have a board of directors). The same applies to transactions in which there is a conflict of interest between the director and the company, such as the director carrying out a transaction with the company, or if the company guarantees a director's debts (Companies Act, art. 356 and art. 365). Directors will face a serious liability if the company incurs a loss as a result of activity of this nature (*ibid.*, art. 423 and art. 428).

Remuneration for directors must be stipulated in the articles of incorporation or determined by a resolution at a shareholders meeting in order to prevent directors from simply taking as much as they want. Details such as the amount of and the method of calculating remuneration need to be specified depending on the type of remuneration (Companies Act, art. 361, para. 1). In recent years, it has been emphasized that the regulations on remuneration for directors should function not only in preventing directors from taking as much remuneration as they want, but also in providing incentives for or enforcing supervision on directors. With a view to enhancing the transparency of the process of determining remuneration, the 2019 amendment provides that the board of directors of a company falling within the prescribed scope must decide a policy for determining the details of remuneration for directors by resolution at a board of directors meeting, except when remuneration for each director is specified by the articles of incorporation or resolution at a shareholders meeting (*ibid.*, para. 7; Companies Ordinance, art. 98-5).

(4) Indemnity Agreement and Directors and Officers Liability Insurance Policy

An indemnity agreement is an agreement whereby a company promises to its directors and other officers that it will pay legal costs, damages and other costs they would incur when they are sued for damages in connection with the execution of their duties. A directors and officers liability insurance policy is an insurance policy concluded by a company with an insurance company, whereby the insurance company promises to cover any loss or damage the company's directors would sustain due to being sued for damages.

Both an indemnity agreement and directors and officers' liability insurance policy seem to have significance in providing appropriate incentives to directors so that they are not discouraged in the course of executing their duties. However, at the same time, the risk can inhibit proper execution of duties by directors. In light of this, in order to ensure that an indemnity agreement and directors and officers liability insurance policy will be properly employed, the 2019 amendment has introduced provisions on necessary procedures, such as requiring resolution at a board of directors meeting (or at a shareholders meeting in the case of a company without a board of directors) for the conclusion of such an agreement or insurance policy (Companies Act, art. 430-2 and art. 430-3).

(5) Responsibilities of Directors and Other Officers

If a company incurs damages arising as a result of negligence of a director or any other officer in performing his/her duties, the director or officer must be liable for such damage (Companies Act, art. 423, para. 1). As a rule, the unanimous consent of all shareholders is required to exempt a director from this liability (*ibid*., art. 424). This is in order to protect a right to bring shareholder derivative suit that can be filed even by a shareholder who has only one share. In the case of a corporate group in which a multiple derivative suit can take place, consent must be obtained from all shareholders of the ultimate wholly-owning parent company, etc. (*ibid*., art. 847-3, para. 10; see Column [12] below).

A ceiling of a certain amount may be set on the liability to compensate the company (amount equivalent to the remuneration for six years for a representative director or representative executive officer; amount equivalent to the remuneration for four years for an executive director, etc. or an executive officer other than an representative executive officer; and amount equivalent to the remuneration for two years for a director other than those mentioned above, accounting advisor, company auditor or accounting auditor). There are three methods by which this can be achieved: (i) reduce the liability through an extraordinary resolution at a shareholders meeting after the liability has occurred (Companies Act, art. 425); (ii) prescribe a reduction to the liability in the articles of incorporation in advance and make the reduction effective by a resolution of the board of directors (*ibid*., art. 426; this resolution cannot be made if there is opposition from shareholders holding three percent or more of the voting rights) after the liability has occurred; or (iii) conclude an agreement for limiting the liability as provided in the articles of incorporation with regard to an officer whose liability may be limited to the amount of remuneration for two years (*ibid*., art. 427). In a corporate group in which a multiple derivative suit can take place, a resolution of the shareholders general meeting of the ultimate wholly-owning parent company, etc. is required, and the liability cannot be reduced even partially if shareholders holding 3% or more of the voting rights thereof dissent from the reduction.

The partial release from liability mentioned above is possible with respect to liability in the case of simple negligence in performance of a duty (Companies Act, art. 423, para. 1). It is not possible to reduce the liability for, *inter alia,* providing economic gain (*ibid*., art. 120, para. 4), or illegal dividends (*ibid*., art. 462). Nor is a reduction of liability possible in the case of misconduct with knowledge, or an extreme lack of care (gross negligence).

If director's illegal conduct is likely to cause irreparable detriment to the company, shareholders may demand that such director cease such act and seek provisional disposition from a court (right to claim injunction Companies Act, art. 360).

If a third party incurs damages arising as a result of the illegal conduct of a director with knowledge or gross negligence, such as drawing a bill with no prospect of payment or window-dressing accounts, the third party may claim compensation for damages against the director (Companies Act, art. 429). The Financial Instruments and

Exchange Act provides similar provisions with regard to false statements in a prospectus and the like (Financial Instruments and Exchange Act, art. 21, art. 21-2, art. 22 and art. 24-4).

[12] Shareholder Derivative Suits and Multiple Derivative Suits

When a company does not claim damages against its director or any other officer (in a case where the directors defend one another), a shareholder who holds (or in the case of a public company, a shareholder who has been holding for at least six months) even only one share is entitled to file a suit to enforce the liability of the director or other officer on behalf of the company (Companies Act, art. 847; this suit can be filed against a broader scope of persons than “officers, etc.” as defined in Article 423, Paragraph 1 of the said Act). This system, which is referred to as a shareholder derivative suit, was introduced through the amendment in 1950 modeled on the US law, but has rarely been used for nearly half a century. This is because, even if the claimant shareholder won the suit, the company would receive the damages paid by the defendant director, even though the shareholder had incurred a large amount of costs for filing the suit in proportion to the amount claimed. An amendment was made to eliminate this problem and enable a shareholder to file a suit at a uniform low cost, and since then, this litigation system has been more frequently used than before.

Meanwhile, activities carried out by corporate groups that consist of the parent company and subsidiary companies have become more important (see Column [7] above). Since the ban on the formation of a shareholding company was lifted as a result of the amendment to the Antimonopoly Act in 1998, it has become common to see that the parent company takes responsibility only for controlling the overall management of the subsidiary companies, while having them carry out the business activities. In that case, if the shareholders who may enforce the liability of a company’s officer are limited to shareholders of that company, it would often end up with the subsidiary company’s officers escaping from their liability. The 2014 amendment to the Companies Act was made to partially fill such gap by introducing a new litigation system called the multiple derivative suit.

Minority shareholders (see 5-1 above) who hold (or in the case of a public company, minority shareholders who have been holding for at least six months) 1% or more of the issued shares or voting rights of the ultimate wholly-owning parent company, etc. (see Column [7] above) are entitled to file a suit to enforce the liability of an officer of the subsidiary company (Companies Act, art. 847-3). This does not apply to the subsidiary company which is so small that the book value of its shares does not exceed one-fifth of the total assets of the ultimate wholly-owning parent company, etc. (that is, the total assets of the group as a whole), because it is not necessary to ensure such entitlement in relation to a company with less importance (*ibid.*, para. 4).

Even if a shareholder loses the shareholder’s status before a shareholder derivative suit is filed, the shareholder is still entitled to file such suit if certain requirements are satisfied, such as that the loss of the shareholder’s status was not due to the shareholder’s voluntary transfer of the shares but was caused by the share exchange or any other measure taken by the company (Companies Act, art. 847-2).

8-3 Board of Directors

In a preceding section we have discussed companies that must have a board of directors and companies which are not required to have a board of directors (see 2-4(3) above). Now, let us look at the functions and activities of the board of directors of a company that has a board, regardless of whether this is optional or mandatory. It should be noted that this is different from the board of directors of a company with nominating committee, etc. (as discussed in 8-9 below).

Decisions regarding the management of the company (execution of business) are made by the board of directors. Aside from daily business decisions, decisions on substantial business affairs must at all times be resolved by the board of directors.(Note) In addition, the board of directors bears the responsibility for overseeing the performance of duties by directors (Companies Act, art. 362, para. 2).

(Note) This includes disposing or acquiring significant assets, incurring of large debt, important personnel matters, changes in branches, and implementing an internal control system (Companies Act, art. 362, para. 4), issuing of bonds (*ibid*., art. 362, para. 4, item 5; Companies Ordinance, art. 99), issuing of shares (Companies Act, art. 200, para. 1 and art. 201), issuing of share options (*ibid*., art. 239, para. 1, and art. 240), calling of a shareholders meeting (Companies Act, art. 298, para. 4), appointing or removing a representative director (*ibid*., art. 362, para. 2, item 3), share splits (*ibid*., art. 183, para. 2), and transferring reserves into capital (*ibid*., art. 448, para. 3).

The board of directors is a deliberative body comprising all of the directors (Companies Act, art. 362, para. 1). Resolutions and reports are made in a meeting that is convened according to the procedures for calling the meeting, but if all directors agree a meeting may be called without following these procedures, and waiving the holding of the meeting is also allowed (*ibid*., art. 366 through art. 370, and art. 372).

A resolution at the board of directors meeting is passed by a majority head count of directors (Companies Act, art. 369, para. 1). Voting by proxy is not permitted. As in the case of obtaining approval for transactions with the company, a director who has a specific interest in the resolution must not vote (*ibid*., art. 369, para. 2). Any resolution involving anything illegal during the proceedings or in the content is null and void.(Note)

(Note) Having a large number of directors can make it difficult to call a meeting, but that does not mean it is allowed to delegate the authority to decide on the matters which should be resolved at a board of directors meeting. However, at the companies having at least six directors (of whom at least one is an outside director), it is possible to designate in advance at least three special directors who alone among themselves will deliberate and make resolutions by the board of directors in cases in which urgency is required (such as the disposing of significant assets, or incurring of a large amount of debt) (Companies Act, art. 373).

A company with audit and supervisory committee is permitted to delegate some directors to make decisions on important matters (Companies Act, art. 399-13, para. 5 and para. 6), in which case the rules for special directors do not apply. A company with nominating committee, etc. has nothing to do with such rules for special directors because its board of directors has a different nature and it may delegate executive officers to make a wide range of decisions.

Minutes of the board of directors meetings must be maintained at the company's principal office for 10 years (although they may be stored on a disk or similar media). Shareholders and creditors of the company and shareholders of the parent company may obtain prior permission from a court (such permission is not required for some companies) and inspect or copy these minutes (Companies Act, art. 371).

8 4 Representative Directors

(1) Status and Appointments

The representative directors conduct the daily business of the company, execute resolutions of shareholders meetings and board of directors, and act as representatives of the company outside the company. A company with nominating committee, etc. has no representative director whose role is played by a (representative) executive officer. A company with board of directors must have at least one representative director. The representative directors are appointed from among the directors by the board of directors (Companies Act, art. 362, para. 3). The names and addresses of the representative directors must be registered (*ibid*. art. 911, para. 3, item 14). The board of directors may remove a representative director at any time. (After removal, the former representative director becomes a director without the right of representation.) If an individual loses his or her position as director, the individual is, automatically, no longer a representative director.

The main duty of directors without the right of representation is to attend board of directors' meetings, although these directors may also execute operations of the company if designated by the board of directors (Companies Act, art. 363, para. 1; in Article 2, Item 15 of the said Act, these directors and the representative directors are referred to as executive directors). Moreover, if a director has a concurrent post, such as a branch general manager or division general manager (concurrent duties as an employee), he/she can represent the company outside of the company based on such post.

(2) Apparent Representative Director

Many companies place directors in responsible positions, such as chairman, president, vice president, executive managing director, managing director, and the like. Classification of these positions is determined internally, rather than by law (unlike representative directors, these positions cannot be registered). The public, however, tend to think directors in these positions have the right to represent the company. In order to protect that confidence, when any of these directors in such positions engage in a transaction on behalf of the company, the company must be responsible for the counter party of such transaction if the said director is not a representative director but the counter party believed that the said director had the authority to represent the company (Companies Act, art. 354).

(3) Authority

Representative directors have the authority to do any and all acts in connection with the operations of a company. Even if the company imposes a restriction on this authority (for instance, limiting the scope to responsibility only for labor issues or setting a cap on the value of transactions at a certain amount), the company cannot be exempted from responsibility when the counterpart to a transaction, who is unaware of these restrictions, requests that the company perform the transaction (Companies Act, art. 349, para. 4 and art. 349, para. 5). The same applies when the representative director conducts a transaction in the name of the company in order to enrich him/herself (abuse of authority; Civil Code, art. 107).

8 5 Company Auditors and the Board of Company Auditors

(1) Status of Company Auditors

A company auditor can be thought of as a kind of company watchdog. A company with board of directors must have a company auditor, but if restriction on transfer is imposed on all of its shares, the company can dispense with having a company auditor on the condition that it has an accounting advisor (Companies Act, art. 327, para. 2). A company auditor is also required for a company that has an accounting auditor (*ibid*., art. 327, para. 3). A company with audit and supervisory committee and a company with nominating committee, etc. cannot have a company auditor (*ibid*., art. 327, para. 4).

Company auditors are elected and dismissed by a shareholders meeting (Companies Act, art. 329, para. 1, and art. 339, para. 1). The consent of the existing company auditor is required in order to make a proposal for election of a company auditor to the shareholders meeting, and a company auditor may also demand that a director make a proposal for election of a company auditor (*ibid*., art. 343). The term of office is four years but a company that imposes transfer restriction on all of its shares may extend this to 10 years by stipulation to that effect in its articles of incorporation (ibid., art. 336, para. 1 and para. 2). It is also possible to stipulate in the articles of incorporation that the term of office of a company auditor appointed as a substitute will not be four years, but will be until the expiration of the term of office of his or her predecessor (*ibid*., art. 336, para. 3). In some cases, as well, the term of office of a company auditor may end earlier in association with a change in the type of company, such as when the company becomes a company with audit and supervisory committee or a company with nominating committee, etc. (*ibid*., art. 336, para. 4).

A person who has been convicted of any of certain crimes is not entitled to become a company auditor (Companies Act, art. 335, para. 1). A company auditor may not concurrently hold a position as director, accounting advisor, executive officer or employee of the company or any of its subsidiaries (*ibid*., art. 335, para. 2). This is because it is essential for company auditors to remain independent from directors who are audited by the company auditors.

(2) Duties and Authorities of Company Auditors

A company auditor has a duty to audit the execution of duties by directors and accounting advisors (Companies Act, art. 381, para. 1). Nevertheless, a company that imposes transfer restriction on all of its shares may narrow the company auditor’s authority by stipulation in the articles of incorporation, and limit it to an accounting audit (*ibid*., art. 389; for registration, *ibid*., art. 911, para. 3, item 17, (a)). The opposing term to an accounting audit is a business audit. In all likelihood small companies will add the above limitation because they will have problems in finding the appropriate person to whom these duties should be delegated.

A company auditor who has broad authority including the conduct of business audits has a duty to attend meetings of the board of directors and to express his or her opinion when necessary. Such company auditor may also request the calling of or call a meeting of the board of directors (Companies Act, art. 383). The company auditor must report misconducts of a director to the board of directors (or the directors in the event of a company that does not have a board of directors) and if a director's act is likely to cause substantial detriment to the company, the company auditor may demand that such director cease such act (*ibid*., art. 382 and art. 385). The company auditor shall represent the company in litigation between the company and a director (*ibid*., art. 386). A company auditor that only handles accounting audits does not have this authority, and the investigation by such company auditor of a company or a subsidiary is limited to the matters relating to accounting (*ibid*., art. 381, para. 2 through para. 4, art. 389, para. 3 through para. 7; Companies Ordinance, art. 108). The content of audit reports will also differ (*ibid*., art. 381, para. 1 and art. 389, para. 2).

(3) Liability of Company Auditors

If a company incurs damages as a result of negligence in duty on the part of the company auditor, the company auditor will be liable in the same manner as a director, and the shareholders may bring a shareholders derivative suit and a multiple derivative suit (Companies Act, art. 423, para. 1, art. 847, and art. 847-3). The liability of a company auditor to a company may be reduced to the amount equivalent to the company auditor's remuneration for two years (*ibid*., art. 425 through art. 427).

If any false entries in an audit report have been made by a company auditor, the auditor will be responsible for damages to any third party as well (Companies Act, art. 429, para. 2, item 3; see 8-2(5) above).

(4) Board of Company Auditors

The board of company auditors is a deliberative organ comprising all company auditors (Companies Act, art. 390, para. 1). A company with board of company auditors must have at least three company auditors, of whom at least half must be outside company auditors (*ibid*., art. 335, para. 3).[Note] A large company that is a public company has neither an audit and supervisory committee nor a nominating committee, etc. must have a board of company auditors (*ibid*., art. 328, para. 1). A company with board of company auditors cannot limit the scope of audits to accounting audits (*ibid*., parenthetical statement in art. 389, para. 1).

(Note) An outside company auditor must be a person who falls under none of the following categories: (a) a person who has been a director, accounting advisor, executive officer or employee of the company or its subsidiary company over the past ten years; (b) a person who has been a company auditor of the company or its subsidiary company over the past ten years, and had been a director, accounting advisor, executive officer or employee of the company or its subsidiary company within ten years prior to assuming the position of such company auditor; (c) the company's controlling shareholder; (d) a director, company auditor, executive officer or employee of the company's parent company, etc. (see (Note) in Column [7] above); (e) an executive director, executive officer or employee of the company's sister company (meaning a company whose parent company is the same as that of the company in question); and (e) the spouse or relative within the second degree of kinship of the company's directors, important employees (*e.g*., corporate officer) or controlling shareholders (Companies Act, art. 2, item 16). If there are four company auditors three would be a majority, but two (i.e. half) or more would be sufficient.

The board of company auditors will appoint full-time company auditor(s) from among the company auditors (Companies Act, art. 390, para. 2, item 2 and para. 3). In most cases the outside company auditors would probably be non-full-time company auditors, but sharing of information will be facilitated by use of the board of company auditors as a forum. It is also likely that statements by the board of company auditors will carry more weight with the directors, and enable more emphatic assertions to be made.

The board of company auditors determines matters such as the auditing policy and the auditing methods, but each company auditor is to exercise his or her authorities at his or her own discretion, and in this regard majority decisions of the board of company auditors are not binding (Companies Act, art. 390, para. 2, *proviso*). The opinion of a company auditor who dissents may also be attached to an audit report (Companies Ordinance, art. 130, para. 2).

8 6 Accounting Auditor

All large companies are required to have an accounting auditor, and a company with audit and supervisory committee and a company with nominating committee are also required to have an accounting auditor (Companies Act, art. 327, para. 5 and art. 328). Only certified public accountants or audit firms are qualified to become accounting auditors. In addition, any entity having a close relationship with or interest in the company is excluded (*ibid*., art. 337). While the election as well as dismissal of an accounting auditor is determined by a resolution at a shareholders meeting (*ibid*., art. 329, para. 1, and art. 339, para. 1), the proposal on these matters is to be decided by the board of company auditors (or by a majority of company auditors if the company has no board of company auditors; *ibid*., art. 344), by the audit and supervisory committee if the company is a company with an audit and supervisory committee, or by the audit committee if the company is a company with a nominating committee, etc. (*ibid*., art. 399-2, para. 3, item 2 and art. 404, para. 2, item 2). In some cases, such as when an accounting auditor has difficulty in the execution of his/her duties, such accounting auditor may be dismissed by the unanimous consent of all company auditors (*ibid*., art. 340). The term of office is one year, but unless otherwise resolved at the annual shareholders meeting, the term is renewed automatically (*ibid*., art. 338).

The accounting auditor audits the financial statements and the supplementary schedules (audit at the end of fiscal year). In order to perform this particular duty, the accounting auditor needs to consistently audit daily activities (audit during fiscal year), and is therefore provided with investigation authority for that purpose (Companies Act, art. 396). The responsibilities assumed by the accounting auditor on any occasion when he/she fails to perform his/her duties, such as overlooking window dressing of accounts, are essentially the same as for company auditors, and an accounting auditor may also be a defendant in a shareholders derivative suit (*ibid*., art. 423 through art. 427, art. 429, para. 2, item 4, art. 847, and art. 847-3). Penalties such as deregistration or suspension of business may also be imposed (Certified Public Accountants Act, art. 29, *et seq*.).

8 7 Accounting Advisor

An accounting advisor is a new class of company organ that was enacted with the Companies Act. The accounting advisor works with the directors to prepare financial statements (Companies Act, art. 374, para. 1), and consequently is not an auditing organ. Persons who are eligible to be accounting advisors are certified public accountants, audit firms, tax accountants and tax accounting corporations (*ibid*., art. 333, para. 1). There are many cases in small companies in which financial disclosure is not sufficient while at the same time many companies have relied on these persons for accounting advice as well as preparation of financial statements. This system has been introduced as a means of improving legitimacy and transparency in accounting on the part of companies that do not have a well-developed auditing organization. Companies are not required to have an accounting advisor, but any company may create this post by making a statement to that effect in its articles of incorporation. Experience leads us to believe that most of the companies having this organ will be comparatively small companies. Even in the case of a company with board of directors, if the company places transfer restrictions on all of its shares the company may dispense with having company auditors on the condition that it has an accounting advisor (*ibid*., art. 327, para. 2).

Election and dismissal of an accounting advisor is made by resolution of a shareholders meeting (Companies Act, art. 329, para. 1, art. 339, para. 1 and art. 341). The term of office is two years but a corporation which imposes transfer restrictions on all of its shares may extend this to 10 years by stating that effect in its articles of incorporation (*ibid*., art. 334, para. 1). As with a company auditor, there is a prohibition against concurrent holding of other positions (*ibid*., art. 333, para. 3, item 1). The investigation authority and the substance of reports is similar to that of a company auditor (*ibid*., art. 374; Companies Ordinance, art. 102), and an accounting advisor has a duty to attend meetings of the board of directors that will approve matters such as the financial statements, and express opinions (Companies Act, art. 376).

One important job of an accounting advisor is to maintain materials such as financial documents and accounting advisor reports, to enable shareholders and creditors to obtain information (Companies Act, art. 378; Companies Ordinance, art. 104). If there is disagreement between the accounting advisor and the directors in connection with areas such as the preparation of financial documents, the accounting advisor may express his or her opinion at a shareholders meeting (Companies Act, art. 377). Faithful performance by an accounting advisor of his or her duties as intended by law would make it difficult for directors to get away with acting irresponsibly in the handling of accounting. An accounting advisor faces essentially the same liability as a company auditor in the event that the accounting advisor is negligent in the performance of his or her duties, and may be a target of a shareholders derivative suit (*ibid*., art. 423 through art. 427, art. 429, para. 2, item 2, art. 847, and art. 847-3).

8 8 Inspector

An inspector is elected at a shareholders meeting or temporarily by a court, for the purpose of investigating the business and financial condition of a company or the procedures of the shareholders meeting (Companies Act, art. 33, para. 1, art. 207, para. 1, art. 306, para. 1, art. 316, para. 2 and art. 358, *et al*.). A court appointed inspector will report the findings of the investigation to a court.

8 9 Company with Nominating Committee, Etc.

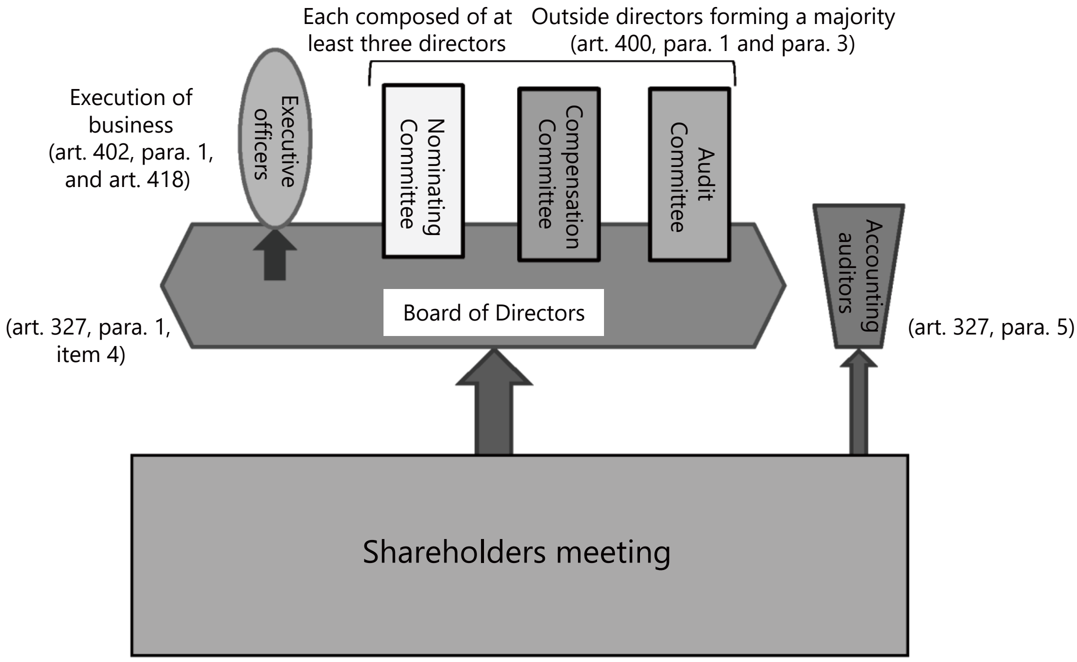
A company with nominating committee, etc. is based on the theory that separating actual management from the persons who create basic management policy and monitor its implementation would facilitate the achievement of sound management. This became available as an option for some companies with the 2002 amendments, under the name of a company with committees, etc. The name of this category of company was changed to a company with committees under the 2005 Companies Act, and then changed again to the current name upon the 2014 amendment which introduced a company with audit and supervisory committee as a new category of company. A company with nominating committee, etc. has two committees in addition to the nominating committee and executive officers.

In a company with nominating committee, etc., the execution of business is carried out by executive officers who are appointed by the board of directors and have a broad range of authority. The board of directors only determines significant matters of core management such as determining the basic management policy and officers (Companies Act, art. 402, para. 2 and art. 416). Directors who are not executive officers cannot execute the operations (*ibid*., art. 415). If there is only one executive officer this would naturally be the representative executive officer, but if there is more than one, the board of directors will determine a representative officer (*ibid*., art. 420, para. 1). Both directors and executive officers have a term of service of one year (*ibid*., art. 332, para. 3, and art. 402, para. 7). This is because it is necessary to ensure that there is an opportunity to confirm the confidence of shareholders at least once a year since the settlement of account is normally not presented for approval at an annual shareholders meeting. A director must not serve concurrently as an employee (*ibid*., art. 331, para. 4).

A company with nominating committee, etc. has three committees: First, the audit committee which audits the execution of duties by the directors and the executive officers, and also decides on the election, dismissal and denial of reappointment of the accounting auditor. In principle, the members of the audit committee also represent the company in litigation against directors (Companies Act, art. 404, para. 2 and art. 408). Since a company of this type has an audit committee, it has no company auditors (*ibid*., art. 327, para. 5). Second, the nominating committee, which decides on proposals to the shareholders meeting to elect and dismiss directors (*ibid*., art. 404, para. 1). Third, the compensation committee, which determines the compensation for each director and executive officer (*ibid*., art. 404, para. 3 and art. 409).

The membership of each of these committees shall consist of at least three directors who are chosen by the board of directors and majority of them must be outside directors. Moreover, the audit committee must not have any members who also serve as an executive officer, an executive director or an employee, including that of a subsidiary (Companies Act, art. 400). A company with nominating committee, etc. is designed to have the board of directors perform strong supervisory role mainly through the committees that are independent from executive officers and thereby minimize the likelihood of having a president who acts solely on the basis of his or her own opinions.

Chart 3-5 Company with Nominating Committee, Etc.



8 10 Company with Audit and Supervisory Committee

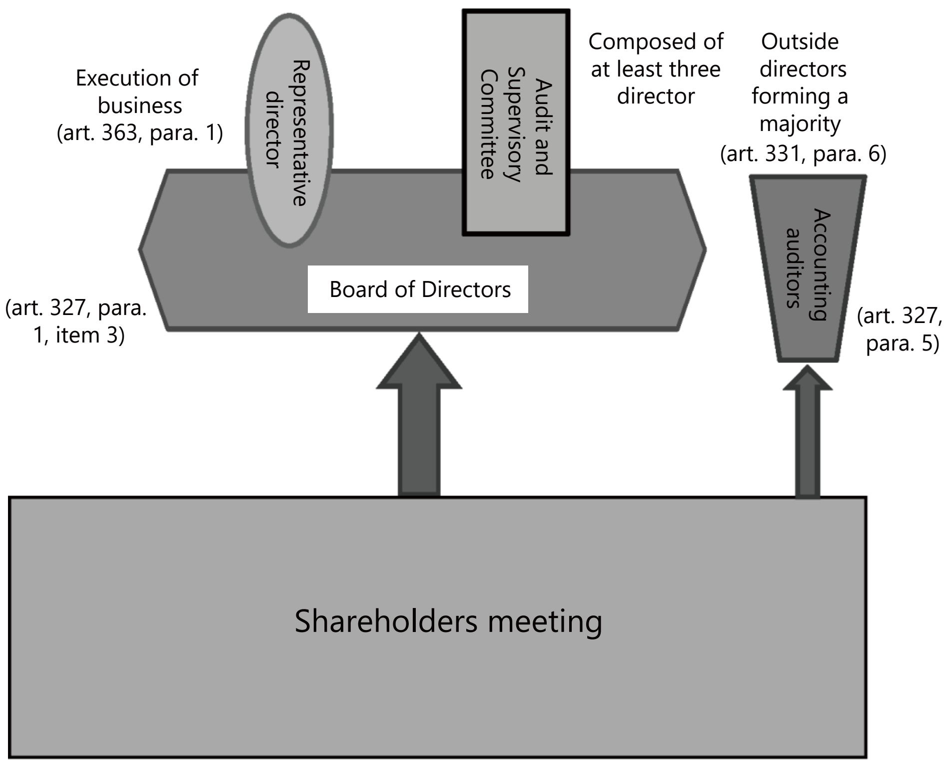
Most large companies in Japan are companies with board of company auditors. Although efforts have been made to improve corporate management by introducing a system of outside company auditors, it is still difficult to gain understanding of the international business community for the concept of company auditors, which is not adopted under corporate laws in many countries. In recent years, business results of Japanese companies compared unfavorably with those of foreign companies, and an argument that this was attributed to the absence of outside directors authorized to participate in making management decisions gained support.

A company with nominating committee, etc. discussed earlier may be a desired form of company. However, very few of Japanese companies adopt this form although it was introduced as a form that would be acceptable on an international level. They might be unwilling to be restricted by the nominating committee or compensation committee, in which outside directors form a majority of members, in assessing their business results or deciding successors. Another option would be to require a company with board of company auditors to have outside directors. This idea was also strongly opposed by Japanese companies, arguing that it would ask too much to require a company to have both outside company auditors and outside directors. As a result, the 2014 amendment introduced a system of company with audit and supervisory committee, which can be described as a form between a company with board of company auditors and a company with nominating committee, etc.

A company with audit and supervisory committee has representative directors and a board of directors (Companies Act, art. 327, para. 1, item 3 and art. 399-13, para, 3), as in the case of a company with board of company auditor, but it does not have a company auditor (*ibid*., art. 327, para. 4) and the audit and supervisory committee within the board of directors (the audit and supervisory committee must have three or more members the majority of whom are outside directors; *ibid*., art. 331, para. 6) takes charge of the duty to audit (*ibid*., art. 399-3 through art. 399-7). While audit and supervisory committee members are directors (*ibid*., art. 399-2, para. 2), they are appointed separately from other directors due to the differences in duties (*ibid*., art. 329, para. 2; prohibition of concurrent holding of positions, *ibid*., art. 331, para. 3). Their remuneration is also determined separately from the remuneration for other directors (*ibid*., art. 361, para. 2). The term of office of other directors is one year in principle, whereas audit and supervisory committee members may hold office for two years (*ibid*., art. 322, para. 2 through para. 4) and a special resolution of the shareholders meeting is required to dismiss them (*ibid*., art. 309, para. 2, item 7). Thus, while audit and supervisory committee members are similar to company auditors in some aspects, their authority goes beyond the scope of audit and further covers supervision, *e.g*., they may state their opinions regarding the appointment, dismissal and resignation of and remuneration for other directors (*ibid*., art. 342-2, para. 4, art. 361, para. 6, and art. 399-2, para. 3, item 3), as the name of their title represents. The audit and supervisory committee can be described as covering part of the role of the nominating committee and compensation committee.

The board of directors in a company with audit and supervisory committee may delegate the representative directors to make a board range of decisions in the execution of business if a majority of its members are outside directors or it is so prescribed in the article of incorporation (Companies Act, art. 399-13, para. 5 and para. 6). For example, in order to make an offering of new shares or company bonds, a resolution of the board of directors is required in a company with board of company auditors but it is not required in a company with audit and supervisory committee, as in the case of a company with nominating committee, etc.

Chart 3-6 Company with Audit and Supervisory Committee



8 11 Internal Control System

What type of internal organization will achieve proper and efficient operation is an unavoidable issue that must be addressed in order to improve performance and to compete effectively. As such all companies have taken this issue seriously, and this should in principle be handled on the voluntary initiative of each company. Whenever a scandal occurs, mention is made of a weakness in risk management as well as poor awareness of legal compliance, and legal reforms as well as manual preparation are conducted repeatedly in order to improve this situation. In addition to the various reforms in connection with organizational design that are discussed in this Chapter, the Companies Act encourages companies to build up their systems in the following manner.

The Companies Act stipulates “The development of systems necessary to ensure that the execution of duties by the directors complies with law and regulation and the articles of incorporation, and other systems…necessary to ensure the properness of operations of a stock company and operations of group of enterprises consisting of the said stock company and its subsidiaries,” as one of the matters that is to be determined by the board of directors (Companies Act, art. 348, para. 3, item 4, and para. 4, art. 362, para. 4, item 6, and para. 5, art. 399-13, para. 1, item 1, (c), and art. 416, para. 1, item 1, (e); a large company, a company with audit and supervisory committee, and a company with nominating committee, etc. must decide these matters without fail). The Ministry of Justice Ordinance on this basis has listed the regimes that each type of company should implement (Companies Ordinance, art. 98, art. 100 and art. 112).

These systems are generally called internal control systems. Each company is required to develop systems for legal compliance, information control, risk management, assuring efficiency, assuring proper conduct in business by the corporate group, independence of auditing staff, and reporting to auditing organizations. These matters must be stated in the content of business reports, and if the development of systems is not appropriate, audit reports by the auditing organization must make a statement to that effect with the reason therefor (Companies Ordinance, art. 118, item 2, art. 129, para. 1, item 5, and art. 130, para. 2, item 2, and art. 130-2, para. 1, item 2).

9 Company Accounting

9 1 Financial Statements

(1) Preparation and Approval

A stock company must prepare the following documents for each fiscal period: (i) balance sheet, (ii) profit and loss statement, (iii) the business reports, (iv) the statement on changes in shareholders’ equity, etc., (v) the list of particular notations, and (vi) supplementary schedules (Companies Act, art. 435, para. 2; Accounting Regulation, art. 59, para. 1). What must be stated in these documents is stipulated by the Ministry of Justice Ordinance. These documents may be created by means of recording on a disk or similar media (*ibid*., art. 435, para. 3).

These documents must be audited by the respective auditing organizations within the company (Companies Act, art. 436, para. 1 and para. 2; Accounting Regulation, art. 121 through art. 132). The audit reports differ in their content depending on the type of auditing organization as well as whether such documents are audited by other auditing organization. After the audit is completed these documents must be approved by the board of directors (*ibid*., art. 436, para. 3). Thereafter, when the annual shareholders meeting is called, the financial statements, business reports and auditors report are furnished to shareholders in writing or in email depending on the method of notice (*ibid*., art. 437; Companies Ordinance, art. 116, item 4; Accounting Regulation, art. 133). Listed companies also provide these materials electronically as materials for a shareholders meeting (see Column [11] above).

The financial statements are submitted to an annual shareholders meeting for approval, while a report on the substance of the business report is made (Companies Act, art. 438). Nevertheless, in the event of a company with board of directors, a report on the content of the financial statements is sufficient if the accounting auditors and all other auditing organizations issue the audit reports that opine the financial statements are prepared in accordance with law (*ibid*., art. 439; Accounting Regulation, art. 135).

[13] Fair Accounting Practices

The Companies Act and other related laws set forth many rules concerning accounting procedures but it is impossible for legislation to cover the entire area of company accounting. Therefore, in order to prevent accounting irregularities, companies are required to follow fair accounting practices, as a general principle (Companies Act, art. 431; Accounting Regulation, art. 3). Companies can usually satisfy this requirement by complying with corporate accounting principles and standards. Recently, along with the trends in globalization, companies adopting consolidated accounting (see 9-5 below) have been allowed to choose to follow international accounting standards or U.S. accounting standards (Accounting Regulation, art. 120 through art. 120-3).

(2) Disclosure

It is important to accurately inform shareholders and corporate creditors of the condition of the company. Wrongdoing should be difficult when everything is transparent.

Notices convening an annual shareholders meeting must furnish to the shareholders documents such as financial statements, as stated above. Moreover, the financial statements, business report, supplementary schedules and audit report must be maintained from at least two weeks prior to the date of the annual shareholders meeting (or one week in the event of a company other than a company with board of directors) for at least five years at the head office and three years at the branch offices, to allow shareholders and creditors of the company as well as shareholders of the parent company to inspect the same (Companies Act, art. 442). After the annual shareholders meeting has been closed public notice will be given of the balance sheet (and in the event of a large company the profit and loss statement as well), but this may be made by methods such as posting on a website. If the method of public notice is the Official Gazette or a daily newspaper, public notice of a summary of the balance sheet is sufficient (*ibid*., art. 440; Accounting Regulation, art. 136 through art. 147).

Seeking further information requires a review of the account books and related documents. Since this may involve company trade secrets, the right of viewing these documents is granted only to minority shareholders who hold three percent or more of the voting rights or shares issued (Companies Act, art. 433, para. 1 and para. 2; ibid., art. 433, para. 3 and para. 4 with respect to the rights of shareholders in a parent company). If any wrongdoing by management is suspected, minority shareholders holding three percent or more may bring the allegations before a court, and request appointment of an inspector for an investigation of the situation in the company or a subsidiary (*ibid*., art. 358).

[14] Electronic Public Notice

Stock companies are required to disclose a large amount of information in addition to their financial statements. While the customary method has been to make such disclosure by means of the official gazette (*kanpō*) or newspaper, the 2004 revision now allows for the use of electronic public notice. The choice of which method to use is to be stipulated in the articles of incorporation (Companies Act, art. 2, item 33 and item 34, and art. 939, para. 1). For electronic public notice, the address of the home page and other relevant information shall be registered (*ibid*., art. 911, para. 3, item 29) and the relevant company shall be subject to an investigation as to whether the required matters are being made available to the general public during the public notice period (*ibid*., art. 941; no such investigation is necessary for reporting of public notice of account closing). Even if what is being disclosed during the public notice period is cut off or corrupted (both cases referred to as "interruption of public notice"), the validity of the electronic public notice will not be affected if the company has been acting in good faith without material negligence or if there is legitimate reason for the interruption, and the interruption occurs only for a brief period, with the company having taken action to give public notice as soon as it became aware of the problem (*ibid*., art. 940, para. 3).

(3) Assets and Liabilities

On balance sheet, assets are listed on the left side, and liabilities as well as net assets (including stated capital, reserves and surpluses, etc.) are listed on the right side (Accounting Regulation, art. 73 through art. 76). If assets are overvalued, there is the risk of appearances with no substance. Thus, standards of evaluation are specified for asset items (such as current assets, fixed assets, stocks, monetary claims, etc.), and as a rule they are based on the acquisition price, although market value is to be used for assets that have a market price. Regular depreciation needs to be applied to fixed assets (Accounting Regulation, art. 5).

Liabilities not only include debts but also anticipated expenses to prepare for specific expenditures and losses, and the appropriation of earnings from the current term is booked as an allowance (Accounting Regulation, art. 6).

9 2 Legal Reserves

Legal reserves are mandatory reserves required by law. As with stated capital (2-3 above), both are figures merely for accounting purposes. Payment of dividends of surplus, and acquisition of treasury stock, etc. cannot be executed unless assets equivalent to the total of stated capital and reserves are set aside. In this way, reserves play a cushioning role to prevent assets from falling below capital.

One of the legal reserves is retained earnings reserve. At least one-tenth of the amount of payment whenever payments such as dividends are to be paid from the surplus must be added to retained earnings reserve, until the total of retained earnings reserve and capital reserve reaches one-fourth of the stated capital (Companies Act, art. 445, para. 4; Accounting Regulation, art. 22).

Another legal reserve is capital reserve. Out of the paid in amount for stocks, the portion that is not added to stated capital (for paid-in surplus, 2-3 above) must be put in this reserve. Any gains in funds from merger, company split, shares exchange, share transfer or share delivery must also be put into this reserve (Companies Act, art. 445, para. 1 through para. 3 and para. 5; Accounting Regulation, art. 35 through art. 39-2, and art. 45 through art. 52). As with the stated capital, the capital reserve is formed from the contribution by shareholders and its accumulation does not have any upper limit.

[15] Reserves and Surplus

The amount remaining after deducting the amount of liabilities from the amount of assets is not repayable to anyone and belongs to shareholders and thus is called net assets (= net worth = shareholder's capital) (at the time of dissolution of a company, this amount shall be distributed to the shareholders as the residual assets). The portion of the net assets which exceed the stated capital includes reserves whose distribution is subject to some restriction.

When simply referred to as reserves, they mean legal reserves, while there are voluntary reserves which are not mandatory but the companies reserve pursuant to the provisions of the articles of incorporation. For example, the companies reserve them to stabilize dividends or for an anniversary project. Moreover, there are some cases where terms such as reserves for bad debts and depreciation reserves are used, but these are different from the abovementioned reserves in nature. (Sometimes, the term "allowances" is used in place of reserves).

Surplus may also be divided into capital surplus and retained earnings and these terms have been used in the Accounting Regulation, in accordance with the concept of accounting where capital transactions and profit and loss transactions are distinguished.

9 3 Dividends of Surplus

(1) Source of Dividends

Since the capital maintenance requirement is rather stringent for a stock company, dividends are distributable only when the company has a surplus. The amount of surplus that can be appropriated for dividends (distributable amount) are calculated as follows: Net assets are obtained by subtracting the amount of liabilities from the amount of assets on the balance sheet. The distributable amount can then be calculated by deducting the amount of capital as well as the legal reserves and the other amounts set forth in other regulations from the amount of net assets (Companies Act, art. 461, para. 2; Accounting Regulation, art. 156 through art. 158).

Dividends paid to shareholders without distributable amounts are invalid (improper dividends). Creditors of the company may request that improper dividends be returned (Companies Act, art. 463, para. 2). Also, directors must assume responsibility for paying the amount of these illegal dividends to the company (*ibid*., art. 462, para. 1, item 6; for penal provisions, *ibid*., art. 963, para. 5, item 2).

(2) Determination of Dividends

Dividends of surplus are determined by a resolution of the shareholders meeting on each occasion (Companies Act, art. 454, para. 1). A company with an accounting auditor and one of the following: a board of company auditors, audit and supervisory committee or nominating committee, etc. may, if the term of office of directors (in the case of a company with audit and supervisory committee, directors who are not audit and supervisory committee members) is shortened to one year, and accounting is recognized to be properly conducted without problem, determine the payments of dividends solely on the authority of the board of directors pursuant to the provisions of the articles of incorporation (*ibid*., art. 459; Accounting Regulation, art. 155). It is also possible to stipulate in the articles of incorporation that the shareholders meeting will not resolve on the dividends (*ibid*., art. 460).

Dividends may also be made through delivery of properties other than cash (dividends in kind) although a special resolution by a shareholders meeting is required in this case (Companies Act, art. 454, para. 4 and art. 309, para. 2, item 10). If the right to demand cash distributions is granted to those shareholders who desire payment in this form, then this may be determined through an ordinary resolution.

(3) Semi-Annual Dividends and Quarterly Dividends

As stated above, dividends are determined at a shareholders meeting, but it is unnecessary for this to be an annual shareholders meeting. A provisional account closing may be determined on a provisional account closing day, and if the provisional financial statements on that date are approved by the shareholders meeting, or the board of directors meeting if certain requirements are met, dividends may be paid any number of times in the same year (Companies Act, art. 441; Accounting Regulation, art. 135).

A company with board of directors may, if stipulated to that effect in its articles of incorporation, make cash dividends by resolution of its board of directors once in the middle of each fiscal year (interim dividends; Companies Act, art. 454, para. 5). It is necessary for there to be no risk of a deficit at the end of the period, and if a deficit occurs at the end of the fiscal year, the directors may be held liable (*ibid*., art. 465, para. 1, item 10).

9 4 Reduction in Stated Capital and Reserves

A larger amount of stated capital and legal reserves may be preferable as it shows the scale of the company. However, companies whose amount of net assets falls below the sum of the abovementioned amounts are incapable of paying dividends, and the larger the difference is, the longer it takes the companies to resume dividends. Even if a company had no loss, it may prefer to lighten its burden to pay dividends by reducing idle assets. Especially, as capital reserves could increase without limitation (see 9-2 above), if a company with a high share price repeats capital increase, reserves with limited utility would increase disproportionately.

The reduction of the amount of stated capital requires an extraordinary resolution by a shareholders meeting (Companies Act, art. 447, para. 1 and art. 309, para. 2, item 9), although an ordinary resolution at an annual shareholders meeting is sufficient if made to cover a deficit (in other words not for the purpose of producing an amount which may additionally be paid as dividends) (*ibid*., art. 309, para. 2, item 9, (b); Companies Ordinance, art. 68). Moreover, a resolution by the board of directors (or the directors in the event of a company that does not have a board of directors) will be sufficient if shares are to be issued at the same time that the amount of stated capital is reduced, with the netting of the amount of increase in the stated capital by capital increase and the amount of decrease in the stated capital by capital reduction resulting in no less than the prior amount of stated capital (*ibid*., art. 447, para. 3).

A reduction in the amount of reserves will require the procedure as discussed above (Companies Act, art. 448).

In principle, procedures to protect creditors must be taken in order to reduce the amount of stated capital or reserves, since there will be a reduction in the amount of assets that are restricted from being transferred outside of the company (Companies Act, art. 449).

In order to claim invalidity of a reduction of stated capital that is in violation of the law, one must bring a law suit within six months (Companies Act, art. 828, para. 1, item 5). In addition to shareholders, directors, company auditors and executive officers, a creditor who did not approve a reduction in the amount of stated capital may become a plaintiff in a suit of this nature (*ibid*., art. 828, para. 2, item 5). Even if a judgment invalidating the capital reduction becomes final, the effect thereof will not be retroactive (*ibid*., art. 839).

9 5 Accountings of Group of Companies

In an extreme case, for example, company P is a wholly owning parent company of company Q. Even if company P and company Q stated their amount of stated capital to be 10 billion yen and 2 billion yen respectively in their balance sheets on a non-consolidated basis, the amount of stated capital to be stated in the consolidated balance sheet of the group consisting of the two companies shall be 10 billion yen instead of 12 billion yen. This is because the 2 billion yen, which is included in company P’s assets as an investment in company Q, shall be set-off against company Q’s stated capital of 2 billion yen (Accounting Regulation, art. 68). In cases where company P’s products are sold to company Q or conversely, company Q’s products are sold to company P, the relevant products shall be treated as inventory while they remain under the control of the two companies, and their sales shall be included in the sales volume only after they have been sold to companies other than those consisting the group. All of the claims and obligations existing between company P and company Q shall be set-off in the same manner.

In cases where company R (whose stated capital is 2 billion yen) is not a wholly owned subsidiary company of company P and 70% of company R’s shares is held by company P while the remaining 30% is held by A, 1.4 billion yen, which amounts to 70% of company R’s stated capital of 2 billion yen, shall be set-off against company P’s investment in company R. The remaining 0.6 billion yen shall be included in the net assets section as non-controlling interests in the consolidated balance sheet (Accounting Regulation, art. 76, para. 1, item 2, (e)).

In principle, all of the subsidiaries shall be included in the scope of consolidation (for details, see Chart 3-3, Column [7]). Exceptions that shall be excluded from the scope of consolidation are companies that are temporarily controlled and companies that are under the control of trustee in charge of the insolvency procedures (Accounting Regulation, art. 63). Large companies which are obliged to submit annual securities report are required to prepare consolidated financial statements (Companies Act, art. 444, para. 3).

In cases where, unlike its relationship to its subsidiaries, company P is not controlling company S, but is in a position capable of influencing decisions of financial and business policy thereof, company S shall be deemed to be an “affiliated company” of company P (Accounting Regulation, art. 2, para. 3, item 21). The scope of affiliates is defined from both the holding ratio of voting rights and additional facts, and in case the voting rights of company S held by company P and its subsidiaries under their accounting amounts to 20% or more, such fact alone shall lead to a conclusion that company S is an affiliated company of company P, but in the case where the holding ratio of such voting rights is 15% or more, company S shall be regarded as an affiliated company of company P only after additional facts such as the dispatch of officers or significant financing are found (Accounting Regulation, art. 2, para. 4). With regard to company P’s investments in its affiliated companies and non-consolidated subsidiaries, the amount attributable to company P shall be calculated by applying the equity method (Accounting Regulation, art. 2, para. 3, item 26 and art. 69).

There is a term that is confused with and very similar to “affiliated companies,” “associated companies.” This term refers to the group of companies itself, and not only shall it include company P and its subsidiaries and affiliated companies, but also company P’s parent company M, if any, and moreover, company T, which has company P as its affiliated company (*i.e.*, company T is capable of influencing the decisions of financial and business policies of company P) shall be included in the scope of associated companies of company P (Accounting Regulation, art. 2, para. 3, item 25). Among the assets, shares of associated companies shall be classified and recorded in the non-consolidated balance sheet (Accounting Regulation, art. 74, para. 3, item 4 and art. 82).

There is another term "affiliated party" which refers to a broader scope. This includes major shareholders of each company who hold 10% or more of the voting rights thereof and their relatives, as well as each company's officers and their relatives, in addition to the abovementioned associated companies (Accounting Regulation, art. 112, para. 4). Attention is paid to these persons as, among acquaintances, the screening standard for transactions would be lax and the request for performance will be loose, and thus such transactions should be examined in distinction from arm's length transactions (as stated in the notes; Accounting Regulation, art. 98, para. 1, item 11 and art. 112).

10 Issue of New Shares

10 1 Authorized Capital System

At incorporation, a company need only issue one-fourth or more of the total number of authorized shares as stipulated in the articles of incorporation (Companies Act, art. 37, para. 3). The remainder may be issued at any time by a resolution of the board of directors as needed. The board of directors is granted the authority to increase capital by the unissued capital stock, calculated by subtracting the shares that have already been issued from the total number of authorized shares. If there is a short supply of shares in unissued capital stock, the articles of incorporation may be amended to increase the total number of authorized shares. In this case as well, the increase is limited to up to four times the outstanding shares (*ibid*., art. 113, para. 3, art. 184, para. 2). These are the restrictions imposed on public companies. A company which places transfer restrictions on all of its shares may issue less than one-fourth of its authorized shares at the time of incorporation, or amend its articles of incorporation to increase the total number of authorized shares in excess of four times the shares outstanding and accordingly, can significant capital increase at one step.

The amendment made to the Companies Act in 2014 clearly stipulates that public companies shall be subject to the same restrictions mentioned above in the case of consolidation of shares (*ibid*., art. 180, para. 3, and art. 182, para. 2) or incorporation of a company by consolidation-type merger, incorporation-type company split or share transfer (*ibid*., art. 814, para. 1).

10-2 Procedures for Issue of New Shares

(1) Issue of Shares for Subscription

(i) Allotment to Shareholders

This is a method for allotting new shares to existing shareholders in proportion to the number of shares held by them. In many cases shares are issued at below market value. The ratio of shares held by shareholders does not change before or after the issuance, and because shareholders can obtain new shares cheaply, they do not suffer any loss even if the price of the old shares drops due to the increase in the number of shares. If an increase in capitalization of a company whose shares are not listed on a financial instruments exchange has been made other than through this method, the shareholders would be unable to purchase shares on a market to prevent a decline in their shareholding ratio. Accordingly, there is a strong necessity for this method. If this method is used to increase capitalization, the company will issue to each shareholder a notification with an advance notice of loss of right stating the number of shares to which the shareholder has the right to receive an allotment, as well as when the right will expire if the shareholder does not apply for subscription (Companies Act, art. 202).

The same results can be achieved by a method called rights offering. The 2011 amendment to the Financial Instruments and Exchange Act made it much easier to use the method, which suggests that the capital increase through this method will grow in the future. Under this method, share options shall be allotted to all shareholders without contribution (allotment of share options without contribution; Companies Act, art. 277 through art. 279) (see 10-4 below), and the shareholders will have the option to either exercise the share options and invest in new shares or sell the share options. If the new shares are issued at a price lower than the market price, the price of old shares in hand decline, but the loss arising as a result thereof shall be covered by the profits to be gained by obtaining the new shares at a low price (by exercising share options), or by the sales price of the share options. Share options listed on a financial instruments exchange can be sold easily. There are cases where a company sells the share options yet to be exercised in their entirety to a securities company, and the securities company sells at the market the new shares which it obtained by exercising the share options (*i.e.*, commitment-type rights offering). Shareholders are guaranteed a period of at least two weeks after they are notified of the details and number of share options to be allotted until they exercise their options (Companies Act, art. 279, para. 3), while the company is exempted from the obligation to prepare and deliver a prospectus to a certain extent (Financial Instruments and Exchange Act, art. 13, para. 1, *proviso,* and art. 15, para. 2, item 3).

(ii) Public Offering or Third Party Allocation

If a company does not adopt the method of allotment to shareholders, the company is required to set the issue price at a fair value based on the financial condition of the company (issue at market price). Otherwise, the assets of the company would not increase proportionately to the increase in number of outstanding shares, value per share would decline, and it would impair the interests of existing shareholders. As long as the issue price is a fair value, new shares may be allotted to any applicant (principle of free allotment).

If a company wants to allot new shares to a third party, such as a business partner, client or employee, at an issue price significantly below fair value, the company must present the reasons for this allotment and pass a special resolution at a shareholders meeting (Companies Act, art. 199, para. 3, art. 200, para. 2 and art. 309, para. 2, item 5). The issuance of new shares at a "price that is particularly favorable" to such third parties could result in a decline in the value per share and cause a disadvantage to the existing shareholders.

It came into question whether or not it should be allowed to conduct capital increase without hearing the opinions of shareholders in cases where there is a person who is to be allotted a substantial number of shares (special subscriber) and, as a result, the controlling shareholder is to be changed, even though the amount to be paid for new shares is fair and the value of the existing shares would not decline. If a person will come to hold more than half of the voting rights as a result of a capital increase, the 2014 amendment introduced a requirement for public companies to notify the shareholders to that effect, and to obtain the approval under the resolution of a shareholders meeting if 10% or more of the voting rights dissent to the capital increase (Companies Act, art. 206-2; except for cases where there is an urgent need for the capital increase). The same amendment is planned to be made with respect to allotment of share options (*ibid,*, art. 244-2).

[16] Issue of New Shares and Disposition of Treasury Shares

While the issue of new shares is an act of newly issuing additional shares, the treasury shares held by a company are issued shares although the shareholder's rights thereof are restricted, and the disposition of treasury shares is one of the transfers of company's assets (6-2(4) above). Moreover, while the issue of new shares results in the increase in the number of issued shares, the disposition of treasury shares will not, and thus the two acts are different in nature. However, the two acts are common in that the company raises the funds and the number of shareholders holding shareholder's rights increases, and they also have the same influence on the interests of existing shareholders. For this reason, the Companies Act stipulated these matters together in Part II, Chapter II, Section 8 (art. 199, *et seq*.) and entitled it "Issue of Shares for Subscription."

(2) Resolutions for New Issues, Disclosure and Allotments

All details regarding new issues are determined by resolutions of the board of directors, including which method will be used, when and how many shares of what kind of stock will be issued at what price, how much of the issue price will be accounted for stated capital, (Companies Act, art. 201, para. 1). These are to be determined by a shareholders meeting in the case of a company that has transfer restrictions on all of its shares, but it is possible to delegate this to the directors or the board of directors (*ibid*., art. 199, para. 2, and art. 200, para. 1). If shares which have a market price are being issued at a fair price, it is not necessary to set the amount to be paid in itself in the resolution approving the issue, and it will be sufficient to stipulate the method for setting the price (*e.g*., a formula based on the closing price on (a certain date) multiplied by XX%, etc.) (*ibid*., art. 201, para. 2). The reason for this is that the market price may fluctuate during the period for public notice described below.

Once these items have been determined, the company must provide notice or public notice at least two weeks prior to the payment date (Companies Act, art. 201, para. 3 and para. 4). Existing shareholders must receive notification in advance of information on new share issues in order to prevent an increase in capitalization that would be to their disadvantage.

Notice of particulars such as the subscription requirements and the places of handling payment must be given to persons who intend to subscribe for the shares in response to the solicitation (Companies Act, art. 203, para. 1; Companies Ordinance, art. 41). Nevertheless, if a prospectus set forth in the Financial Instruments and Exchange Act is delivered, it is not necessary to provide this information (Companies Act, art. 203, para. 4; Companies Ordinance, art. 42).

[17] Public Notice of Offering and Notification with an Advance Notice of Loss of Rights

The Companies Act uses the term "*boshu*" in the broad sense of the term meaning to solicitation for contributions to others. The Financial Instruments and Exchange Act, however, uses a narrower definition of this term, to mean a solicitation of at least 50 persons, including general investors (so-called amateur) (Financial Instruments and Exchange Act, art. 2, para. 3). If an offering falls under this category, securities registration statement must be filed with the prime minister, or a shelf registration shall be made (Financial Instruments and Exchange Act, art. 4 and art. 23-3).

The notice and public notice of subscription requirements as well as a notification with an advance notice of loss of rights (which is a notice that a shareholder will lose his/her rights unless he/she applies for the subscription) shall be made to the shareholders two weeks prior to the payment date, but when the payment period is set, such notice and notification shall be made two weeks prior to the initial date of the period (Companies Act, art. 201, para. 3). When the abovementioned procedures are to be taken pursuant to the Financial Instruments and Exchange Act, a notification with an advance notice of loss of rights is not required to be sent to shareholders (Companies Act, art. 201, para. 5; Companies Ordinance, art. 40).

(3) Effective Date of Issues

In the case of a new issue by shareholder allotment, subscription by the shareholder is concluded when the shareholder applies for subscription by the due date. With any other new issue, subscription is concluded only when the company completes allotment to the applications.

A person who has subscribed for new shares must pay the entire amount of the amount to be paid in on the payment date (within the payment period) to the bank handling the payments (Companies Act, art. 208, para. 1). In practice, an amount equivalent to the amount to be paid in is collected at the same time as the application is submitted (advance on subscription), and that amount is appropriated to payment for the shares on the payment date. A company may turn down an application by a person who does not pay an advance on subscription (judicial precedent).

There is nothing to prevent the new issue becoming effective even if there are unsubscribed or unpaid new shares in the total of new shares as determined by the issue resolution. A fully paid up subscriber of new shares becomes a shareholder form the date on which the payment is made (Companies Act, art. 209, para. 1). While a subscriber who has disguised payment may not exercise a shareholder's rights until after performing contributions, a person who has acquired shares from such subscriber may exercise rights if the person has no knowledge of such disguise and has no gross negligence in not knowing it (*ibid*., art. 209, para. 2 and para. 3; see 3-2(2) above).

Issuance of new shares increases the number of outstanding shares as well as stated capital and these matters must be registered (Companies Act, art. 911, para. 3, item 5 and item 9, and art. 915, para. 1). However, registration itself is not relevant to the effectiveness of new issue; provided that one year after the payment date, the subscription can no longer be invalidated or revoked (*ibid*., art. 211, para. 2).

10 3 Illegal New Issues

If there is anything materially illegal in the procedures of a new issue of shares, such new issue of shares is null and void, but there are many expedients for reducing confusion in trading in new shares. A new issue of shares can only be invalidated if a lawsuit is filed by shareholders, directors, company auditors or executive officers within six months (or within one year in the case of a company that imposes transfer restriction on all of its shares) after the issue date (Companies Act, art. 828, para. 1, item 2 and para. 2, item 2). The causes of action for invalidation are narrowly defined. For instance, if a new issue is carried out by a representative director without a resolution legally passed by the board of directors, the issue will not be null and void (judicial precedent). If the new issue is adjudicated to be null and void, the new shares will become null and void. However, transactions made prior to the judgment will not be affected. The company must then take steps such as collecting the share certificates, and refund payments (*ibid*., art. 840).

If virtually no procedures have been taken for the purpose of issuing the shares, anyone can assert the nonexistence of a new issue at any time and by any means, including bringing a suit for confirmation of the nonexistence of a new issue (Companies Act, art. 829).

Prior to the date new issue of shares becomes effective, a shareholder may file for enjoinment of the illegal new issue of shares (Companies Act, art. 210). Anyone subscribing for new shares at a significantly unfair price in conspiracy with a director has the obligation to pay the balance between that amount and the fair price (market value) (*ibid*., art. 212).

10 4 Share Options

(1) Meaning and Effect of Share Options

Share option is a right to receive shares in a company in exchange for exercising the right against the company (Companies Act, art. 2, item 21). When a holder of share options exercises this right the company must issue new shares to the holder, or transfer to the holder treasury shares that the company has. The amount payable at the time of exercise of the rights is predetermined, and if the price of the stock is higher than this amount, the person exercising the share options obtains profits. If the exercise price is lower than the share price the holder of the share options can defer the exercise of the rights and consequently a person who has purchased a share option for valuable consideration will not lose more than the value of this consideration.

Share options are used for various purposes. Share options granted to directors and employees as incentive compensation are called stock options. If share options are issued in return for compensation, they may function as a fund-raising vehicle. Share options are also used in the case of issuing new shares by a method called a rights offering (see 10-2(1)(i) above). In addition, share options may be used as measures against a hostile takeover.

(2) Issue of Share Options

Share options are issued through a resolution by the board of directors in the case of a public company (Companies Act, art. 240, para. 1). While in the case of a company that imposes transfer restrictions on all of its shares the decision to issue is to be made by resolution of a shareholders meeting, the decision may be delegated to the board of directors or the directors (*ibid*., art. 238, para. 2, and art. 239, para. 1). A special resolution by a shareholders meeting is required in order to issue share options to persons other than shareholders on particularly favorable conditions, and, in the event of an issue proportional to the shareholding of shareholders (allotment to shareholders), the same procedures as required for an issue of new shares also apply to share options, including the determination and notification of the allotment date and public notice of certain matters (*ibid*., art. 241, *et seq*.). The allotment to shareholders without contribution and the issuance of new shares resulting in the change of the controlling shareholder were described above (see 10-2(1)(i) and (ii)).

(3) Transfer and Succeeding to Share Options

Share options include those for which certificates are issued (share options with issued certificates) and those for which certificates are not issued. Transfer of share options with issued certificates is not valid unless the certificates are delivered (Companies Act, art. 255, para. 1). Share option certificates can be either registered or in bearer form (*ibid*., art. 290). If the certificates are registered form, then transfer of the share options requires a statement in the share option registry in order to assert the transfer against the company (*ibid*., art. 257).

It is possible to stipulate at the time of issue that company approval must be obtained in order to transfer share options (Companies Act, art. 236, para. 1, item 6). Although the restrictions against transfer are similar to those of shares, the company will not designate a purchaser even if the company denies approval for transfer (*ibid*., art. 262 through art. 266).

If an event such as a merger or a share exchange has occurred in connection with a company that issues share options, whether the company after a merger or the wholly owning parent after a share exchange will have a duty of succession in connection with the share options would differ depending on the nature of stipulations of the rights under the share options as well as the nature of stipulations in the merger agreement or share exchange agreement (*inter alia*, Companies Act, art. 236, para. 1, item 7 and item 8, art. 749, para. 1, item 4, and art. 911, para. 3, item 12).

[18] Public Notification and Decision for Invalidation

The instruments such as promissory notes and checks where the rights are combined with certificates and distributed are called securities, and the invalidation of the certificates separately from the rights is required to be made through a cautious procedure, to secure the safety of transactions based on the trust in such securities. First, the person who seeks such invalidation shall file a request for public notification with the summary court. If the court finds that the relevant certificates have been lost due to loss or theft or disasters such as fire or tsunami, it gives a public notice on the bulletin board of the court and official gazette to the effect that the relevant certificates shall lose their validity unless the person who currently possess them notify to that effect. If no notification has been made by the date prescribed to be two months after the date of public notice, the court will declare the relevant securities to be invalid. When a person receives this decision of invalidation, he/she may exercise his/her rights pertaining to the securities without the certificate. This procedure is stipulated in the Non-contentious Cases Procedures Act.

In the past, share certificates were reissued through this procedure when share certificates were lost. At present, not only is it often the case where no share certificates have been issued in the first place (see 7-1), but also the procedures for registration of lost share certificates and public notice of objections shall be used in case where the issued share certificates have been lost, and thus the abovementioned procedure is irrelevant to share certificates (Companies Act, art. 233). However, when share option certificates or bond certificates have been lost, the abovementioned procedures must be taken (*ibid*., art. 291 and art. 699).

(4) Exercising Share Options

Share options may be exercised at any time during the exercise period. To exercise the share options, the holder will pay the prescribed amount into a bank or other financial institution. The share options holder will become a shareholder on the date that the share options is exercised (Companies Act, art. 281 and art. 282).

A company may acquire its own share options (Companies Act, art. 273 through art. 275) but may not exercise them (*ibid*., art. 280, para. 6).

If the share options have been exercised in violation of the predetermined conditions for exercise, the issue of new shares is invalidated based on an action seeking invalidation of a new share issue (judicial precedent).

11 Bonds

11 1 Bonds and Shares

A bond is a type of long-term debt. The bonds are divided into multiple parts, similar to the case of shares and take the form of a negotiable security (debt security). Bonds are a convenient vehicle for widely procuring funds from the public. Bonds are the same as government bonds and public bonds by nature. A person who has acquired a bond is called a bondholder.

Bonds are liabilities of the company. Thus, they must be repaid upon maturity. Pre-specified interest must be paid even if the company's performance is poor. Market prices of bonds fluctuate only slightly. Therefore, the market involves little speculation when compared to shares (except when interest rate fluctuations are extremely large). Unlike shareholders, bondholders are not constituent members of a company, and therefore do not have the right to engage in management of the company. If a company is dissolved, bondholders are repaid from corporate assets in the same way as other general creditors, and the shareholders receive distributions only if there are assets remaining after the repayment to creditors.

These are some of the significant differences between bonds and shares. However, in actuality, the differences are not that significant. An ordinary shareholder has little interest in exercising voting rights and pays attention only to share prices and yields. Also, dividends tend to level out (tendency of shareholders by nature to be like bondholders). In particular, dividend preferred shares subject to call option and no voting rights are close to bonds in character. Redemption of subordinated bonds ranks junior to other claims. Although it is doubtful whether a company would continuously exist in the case of bonds with 100 year maturity, there are even perpetual bonds. In this sense, it may be said that subordinated bonds, perpetual bonds and bonds with share option are similar to shares. Bonds with share options and shares are sometimes collectively referred to as "equity" (11-6 below).

[19] Provisions Concerning Bonds

Prior to the enactment of the Companies Act, stock companies were regarded to be the sole entity that would issue bonds, and thus the provisions concerning bonds were stipulated as part of the provisions concerning stock companies. However, in the Companies Act, the provisions concerning bonds have been enhanced to constitute Part IV of the Act, and a definition clause (Companies Act, art. 2, item 23) was provided as well, on the grounds that membership companies are entitled to issue bonds too.

11 2 Issuance of Bonds

Issuance of bonds is determined by a resolution of the board of directors (Companies Act, art. 362, para. 4, item 5; this is determined by the directors if the company does not have a board of directors, and is usually delegated to executive officers in a company with nominating committee, etc. or to representative directors in a company with audit and supervisory committee; see 8-9 and 8-10 above). Any offering under the Financial Instruments and Exchange Act requires a registration or a shelf registration with the Prime Minister. Documents such as the prospectus may be used for disclosure both under the Companies Act and the Financial Instruments and Exchange Act (Companies Act, art. 677, para. 4; Companies Ordinance, art. 164).

The bond issuer can immediately procure funds if an underwriting syndicate underwrites the entire amount of bonds and then offers subscriptions to the public (gross amount underwriting). There are also bonds such as bond issued by certain financial institutions which use a best efforts method.

Even if some of the bonds to be issued go unsubscribed, in principle the bonds which have been subscribed will be issued (*uchikiri-hakkō*), and if this is not to be the case then a stipulation to the contrary must be made at the time of issuing the bonds (Companies Act, art. 676, item 11).

When a company offers bonds, the company must specify a bond administrator, such as a bank. However, there is an exception to this; a bond administrator need not be appointed if a single bond offering is for less than 50 lots or if only large-denomination bonds of JPY100 million or more are issued (Companies Act, art. 702 and art. 703; Companies Ordinance, art. 169 and art. 170). In reality, it is often the case that companies employ this exception and avoid appointing a bond administrator due to the difficulty in finding an entity that can serve as their bond administrator and the high costs required for the appointment.

The 2019 amendment has introduced a new system allowing companies, even when they do not need to appoint a bond administrator, to appoint a bond administration assistant as a person authorized to perform certain limited functions to assist the bond holders in the administration of bonds (Companies Act, art. 714-2).

11 3 Protection for Bondholders

Although bondholders are also creditors of the company, each individual bondholder may not have much financial influence, and many may have little expert knowledge. It is also very difficult for a company to negotiate separately with many individual bondholders, and it is of course more convenient to handle all bondholders with a common interest as a group. Having a bond administrator serve as manager to act as liaison for the group, and consolidating the voices of the bondholders in a resolution at a bondholders' meeting, are for the purpose of accommodating this need.

A bond administrator is provided with the authority to carry out actions requisite to protecting the bondholders, as follows. For instance, the bond administrator completes the necessary procedures for all the bondholders to receive redemption funds in respect of the bonds from the issuing company (Companies Act, art. 705, para. 1), is in charge of coordinating the bondholders' meetings (*ibid*., art. 717, para. 2, and art. 731, para. 1, *et al*.), and can file claims to reverse any wrongdoing by the issuing company toward bondholders (*ibid*., art. 865). Because the bond administrator has these significant duties, the bond administrator cannot freely resign from the position (*ibid*., art. 711), and the dismissal of the bond administrator by the issuing company is restricted (*ibid*., art. 713). In addition, the bond administrator owes the duty of fairness and good faith against the bondholders in the management of the bonds (*ibid*., art. 704, para. 1) as well as the duty of due care of a prudent manager, and if the issuing company is highly likely to go bankrupt and the bond administrator is a bank, the bank will be subject to severe responsibility if it collects its loans from the issuer while bypassing bondholders (*ibid*., art. 710, para. 2).

While the bond administrator has a blanket authority and broad discretion, the bond administration assistant (mentioned in 11-2 above) is a person authorized to assist the bond holder in the administration of bonds and has a significantly limited scope of authority and discretion compared to the bond administrator (Companies Act, art. 714-4).

11 4 Distribution and Redemption of Bonds

If a bond contains a stipulation that the bond certificate is to be issued, the transfer of that bond will not be valid unless the bond certificate is delivered (Companies Act, art. 687). For a bearer bond, delivery of the bond is itself sufficient to effect a transfer, but in the case of a registered bond, the transfer cannot be effected against the issuing company unless the acquirer is recorded in the bond registry, and in the event of a bond for which the certificate will not be issued this recording is required in order to assert the transfer against the issuing company or another third party (*ibid*., art. 688).

In Japan almost all bonds certificates are bearer form. As with share certificates, good faith acquisition by a good faith third party may occur (Companies Act, art. 689, para. 2; see 6-5 above, for loss of bond certificates, see Column [18]).

Bonds have become paperless earlier than shares, and are managed through a digitized accounting book (see Column [10] above).

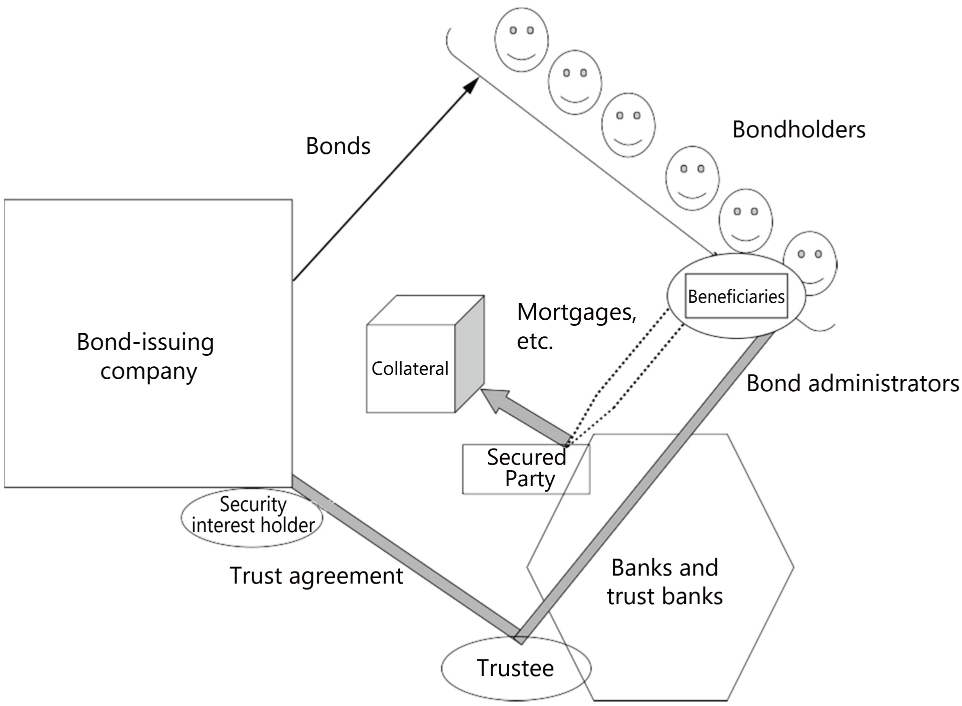
Some bonds are coupon bearing (Companies Act, art. 697, para. 2). If the coupons are missing at the time of early redemption of bonds before their maturity then the portion of interest for which the payment date has not fallen due will be deducted from the redemption price (*ibid*., art. 700).

11 5 Secured Bonds

It is impossible to collateralize each bond when there are so many bondholders and they constantly turn over. So, a trust company (trustee of the collateral) comes between the issuing company (trustor) and the bondholders, and the trustee and trustor enter into a trust agreement (deed of trust). As a formality the trustee is the secured party and assumes the obligation to retain, and execute, the security rights for the benefit of all bondholders. Bondholders are the beneficiaries and receive the benefits of collateral equally, according to the amount of credit. Also, a trustee functions as the bond administrator. The Secured Bonds Trust Act applies in these circumstances.

The collateral that can secure the bonds are factory, real property, railway, and enterprise mortgages, and the like. An enterprise mortgage is the collateral of total assets of a stock company as a whole (The Enterprise Mortgage Act). Secured bonds can be issued several times until the issue amount reaches a limit, by predetermining a cap for the scheduled issue and creating collateral for the entire issue. Also, any additional bond issues will be secured pari passu with any earlier issues.

Chart 3-7 Structure of Secured Bonds



[20] Collateral of Bonds

Banks learned a harsh lesson from the financial crisis of 1927, and have maintained a policy of securing all normal financing including all claims (the principle of security). Most bond issues in Japan were secured by collateral and the costs for issue were rather expensive. However, unsecured bonds are on the increase, reflecting the importance of the earning capacity of an issuing company since the value of collateral becomes dubious if the issuing company should go bankrupt. Effort to ensure payment of the principal and interest is made by utilizing credit ratings or by including financial covenants, such as a limitation on dividends, in place of collateral.

11 6 Bonds with Share Options

(1) Meaning and Effect

Bonds with share options are bonds with share options attached (Companies Act, art. 2, item 22). By paying a predetermined exercise price, bondholders can acquire a certain number of shares even if the share price rises. The company can also prescribe advantageous terms for issuing of the bonds, including an interest rate that is lowered commensurately with the sweetener provided. The number of issued shares will increase more gradually through each exercise of share options and thereby makes the cost of dividends rise in a gentle slope rather than what would be the case for an issue of new shares which causes a sudden increase in the number of shares outstanding.

(2) Two Types of Bonds with Share Options

Bonds with share options come in two types:

(i) Those in which the bondholder pays an exercise price at the time of exercising the share options and becomes a shareholder who continues to hold the bonds. This is the same as the bond with equity warrants prior to the amendment in 2001. The amount of stated capital will increase each time when the share options are exercised, and the assets of the company will increase, and the bonds will be redeemed at their maturity; and

(ii) Those in which the bonds are redeemed at the accelerated maturity date when the share option is exercised, and the redemption price is applied to payment for the new shares. There is no need for the bondholder to make a payment for new shares, and, in substance, the bond is simply converted to shares. Although the amount of stated capital increases the assets do not increase. Since this is equivalent to the convertible bonds prior to the amendment in 2001, an instrument of this nature is referred to as a convertible bond-type bond with share option.

(3) Issue of Bonds with Share Options

An offering of bonds with share options is an offering of share options attached to bonds. The details are to be stipulated in the form of subscription requirements for share options (Companies Act, art. 238, para. 1, item 6) including subscription requirements for bonds (*ibid*., art. 676). In principle, these stipulations are to be determined by the board of directors (*ibid*., art. 238, para. 2, art. 239, para. 1, and art. 240, para. 1; see 10-4(2) above). If an issue is to be made to a third party on particularly favorable conditions, it is necessary to have a special resolution by the shareholders meeting (*ibid*., art. 238, para. 2 and para. 3, art. 240, para. 1, and art. 309, para. 2, item 6). If bonds with share options are issued, registration of the share options is made (*ibid*., art. 911, para. 3, item 12), and entry in both the registry of share options and the bond registry is made (*ibid*., art. 249 and art. 681; Companies Ordinance, art. 165 and art. 166).

(4) Transfer, Exercise of Share Options and Redemption

Both the bond and the share options in a bond with share option can only be transferred together until either the bond or the share option has been extinguished (Companies Act, art. 254, para. 2 and para. 3). A bond with share options for which it is specified that the bond certificate will be issued is referred to as a bond with share options with issued certificate, and when the certificate is issued it will be a bearer bond with share options (*ibid*., art. 249, item 2), and consequently transfer of the share options embodied in this certificate will not be valid unless the certificate of bonds with share options is delivered (*ibid*., art. 255, para. 2).

The certificate of bonds with share options must be presented to the company in order to exercise the share options. Whether payment into a financial institution such as a bank is required or the bond will be extinguished would differ depending on whether the type of instrument is warrant bonds mentioned in (2) (i) above or convertible bonds mentioned in (2) (ii) above, but in either case the bondholder would become a shareholder on the date that the share option is exercised (Companies Act, art. 282).

Since the certificate of bonds with share options embodies both bond rights and share options, the remaining rights will continue to exist even when the other rights are extinguished, and consequently the company will not retain the certificate but rather will return the certificate to the bondholder after stating that the relevant rights have been extinguished (Companies Act, art. 280, para. 3 through para. 5).

12 Reorganization of Company

12 1 Mergers

(1) Meanings and Types of Mergers

Quite often two or more companies merge into one company for the purpose of diversification, to streamline business, or to rescue a company with poor business results. Mergers can involve dissolving all the concerned companies and setting up a new company (consolidation-type merger, Companies Act, art. 2, item 28) or having one concerned company survive and absorb the other companies (absorption-type merger, *ibid*., art. 2, item 27).

In either case, the assets of the dissolved companies will be transferred in their entirety to the newly incorporated company or the surviving company, and the shareholders of the dissolved companies will receive shares in the newly incorporated company or surviving company, or cash payments or other assets, in exchange for their shares in the dissolving companies.

The method where the surviving company delivers the shares of its parent company and not the share of the surviving company itself to the shareholders of the dissolving company is called a “triangle merger.” If the shareholders of company Q receive bonds or cash in exchange of company Q’s shares, they no longer hold the position of shareholders of any company (an absorption-type merger in which merger consideration is composed of cash only is called a “cash out merger”). Since a comprehensive succession is made of all of the assets, the dissolved companies do not have to go through liquidation proceedings (Companies Act, parenthetical statement in art. 475, item 1).

Since a merger changes a company’s competitive position in the market, it is necessary to file a notice in advance with the Fair Trade Commission, and mergers that will have a result of restricting competition are not permitted (Antimonopoly Act, art. 15, art. 17-2, and art. 18).

[21] Flexibility in Merger Consideration — Squeeze Out and Triangle Merger

Prior to the enactment of the Companies Act, when one company, company S, has acquired and merged with another company, company Q, the shareholders in company Q would in all cases be allotted shares in company S. Yet, the Companies Act introduced some flexibility into consideration that can be paid, and allows payment of properties other than shares in company S (Companies Act, art. 749, para. 1, item 2). Accordingly, money and other property may be delivered in lieu of the shares in the company concerned in mergers as in the case of company split, share exchange, share transfer and share delivery. This part will only provide explanation in the case of merger. If the shareholders in company Q receive bonds or money in exchange of company Q's shares, they no longer hold the position of shareholder of any company and thus, would be "squeezed out" (for a "cash-out" not resulting from a merger, see 4-4(7) and 6-6(2) above).

In contrast to this, the merger called "triangle merger" is conducted by the following method. If company P was a foreign company, it would face difficulty in directly merging with company Q. However, if company P incorporated a Japanese subsidiary S and merged it with company Q, company P may deliver company P's shares to the shareholders of company Q as consideration.

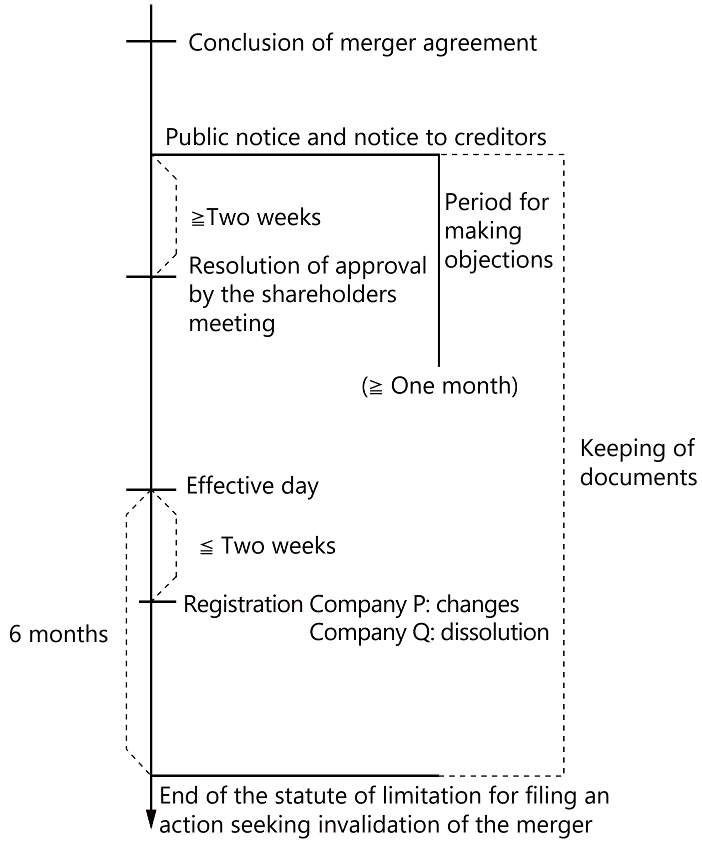
(2) Formal Procedures for Mergers

In addition to a merger between stock companies or between membership companies, it is also possible for a merger to take place between a stock company and a membership company. The following is a general outline of the merger procedures in the case that stock company P acquires stock company Q in which shares in company P are used as consideration (with both companies being companies with boards of directors, and neither company being a company with nominating committee, etc.).

The representative directors of company P and company Q negotiate and execute a merger agreement (Companies Act, art. 749). The agreement is approved by a special resolution at a shareholders meeting of each of the companies (*ibid*., art. 783, para. 1, art. 795, para. 1, and art. 309, para. 2, item 12). Prior to this the companies maintain at their principal office the documents stating matters such as the content of the merger agreement as well as the reasonableness of the consideration for the merger, and enable shareholders or creditors to obtain this information (*ibid*., art. 782 and art. 794; Companies Ordinance, art. 182 and art. 191). Steps are also taken that include public notice asking if creditors to the companies have an objection. The period for expressing an objection must be at least one month. A creditor who does not lodge an objection within this period is deemed to have approved the merger, but actions such as making payment must be taken to a creditor who has objected (*ibid*., art. 789 and art. 799; Companies Ordinance, art. 188 and art. 199).

On the effective date set forth in the merger agreement company P will succeed to the rights and obligations of company Q, and the shareholders in company Q will become shareholders in company P (Companies Act, art. 750, para. 1 and para. 3, item 1. For the effect of a consolidation-type merger please see *ibid*., art. 754). Company P must register changes in matters such as the amount of stated capital within two weeks from that date, and company Q must register its dissolution (*ibid*., art. 921. This is a condition for perfecting the dissolution. See *ibid*., art. 750, para. 2). Company P must also maintain the documents stating matters such as the course of events leading to the merger, which must be maintained at the principal office of company P from promptly after the effective date for six months from that date, to enable shareholders and creditors to obtain this information (*ibid*., art. 801, para. 1 and para. 3, item 1; Companies Ordinance, art. 200).

Chart 3-8 Procedures of Absorption-type Merger



(3) Simplified Merger Proceedings

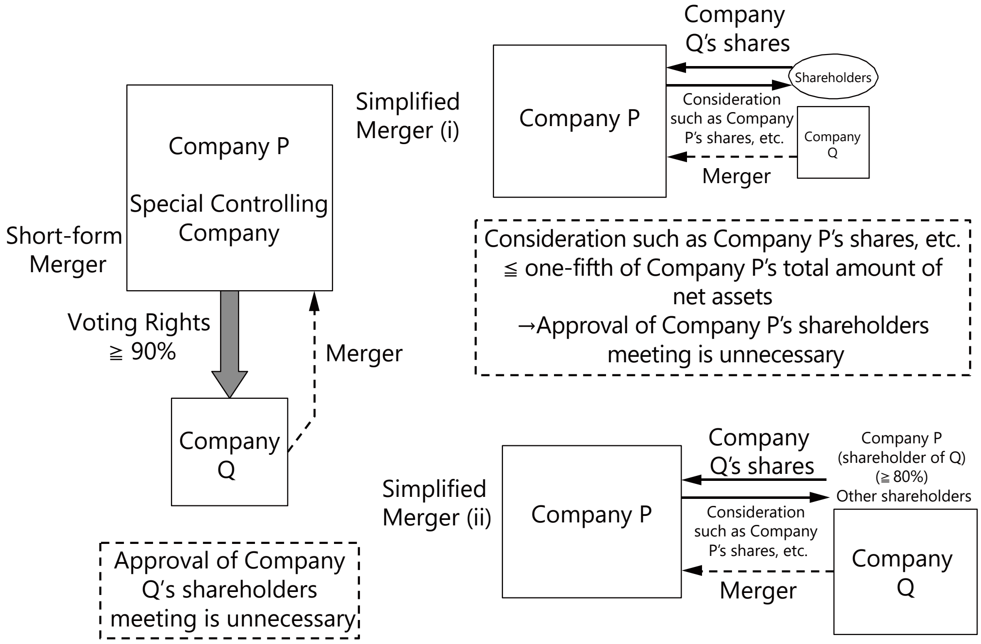
(i) Short-Form Merger

In the above situation if company P owns at least 90 percent of the shares of company Q, company P will be a special controlling company of company Q (including cases of ownership through wholly owned subsidiary of company P or combined ownership with a wholly owned subsidiary of company P. Companies Act, art. 468, para. 1; Companies Ordinance, art. 136). Since it would be obvious that the merger will be approved by the shareholders meeting of company Q, the resolution by this shareholders meeting may be waived (Companies Act, main clause of art. 784, para. 1, although the *proviso* to this clause sets forth exceptions). If company Q is a specially controlling company of company P, the resolution by the shareholders meeting of the surviving company P may be waived (*ibid*., main clause of art. 796, para. 1). If company R is a special controlling company of both company P and company Q, it may be construed that resolutions of the shareholders meetings for both companies P and Q may be omitted in the event of a merger between these two companies.

(ii) Simplified Merger

If the total net assets from company P that will be paid to the shareholders of company Q as consideration for the merger will not exceed one-fifth of the total amount of net assets of company P (such as in cases in which company Q is far smaller than company P, or company P already owns most of the shares of company Q), then the impact from the merger on the shareholders of company P will be of minimal significance, and consequently, as long as the assets assumed will not be less than the liabilities assumed, approval by the shareholders meeting of the surviving company P will not be required (Companies Act, art. 796, para. 2). However, a resolution of the shareholders meeting may not be omitted if a considerable percentage of shareholders express their dissent (*ibid.,* art. 796, para. 3; Companies Ordinance, art. 197).

Chart 3-9 Short-form Merger and Simplified Merger



(4) Illegal or Improper Mergers

A merger will be invalid if there is an illegality in the merger procedures, but a shareholder, director, auditor, executive officer, bankruptcy administer or a creditor who was not provided with an opportunity to lodge an objection or whose objection was ignored cannot assert a claim of invalidity of the merger unless the said party brings a lawsuit within six months from the effective date of the merger (Companies Act, art. 828, para. 1, item 7 and item 8 as well as art. 828, para. 2, item 7 and item 8). Even if a judgment of invalidity of a merger becomes final, it will not retroactively rewind everything back to the way it was from the start, but instead the matter will be handled by once again splitting up the companies that have effectively merged (*ibid*., art. 843).

As a relief available in advance, shareholders are allowed to demand the company not effect a merger if the merger violates laws and regulations or the articles of incorporation and the shareholders are likely to suffer disadvantages therefrom (Companies Act, main clause of art. 784-2, item 1, main clause of art. 796-2, item 1, and main clause of art. 805-2; shareholders may demand a director to stop illegal conduct only when the company is likely to suffer damage from such conduct. See 8-2(4) above). In the case of a short-form merger, the shareholders of the controlled company (company Q on the left in Chart 3-9) would have no chance to deliberate on this matter at the shareholders meeting, and therefore they may demand the company not effect the merger also in cases where the terms for the merger are extremely improper in light of the status of the company's property (*ibid*., main clause of art. 784-2, item 2, and main clause of art. 796-2, item 2). On the other hand, since a simplified merger would only have a marginal impact on the shareholders of the surviving company (company P on the right in Chart 3-9), these shareholders are not allowed to demand the company not to effect the merger, with an exception that they may make such demand if the merger could incur a loss (*ibid*., art. 784-2, *proviso,* art. 796-2, *proviso,* and art. 805-2, *proviso*). Shareholders who dissent from a merger may exercise appraisal rights (6-6(1) above), except for shareholders of company P in the simplified merger procedure who would be affected only marginally (*ibid*., art. 469, para. 2, art. 785, para. 2, art. 797, para. 2, and art. 806, para. 2; the special controlling company in the short-form merger procedure has no appraisal right because it does not need such right).

12 2 Company Split

(1) Incorporation-type Company Split and Absorption-type Company Split

The inverse of a merger is a company split. Spinning off a division of a company (splitting company in incorporation-type company split P) and establishing it as an independent corporation Q is referred to as an incorporation-type company split (Companies Act, art. 2, item 30), while spinning off a division and adding it to a different company R that already exists is referred to as an absorption-type company split (*ibid*., art. 2, item 29). In these transactions, unlike an assignment of business, the rights and liabilities which form the business are not transferred individually, but rather the entire division is assumed.(Note)

(Note) A company split may be made between limited liability companies (*gōdō kaisha*), a limited liability company (*gōdō kaisha*) and a stock company in addition to being made only between stock companies. The new company or assuming company may also be a general partnership company (*gōmei kaisha*) or a limited partnership company (*gōshi kaisha*) (Companies Act, art. 760, item 4 and art. 765, para. 1, item 1), although the example below discusses the case in which a company split takes place between stock companies. As with a merger, properties other than shares in the relevant companies may be used as consideration for the company split, including cash, bonds or shares in another company, although the explanation presented here is limited to the case in which shares in the relevant companies are used as consideration.

Under an incorporation-type company split, the new company Q (company incorporated through incorporation-type company split, *i.e.,* newly incorporated company) issues shares, and under an absorption-type company split, the other company R already in existence (succeeding company in absorption-type company split, *i.e.,* the succeeding company) issues new shares or delivers treasury shares. Since all of these shares will be allocated to the original company (splitting company P), the newly incorporated company Q will become a wholly owned subsidiary of the splitting company P, and the only result will be to add company P as a shareholder to the succeeding company R.

It is also possible for the shares that the splitting company P receives (whether shares in company Q or company R) to be distributed to the shareholders of company P in a form such as a dividend of surplus (Companies Act, art. 758, item 8, (b) and art. 763, item 12, (b)). If shares are distributed in this manner the shareholders in company P will hold both their shares in that company which have been reduced in value, as well as shares in the newly incorporated company Q or the succeeding company R. The assets in company P will have been reduced by the relevant amount and the size of that company will be smaller than that prior to the company split. This method is a more extensive company split, as it also involves the shareholders.

(2) Company Split Procedures

In an incorporation-type company split, Company P will prepare a company split plan which will state important matters such as the allotment of shares and the rights and liabilities to be assumed, and will have this plan approved by a special resolution of a shareholders meeting (Companies Act, art. 762, art. 763, art. 804, para. 1 and art. 309, para. 2, item 12). In an absorption-type company split, the splitting company P will execute an absorption-type company split agreement with the succeeding company R, and the agreement will be approved by a special resolution of the shareholders meetings of both companies (*ibid*., art. 783, para. 1, art. 795, para. 1, and art. 309, para. 2, item 12).

If the book value of the assets that the newly incorporated company Q will succeed from the splitting company P in an incorporation-type company split constitutes not more than one-fifth of the total value of the assets of the splitting company P, approval by the shareholders meeting of company P is not required (simplified company split; the shareholders meeting's approval would be required if the number of dissenting shareholders exceeds the threshold; Companies Act, art. 796, para. 2 and para. 3, and art. 805; Companies Ordinance, art. 207). Moreover, if the succeeding company in absorption-type company split R is a special controlling company of the splitting company P, approval by the shareholders meeting of company P is not required (short-form company split, Companies Act, art. 784, para. 1, main clause and art. 796, para. 1, main clause).

The other procedures are similar to those of a merger. The company split plan or company split agreement and other documents are disclosed in advance and after the effective date. A shareholder who dissents from the company split may exercise its right to demand a buyout of its shares (some shareholders may not exercise such right in the case of a simplified merger or short-form merger; Companies Act, art. 785, art. 797, and art. 806).

An absorption-type company split will have effect on the date determined in the company split agreement (Companies Act, art. 759 para. 1; for the effect of an incorporation-type company split, see *ibid*., art. 764, para. 1). An assertion of invalidity of a division cannot be made other than the lawsuit brought within six months. A judgment of invalidity of a company split will not have retroactive effect (*ibid*., art. 834, item 9 and item 10, and art. 843). As in the case of a merger, shareholders may demand the company not to effect a company split (*ibid*., art. 796-2, *et al*.).

[22] Company Spilt and Creditors

The decision on whether creditor A of company P would suffer any disadvantage due to the split of company P shall be determined based on various factors such as whether or not company P's obligations to creditor A shall be transferred to the newly incorporated company Q or succeeding company R, whether company P shall be liable for the performance of such obligations as before even if the obligations are to be transferred, the value of company P's assets that would be transferred as a result of the split (whether or not such assets are the most profitable business or central division or are an unprofitable division or bad loans), the value of shares of company Q and company R which are to be received by company P, and whether or not such shares shall be distributed to the shareholders of company P. A procedure must be taken to ask whether the creditors have any objection to the company split as in the case of merger (by way of publication in a daily newspaper or electronic public notice, and notice to known creditors), after disclosing the prospects of performance of the obligations that each of the companies will have after the company split. However, if creditor A can demand company P to perform the obligation after the company split, creditor A cannot file objections against such split. Even if the company split plan (contract) prescribes that creditor A cannot demand the performance by any of the companies P, Q and R, if the procedures to file objections have been disregarded, creditor A can demand the performance within a certain scope (since the company is obligated to give notice to the creditors of obligations arising from tort claims even if the company was not aware of the existence of these creditors, they can always make such demand; Companies Act, art. 759, para. 2 and para. 3, and art. 810, para. 2 and para. 3). Creditor A can file an action to seek invalidation of an illegal company split if the creditor does not approve the split (*ibid*., art. 828, para. 2, item 9 and item 10).

Recently, company splits fraudulent to creditors wherein valuable assets are flown out, while the consideration to be received does not have the value corresponding to it, have become serious problems. There is a case in which the court invalidated the company split wherein a company selected and transferred its valuable assets to another company in an attempt to keep them away from its creditors. In order to prevent such abusive use of company splits, the 2014 amendment provides as follows: in cases where company P's obligations to creditor A shall not be transferred to newly incorporated company Q or succeeding company R, if company P conducts the company split with knowledge that remaining creditor A would suffer damage due to such split, creditor A may demand the performance of the obligations to company Q or company R that have succeeded to company P's assets to the extent of the value of assets succeeded (Companies Act, art. 759, para. 4 and para. 6, and art. 764, para. 4 and para. 6).

Although workers form a category of creditors, the treatment of workers involved in company splits is stipulated by a separate law in order to address issues of a special nature (Act on the Succession to Labor Contracts upon Company Split (Act No. 103 of 2000)).

12 3 Share Exchange (*kabushiki kōkan*) and Share Transfer (*kabushiki iten*)

(1) Share Exchange (kabushiki kōkan)

If one company (company P) intends to acquire all of the shares issued of another company (company Q), both parties will enter into a share exchange agreement, and company P will exchange the shares in company Q that are held by company Q's shareholders, for new shares issued by company P or for treasury shares that company P holds (Companies Act, art. 2, item 31 and art. 767). Company P will become the wholly owning parent, and company Q will be its wholly-owned subsidiary. The wholly owning parent company P may be a limited liability company (*gōdō kaisha*).

The share exchange agreement will stipulate significant details such as the ratio by which the shares will be exchanged, and must be approved by a special resolution at shareholders meetings of both company P and company Q (Companies Act, art. 768, art. 783, art. 795, para. 1 and art. 309, para. 2, item 12). If the number of shares that company P will allocate to shareholders of company Q will only be a small portion of all shares of company P (not more than one-fifth of net assets), company P may skip this resolution by its shareholders meeting (simplified share exchange; *ibid*., art. 784, para. 2, and art. 796, para. 2; Companies Ordinance, art. 196). Moreover, if company P is a special controlling company of company Q, approval at the shareholders meeting of company Q is not required (short-form exchange of shares; Companies Act, art. 784, para. 1, and art. 796, para. 1)). Both cases have exceptions (see the *proviso* to each of the Paragraphs mentioned above).

The share exchange agreement and other important documents must be disclosed two weeks prior to the shareholders meeting, and made open for inspection for six months after the effective date. Dissenting shareholders may execute their right to demand that the company purchase their shares (some shareholders may not execute such right in the case of a short-form or simplified share exchange; Companies Act, art. 785, para. 1, item 2, and para. 2, item 2, art. 797, para. 1. *proviso,* and art. 797, para. 2, item 2). A share exchange shall have effect on the effective date set forth in the agreement. Since the number of shares issued of company P and its stated capital will increase, a registration of amendment must be made. A demand for invalidation of a share exchange may only be made by means of a lawsuit within the aforementioned six month period. A judgment of invalidation of a share exchange will not have retroactive effect (*ibid*., Article 844). In addition, shareholders may demand the company not to effect a share exchange. Thus, the procedures for a share exchange are similar to those for a merger.

Nevertheless, there is no requirement to take procedures to protect creditors, since although company Q will become a wholly owned subsidiary it will continue to own the same assets as it did before, and while company P will become a wholly owning parent, the only effect of the share exchange will be that company P will become larger and the shareholders in both companies will change. If the consideration delivered to the shareholders of company Q by company P is other than company P's shares and company P's assets are decreased, then, as an exceptional case, it is necessary to take procedures to protect creditors (Companies Act, art. 789, para. 1, item 3 and art. 799, para. 1, item 3).

(2) Share Transfer (*kabushiki iten*)

Share transfer consists of a procedure in which a new company P will be incorporated, which will be a wholly owning parent company (Companies Act, art. 2, item 32 and art. 772). It is possible for company Q to be the only company that intends to become a wholly owned subsidiary of company P, or for several companies to jointly intend to become subsidiaries, but all of the parties must be stock companies.

In either event company P will not exist at the time that the procedures are being undertaken. Company Q will prepare the share transfer plan either on its own or in cooperation with other stock companies such as company R. The share transfer plan will stipulate important matters such as the ratio of allotment of shares, and will be approved by a special resolution of a shareholders meeting of company Q and the other participating companies, if any (Companies Act, art. 773, art. 804, para. 1 and art. 309, para. 2, item 12; there is no short-form or simplified procedure for share transfer).

Almost the same procedures apply to a share transfer as to a share exchange. The company must disclose details of a share transfer plan before and after effecting the share transfer. Measures for creditor protection are only required in exceptional cases. Dissenting shareholders may demand the company to purchase their shares or not to effect the share transfer. Shareholders and creditors who dissent from or do not approve the share transfer may file an action to seek invalidation, and a judgment to invalidate the share transfer will not be effective retroactively. However, the share transfer will not be completed until the wholly owning parent is incorporated, and consequently, the share transfer will take effect from the time of registration of incorporation of company P (Companies Act, art. 774, para. 1).

In some cases, a wholly owning parent company incorporated in the share transfer will be established as a holding company, thereby restructuring the companies and operating them as a corporate group.

12 4 Share Delivery (*kabushiki kōfu*)

Share exchange (mentioned in 12-3 above) is a procedure for forming a relationship of a "wholly" owning parent company and a "wholly" owned subsidiary company. Suppose that company P wishes to own Company Q as a subsidiary but may consider it unnecessary to own company Q wholly. If company P acquires a large number of shares in company Q from company Q's shareholders by delivering the shares in company P to them as consideration, company P can acquire company Q as a subsidiary without spending any cash. However, such delivery of the shares in company P as consideration constitutes the issuance of new shares in company P (or disposition of treasury shares), and it is subject to the regulations on the procedure for issuing new shares (mentioned in 10-2 above), and in particular, the same strict regulations on contribution in kind as in the case of incorporation of a company (mentioned in 3-1(1) above). Therefore, it has been difficult to choose this method to acquire a company as a subsidiary.

To solve this problem, the 2019 amendment has established a system of share delivery in order to make it easy for a company to make another company its subsidiary by delivering its shares as consideration (Companies Act, art. 2, item 32-2, and art. 774-2). By using this new system, when company P intends to acquire company Q as a subsidiary, company P can deliver its shares to company Q's shareholders as consideration for the shares in company Q, without going through the procedure for issuing new shares (*ibid.*, art. 199, *et seq.*).

In order to protect company P's shareholders and creditors, the provisions for corporate restructuring similar to those concerning share transfer are applied to company P. More specifically, company P must prepare a share delivery plan and obtain approval of the plan by special resolution at a shareholders meeting, while dissenting shareholders have appraisal rights to demand that company P purchase the shares they hold (Companies Act, art. 774-2, art. 816-3, art. 816-6 and art. 309, para. 2, item 12). If company P delivers assets other than its shares as consideration, this results in a decrease in company P's assets and therefore requires the company to take measures to protect its creditors (*ibid.*, art. 816-8). In addition, disclosure before and after share delivery is required (*ibid.*, art. 816-2 and art. 816-10). Dissenting shareholders may demand that the company cease share delivery and may file an action to seek invalidation of share delivery (*ibid.*, art. 816-5 and art. 828, para. 1, item 13). The share delivery system has a reason for existence in that it enables a company to make another company its subsidiary, which will not be a wholly owned one, while avoiding the regulations on contribution in kind.

On the other hand, unlike share exchange, share delivery has a structure wherein company Q, which will become a subsidiary of company P, is not the party to the share delivery, and individual shareholders of company Q transfer their shares in company Q if they wish to do so. Accordingly, there is no need to undergo any corporate restructuring procedure at company Q (*e.g.*, obtaining special resolution at a shareholders meeting), and only procedures similar to those for issuing new shares are required, such as company Q shareholders' offers and company P's allotment (*ibid.*, art. 774-4, *et seq.*). Thus, share delivery is structured as an act of corporate restructuring to build a parent-subsidiary relationship only for company P, which will become a parent company, and therefore it is sometimes referred to as "partial share exchange."

12 5 Assignment of Business

A company P may increase its size by purchasing the business of another company Q. This transaction differs from a merger in that a separate transfer of each of the properties constituting the business is required. Normally the consideration for the assignment is cash or other property. Shares in company P may be used as consideration, but in this event if company P will issue shares, etc. to be offered, the procedures for a contribution in kind will be required, which complicates the process (Companies Act, art. 207).

Approval by a special resolution at a shareholders meeting of company P is required if company P accepts the assignment of the entire business of company Q (Companies Act, art. 467, para. 1, item 3, and art. 309, para. 2, item 11; it is not required for accepting the assignment of a part of the business of company Q). If the consideration is minimal, and not more than one-fifth of the net assets of company P, then approval by the shareholders meeting is not required (simplified procedures, Companies Act, art. 468, para. 2; Companies Ordinance, art. 137).

A special resolution at a shareholders meeting on the part of the assigning company Q is required both in the case of assigning the entire business of the company as well as when a significant portion of that business is to be assigned, provided that this resolution is not required if the assets to be assigned are not more than one-fifth of the total assets of company Q (unless the articles of incorporation of company Q stipulate that approval by the shareholders meeting is required even if a smaller percentage of the assets is to be assigned (simplified procedures; Companies Act, art. 467, para, 1, item 1 and item 2, and art. 309, para. 2, item 11; Companies Ordinance, art. 134). In the case where company P is a special controlling company of company Q, a resolution of company Q's shareholders meeting is not required (short-form procedures; Companies Act, art. 468, para. 1; Companies Ordinance, art. 136). Even if company Q will transfer all of its assets, as long as company P will not take over the business activities of company Q, such as in a case where company Q has effectively closed its business, and if company Q is not prohibited from engaging in the same business (Companies Act, art. 21), case precedent has held that a resolution of a shareholders meeting is not required. Even if company Q will assign its entire business, since it will be able to engage in a different business with the consideration that it receives from company P, the assignment by company Q will not automatically result in its liquidation.

When company P is the parent company and company S is its subsidiary company, company P owns shares in company S. Since shares are "assets" but not a "business" discussed above, company P should not need a resolution of the shareholders meeting in order to transfer the company S shares to another party. However, if company P disposes of a large number of company S shares and company S ceases to be its subsidiary, the consequence would be the same as company P losing the business that it has operated via company S. In that case, company P's shareholders should be guaranteed the same right as in the case of a business transfer. From this standpoint, an amendment has been made to require a special resolution of the shareholders meeting for such share transfer (2014 amendment, Companies Act, art. 467, para. 1, item 2-2).

Shareholders who dissent from the assignment of business may exercise their rights to demand for purchase of shares (Companies Act, art. 469; for exceptions in simplified or short-form procedures, *ibid*., art. 469, para. 2).

12 6 Entity Conversion

A stock company may become a general partnership company (*gōmei kaisha*) or a limited partnership company (*gōshi kaisha*) or a limited liability company (*gōdō kaisha*), and a company of one of these three types may also become a stock company (Companies Act, art. 2, item 26). For this purpose, an entity conversion plan to be prepared (*ibid*., art. 743).

An entity conversion plan of a stock company shall state the matters to be set forth in the articles of incorporation of the company after the change, such as what type of membership companies into which the change is to be made, who will be the general partners and who will be the limited partners (Companies Act, art. 744). Consent of all shareholders to the entity conversion plan is required (*ibid*., art. 776, para. 1). Moreover, the same procedures must be taken for protecting creditors as are to be taken in the case of a merger, etc. (*ibid*., art. 779). The entity conversion plan shall have effect when the procedures have been completed, and the effective date as set forth in the entity conversion plan has come (*ibid*., art. 745). Whereupon a registration of dissolution as a stock company is to be made within two weeks thereafter, and registration is to be made of incorporation of the company after the conversion (*ibid*., art. 920).

It is possible to dissolve a stock company and incorporate a membership company, but in this case, the old company and the new company would be two different companies. If the conversion is made through procedures for entity conversion, the identity of the company can be maintained and there is no need for liquidation proceedings, which is also convenient for business relationships.

13 Company Insolvency

13 1 Insolvency in General

Any business can fail. If a company owes so much that the company is unable to repay its debts, and reductions in capitalization are no longer a sufficient remedy for recovery, a request for a grace period or for debt forgiveness become the only choices. In some cases, creditors gather and prepare an arrangement plan based on discussions (private arrangement or internal arrangement), but any objection would prevent the plan from being implemented. The oversight of a court is required to ensure fairness of the procedures in order to avoid a chaotic situation wherein creditors are vying with one another for the remaining assets after checks are no longer honored.

The bankruptcy proceedings are thorough in this respect. However, since bankruptcy actually dismantles a company, it may be a disservice to the interests of the shareholders and employees. Also, should the company recover and start making a profit, it might give creditors more satisfactory repayment rather than the relatively small recovery paid in the course of a bankruptcy.

[23] Various Methods of Bankruptcy

Where there is no chance for the bankrupt company to reconstruct, liquidation-type insolvency proceedings are carried out to realize a fair settlement. Examples of these are bankruptcy and special liquidation procedures (14-2 below). On the other hand, where there is a chance for the company to recover if the parties exchanged concessions by taking some time, the creditors may receive a bigger repayment in the end. Corporate reorganizations and civil rehabilitations are the procedures for reconstruction-type insolvency proceedings which include voluntary liquidation that is not supervised by the court.

Normally, insolvency proceedings shall be carried out by a trustee, who is other than the management of the company that turned the company into insolvency. However, there are cases where the persons concerned prefer the management who knows the circumstances well to maintain his/her position. This is often the case in voluntary liquidation and civil rehabilitation and is allowed in some cases regarding corporate reorganization (debtor-in-possession = DIP reconstruction).

13 2 Corporate Reorganization

An application for reorganization proceedings may be filed when the repayment of debt on the due date could potentially cause significant impediments to the continuation of business or could cause bankruptcy (suspension of payment or insolvency), and also when there is the possibility of reconstruction. The Corporate Reorganization Act which prescribes these procedures was amended in its entirety in 2002, to enable widespread use of these procedures to begin, and made many improvements in order to allow effective reconstruction techniques to be utilized, and for the process to be completed in a timely fashion.

The claimant can be the company itself, creditors for an amount equivalent to 10% or more of the stated capital, or minority shareholders who hold 10% or more of the voting rights. The court may order the cancellation of all other proceedings such as compulsory execution against the company.

When reorganization proceedings commence, the management of the company is transferred to a reorganization administrator, although directors may be appointed to a post such as an administrator if the court finds this to be appropriate. Reorganization proceedings differ from the subsequently discussed rehabilitation proceedings in that secured creditors cannot exercise their rights without permission. Procedures such as reduction in capital, issue of new shares or bonds or merger can only be carried out within the reorganization process.

The administrator prepares a proposal of reorganization plan for the purpose of reconstructing the company, but the shareholders and creditors of the company may also submit their own proposal. The proposal of reorganization plan will set forth the manner in which the rights of the related parties are to be reduced, and the method by which the company will rebuild. In some cases, there may be a complete reduction in capitalization with shareholders losing their rights. The proposal must be approved by a majority resolution at a meeting of the related parties, and will take effect as the reorganization plan when it is approved by the Court.

Once the rebuilding of the company begins to take effect and the implementation of the reorganization plan is a certainty, the reorganization proceedings will be terminated. If there is no prospect of rebuilding the company, the reorganization proceedings will shift to bankruptcy proceedings.

13 3 Corporate Rehabilitation

Rehabilitation proceedings as provided in the Civil Rehabilitation Act are similar to reorganization proceedings, but can also be used by an individual and allow for an early resolution with simplified procedures. If court permission is obtained, an assignment of business or a capital reduction can be made without the approval of a shareholders meeting. Moreover, in some cases the directors of the bankrupt company can continue to conduct the business, and consequently use of this procedure is desired in many cases.

14 Dissolution of a Company

14 1 Causes of Dissolution

In addition to a merger, bankruptcy, or completion of the term of existence stipulated in the articles of incorporation, a company may be dissolved by a special resolution at a shareholders meeting (Companies Act, art. 471 and art. 309, para. 2, item 11). A company established for illegal purposes can be dissolved by a dissolution order of a court (*ibid*., art. 824). Also, in situations such as when a company finds no alternative in a hopeless impasse caused by internal conflict, the company may be dissolved by a dissolution judgment as a result of a claim filed by minority shareholders who hold 10% or more of the voting rights or shares issued (*ibid*., art. 833).

A stock company must, in principle, appoint and register its directors once every other year (8-2(1) above). However, there are many companies that have not registered for many years and are not substantive entities. A company that has not made any registration in 12 years will be deemed to be a sleeping company, and will be deemed to have been dissolved unless any registration or a notification that the business has not been discontinued is made within two months after the Minister of Justice issues a public notice in this regard (Companies Act, art. 472; Companies Ordinance, art. 139).

14 2 Liquidation of a Company

If a company is dissolved, it enters into a liquidation proceeding (this is not required in the case of a merger or bankruptcy, Companies Act, art. 475). While liquidation carried out by voluntary procedures is permitted in the case of general partnership companies, liquidation of a stock company must be carried out in accordance with the relevant legal procedures. If there is any hindrance to the liquidation proceedings or if there is any suspicion of insolvency, liquidation will proceed by means of especially strict procedures under court oversight (special liquidation; Companies Act, art. 510 through art. 574; Companies Act, art. 879 through art. 902; Companies Ordinance, art. 152 through art. 158).

Once a company enters into liquidation proceedings, the directors lose their positions and, in their place, liquidators are responsible for liquidation-related administrative work. In some cases, a court appoints liquidators. As with the board of directors and representative directors, there are requirements such as a board of the liquidators and the representative liquidators (a judicial precedent allows having only one liquidator).

Assets are liquidated into cash, debts are repaid to creditors, and if there are any assets left, these are distributed to the shareholders (distribution of residual assets). When all these procedures of the liquidation proceedings have been completed and completion of liquidation is registered, the company as a juridical person finally disappears. The company is deemed to continue in existence if registration occurs while the liquidation proceedings have not been completed, for instance while there are still debts to be repaid.

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I STRUCTURE AND INTERPRETATION OF FINANCIAL STATEMENTS

1 Significance and Role of Financial Statements

1-1 Accounting and Financial Statements

[Relationship Between Accounting and Financial Statements]

Accounting refers to the system consisting of the series of activities of identifying the various financial aspects of corporate activity as monetary amounts, representing all of the results derived from these in a tabular format, and communicating the same over specific media to accommodate the needs of a broad spectrum of interested parties.

Specifically, accounting can be explained as follows:

(1) Accounting is a means to assist various interested parties such as investors, creditors and business partners to make economic decisions (*i.e.*, evaluation, decisions, etc. related to investment and extension of credit).. [purpose and users of the accounting]

(2) Status of economic activities (transactions) that occurred in a company during a fixed interval of time ....[subject of the accounting]

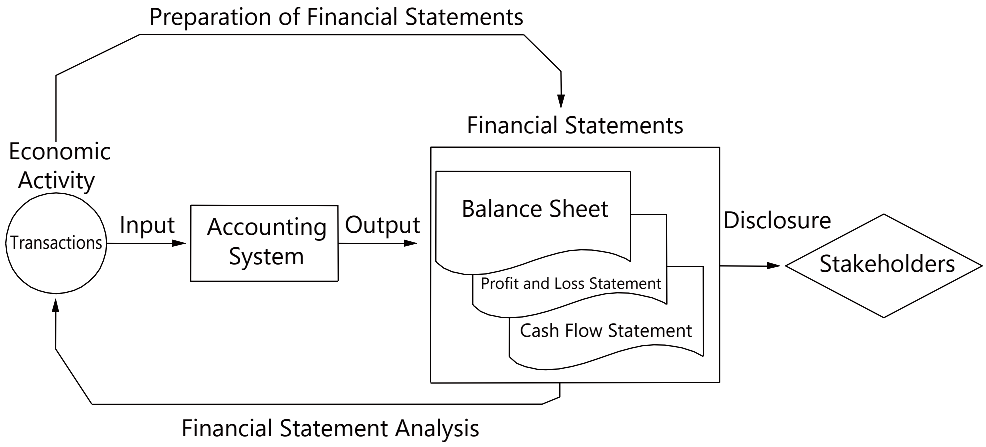
(3) So that the values are represented in currency values in a uniform format by means of an Accounting System .... [apparatus for accounting processing]

(4) With the results then compiled into the table reporting format referred to as the Financial Statements which are then communicated to the interested parties by means of a series of systemized actions .... [media steps for transmission]

In this manner accounting functions as the apparatus or system for translating the activity of a company into monetary values, and the output which compiles these results into table format are the Financial Statements. Accordingly, it is the Financial Statements that reveal the true face of a business enterprise. Most Japanese companies prepare financial statements in compliance with the accounting standards established by the Accounting Standards Board of Japan. Along with the recent advancement of globalization in corporate activities and securities markets, the International Accounting Standards Board (IASB) has been working on the International Financial Reporting Standards (IFRS) with the aim of achieving international unification of accounting standards. Some Japanese companies prepare financial statements and disclose them to the interested parties in compliance with the IFRS.

Chart 4-1 is a summary of the relationships referred to above.

Chart 4-1 **Process of Preparation and Analysis of Financial Statements**



[Relationship Between Financial Statements and Company Analysis]

Company analysis is a term used to describe a technique of evaluating a corporation's financial condition and performance results. It is also generally known as management analysis, financial analysis or financial statement analysis.

As shown in Chart 4-1, from the accounting perspective, a corporation's financial activities are recognized as "transactions," and a corporation's activities are ultimately compiled into the three different financial statements consisting of the Profit and Loss Statement, Balance Sheet and Cash Flow Statement (referred to as "***keisan shorui***" (the financial statement) in the Companies Act) through recording, sorting and aggregating transactions. Since the process of preparing the financial statements is one whereby the economic activities of a corporation are reflected in numerical values in terms of monetary values, it therefore becomes possible to have a clear and comprehensive understanding of and to evaluate the actual condition of a corporation through its financial statements.

Company analysis thus entails making use of the financial statements in this manner to make a judgment concerning the quality of a company's business activities.

- Profit and Loss Statement : Shows the "business performance" of a company during a fixed interval of time
- Balance Sheet : Shows the "financial condition" of a company at a certain point in time
- Cash Flow Statement : Shows the "changes of cash flows" of a company during a fixed interval of time

[Relationships Among Three Financial Statements]

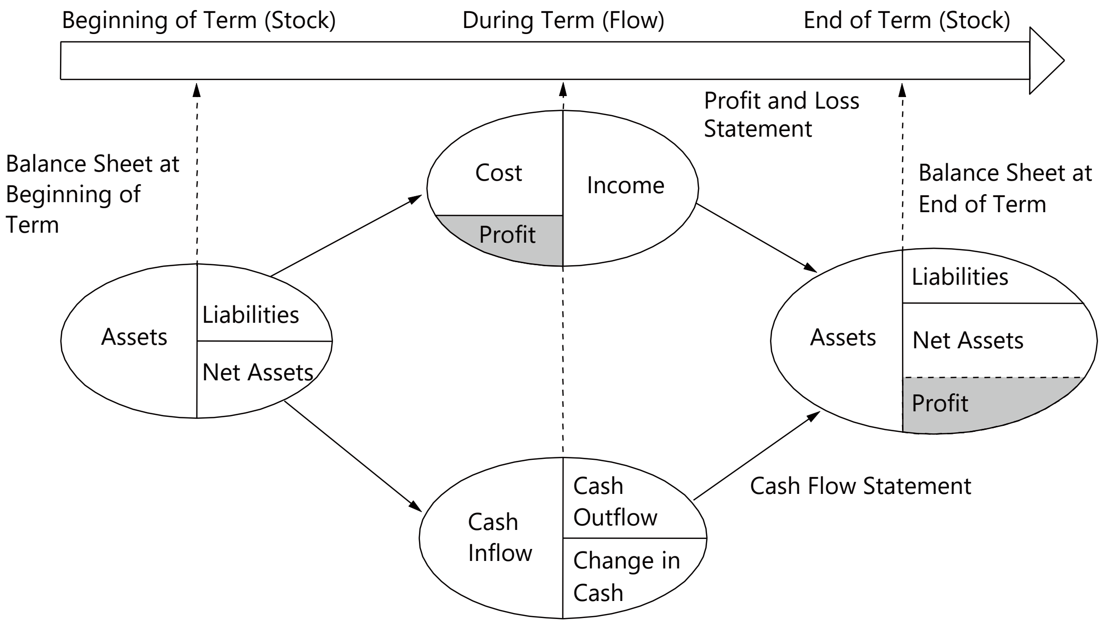
The **Profit and Loss Statement** represents a corporation's earning process during a fixed term interval. It shows how much income was obtained during this fixed term interval and how much cost was incurred in doing so. Thus, a Profit and Loss Statement can provide a means for evaluating management performance and enable analysis of the degree of a corporation's profitability.

The **Balance Sheet** shows the relationship between the source and usage of funds at a certain point in time (closing day) in a single table. This enables a comprehensive and clear understanding of a corporation's financial condition. Analysis of the Balance Sheet thus makes it possible to evaluate the degree of stability and liquidity of a corporation.

Cash Flow Statement shows the inflow and outflow of the cash in relation to the areas of activity of a corporation during a fixed interval of time. This enables a comprehensive and clear understanding of a corporation's cash flow situation. Analysis of the Cash Flow Statement thus makes it possible to evaluate the degree of stability and liquidity of a corporation.

The relationship among these three financial statements is shown in Chart 4-2.

Chart 4-2 Relationship Among Three Financial Statements



In this chart, please note that the amount in the Net Assets section of the Balance Sheet at the end of the term is increased only by the amount of profit appearing in the Profit and Loss Statement. In other words, the table in which the details concerning the amount of increase in net assets (difference between assets and liabilities) between the beginning and the end of the term are shown is the Profit and Loss Statement.

Some companies also prepare statements of shareholders' equity which describe the changes in the amount in the Net Assets section of the Balance Sheet, and changes in the amount in the Nets Assets section can also be recognized.

1 2 System of Consolidated Financial Statements

[Non-Consolidated Financial Statements and Consolidated Financial Statements]

The system of corporate disclosure is broadly divided between the non-consolidated financial statements and consolidated financial statements. The non-consolidated financial statements are prepared for the purpose of clearly showing the financial condition and management performance of individual corporations that have legal standing in their own right (legal substance). In contrast, the consolidated financial statements are prepared for the purpose of clearly showing the economic situation in terms of the financial condition and management performance of a group of companies that are in a relationship of controlling and being controlled as a single accounting unit (see "4-1 Perspective and Interpretation of Consolidated Financial Statements" of this Chapter for details).

While Japan first made submission of consolidated financial statements mandatory for business years starting on or after April 1, 1977, the approach was largely centered on the non-consolidated financial statements under the customary disclosure system. Nevertheless, Japanese companies found themselves caught up in a wave of internal and external changes both brought on by greater diversification and internationalization as well as seeing higher levels of participation of foreign investors in the Japanese securities markets. In response, from April 1999, corporations changed from financial reporting based on non-consolidated financial statements to financial reporting based on consolidated financial statements. For the purposes of the (then) Securities and Exchange Act, corporations settling their books for the fiscal year ending in March 2000 and after moved to a system that places primary emphasis on the consolidated financial statements and only secondary emphasis on the non-consolidated financial statements.

Chart 4-3 shows the system of consolidated financial statements. Naturally, such consolidated financial statements are a key topic that is covered in company analysis below (Part II).

Chart 4-3 System of Consolidated Financial Statements

- System of Consolidated Financial Statements
  - Consolidated Financial Statements
    - Consolidated Balance Sheet
    - Consolidated Profit and Loss Statement and Consolidated Statement of Comprehensive Income
    - Consolidated Statement of Changes in Shareholder's Equity, Etc.
    - Consolidated Cash Flow Statement
  - Quarterly Consolidated Financial Statements
    - Quarterly Consolidated Balance Sheet
    - Quarterly Consolidated Profit and Loss Statement and Quarterly Consolidated Statement of Comprehensive Income
    - Quarterly Consolidated Cash Flow Statement

[Example of Consolidated Financial Statements]

What follows are examples of a consolidated balance sheet, consolidated profit and loss statement, consolidated statement of comprehensive income, consolidated statements of changes in shareholders' equity and a consolidated cash flow statement prepared by Company A that is engaged in the business of information services (see Charts 4-4, 4-5, 4-6, 4-7, and 4-8).

Chart 4-4 Consolidated Balance Sheet

(Unit: JPY million)

	Previous Consolidated Fiscal Year (As of March 31, 2021)	Current Consolidated Fiscal Year (As of March 31, 2022)
Assets		
Current Assets		
Cash and Deposits	5,255	5,865
Deposits Paid	73,530	90,216
Notes and Accounts Receivable	61,074	–
Notes Receivable	–	266
Accounts Receivable	–	55,100
Contract Assets	–	11,592
Securities	1,000	2,000
Work in Process	28,344	19,488
Raw Materials and Supplies	42	159
Other Current Assets	2,612	3,115
Allowance for Bad Debt	−25	−120
Total Current Assets	171,834	187,686
Fixed Assets		
Tangible Fixed Assets		
Buildings and Structures, net	8,179	10,331
Tools, Furniture and Fixtures, net	6,913	7,308
Land	2,543	2,543
Lease Assets	1,491	2,711
Construction in progress	443	851
Other Tangible Assets	1	0
Total Tangible Fixed Assets	19,572	23,747
Intangible Fixed Assets		
Software	1,507	2,757
Goodwill	2,923	2,458
Other Intangible Fixed Assets	609	1,685
Total Intangible Fixed Assets	5,040	6,900
Investments and Other Assets		
Investment Securities	65,036	67,824
Deferred Tax Credits	4,127	4,091
Guarantee Deposits	6,336	6,223
Other Investments	324	366
Allowance for Bad Debt	−48	−48
Total Investments and Other Assets	75,776	78,455
Total Fixed Assets	100,388	109,103
TOTAL ASSETS	272,223	296,790

(Unit: JPY million)

	Previous Consolidated Fiscal Year (As of March 31, 2021)	Current Consolidated Fiscal Year (As of March 31, 2022)
Liabilities		
Current Liabilities		
Promissory Notes and Accounts Payable	15,884	17,828
Lease Obligations	901	2,034
Accounts Payable	9,099	11,695
Accrued Corporate Taxes	3,753	6,476
Contract Liabilities	–	12,311
Advances Received	18,347	–
Provision for Bonuses	9,553	10,301
Provision for Loss on Order Received	2,255	521
Reserve for Software Programs	185	183
Provision for Loss on Business Withdrawal	19	149
Provision for Surcharge	90	–
Other Current Liabilities	603	662
Total Current Liabilities	60,694	62,165
Fixed Liabilities		
Lease Obligations	1,363	2,918
Provisions for Directors' Retirement Benefits	149	97
Provision for Loss on Business Withdrawal	173	259
Net Defined Benefit Liability	10,956	11,205
Asset Retirement Obligations	63	2,931
Deferred Tax Liabilities	10,231	10,534
Other Fixed Liabilities	2,462	3,247
Total Fixed Liabilities	25,400	31,195
TOTAL LIABILITIES	86,094	93,360
Net Assets		
Shareholders' Equity		
Stated Capital	12,952	12,952
Capital Surplus	9,950	9,950
Earned Surplus	118,600	135,150
Treasury Shares	−2	−2
Total Shareholders' Equity	141,501	158,051
Other Aggregated Comprehensive Income		
Valuation Difference on Available-for-Sale Securities	38,310	38,427
Foreign Currency Translation Adjustment	15	208
Total Other Aggregated Comprehensive Income	38,325	38,636
Non-Controlling Interest	6,301	6,741
TOTAL NET ASSETS	186,128	203,429
TOTAL ASSETS	272,223	296,790

(Source) EDINET website (data on Company A, an information services provider)

Chart 4-5 Consolidated Profit and Loss Statement

(Unit: JPY million)

	Previous Consolidated Fiscal Year (April 1, 2020 through March 31, 2021)	Current Consolidated Fiscal Year (April 1, 2021 through March 31, 2022)
Sales	251,992	270,332
Sales Costs	200,042	210,011
Gross Profit on Sales	51,950	60,321
Selling Expenses and General and Administrative Expenses	27,400	30,505
Operating Profit	24,549	29,815
Non-Operating Income		
Interest Received	182	217
Dividends Received	334	318
Share of Profit of Entities Accounted for Using Equity Method	–	39
Gain on Investments in Investment Partnerships	76	467
Penalty Income	63	304
Compensation for Damage Received	99	–
Other Non-Operating Income	224	280
Total Non-Operating Income	980	1,627
Non-Operating Expenses		
Interest Paid	7	42
Share of Loss of Entities Accounted for Using Equity Method	53	–
Loss on Retirement of Non-Current Assets	50	29
Foreign Exchange Losses	48	120
Provision of Allowance for Doubtful Accounts	–	118
Provision for Loss on Business Withdrawal	–	239
Special Research Expenses	72	–
Litigation Expenses	158	0
Other Non-Operating Expenses	37	80
Total Non-Operating Expenses	428	631
Ordinary Income	25,101	30,811
Extraordinary Income		
Gain on Sales of Investment Securities	2,034	–
Total Extraordinary Income	2,034	–
Extraordinary Losses		
Loss on Termination of Retirement Benefit Plan	–	702
Expenses for Maintenance of Offices	1,818	–
Total Extraordinary Losses	1,818	702
Pre-tax Net Profit (or Loss) for the Term	25,318	30,109
Corporate, Inhabitants and Enterprise Taxes	7,414	9,980
Adjustment for Corporate and Other Taxes	298	−484
Total Corporate and Other Taxes	7,713	9,495
Net Profit for the Term	17,604	20,613
Net Profit for the Term Attributable to Non-Controlling Interest	622	636
Net Profit for the Term Attributable to Owners of Parent	16,982	19,977

(Source) EDINET website (data on Company A, an information services provider)

Chart 4-6 Consolidated Statement of Comprehensive Income

(Unit: JPY million)

	Previous Consolidated Fiscal Year (April 1, 2020 through March 31, 2021)	Current Consolidated Fiscal Year (April 1, 2021 through March 31, 2022)
Net Profit for the Term	17,604	20,613
Other Comprehensive Income		
Valuation Difference on Available-for-sale Securities	18,738	116
Foreign Currency Translation Adjustment	−81	203
Total Other Comprehensive Income	18,657	320
Comprehensive Income	36,261	20,934
(in which)		
Comprehensive Income Attributable to Owners of Parent	35,640	20,287
Comprehensive Income Attributable to Non-Controlling Interests	621	646

(Source) EDINET website (data on Company A, an information services provider)

Chart 4-7 Consolidated Statement of Changes in Net Assets

Previous Consolidated Fiscal Year (April 1, 2020 through March 31, 2021) (Unit: JPY million)

	Shareholders' Equity				
	Stated Capital	Capital Surplus	Earned Surplus	Treasury Shares	Total Shareholders' Equity
Balance at Beginning of Current Period	12,952	9,950	116,904	−10,026	129,780
Cumulative Effects of Changes in Accounting Policies	–	–	–	–	–
Restated Balance	12,952	9,950	116,904	−10,026	129,780
Change of Items During the Term					
Distribution of Surplus			−5,261		−5,261
Net Profit for the Term Attributable to Owners of Parent			16,982		16,982
Acquisition of Company's Own Shares				−0	−0
Cancellation of Company's Own Shares		−10,024		10,024	–
Transfer from Retained Earnings to Capital Surplus		10,024	−10,024		–
Net Changes of Items Other Than Shareholders' Equity					
Total Change of Items During the Term	–	–	1,696	10,024	11,720
Balance as of the End of the Term	12,952	9,950	118,600	−2	141,501

(Unit: JPY million)

	Other Aggregated Comprehensive Income			Non-Controlling Interests	Total Net Assets
	Valuation Difference on Available-for-Sale Securities	Foreign Currency Translation Adjustments	Total Other Aggregated Comprehensive Income		
Balance at Beginning of Current Period	19,571	95	19,667	5,944	155,392
Cumulative Effects of Changes in Accounting Policies	–	–	–	–	–
Restated Balance	19,571	95	19,667	5,944	155,392
Change of Items During the Term					
Distribution of Surplus					−5,261
Net Profit for the Term Attributable to Owners of Parent					16,982
Acquisition of Company’s Own Shares					−0
Cancellation of Company’s Own Shares					–
Transfer from Retained Earnings to Capital Surplus					–
Net Changes of Items Other Than Shareholders’ Equity	18,738	−80	18,658	357	19,015
Total Change of Items During the Term	18,738	−80	18,658	357	30,736
Balance as of the End of the Term	38,310	15	38,325	6,301	186,128

Current Consolidated Fiscal Year (April 1, 2021 through March 31, 2022) (Unit: JPY million)

	Shareholders’ Equity				
	Stated Capital	Capital Surplus	Earned Surplus	Treasury Shares	Total Shareholders’ Equity
Balance at Beginning of Current Period	12,952	9,950	118,600	−2	141,501
Cumulative Effects of Changes in Accounting Policies	–	–	1,834	–	1,834
Restated Balance	12,952	9,950	120,435	−2	143,335
Change of Items During the Term					
Distribution of Surplus			−5,261		−5,261
Net Profit for the Term Attributable to Owners of Parent			19,977		19,977
Acquisition of Company’s Own Shares				−0	−0
Cancellation of Company’s Own Shares					–
Transfer from Retained Earnings to Capital Surplus					–
Net Changes of Items Other Than Shareholders’ Equity					
Total Change of Items During the Term	–	–	14,715	−0	14,715
Balance as of the End of the Term	12,952	9,950	135,150	−2	158,051

(Unit: JPY million)

	Other Aggregated Comprehensive Income			Non-Controlling Interests	Total Net Assets
	Valuation Difference on Available-for-sale Securities	Foreign Currency Translation Adjustments	Total Other Aggregated Comprehensive Income		
Balance at Beginning of Current Period	38,310	15	38,325	6,301	186,128
Cumulative Effects of Changes in Accounting Policies	–	–	–	12	1,846
Restated Balance	38,310	15	38,325	6,313	187,975
Change of Items During the Term					
Distribution of Surplus					−5,261
Net Profit for the Term Attributable to Owners of Parent					19,977
Acquisition of Company’s Own Shares					−0
Cancellation of Company’s Own Shares					–
Transfer from Retained Earnings to Capital Surplus					–
Net Changes of Items Other Than Shareholders’ Equity	116	193	310	428	738
Total Change of Items During the Term	116	193	310	428	15,454
Balance as of the End of the Term	38,427	208	38,636	6,741	203,429

Chart 4-8 **Consolidated Cash Flow Statement**

(Unit: JPY million)

	Previous Consolidated Fiscal Year (April 1, 2020 through March 31, 2021)	Current Consolidated Fiscal Year (April 1, 2021 through March 31, 2022)
Cash Flow from Operating Activity		
Pre-tax Net Profit for the Term	25,318	30,109
Depreciation Expenses	6,145	5,523
Amortization of Goodwill	465	465
Increase (Decrease (–)) in Allowance for Doubtful Accounts	–0	94
Increase (Decrease (–)) in Provision for Bonuses	24	740
Increase (Decrease (–)) in Provision for Employee Retirement Benefits	1,097	247
Increase (Decrease (–)) in Provision for Directors' Retirement Benefits	20	–51
Increase (Decrease (–)) in Provision for Loss on Orders Received	1,255	–1,438
Increase (Decrease (–)) in Provision of Allowance for Loss on Business Withdrawal	–59	216
Increase (Decrease (–)) in Other Provision	–32	–92
Interest and Dividends Income	–516	–536
Interest Paid	7	42
Gain (Loss (-)) on Sale of Investment Securities	–2,034	–0
Share of Profit (Loss (-)) of Entities Accounted for Using Equity Method	53	–39
Loss on Retirement of Fixed Assets	50	29
Decrease (Increase (–)) on Receivables	1,407	272
Decrease (Increase (–)) on Contract Assets	–	–351
Decrease (Increase (–)) on Inventory Assets	–1,531	–1,013
Decrease (Increase (–)) on Other Current Assets	–79	–421
Increase (Decrease (–)) on Inventory Obligations	–1,814	1,825
Increase (Decrease (–)) in Other Current Assets	–3,461	3,090
Other Cash Flow from Operating Activity	–434	403
Subtotal	25,881	39,117
Interest and Dividends Received	518	537
Interest Paid	–7	–43
Corporate and Other Taxes Paid	–8,846	–7,299
CASH FLOW FROM OPERATING ACTIVITY	17,544	32,313
Cash Flow from Investment Activity		
Payments into Time Deposits	–	–164
Proceeds from Redemption of Securities	–	1,000
Purchase of Property, Plant and Equipment and Intangible Assets	–3,644	–5,337
Purchase of Investment Securities	–53	–4,070
Proceeds from Sale of Investment Securities	2,158	0

(Unit: JPY million)

	Previous Consolidated Fiscal Year (April 1, 2020 through March 31, 2021)	Current Consolidated Fiscal Year (April 1, 2021 through March 31, 2022)
Proceeds from Collection of Short-term Loans Receivable from Subsidiaries and Associates	12,000	–
Payments for Guarantee Deposits	−91	−19
Proceeds from Collection of Guarantee Deposits	800	67
Other Cash Flow from Investment Activity	−754	−15
CASH FLOW FROM INVESTMENT ACTIVITY	10,414	−8,540
Cash Flow from Financial Activity		
Purchase of Treasury Shares	−0	−0
Cash Dividends Paid	−5,261	−5,261
Cash Dividends Paid to Non-Controlling Shareholders	−264	−218
Repayments of Lease Obligations	−1,869	−1,365
CASH FLOW FROM FINANCIAL ACTIVITY	−7,395	−6,845
Translations Gains and Losses on Cash and Cash Equivalents	−20	199
Increase (Decrease (−)) on Cash and Cash Equivalents	20,543	17,126
Balance of Cash and Cash Equivalents at Beginning of Term	58,036	78,579
Balance of Cash and Cash Equivalents at End of Term	78,579	95,706

(Source) EDINET website (data on Company A, an information services provider)

2 Structure and Interpretation of Balance Sheet

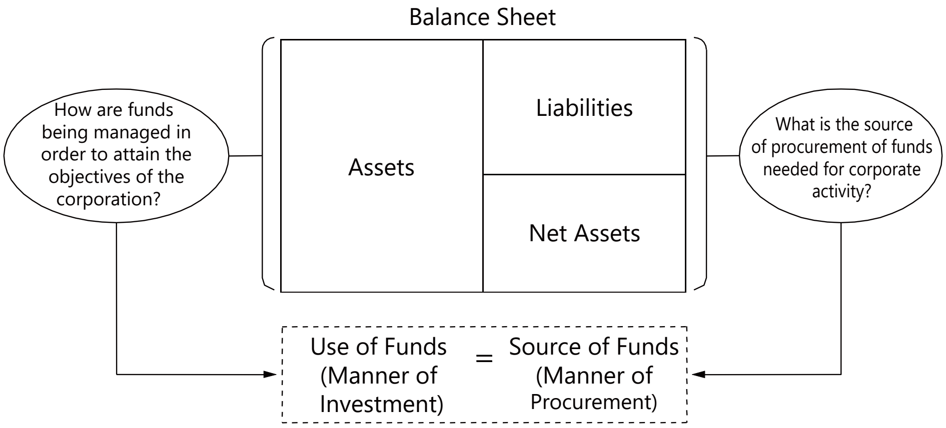
2 1 Structure of Balance Sheet

[Structure of the Balance Sheet]

The balance sheet is a tabulation of a corporation's financial condition at a certain point in time and is broadly structured to show the following two aspects: where the funds come from (*i.e.*, "source of funds") and how these funds are employed (*i.e.*, "usage of funds"). In other words, the balance sheet shows the sources from which a corporation has obtained the funds necessary for it to conduct its business operations. It also shows whether the funds are obtained by means of loans from financial institutions (*i.e.*, debt finance) or by the issuance of shares (*i.e.*, equity finance) as well as how such assets were invested and managed. The term "Balance Sheet" originates from the demonstration of the equilibrium (*i.e.*, balance) between the source and usage of funds.

Chart 4-9 shows the basic structure of the balance sheet in this respect.

Chart 4-9 Structure of the Balance Sheet

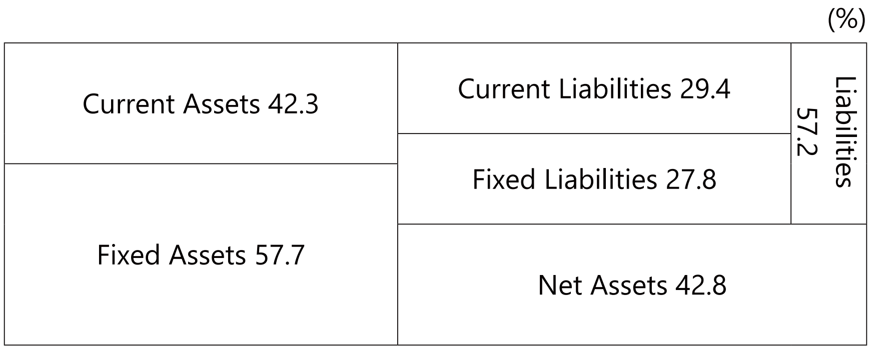


[Creating a Common-Size Balance Sheet]

The **common-size balance sheet** is one of the structures used by a corporation for its balance sheet. It is prepared by using the total asset figure as the denominator and using each of the categories as the numerator to create an overall profile for the corporation.

Chart 4-10 shows the balance sheet for all industries in Japan for the fiscal year 2021.

Chart 4-10 Balance Sheet for All Industries (FY 2021, Consolidated Basis)

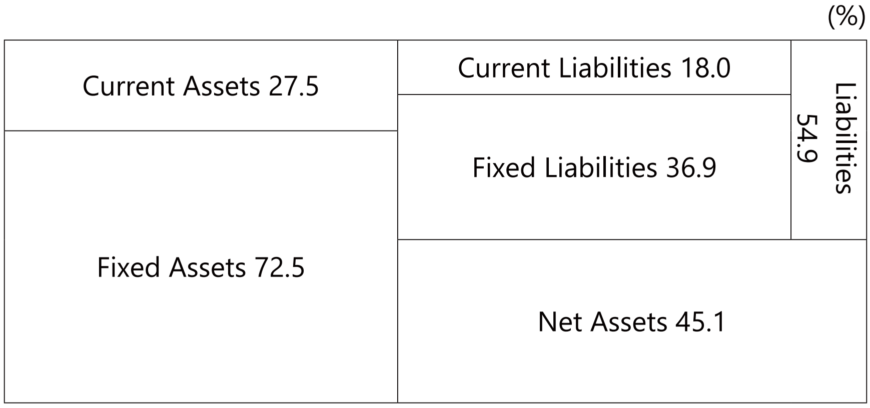


(Source) Calculated in part based on "Handbook of Industrial Financial Data 2022" (Development Bank of Japan) (hereinafter referred to as "Handbook of Industrial Financial Data 2022")

[Characteristics of Industry Sectors Expressed in the Balance Sheet]

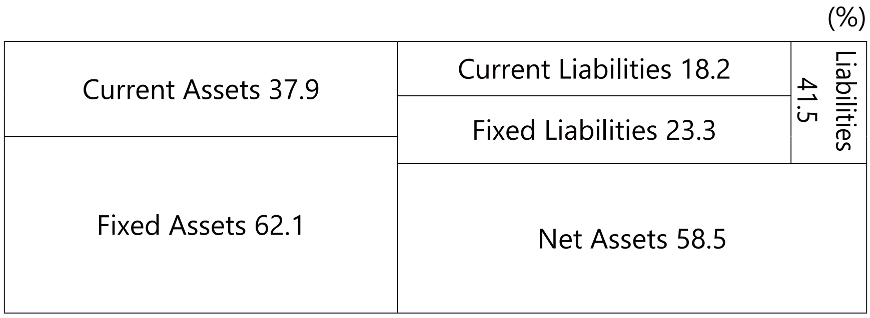
There are significant differences in the make-up of the balance sheet depending on the particular characteristics of the industry. Two such examples are shown in Charts 4-11 and 4-12 below as a comparison between the gas and pharmaceuticals industries for fiscal year 2021.

Chart 4-11 Balance Sheet for Gas Industry (FY 2021, Consolidated Basis)



(Source) Calculated in part based on "Handbook of Industrial Financial Data 2022"

Chart 4-12 Balance Sheet for Pharmaceuticals Industry (FY 2021, Consolidated Basis)



(Source) Calculated in part based on "Handbook of Industrial Financial Data 2022"

By comparing these two charts, the following conclusions can be drawn with regard to the particular characteristics of the industries:

(1) There is a difference in the ratio of fixed assets, with gas at 72.5% of total assets and pharmaceuticals at only 62.1% of total assets.

(2) There is a difference in the ratio of net assets, with pharmaceuticals at 58.5% and gas at only 45.1%.

(3) There is a difference between the ratios of current liabilities and fixed liabilities within total liabilities. The ratio of current liabilities in the gas industry (18.0%), is slightly more than 40 percent of the ratio of fixed liabilities (36.9%) in the same industry whereas in the pharmaceuticals industry, the ratio of current liabilities (18.2%) is slightly more than 70 percent of the ratio of fixed liabilities (23.3%).

As shown above, when analyzing the balance sheet of any given corporation, it is critical to be aware of the fact that significant differences exist in the make-up of balance sheets between industries.

2 2 Classification Standards for Account Entries on Balance Sheet

[Classification Standards for Assets]

Broadly speaking, assets are classified as Current Assets and Fixed Assets, and the customary criteria used in making this classification are (i) the operating cycle standard and (ii) the one-year standard.

In the operating cycle standard, current and fixed assets are categorized based on the time it takes for cash to circulate through a corporation's business activities and become cash again. In the merchant business, for example, the operating cycle is cash → product → accounts receivable → cash. In the manufacturing business, the operating cycle for the flow from "cash" to "cash" involves a series of processes consisting of procurement → manufacturing → sales → financial. All items in this cycle are treated as current assets based on this standard. Current assets classified according to this standard are arranged in descending order with those items closest to cash listed first and those less easily convertible to cash coming after.

Not all accounting items on the asset side of the balance sheet can be categorized under the operating cycle standard, and those that cannot, such as credits other than accounts receivable, are categorized according to the one-year standard. According to the one-year standard, items that will become cash within one year from the day following the date stated on the balance sheet (closing date) are considered current assets, and items that will take more than one year to become cash are considered fixed assets.

[Classification Standards for Liabilities]

Liabilities are divided broadly into Current Liabilities and Fixed Liabilities. Here as well, the standards that apply when categorizing liabilities into current and fixed liabilities are the same as those used for categorizing assets, namely, the operating cycle standard and the one-year standard. Under the operating cycle standard, advances, accounts payable and notes payable, etc. are treated as current liabilities since these are liabilities incurred as a result of business activity, the main objective of the corporation. According to the one-year standard, other liabilities for which the due date comes within 1 year are considered current liabilities, and those for which the due date comes after one year are considered fixed liabilities.

[Classification Standards for Net Assets]

In contrast to liabilities for which funds are necessary for repayment purposes, capital constitutes funds that need not be returned in the normal course of business. At its basic level, capital consists of invested funds originating from shareholders and funds accumulated from past profits that have been retained by the corporation. Capital in the form of stated capital and capital reserves are funds paid into the corporation by shareholders; capital in the form of retained earnings is additional capital accumulated from past profits which are held in reserve by the corporation.

2 3 Classification of Balance Sheet Items

[Classification of Assets]

Assets are broadly divided into the three categories of current assets, fixed assets and deferred assets. Current Assets are further divided into quick assets, inventory assets and other liquid assets. Fixed Assets are further divided into tangible fixed assets, intangible fixed assets and investments and other assets. These classifications are shown in Chart 4-13.

Chart 4-13 Classification of Assets

Assets	Current Assets	Quick Assets	Cash, deposits, notes receivable, accounts receivable, temporarily owned securities, etc.
		Inventory Assets	Products and manufactured goods, semi-finished goods, work in process, stored supplies, etc.
		Other Current Assets	Advance payments, short-term prepaid expenses, etc.
	Fixed Assets	Tangible Fixed Assets	Buildings, structures, machinery and equipment, vessels, vehicles, transportation equipment, tools, instruments, fixtures, land, construction in progress, etc.
		Intangible Fixed Assets	Goodwill, patents, land rights, trademarks, design rights, mining rights, fishing rights, etc.
		Investments and Other Assets	Investment securities, stock and bond holdings in affiliated companies, financing, long-term loans, investment real estate, claims in bankruptcy, reorganization claims, long-term prepaid expenses, net defined benefit asset,(Note) tax-deferred assets, etc.
	Deferred Assets		Expenses incurred to establish business, start-up costs, bond issuance costs, development expenses, etc.

(Note) Prepaid pension costs in a non-consolidated balance sheet.

Generally, corporations that have significant holdings of assets that are liquid and easily convertible to cash are evaluated as stable and possessing a high level of ability to meet payment obligations. However, there is another line of reasoning that evaluates corporations with excessive liquidity as failing to make effective use of their funds. The manner in which a corporation apportions funds among the asset categories is a reflection of both its financial strategy and management planning.

[Explanation of Account Items]

Quick assets are assets that can be easily converted into cash in a relatively short period of time without going through the marketing process. Inventory assets are (i) assets held to be marketed during the normal course of business (products or merchandise), (ii) assets in the process of being manufactured into assets for sale (work in process), and (iii) assets that will be consumed during the manufacturing of the marketing assets (raw materials and expendable supplies).

Inventory assets are generally referred to as stock. Not only does excessive stock impede a corporation’s cash flow situation, its overall financial condition is worsened by appraisal losses and the costs of storage and management. Consequently, it is important that steps be taken to reduce the level of excessive stock and ensure that it is managed effectively.

Fixed assets are divided into the categories of tangible assets, intangible assets and investment assets. Tangible fixed assets are those assets with intrinsic value that are used in the manufacturing process. Intangible fixed assets consist of legal rights (patents, etc.) and practical rights (goodwill), both of which have no intrinsic value. Investments and other assets consist mainly of investment assets but also include entries that are listed as assets solely for accounting purposes and have no disposal value (sale value) such as long-term prepaid expenses (expenses paid for the long-term use of land, etc.) or tax deferred assets.

[Classification of Liabilities]

Liabilities are normally classified into current liabilities and fixed liabilities. Current liabilities usually refer to those liabilities for which obligations are due within one year, whereas fixed liabilities are those liabilities for which obligations are due after a one–year period. Therefore, the former are often referred to as short-term liabilities and the latter are often called long-term liabilities. The breakdown of liabilities is shown in Chart 4-14:

Chart 4-14 Classification of Liabilities

Liabilities	Current Liabilities	Short-term Monetary Obligations	Notes payable, accounts payable, short-term loans, corporation tax due, etc.
		Short-term Provisions	Provisions for adjustments for returned goods, etc.
		Other Current Liabilities	Advances received, deposits received, unearned revenue, accrued expenses, etc.
	Fixed Liabilities	Long-term Monetary Obligations	Corporate bonds, long-term loans, long-term loans from affiliated companies, etc.
		Long-term Provisions	Net defined benefit liability(Note)
		Other Fixed Liabilities	Tax deferred liabilities, etc.

(Note) Provisions for retirement benefits in a non-consolidated balance sheet.

The provisions included in current liabilities and fixed liabilities function as reserve funds to cover expenses or losses that may occur in the future such as product warranty provisions, provisions for returned goods, provisions for repairs and provisions for special renovations.

[Classification of Net Assets]

Net assets are roughly divided into shareholders' equity and items other than shareholders' equity. These three principal elements of shareholders' equity are stated capital, capital surplus and earned surplus; items other than shareholders' equity are valuation and translation adjustments, etc., share options, and non-controlling interests (with consolidated financial statements). Net assets are classified as shown in Chart 4-15.

The basic rule that applies with the establishment of a new corporation or an increase in its capital is that the price at which shares are issued is to be regarded as stated capital, although it is permitted to designate the amount not exceeding half of this price as capital reserve. Accordingly, the capital reserve has the character of being part of the capital originally paid in by the shareholders.

Chart 4-15 Classification of Net Assets

(Non-Consolidated Balance Sheet)	(Consolidated Balance Sheet)
I. Shareholders' Equity	I. Shareholders' Equity
1. Stated Capital	1. Stated Capital
2. Deposit for Subscriptions to Shares	2. Deposit for Subscriptions to Shares
3. Capital Surplus	3. Capital Surplus
(1) Capital Reserve	
(2) Other Capital Surplus	
Total Capital Surplus	
4. Earned Surplus	4. Earned Surplus
(1) Profit Reserve	
(2) Other Earned Surplus	
Reserves for XXX	
Earned Surplus Brought / Carried Forward	
Total Earned Surplus	
5. Treasury Shares	5. Treasury Shares
6. Deposit for Subscriptions to Treasury Shares	6. Deposit for Subscriptions to Treasury Shares
Total Shareholders' Equity	Total Shareholders' Equity
II. Valuation and Translation Adjustments	II. Accumulated Other Comprehensive Income
1. Valuation Difference on Available-for-Sale Securities	1. Valuation Difference on Available-for-Sale Securities
2. Deferred Gains or Losses on Hedges	2. Deferred Gains or Losses on Hedges
3. Revaluation Difference on Land	3. Revaluation Difference on Land
	4. Foreign Currency Translation Adjustment
	5. Re-measurements of Defined Benefit Plans
	6. Share Equivalent to Entities' Equity Accounted for Using Equity Method
Total Valuation and Translation Adjustments	Total Accumulated Other Comprehensive Income
III. Share Awards	III. Share Awards(Note)
IV. Share Options	IV. Share Options
	V. Non-controlling Interests
TOTAL NET ASSETS	TOTAL NET ASSETS

(Note) Following the "Act Partially Amending the Companies Act" and the "Act on Arrangement of Relevant Acts Incidental to Enforcement of the Act Partially Amending the Companies Act" coming into effect (and becoming applicable as of March 1, 2021), the draft amendments of government orders related to the Financial Services Agency were published on November 6, 2020. The amendments became applicable as of March 1, 2021 (when the amended Companies Act came into effect).
These amendments introduced a new account item, "share awards" (*kabushiki hikiukeken*) in the section of net assets and requires that share awards be set down under the account title "share awards" (Financial Statements Ordinance, art. 59 and art. 67-2; Consolidated Financial Statements Ordinance, art. 42 and art. 43-2-2).

The capital reserve portion of the capital surplus and the profit reserve portion of the earned surplus are referred to as the legal reserve. The **legal reserve** is a mandatory set-aside under the provisions of the Companies Act intended to ensure the financial soundness of a corporation. One-tenth of the dividends must be accumulated as the capital reserve or the profit reserve until the total amount of legal reserves reaches one-fourth of the stated capital (Companies Act, art. 445). The voluntary reserve is company profit set aside for a specific purpose.

As with the valuation difference on available-for-sale securities and deferred gains or losses on hedges, valuation and translation adjustments, etc. (accumulated other comprehensive income) includes valuation difference amount in cases where the assets or liabilities are treated as balance sheet values assessed at market price but the valuation difference amount is not treated as income or loss for the term, and in the case of consolidated balance sheets, it includes foreign currency translation adjustment and re-measurements of defined benefit plans, etc. Moreover, valuation and translation adjustments, etc. (accumulated other comprehensive income) is entered after deducting the amount of any deferred tax assets or liabilities.

The section of net assets includes share options, share awards, and non-controlling interests (only on a consolidated basis) as account items, in addition to shareholder's equity. The rights to acquire shares under certain conditions are referred to as share options, and the rights to be awarded shares for free as remuneration for directors and executives are referred to as share awards. Non-controlling interests are part of the consolidated subsidiary company's equity which is not included in the equity of the company preparing the consolidated financial statements (the parent company or controlling company).

3 Structure and Interpretation of Profit and Loss Statement

[Structure of the Profit and Loss Statement]

The Profit and Loss Statement is prepared because it can provide better information regarding the corporation's profitability to interested parties, thereby affording such parties material that shows the degree of the profitability of a corporation. By employing a specific step-by-step approach that breaks down profit into the following four categories, it is possible to see a corporation's management performance over a fixed period of time:

(1) **Gross Profit on Sales** : This shows the gross profit after deducting expenses that are the "Sales Cost" from "Sales."

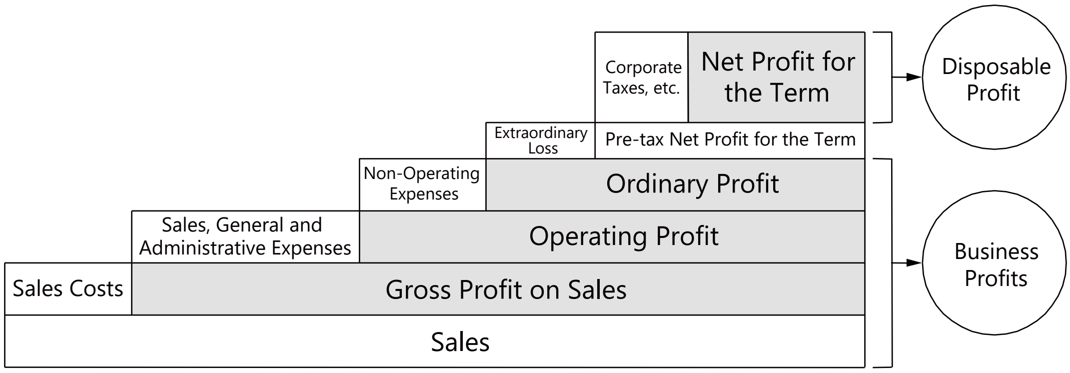
(2) **Operating Profit** : This shows the profit after deducting the expenses associated with sales activity as well as general management and administration that are the "Selling Expenses and General and Administrative Expenses" from gross profit on sales.

(3) **Ordinary Profit** : This shows the profit after adding "Non-Operating Income" to operating profit and deducting "Non-Operating Expenses."

(4) **Net Profit for the Term** : This shows the final profit after adding "Extraordinary Profit" that is profit derived from sources other than ordinary corporate activity from ordinary profit and deducting "Extraordinary Losses" as well as corporate and other taxes.

Chart 4-16 shows the step-by-step structure for calculation of these profits.

Chart 4-16 Structure of the Profit and Loss Statement



The profit shown in (1) through (3) above makes it possible to determine whether a corporation's **periodic business performance** is good or bad, and the profit shown in (4) above makes it possible to calculate **disposable profit** during the relevant term. It is this disposable profit that can be allocated to internal reserves or to pay-outs such as dividends and officer bonuses.

When conducting investment in shares, there are certain standards consisting of earnings per share (EPS), price earnings ratio (PER) and return on equity (ROE) that are calculated based on net profits, and the bottom line is most important for this purpose. However, the bottom line can be significantly impacted by extraordinary gains or losses from sources such as shortfalls in its set-asides to meet retirement benefit obligations. Accordingly, in order to conduct an appraisal of a corporation's profitability from its core business activities, attention must be focused on operating profit and ordinary profit.

With gross sales given as 100%, Chart 4-17 shows the average rates of the four different forms of profit for all industries in Japan generated over a 10-year period.

Chart 4-17 Relative Rates of Profit for All Industries (Consolidated Basis)

(%)

Classification / Fiscal year	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021
Sales	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
Gross Profit on Sales	22.5	23.2	23.6	24.8	25.4	25.4	24.9	24.9	24.9	25.4
Operating Profit	4.9	5.9	6.1	6.5	6.8	7.2	6.8	6.2	5.5	7.1
Ordinary Profit	4.9	6.1	6.4	6.4	7.0	7.5	7.4	6.3	6.9	7.9
After-Tax Gains	2.3	3.6	3.8	3.6	4.3	5.3	4.9	3.3	4.2	5.5

(Source) "Handbook of Industrial Financial Data 2022"

As indicated in Chart 4-6 above, the Financial Instruments and Exchange Act requires companies, which submit securities reports, to prepare comprehensive income statements in addition to profit and loss statements. "Comprehensive income" means the part of the amount of change in net assets of a company as recognized in its financial statements for a particular period, which is not relevant to direct transactions with the equity holders of the net assets (investors). "Other comprehensive income" means the part of comprehensive income which is not included in net profit for the term.

In a consolidated statement of comprehensive income, comprehensive income is recorded by adding or reducing items of other comprehensive income to or from the net profit for the term. Items of other comprehensive income are categorized as the valuation difference on available-for-sale securities, deferred gains or losses on hedges, foreign currency translation adjustment, re-measurements of defined benefit plans, etc. The amount equivalent to equity in other comprehensive income with regard to the scope of companies subject to the equity method is recorded in a single category (for the equity method, see “4-2 Structure of Consolidated Financial Statements”)

[Profit and Loss Statement Characteristics of Different Industries]

When attempting to utilize profit and loss statements for company analysis, consideration should be given to the profit margins and turnover ratios (refer to “Section 7. Profitability Analysis” and “Section 9. Analysis of Capital Efficiency and Break-Even Point Between Profit and Loss” of this Chapter).

As with the balance sheet, careful attention must be given to the uniqueness of the industry under consideration. For example, Chart 4-18 shows the cost and other ratios for all industries, the gas industry and the pharmaceuticals industry in the profit and loss statement for the 2021 fiscal year when sales are given as 100%.

Chart 4-18 Cost and Other Ratios by Industry Type (FY 2021, Consolidated Basis)

(%)

	All Industries	Gas Industry	Pharmaceuticals Industry
Sales Costs	74.6	71.6	32.6
Gross Profit on Sales	25.4	28.4	67.4
Selling Expenses and General and Administrative Expenses	18.3	23.3	50.9
Net Profit for the Term	5.5	5.0	9.7

(Source) Calculation in part based on ”Handbook of Industrial Financial Data 2022”

From this Chart, it can be seen that, for both the gas industry and pharmaceuticals industry, the ratios of gross profit on sales to sales are higher than the average for all industries. In the pharmaceuticals industry in particular, the sales costs are not even half of the average for all industries and the ratios of gross profit on sales are exceptionally high. Conversely, however, it is also an industry that is characterized by significantly higher “Selling expenses and general and administrative expenses” such as marketing and promotion expenses.

To examine the profitability of these two industries, it is necessary to conduct an analysis of the profitability and capital efficiency of the corporation. Chart 4-19 provides an example.

Chart 4-19 Profit Margins and Turnover Ratios by Industry Type (Consolidated Base)

	Gas Industry		Pharmaceuticals Industry	
	FY2020	FY2021	FY2020	FY2021
Profit Margin on Sales (%)	3.8	5.0	12.0	9.7
Ratios of Return on Equity (%)	5.5	7.9	8.6	7.1
Equity Turnover Ratio (Times)	1.44	1.58	0.71	0.81

(Source) Calculation in part based on "Handbook of Industrial Financial Data 2022"

In FY2021, the sales profit margin for the gas industry reached 5.0% while that of the pharmaceuticals industry was 1.94 times this percentage at 9.7%, a much higher figure. Nevertheless, the respective return on equity for gas stood at 7.9%, only 0.90 times larger than that of pharmaceuticals at 7.1%. The explanation for this considerable difference in terms of the return on equity is thought to be the fact that the equity turnover ratio for the gas industry (1.58 times) is about 1.95 times that of the pharmaceuticals industry (0.81 times), something that is a reflection of differing rates of capital efficiency as well.

4 Structure and Interpretation of Consolidated Financial Statements

4 1 Perspective and Interpretation of Consolidated Financial Statements

[What Are Consolidated Financial Statements?]

Consolidated financial statements exist to identify a group of enterprises that are closely connected to each other by investment or other relationships as if a single organization, in an attempt to clarify the financial condition and management results of the group. In situations where a corporation has entered into a variety of business areas by means of subsidiary companies or other affiliations, consolidated financial statements must be prepared because it is not possible to correctly reflect the condition of the corporation in the individual non-consolidated financial statements of the parent company.

While the consolidated financial statements are prepared using the individual financial statements as their basis, rather than employing the simple straight addition procedures used in individual financial statements, they are integrated based upon specific **consolidated accounting procedures** in a manner that eliminates duplications of assets, gains and losses within the group.

[Group-Parent Multiplier]

In comparing the consolidated financial statements with the financial statements for the parent corporation on a non-consolidated basis, it becomes possible to determine the multiplier by which the sales, profit, assets and other factors of the group as a whole exceed those of the parent company on a non-consolidated basis. This multiplier effect is referred to as the **Group-Parent Multiplier**. The Group-Parent Multiplier for total assets, sales and ordinary profit tend to increase with improvement in the economic climate and retreat when the economic climate becomes worse.

[Whether the Consolidated Net Profit Will Be Greater Than the Net Profit of the Parent Company Alone]

Generally speaking, when subsidiary companies operate solely in the red, the situation is one in which the net profit of the parent company alone will be greater than the consolidated net profit. However, is it possible to make the opposite statement that when the subsidiary companies operate in the black, the situation is one in which the net profit of the parent company alone will be less than the consolidated net profit?

To understand the situation, it is first necessary to understand the relationship between individual profit and consolidated profit. This relationship can be expressed as follows:

Consolidated Net Profit & Loss	=	Net Profit of Parent Company Alone	+	Cumulative Net Profit for Consolidated Subsidiaries	±	Consolidated Adjustment

Included in the “Plus Adjustment Entries” are items such as amortization of goodwill (credits), elimination of unrealized losses, investment gains by application of the equity method, translation gains on foreign exchange and deferred tax assets by application of tax effective accounting.

Conversely, included in the “Minus Adjustment Entries” are items such as amortization of goodwill (debits), elimination of unrealized gains, elimination of dividend receipts, investment losses by application of the equity method and deferred tax liabilities by application of tax effective accounting.

Accordingly, when “consolidated adjustment” involves a large number of negative adjustments, even if the consolidated subsidiaries are in the black, this would result in the net profit of the parent corporation alone being greater than the consolidated net profit.

4 2 Structure of Consolidated Financial Statements

[Scope of Consolidation]

(1) Shareholding Standards and Controlling Interest Standards

In Japan, the customary standard for including corporations in consolidated financial statements (range of consolidation) has been the shareholding standard (holding a majority in excess of 50% of the shares with voting rights).

However, in reality, there are instances where even when less than 50% of the voting shares are held, the parent company in effect controls the subject company. Including such companies controlled in this manner into the consolidation is what is referred to as the controlling interest standard.

(2) Parent Company and Subsidiary Company

The term “parent company” refers to a company that controls another company, and the term “subsidiary” refers to the other company.

To “control” as used here means “to control the decision-making organ of another company.” The standard for making this determination is that facts can be recognized to exist such as “holding of a majority of the voting rights in the general meeting of shareholders on a continuous basis” by having a “high percentage of voting rights” and “having cooperative shareholders such as officers or affiliated companies,” even if the shareholding ratio is 50% or less.

(3) Direct Ownership and Indirect Ownership

Subsidiary companies include not only those that are in a direct ownership relationship (a relationship in which the parent company directly controls the subsidiary companies), but also include those companies that are in an indirect ownership relationship (a relationship in which subsidiary companies are themselves controlling other subsidiary companies).

In this way, both the direct and indirect ownership relationships have the character of being defined by the controlling interest standard in a form that includes the shareholding standard.

(4) Non-Controlling Interests and Parent Company Interest

The term "non-controlling interest" refers to "that portion of the capital of the subsidiary company that is not imputed to the parent company."

For example, if the capital account of a subsidiary is divided into proportions of ownership of 60% and 40%, a company that owns a majority of the voting shares (60%) is referred to as the parent company and the shareholders holding the remaining portion (40%) are referred to as the non-controlling shareholders.

Therefore, both the parent company and the non-controlling shareholders possess ownership rights with respect to the capital account of the subsidiary company based on the respective ratios of their holdings. The monetary amount obtained by multiplying the proportion of the shares held by the parent company by the capital account of the subsidiary company is referred to as the parent company interest, and the monetary amount obtained by multiplying the proportion of the shares held by the non-controlling shareholders is referred as the non-controlling interests.

(5) Non-Consolidated Subsidiary Companies

In principle, parent companies must include all subsidiary companies within the scope of their consolidation.

However, a company must not be included in consolidation if this would significantly mislead interested parties, such as in the case of a company over which control is only temporary. Companies such as these are referred to as non-consolidated subsidiary companies.

(6) Affiliate Companies

The term "affiliate company" refers to a non-subsidiary company in which the parent company and/or subsidiary companies are able to exercise significant influence over the financial and operating policies through relationships such as funding, personnel, technology and transactions.

In other words, an affiliate company is one in which the substantive relationship is such that one company is in a position to exercise "significant influence over the financial and operating policies" of another company. A typical example can be found in cases where one company effectively holds at least 20 percent of the voting shares of another company that is not a subsidiary.

In principle, the equity method must be applied with respect to investments in non-consolidated subsidiary companies and affiliate companies as identified above.

[How Consolidated Balance Sheets Are Prepared]

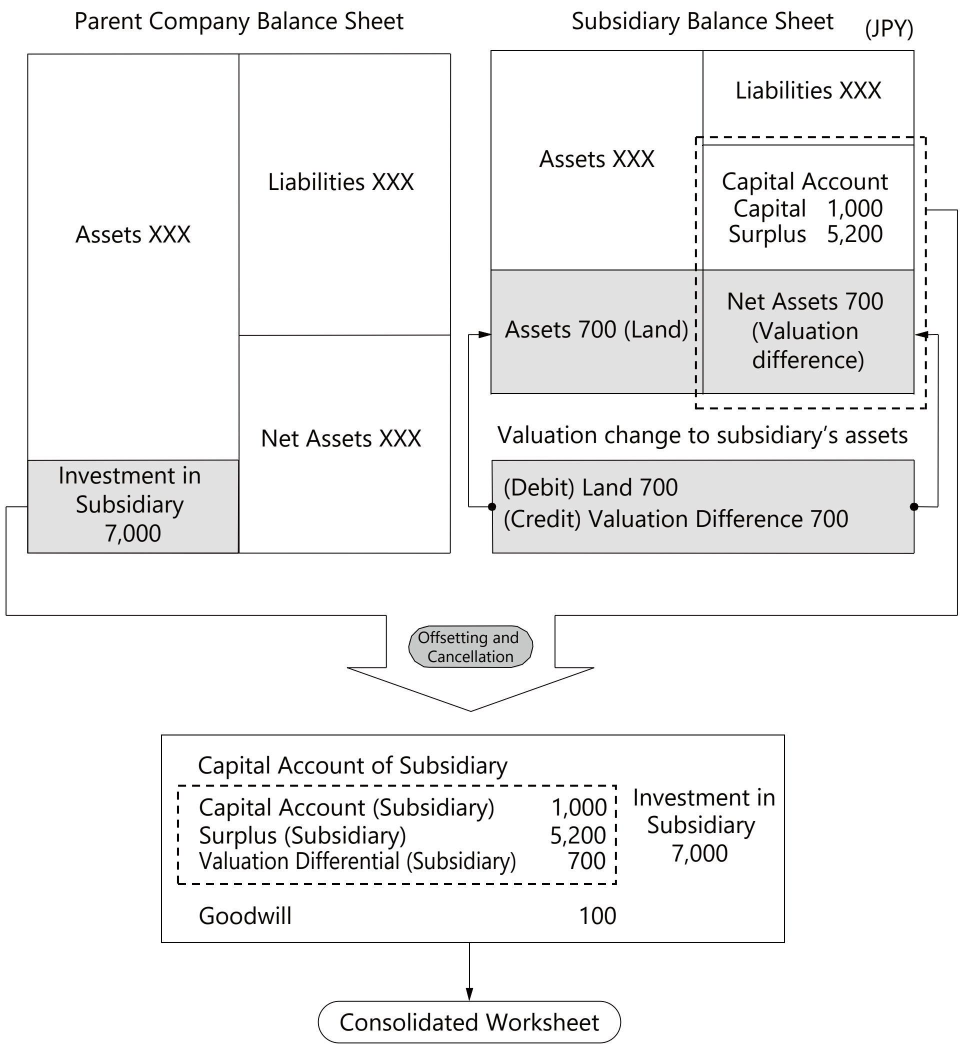
(1) Preparing Market Evaluation of Assets and Liabilities of Subsidiary Companies, and Consolidated Balance Sheets

The preparation of consolidated financial statements is carried out as of the day that the parent company assumes control over another company (day of acquisition of control). However, among the consolidated financial statements, only the consolidated balance sheet is prepared on the day of acquisition of control.

According to the Accounting Standards Board of Japan's "Regulations for Consolidated Financial Statements"

(June 6, 1997), the assets and liabilities of a subsidiary company are to be assessed by a **fair valuation** (so-called **market value**) as of the day of acquisition of control. The difference between the market valuation of the assets and liabilities of the subsidiary company and the monetary value as shown in the individual financial statements (cost valuation) is called the **valuation difference**. This is treated as capital of the subsidiary company. Consolidation of assets (*i.e.*, offset of the parent company's investment against the capital account of the subsidiary company) is carried out after first going through this process.

Chart 4-20 **Capital Consolidation After Revaluation of Assets of a Subsidiary Company on Day of Acquisition of Control**



Let us assume that the book value and market value of the land included in the total assets of the subsidiary are JPY300 and JPY1,000, respectively. Together with appraising the market value of the land, the difference between the market value and the book value (JPY700) is handled as the valuation difference in the capital account.

(2) Goodwill

Next, there must be a cancellation by off-setting between the investment account of the parent company and the capital account of the subsidiary company. When this occurs, if there is a difference (referred to as the "**investment cancellation difference**"), in principle, this investment cancellation difference is processed as **goodwill**. Goodwill represents the amount of excess above market value of an actual property.

When goodwill is generated on the debit side, it is shown in the **intangible fixed assets section**, and when it is generated on the credit side, it is processed as income in the fiscal year in which it was generated (extraordinary income).

Chart 4-20 above shows an example of how capital consolidation occurs after revaluation of the assets of a subsidiary company has taken place effective on the day of acquisition of control.

(3) Consolidated Worksheets

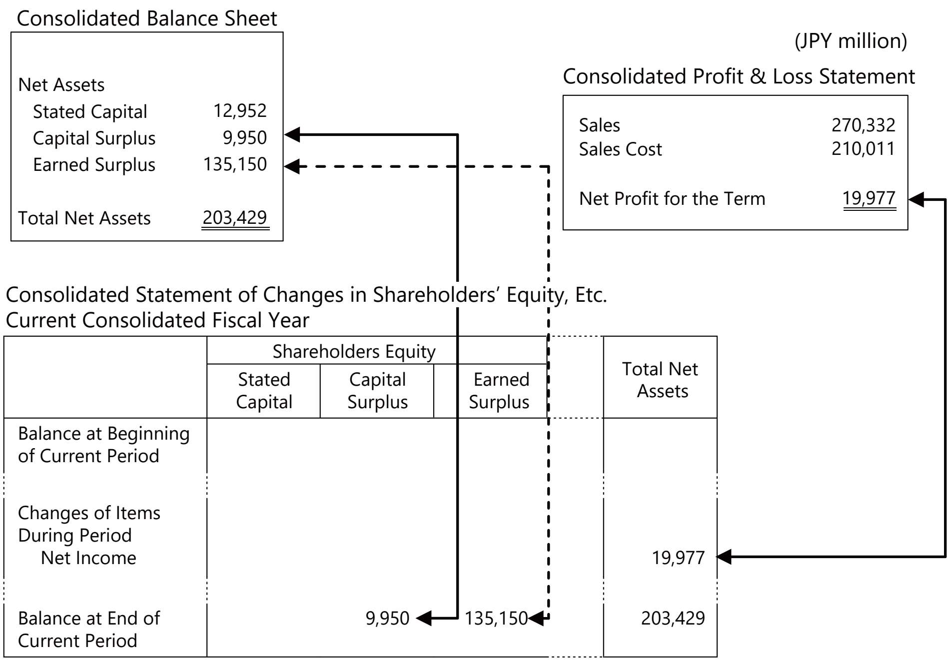
The Consolidated Worksheet represents the consolidation procedures in the form of a single table.

It should be noted that the market valuations of the assets and liabilities of subsidiary companies as well as the capital consolidation procedures are implemented only as procedures on the consolidated worksheets.

[Mutual Relationships Among Consolidated Financial Statements]

Finally, Chart 4-21 shows an example for Company A (refer to Charts 4-4, 4-5 and 4-7) that is being analyzed consisting of the Consolidated Profit and Loss Statement, Consolidated Balance Sheet and Consolidated Statement of Changes in Shareholders' Equity, etc. prepared in March 2021.

Chart 4-21 Mutual Relationships Among Consolidated Financial Statements



5 Structure and Interpretation of Cash Flow Statement

[The Cash Flow Statement]

The Cash Flow Statement shows the status of cash flow broken down by specific categories of activity during one accounting period. Similar to the balance sheet and profit and loss statement, the cash flow statement provides important information on the overall activity of the corporation.

The stock and flow of cash constitutes the sine qua non of managing a corporation; it shows how much cash the company has earned, how much it can devote to investment and paying off its debts, and what is the final amount that it has in hand. The Profit and Loss Statement goes no further than segregating the gains and losses as differences of income and expenses during a specific period of time. Moreover, the Balance Sheet presents only the balance of cash flows as they exist at the end of the term and says nothing regarding the specifics of any increases or decreases.

The Cash Flow Statement breaks down corporate activity into the three categories of (i) sales activity, (ii) investment activity and (iii) financial activity. The cash flow conditions in these categories allow an overall understanding of the activities of the corporation.

[Characteristics of the Cash Flow Statement]

Let us now move on to an explanation of the Cash Flow Statement using a simplified example of how it is constructed beginning with an information services company with an investment of JPY1,000,000. Assume that, as part of its business operations during the period, the company earns JPY700,000 in service commissions, pays out JPY150,000 in lease rent and incurs JPY350,000 in operating expenses. The company's balance sheet, profit and loss statement, and cash flow statement are as shown in Chart 4-22.

Chart 4-22 Summary Financial Reports from Transactions in the Example

Profit and Loss Statement

Lease rent	15	Service Commissions Received	70
Operating Expenses	35		
Net Profit for the Term	20		
	70		70

Balance Sheet (JPY10,000)

Cash	120	Stated Capital	100
		Net Profit for the Term	20
	120		120

Cash Flow Statement (Direct Method)

Operating Income	70	Operating Expenses	50
		Cash Flow from Sales Activity	20
	70		70

Cash Flow Statement (Indirect Method)

I. Cash Flow from Sales Activity	
Net Pre-tax Profit for the Term	20

From this example, the following four points are indicated:

(1) Transactions resulting in profit or loss during the term are related by "cash inflow consisting of service commissions received (income)" and "cash outflow consisting of lease rent and operating expenses (expenses)." The profit and loss statement is prepared by extracting the data on "service commissions received (income)" and "lease rent and operating expenses (expenses)" — abstract aspect of cash flow.

(2) The total of the amount of the increase in cash occurring during the term and the balance of cash at the beginning of the term is recorded in the Cash account of the balance sheet — concrete stock volume of cash.

(3) The Cash Flow Statement (by direct method) is prepared by compiling the revenues and expenditures that cause increases and decreases in the Cash account — specific aspect of cash flow.

(4) The Cash Flow Statement (by indirect method) is prepared by starting with the net profit for the term prior to tax adjustments and excluding any items not involving expenditures of cash as part of the calculation of profit — cash flow by comparison of balances.

[Scope of Funds]

The "concept of cash" appearing in the Cash Flow Statement refers to "cash and cash equivalents." Here, "cash" includes cash on hand and demand deposits, and the term "cash equivalents" includes "short term investments that can be easily converted to cash, and which only face a small risk of changes in prices."

Accordingly, equities are not included since they are subject to significant risk of changes in market prices.

[Funding Components Appearing in the Cash Flow Statement]

The consolidated cash flow statement is divided into the following three categories in relation to corporate activities:

(1) Cash Flow from Sales Activity;
(2) Cash Flow from Investment Activity; and
(3) Cash Flow from Financial Activity.

Sales activity domain consists of the activities of an enterprise that generate earnings through the production and marketing of finished goods. To produce these goods, investment in fixed facilities such as machinery and equipment is necessary.

Investment activity domain involves the acquisition and disposition of these fixed facilities. Capital investment into production facilities defines the production capacity of a company, and the speed of this flow is defined by the size of the sales activity. Accordingly, the relationship is such that, while investment activity works in tandem with sales activity, sales activity determines the efficiency of investment.

By the same token, funds must be procured in order to carry out sales and investment activity, and this is the purpose of financial activity domain. This in turn causes changes in the size and composition of a corporation's shareholder equity and its borrowings.

The Cash Flow Statement is an attempt to show the cash flow in relation to these three areas.

Ⅱ METHODS FOR COMPANY ANALYSIS

6 Purpose and Methodology for Company Analysis

6 1 Purpose and Subject of Company Analysis

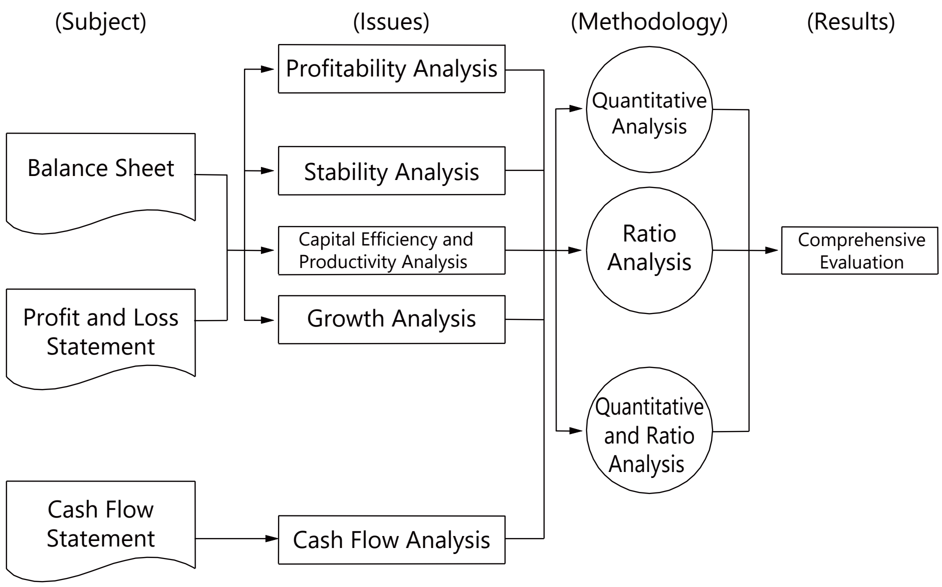
To obtain the information necessary to make investment and other decisions, the users of the financial statements must analyze and interpret the information contained in these statements. From the standpoint of usage in this manner, the processing and breaking down of the information contained in the financial statements is referred to company analysis or management analysis (financial statement analysis).

The financial statements attempt to recognize and measure corporate activity from the financial viewpoint with the results communicated to the users of this information. Through analysis of information disclosed in this manner and consistent with their purposes, users are thus able to make judgments regarding the efficacy of a corporation's economic activity. This is company analysis.

Since company analysis is based on the financial statements as the source of original data, the scope and content of company analysis finds its foundation in the content and nature of the financial statements. The principal subjects of this analysis are the financial statements that have already been discussed in Sections 1 through 5 of this Chapter, namely, the balance sheet, profit and loss statement and cash flow statement.

Chart 4-23 shows the basic elements of company analysis.

Chart 4-23 Elements of Company Analysis



6 2 Issues of Company Analysis

A variety of different forms of company analysis can be conducted depending on the intended purpose of the users. Generally speaking, company analysis breaks down into the following five major objectives (issues):

(1) Profitability Analysis
(2) Stability Analysis
(3) Capital Efficiency and Productivity Analysis
(4) Growth Analysis
(5) Cash Flow Analysis

Profitability analysis shows to what degree a company has been able to earn a profit from its business activities by looking at the ratio between the size of the company's "capital," which is its starting point for the earning of profits, and the "sales" generated from use of these initial funds. Since the profit and loss statement shows how much income is earned during a specific period of time together with the economic sacrifices needed to generate such income (*i.e.*, expenses and losses), the information contained here is the information related to the profitability of the company.

Stability analysis has to do with the financial soundness of a company. It serves as an indicator of financial health and liquidity such as whether it has the ability to meet its obligations as they come due. Since the balance sheet serves as a systematic indication of a company's financial condition at a specific point in time, it serves as the principal source of materials for stability analysis. As with profitability analysis, stability analysis serves as an indicator for determining a company's ability to continue its existence over the long term.

When considering the profitability of invested capital, it is necessary to have a clear understanding of whether capital is being utilized effectively. Efficiency analysis (or capital efficiency analysis) is carried out to determine if capital (assets) is being utilized efficiently and generally focuses on "turnover ratio."

On the other hand, productivity analysis is the process employed to have a clear understanding of the degree to which the elements of production such as labor and machinery are being utilized effectively. It includes analysis of labor and plant productivity in terms of value-adding per employee or unit of capital equipment.

From the perspective of the investor, what is the most important for making investment decisions is growth analysis, which is an examination over the short term of how sales and ordinary profit have grown relative to the previous year. The most commonly used growth indices are rate of growth of revenues and rate of growth of profit.

It is not uncommon to hear expressions such as "the accounts are in order but there is a shortage of cash." In other words, although the accounting may show that conditions are profitable, if there is no corresponding cash flow (*i.e.*, cash receipts and expenditures), it will be difficult for an enterprise to carry on with normal business activity. Cash flow analysis is analysis that is based on this cash flow situation. In recent years, together with the careful attention being paid to corporate creditworthiness, investors and managers have been greatly concerned with a company's cash flow situation, and it is the cash flow statement that provides a look at the cash flow conditions broken down by different categories of activity.

6 3 Methods of Company Analysis

There are three principal methods for conducting company analysis:

(1) Quantitative Analysis Method
(2) Ratio Analysis Method
(3) Combined Quantitative and Ratio Analysis Method

The quantitative analysis method entails a detailed breakdown of the amounts contained in the analysis materials and identifies the causes of any increases or decreases in amounts by the differences obtained. For example, conducting an analysis of increases and decreases in profit and sales occurring in the current fiscal year and doing a detailed breakdown of the sources of income (sales of products, consignments, services, etc.) where they have been generated (parent company, subsidiaries, etc.) and the form of income (cash, credit, etc.) make it possible to identify the causes for the increases or decreases in sales during the term.

The most preferred method for conducting company analysis is the ratio analysis method. This involves showing the monetary values of each of the various constituent items as a share of the overall (weight analysis method); obtaining a ratio for two or more mutually related items (designated ratio analysis method); or setting a certain value as 100 in a designated base year and showing subsequent years indexed relative to this base value (trend ratio analysis method). By doing so, a clear understanding can be gained of the correlations among financial values.

As the name implies, another method, the **combined quantitative and ratio analysis method**, combines these two approaches. For example, with analysis of the break-even points between profit and loss (*i.e.*, analysis of the amount of sales necessary to establish equilibrium between revenues and expenses), one must categorize all expenses as either fixed costs or variable costs and find the ratio between variable costs and sales (variable cost ratio).

6 4 Comprehensive Evaluation

Finally, the results of analysis are all brought together in a comprehensive manner to form a general opinion regarding the quality of the business performance and financial condition of the subject company. The following two aspects of the analysis are of particular importance to this process:

a. Analysis of the particular financial characteristics of the industry in which the subject company is conducting business relative to all industries – **understanding the specificity of the subject industry**; and
b. Analysis of the particular financial characteristics of the subject company relative to the industry in which it is conducting business – **understanding the specificity of the subject company**.

A final comprehensive judgment thus becomes possible from these two approaches taking into consideration the indices obtained from the various results from analysis.

7 Profitability Analysis

7 1 Significance and Mechanism of Profitability Analysis

When the entity being analyzed is a for-profit enterprise, a major concern of investors into the company is whether it is earning a profit and whether it is one that has high earnings capacity. Thus, this presents the problem of how to measure the "profitability" or "earnings capacity" of the company.

Profit is the most commonly employed index for measuring profitability. However, a simple comparison of profit amount between enterprises that differ in scale will not correctly reflect the true profitability of a given company. To make a fair comparison between companies, it is necessary to make use of a ratio that measures the amount of profit earned from an "original base." Broadly speaking, there are two points of analysis for ascertaining this original base:

(1) To obtain a ratio of profit using the capital base as the volume of stock – **ratio of profit to capital**; and
(2) To obtain a ratio of profit using the sales base as the volume of flow – **profit margin on sales**.

Therefore, profitability of a corporation is a ratio that expresses the rate of effectiveness based on the relationship between the profits as a result of enterprise activities and the "source" of such profit. **Ratio of profit to capital** provides an understanding of a company's profitability in relation to an invested capital in terms of stock volume by noting the fact that the profit is generated from the utilization of this capital. **Profit margin on sales** allows for an understanding of a company's profit rate in relation to sales in terms of flow volume by noting the fact that the profit is calculated based on the total sales revenue.

Chart 4-24 provides some representative examples of ratio of profit to capital and profit margin on sales.

Chart 4-24 Mechanism of Profitability Analysis

- Profitability Analysis
  - Ratio of Profit to Capital
    - Ratio of (Net) Profit to Total Capital
    - Ratio of Enterprise Profit to (Usage) Total Capital
    - Ratio of Profit to Equity
    - Ratio of (Net) Profit to Stated Capital
    - Ratio of Ordinary Profit to Capital
  - Profit Margin on Sales
    - (Net) Profit Margin on Sales
    - Gross Profit Margin on Sales
    - Operating Profit Margin on Sales
    - Ordinary Profit Margin on Sales

7 2 Ratio of Profit to Capital

This indicator shows how much profit was achieved by utilizing the capital and is generally expressed using the following formula:

$$\text{Ratio of Profit to Capital (\%)} = \frac{\text{Profit}}{\text{Capital (Average Between Beginning and End of the Term)}} \times 100$$

Average total capital is used for the denominator, "Capital." In other words, an average of assets utilized during a certain period must be calculated, and the simplified formula that is most commonly used is "(Capital at the beginning of the term + Capital at the end of the term) ÷ 2." In addition, annual profit is used for the numerator, "Profit."

Many different ratios of profit to capital can be derived depending on the type of capital that is used as the denominator and the type of profit that is used as the numerator. Usually, three different types of capital – total capital, equity and stated capital – are used to calculate profitability. Chart 4-25 shows these types of capital and the relationship amongst them.

Chart 4-25 Outline of Three Types of Capital

<table>
<tr><td rowspan="3">Assets</td><td colspan="2">Third Party Capital (Liabilities)</td><td rowspan="3">Total Capital</td></tr>
<tr><td>Stated Capital</td><td rowspan="2">Equity</td></tr>
<tr><td>Surplus, etc.</td></tr>
</table>

Ordinary income and profit for the term are most often used in the numerator as profit. Therefore, as shown in Chart 4-24 above, each of the different types of capital can be matched with each of the different types of profit to derive a variety of different ratios of profit to capital.

(1) Ratio of (Net) Profit to Total Capital

$$\text{Ratio of (Net) Profit to Total Capital (\%)} = \frac{\text{(Net) Profit for the Term}}{\text{Total Capital (Average Between Beginning and End of the Term)}} \times 100$$

[Explanation of Ratio of (Net) Profit to Total Capital]

The ratio of (net) profit to total capital (also "return on assets," or "ROA") is the most commonly employed and fundamental ratio for determining the effective utilization of the total capital invested in the corporation. This relationship can be expressed as follows:

$$\text{Total Capital} = \text{Total Assets} = \text{Equity} + \text{Third Party Capital (Liabilities)} + \text{Non-Controlling Interests, Etc.}$$

Accordingly, rather than reflecting effectiveness from the perspective of specified investors such as the shareholders, it indicates the effectiveness of the utilization of capital from the overall standpoint of the corporation including its liabilities.

[Ratio of Adjusted (Net) Profit to Total Capital]

However, since third party capital is included in the denominator in the above-mentioned formula, theoretically to make the figures correspond appropriately, the profit figure in the numerator must be an amount that adds interest on third party capital (*i.e.*, interest expense and the discount expense on loans) to the net profit for the term rather than net profit for the term after deduction of interest on third party capital. This adjustment is referred to as the ratio of adjusted (net) profit to total capital.

$$\text{Ratio of Adjusted (Net) Profit to Total Capital (\%)} = \frac{\text{(Net) Profit for the Term} + \text{Interest on Third Party Capital}}{\text{Total Capital (Average Between Beginning and End of the Term)}} \times 100$$

This raises the question of which of the above-mentioned two choices for ratio of (net) profit to total capital should be adopted.

Theoretically, the generally held view is that the ratio of adjusted (net) profit to total capital is the better choice. However, traditional statistical analysis makes use of the ratio of (net) profit to total capital with the (net) profit for the term in question as the numerator, and this is the prevailing method from the perspective of simplicity in calculation as well.

There is also the question of whether (net) profit for the term should be the pre-tax profit or after-tax profit as both are disclosed by the company. The company analysis below uses after-tax net profit as a matter of convenience for comparison with the statistical data by the Development Bank of Japan.

[Application of Formula]

The following shows the results when the ratio of profit to total capital is obtained for the company under analysis (Company A is engaged in the information services business) based on Chart 4-4 and Chart 4-5 above:

$$\text{FY2020: Ratio of Profit to Total Capital (Consolidated Basis)} = \frac{\text{(Net) Profit for the Term}}{\text{Total Capital (Average Between Beginning and End of the Term)}} \times 100$$

$$= \frac{16{,}982}{(240{,}448^{*} + 272{,}223) \div 2} \times 100$$

$$= \frac{16{,}982}{256{,}336} \times 100 = 6.62\%$$

$$\text{FY2021: Ratio of Profit to Total Capital (Consolidated Basis)} = \frac{\text{(Net) Profit for the Term}}{\text{Total Capital (Average Between Beginning and End of the Term)}} \times 100$$

$$= \frac{19{,}977}{(272{,}223 + 296{,}790) \div 2} \times 100$$

$$= \frac{19{,}977}{284{,}507} \times 100 = 7.02\%$$

* Total capital as of the end of FY2019 = JPY240,448 million

[Determining Whether Ratios Are Good or Bad]

Determining whether the end results for a ratio of profit to total capitals of 6.62% (FY2020) and 7.02% (FY2021) are favorable rates or not cannot be done independently; they must be compared with the averages for all industries and the corporation’s particular industry. They must also be identified between years and over time and the trends must be analyzed.

For comparative purposes, the specific figures for the ratio of (net) profit to total capital (consolidated basis) for FY2021 (year ended on March 31, 2022) are as follows (calculated based on "Handbook of Industrial Financial Data 2022"):

All Industries: 3.78%; Non-manufacturing industries: 2.87%

The figure of 7.02% for the FY2021 ratio of (net) profit to total capital (consolidated basis) on the part of the subject company is above the averages for all industries as well as for the non-manufacturing industries. However, to make an accurate judgment of the goodness or badness of this ratio, it is necessary to make a comparison against the average value for the particular industry in which the subject company is conducting business (*i.e.*, the information services industry).

(2) Ratio of Enterprise Profit to (Usage) Total Capital

$$\text{Ratio of Enterprise Profit to (Usage) Total Capital (\%)} = \frac{\text{Operating Profit} + \text{Interest \& Dividends Received}}{\text{(Usage) Total Capital (Average Between Beginning and End of the Term)}} \times 100$$

[Explanation of Ratio of Enterprise Profit to (Usage) Total Capital]

This is an index that uses "enterprise profit" as the profit figure in the numerator relative to the total capital figure in the denominator. Here, "enterprise profit" refers to a figure that is obtained by adding interest and dividend receipts earned from financial activity to the operating profit earned from sales activity.

One of the most popular indices for gauging profitability is ratio of (net) profit to total capital. However, there is a flaw with this indicator in terms of the relationship between the numerator and the denominator: The denominator includes all capital from all sources but the numerator indicates only the net profit that is attributed to equity participants. For the purpose of correcting this flaw, the ratio of enterprise profit to (usage) total capital is used by substituting enterprise profit for net profit in the numerator.

[Application of Formula]

The following shows the results when the ratio of enterprise profit to (usage) total capital is calculated for the subject company based on Chart 4-4 and Chart 4-5 above:

$$\text{FY2020: Ratio of Enterprise Profit to (Usage) Total Capital (Consolidated Basis)} = \frac{\text{Operating Profit} + \text{Interest \& Dividends Received} + \text{Share of Profit of Entities Accounted for Using Equity Method}}{\text{(Usage) Total Capital (Average Between Beginning and End of the Term)}} \times 100$$

$$= \frac{24{,}549 + 516 + 0}{(240{,}448^{*} + 272{,}223) \div 2} \times 100$$

$$= \frac{25{,}065}{256{,}336} \times 100 = 9.78\%$$

$$\text{FY2021: Ratio of Enterprise Profit to (Usage) Total Capital (Consolidated Basis)} = \frac{\text{Operating Profit + Interest \& Dividends Received + Share of Profit of Entities Accounted for Using Equity Method}}{\text{(Usage) Total Capital (Average Between Beginning and End of the Term)}} \times 100$$

$$= \frac{29{,}815 + 535 + 39}{(272{,}223 + 296{,}790) \div 2} \times 100$$

$$= \frac{30{,}389}{284{,}507} \times 100 = 10.68\%$$

* Total capital as of the end of FY2019 = JPY240,448 million

Chart 4-26 shows the changes in the ratio of enterprise profit to (usage) total capital in terms of the average for all industries and average for the information services industry. As seen above, the ratio of enterprise profit to (usage) total capital for FY2021 is above the average for all industries (5.2%) and the average of the information services (3.4%), on a consolidated basis for FY2021.

Chart 4-26 Changes in Ratio of Enterprise Profit to (Usage) Total Capital (Consolidated Basis)

(%)

Fiscal year / Classification	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021
All Industries	4.5	5.4	5.4	5.6	5.6	6.0	5.8	5.0	4.0	5.2
Information Services Industry	9.6	8.5	8.1	8.0	7.8	7.2	6.1	5.4	4.3	3.4

(Source) "Handbook of Industrial Financial Data 2022"

(3) Ratio of Profit to Equity

$$\text{Ratio of Profit to Equity (\%)} = \frac{\text{Net Profit for the Term}}{\text{Equity (Average Between Beginning and End of the Term)}} \times 100$$

[Explanation of Ratio of Profit to Equity]

The ratio of profit to equity (also "return on equity," or "ROE") is an index that shows the degree of profit earned by the company for its shareholders based on the amount of equity invested by shareholders.

Whereas ROA is a measure of the ratio of profit to total capital that includes both equity and capital obtained from borrowed sources (third party capital), ROE is a measure of a company's profit exclusively from the standpoint of the shareholders. Here, net profit for the term in the numerator does not include third party capital and the denominator includes only the amount of shareholders' equity, a relationship that is believed to represent the appropriate correspondence between the two.

Either pre-tax net profit or after-tax net profit is used as net profit for the term. While it is clearly preferable to use after-tax net profit when the analysis of net profit for the term is focused the financial sources of dividends for shareholders, pre-tax net profit would be the better choice when the analysis is focused on management effectiveness in relation to the economic activity of the company because of the lack of any impact from taxes. As noted earlier, for the company analysis in this Chapter, after-tax net profit is used for the purpose of making comparisons between the statistical data supplied by the Development Bank of Japan.

Chart 4-27 shows the changes in ROE for the past 10 years for all industries, the manufacturing industry and non-manufacturing industries in Japan.

Chart 4-27 Changes in Ratio of Profit to Equity (Consolidated Basis)

(%)

Classification \ Fiscal year	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021
All Industries	5.2	8.5	8.2	7.6	8.6	10.6	9.6	6.3	7.1	9.4
Manufacturing Industry	4.9	8.5	8.3	7.6	8.0	10.9	9.5	5.8	6.7	10.1
Non-manufacturing Industry	5.7	8.4	8.0	7.6	9.5	10.1	9.8	7.0	7.6	8.5
Information Services Industry	11.4	10.9	11.1	12.2	11.3	12.1	11.9	9.7	7.5	8.5

(Source) "Handbook of Industrial Financial Data 2022"

[Analysis of Ratio of Profit to Equity]

Generally, a company with a high ROE is said to be a highly profitable one, and when the ROE is low, the initial step must be to clarify the reason for this. To do so, let us begin with an examination of two principal constituents of ROE, one of which is "ROA" and the other being "financial leverage."

Financial leverage has traditionally been spoken of in terms of the proportion of liabilities in total capital or the level of dependency on debt. However, from the perspective of equity, financial leverage is an indication of whether and to what degree the company is utilizing assets by means of funds invested by its shareholders. This results in the following structural relationships:

$$\text{ROE} = \text{ROA} \times \text{Financial Leverage} = \frac{\text{Net Profit for the Term}}{\text{Total Capital}} \times \frac{\text{Total Capital}}{\text{Equity}}$$

From this, assuming that the capital structure remains constant, as ROA increases, so does ROE. However, if liabilities account for a high percentage of total capital, that is to say, equity accounts for a low percentage of total capital, the leveraging effect will increase the ROE even though the ROA is low.

To demonstrate the veracity of this assertion, Chart 4-28 contains statistical data (consolidated basis) compiled for the wholesale industry and pharmaceuticals industry for FY2021.

Chart 4-28 Analysis of Ratio of Profit to Equity (Consolidated Basis)

	ROE	ROA	Financial Leverage
Wholesale Industry	14.29%	4.62%	2.87
Pharmaceuticals Industry	7.85%	3.94%	1.73

(Source) Calculated based on "Handbook of Industrial Financial Data 2022"

In the statistics for FY2021, ROA for the pharmaceuticals industry is about 0.85 times the wholesale industry whereas the ROE for the pharmaceuticals industry is approximately 0.55 times the wholesale industry. Thus, the difference between these industries has decreased. From this, it can be ascertained that the ratio of liabilities in the wholesale industry is high and that the ratio of liabilities in the pharmaceuticals industry is low, a situation that demonstrates the large degree to which financial leverage is utilized in the wholesale industry.

[Application of Formula]

The following shows the results when ROE is calculated for the subject company based on Chart 4-4 and Chart 4-5 above:

$$\text{FY2020: Ratio of Profit to Equity (Consolidated Basis)} = \frac{\text{(Net) Profit for the Term}}{\text{Equity (Average Between Beginning and End of the Term)}}$$

$$= \frac{16{,}982}{(149{,}448^{*1} + 179{,}827^{*2}) \div 2} \times 100$$

$$= \frac{16{,}982}{164{,}638} \times 100 = 10.31\%$$

$$\text{FY2021: Ratio of Profit to Equity (Consolidated Basis)} = \frac{\text{(Net) Profit for the Term}}{\text{Equity (Average Between Beginning and End of the Term)}}$$

$$= \frac{19{,}977}{(179{,}827^{*2} + 196{,}688^{*2}) \div 2} \times 100$$

$$= \frac{19{,}977}{188{,}258} \times 100 = 10.61\%$$

*1 Equity as of the end of FY2019 = JPY149,448 million
*2 "Equity = Total Net Assets – Non-Controlling Interest"

When the ratio of profit to equity for FY2021 is compared with the statistical data for FY2021 given in Chart 4-27 above, it is higher than the average for all industries (9.4%) and the average for the information services industry (8.5%). Therefore, it can be concluded that the subject company has higher profitability relative to all industries and also relative to the average information services industry company.

(4) Ratio of (Net) Profit to Stated Capital

$$\text{Ratio of (Net) Profit to Stated Capital (\%)} = \frac{\text{(Net) Profit for the Term}}{\text{Stated Capital (Average Between Beginning and End of the Term)}} \times 100$$

[Explanation of Ratio of (Net) Profit to Stated Capital]

The ratio of (net) profit to stated capital indicates the ratio of net profit for the term against stated capital and consequently expresses the rough percentage of dividends that can potentially be paid. Theoretically speaking, it is more accurate to use stated capital at the end of the term as the denominator rather than the average of paid-in capital during the term (in the calculation, however, the average capital during the term is used consistently). In addition, it is also more appropriate to use after-tax net profits for net profit for the term as numerator.

Generally speaking, the higher the ratio of (net) profit to stated capital, the better. In most cases, as the scale of a company increases, its ratio of (net) profit to stated capital tends to decrease. Moreover, assuming a fixed level for the ratio of (net) profit to shareholders' equity, the higher the level of the company's stated capital, and, conversely the lower its percentage of retained earnings (surplus), the lower its ratio of (net) profit to stated capital becomes.

The ratio of (net) profit to stated capital serves as an indicator of profitability in relation to stock investment and is also closely related to other indicators in relation to stock investment such as the price-earnings ratio.

[Relationship to Price Earnings Ratio]

The formula for the price-earnings ratio is shown below:

$$\text{Price Earnings Ratio} = \frac{\text{Price per Share}}{\text{Earnings per Share}}$$

The price earnings ratio is expressed as "Price per Share ÷ Earnings per Share" and is used to make judgments as to whether a company's stock is underpriced or overpriced in relative terms. It is important to bear in mind that the price of the stock appearing in the numerator is a reflection of the expected future earnings of the company while the earnings per share figure in the denominator is based on profits as reported in the past.

Assuming that the price earnings ratio stays constant, the stock price increases when the earnings per share increase. Generally, a corporation with high earnings per share is a corporation with a high ratio of profit to stated capital. Therefore, a corporation with a high ratio of profit to stated capital translates to a high price for the corporation's stock and vice versa.

[Application of Formula]

The following shows the results when the ratio of (net) profit to stated capital is calculated for the subject company based on Chart 4-4 and Chart 4-5 above:

$$\text{FY2020: Ratio of (Net) Profit to Stated Capital (Consolidated Basis)} = \frac{\text{(Net) Profit for the Term}}{\text{Stated Capital (Average Between Beginning and End of the Term)}}$$

$$= \frac{16{,}982}{(12{,}952^{*} + 12{,}952) \div 2} \times 100$$

$$= \frac{16{,}982}{12{,}952} \times 100 = 131.11\%$$

FY2021: Ratio of (Net) Profit to Stated Capital (Consolidated Basis)

$$= \frac{\text{(Net) Profit for the Term}}{\text{Stated Capital (Average Between Beginning and End of the Term)}}$$

$$= \frac{19{,}977}{(12{,}952 + 12{,}952) \div 2} \times 100$$

$$= \frac{19{,}977}{12{,}952} \times 100 = 154.24\%$$

* Amount of Stated Capital as of the end of FY2019 = JPY12,952 million

Chart 4-29 shows the ratios of (net) profit to stated capital for FY2021 for all industries, manufacturing industries and non-manufacturing industries in Japan.

Chart 4-29 Changes in Ratio of (Net) Profit to Stated Capital (Consolidated Basis) for Industries

(%)

Classification \ Fiscal year	2021
All Industries	92.60
Manufacturing Industry	106.50
Non-manufacturing Industry	74.97

(Source) Calculated based on "Handbook of Industrial Financial Data 2022"

[Relationship Between Earnings Per Share and Ratio of (Net) Profit to Stated Capital]

$$\text{Earnings Per Share} = \frac{\text{(Net) Profit for the Term}}{\text{Total Number of Issued Shares}}$$

As shown in this formula, while the earnings per share expresses the profit in the material unit of "per share," the ratio of (net) profit to stated capital represents the profit per monetary unit of stated capital. In other words, although there are different approaches involved in using either a material unit or monetary unit, they are both indicators of profitability.

(5) Ratio of Ordinary Profit to Capital

Thus far, a variety of indices have been calculated primarily using (net) profit for the term in the numerator and different amounts in the denominator. The ratio of ordinary profit to capital is obtained by using ordinary profit in the numerator in lieu of (net) profit for the term. By doing so and changing the component of the denominator in relation to capital, the following formulas for ratios of profit can be generated:

$$\text{Ratio of Ordinary Profit to Total Capital (\%)} = \frac{\text{Ordinary Profit}}{\text{Total Capital (Average Between Beginning and End of the Term)}} \times 100$$

$$\text{Ratio of Ordinary Profit to Equity (\%)} = \frac{\text{Ordinary Profit}}{\text{Equity (Average Between Beginning and End of the Term)}} \times 100$$

$$\text{Ratio of Ordinary Profit to Stated Capital (\%)} = \frac{\text{Ordinary Profit}}{\text{Stated Capital (Average Between Beginning and End of the Term)}} \times 100$$

[Application of Formulas]

The following shows the results when the ratios of ordinary profit to capital for the subject company are calculated based on Chart 4-4 and Chart 4-5:

	FY2020	FY2021
Ratio of Ordinary Profit to Total Capital (Consolidated Basis)	$= \frac{\text{Ordinary Profit}}{\text{Total Capital (Average Between Beginning and End of the Term)}} \times 100$	$= \frac{\text{Ordinary Profit}}{\text{Total Capital (Average Between Beginning and End of the Term)}} \times 100$
	$= \frac{25{,}101}{(240{,}448^{*1} + 272{,}223) \div 2} \times 100$	$= \frac{30{,}811}{(272{,}223 + 296{,}790) \div 2} \times 100$
	= 9.79%	= 10.83%
Ratio of Ordinary Profit to Equity (Consolidated Basis)	$= \frac{\text{Ordinary Profit}}{\text{Equity}^{*2}\text{ (Average Between Beginning and End of the Term)}} \times 100$	$= \frac{\text{Ordinary Profit}}{\text{Equity}^{*2}\text{ (Average Between Beginning and End of the Term)}} \times 100$
	$= \frac{25{,}101}{(149{,}448^{*3} + 179{,}827) \div 2} \times 100$	$= \frac{30{,}811}{(179{,}827 + 196{,}688) \div 2} \times 100$
	= 15.25%	= 16.37%
Ratio of Ordinary Profit to Stated Capital (Consolidated Basis)	$= \frac{\text{Ordinary Profit}}{\text{Stated Capital (Average Between Beginning and End of the Term)}} \times 100$	$= \frac{\text{Ordinary Profit}}{\text{Stated Capital (Average Between Beginning and End of the Term)}} \times 100$
	$= \frac{25{,}101}{(12{,}952^{*4} + 12{,}952) \div 2} \times 100$	$= \frac{30{,}811}{(12{,}952 + 12{,}952) \div 2} \times 100$

= 193.80% = 237.89%

*1 Total capital as of the end of FY2019 = JPY240,448 million.
*2 “Equity = Total Net Assets – Non-Controlling Interest”
*3 Equity as of the end of FY2019 = JPY149,448 million.
*4 Stated capital as of the end of FY2019 = JPY12,952 million.

The above ratios must be compared with the average for all industries and the non-manufacturing industries as shown in Chart 4-30 to judge whether they are good or not. What is evident is that the ratio of ordinary profit to total capital for the subject company in FY2021 exceeds the averages for all industries and the non-manufacturing industries.

Chart 4-30 Ratios of Ordinary Profit to Capital of Japanese Industries (Consolidated Basis)

(%)

Ratio of Profit to Capital	Item \ Fiscal year	2021
Ratio of Ordinary Profit to Total Capital	All Industries	5.42
	Non-Manufacturing	4.12
Ratio of Ordinary Profit to Equity	All Industries	13.51
	Non-Manufacturing	12.17
Ratio of Ordinary Profit to Stated Capital	All Industries	132.85
	Non-Manufacturing	107.87

(Source) Calculated based on “Handbook of Industrial Financial Data 2022”

7 3 Profit Margin on Sales

Generally, the following formula is used to establish the level of profit achieved relative to sales:

$$\text{Profit Margin on Sales (\%)} = \frac{\text{Profit}}{\text{Sales}} \times 100$$

Various profit margins can be calculated by use of this formula by including different forms of profit in the numerator such as net profit, gross profit, operating profit and ordinary profit.

Chart 4-16 presented above shows the essentials for determining these different forms of profit. (Refer to “Section 3. Structure and Interpretation of Profit and Loss Statement” of this Chapter for details).

(1) (Net) Profit Margin on Sales

$$\text{(Net) Profit Margin on Sales (\%)} = \frac{\text{(Net) Profit for the Term}}{\text{(Net) Sales}} \times 100$$

This profit margin indicates the level of net profit achieved for the term against sales of JPY100. This ratio fluctuates according to economic trends but has a tendency to flatten out over the longer term. The sales figure used in the denominator is net sales after returns and discounts are deducted from gross sales.

[Nature of (Net) Profit Margin on Sales]

Next is consideration of how the profit margin on sales changes according to the scale of a corporation (*e.g.*, sales). It differs according to the industry in question.

Chart 4-31 shows the effects on profit margins of differing levels of sales for three automobile manufacturing companies.

The rank in the order of total sales matches the rank in the order of gross profit margin on sales, whereas the rank in the order of operating profit margin on sale, ordinary profit margin on sale, and (net) profit margin on sale does not match the rank in the order of total sales. (Note: in the past fiscal years, there were years in which all indicators of profit margin on sales were linked to the total sales.)

Chart 4-31 Pattern of Profit Margin on Sales According to the Scale of Business (Case 1)

Automobile manufacturing companies	Sales (JPY million)	Profit Margin on Sales (%) (FY2021, consolidated basis)			
		Gross Profit Margin	Operating Profit Margin	Ordinary Profit Margin	Net Profit Margin for the Term
SZ Co.	3,568,380	24.00	5.37	7.37	4.49
IS Co.	2,514,291	18.22	7.45	8.29	5.02
HN Co.	1,459,706	17.16	2.32	2.60	-5.80

(Source) Calculated based on securities reports of the companies

Chart 4-32 shows similar data for three food processing companies.

PH, which is by far the strongest in terms of total sales, ranks second for gross profit margin, and FH, which ranks third in terms of total sales, ranks first for gross profit margin. The rank in the order of operating profit margin on sale, ordinary profit margin on sale, and (net) profit margin on sale is the same as the rank in the order of total sales.

Chart 4-32 Pattern of Profit Margin on Sales According to the Scale of Business (Case 2)

Food Processing Companies	Sales (JPY million)	Profit Margin on Sales (%) (FY2021, consolidated basis)			
		Gross Profit Margin	Operating Profit Margin	Ordinary Profit Margin	Net Profit Margin for the Term
PH Co.	419,591	12.30	3.09	3.55	2.32
MS Co.	218,610	14.62	-0.40	-0.17	-0.17
FH Co.	24,420	15.59	-1.52	-1.34	-2.94

(Source) Calculated based on securities reports of the companies

[Analysis of Factors Underlying Irregular Cases]

This raises the question of why the rank in the order of profit margin on sale is not completely linked with the rank in the order of total sales. Chart 4-33 has been prepared in an attempt to clarify the reasons for Case 1. From this chart, three factors are apparent:

(1) For the ratio of cost of goods sold to sales, HN is the highest, followed by IS, and SZ is the lowest, which results in a situation in which SZ has the highest gross profit margin and IS and HN have low margins.
(2) The ratio of selling expenses and general and administrative expenses to sales for IS is significantly lower than the other two companies. Because of this, the company's operating profit margin is higher than the other two companies.
(3) HN has a higher ratio of interest expense to sales than SZ and IS, indicating financing of HN is more dependent on borrowing than the other two companies.

Chart 4-33 Ratios of Expenses Against Sales for Three Companies in Automobile Manufacturing Industry (FY2021, consolidated basis)

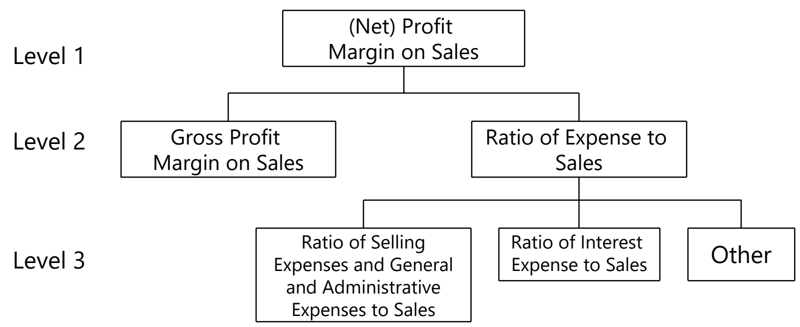
(%)

Automobile Manufacturing Industry	Ratio of Cost of Goods Sold to Sales	Ratio of Selling Expenses and General and Administrative Expenses to Sales	Ratio of Interest Expense to Sales
SZ Co.	76.00	18.64	0.17
IS Co.	81.78	10.78	0.08
HN Co.	82.84	14.85	0.20

(Source) Calculated based on securities reports of the companies

Chart 4-34 shows the model employed in the analysis of (net) profit margin on sales at each level.

Chart 4-34 Model for Analysis of (Net) Profit Margin on Sales at Each Level



[Application of Formula]

The following shows the results when the (net) profit margin on sales is obtained for the subject company based on Chart 4-5 above:

$$\text{FY2020: (Net) Profit Margin on Sales (Consolidated Basis)} = \frac{16{,}982}{251{,}992} \times 100 = 6.74\%$$

$$\text{FY2021: (Net) Profit Margin on Sales (Consolidated Basis)} = \frac{19{,}977}{270{,}332} \times 100 = 7.39\%$$

For the subject company, its (net) profit margin on sales for FY2021 is higher than the averages for all industries shown in Chart 4-35.

Chart 4-35 (Net) Profit Margin on Sales of Japanese Industries (Consolidated Basis)

(%)

Classification \ Fiscal year	2021
All Industries	5.48
Non-Manufacturing Industries	4.32

(Source) Calculated based on "Handbook of Industrial Financial Data 2022"

(2) Gross Profit Margin on Sales

$$\text{Gross Profit Margin on Sales (\%)} = \frac{\text{Gross Profit on Sales}}{\text{(Net) Sales}} \times 100$$

The gross profit margin on sales shows the ratio of gross profit on sales (also referred to as "rough profit") against sales. It is used as an indicator of whether a company's purchase and manufacturing activities are good or bad. This ratio can be expressed as (1 – ratio of cost of goods sold to sales):

$$\begin{aligned}\text{Gross Profit Margin on Sales (\%)} &= \frac{\text{(Net) Sales} - \text{Sales Cost}}{\text{(Net) Sales}} \times 100 \\ &= \left(1 - \frac{\text{Sales Cost}}{\text{(Net) Sales}}\right) \times 100 \\ &= (1 - \text{Ratio of Cost of Goods Sold to Sales}) \times 100\end{aligned}$$

As clearly seen with this formula, when the ratio of the cost of goods sold to sales decreases, the gross profit margin on sales increases. Consequently, a company having superior purchase and production management generally has a relatively low ratio of cost of goods sold to sales and a high gross profit margin on sales.

When evaluating the results by comparing the ratios between periods, it is necessary to examine the factors responsible for the rise and/or fall of sales and sales cost. In addition, since this ratio also exhibits marked differences among industries, it is also necessary to make a comparison between the company and the industry average or other companies in the same industry.

[Application of Formula]

The following shows the results for gross profit margin on sales of the subject company based on Chart 4-5 above:

$$\text{FY2020: Gross Profit Margin on Sales (Consolidated Basis)} = \frac{251{,}992 - 200{,}042}{251{,}992} \times 100 = 20.62\%$$

$$\text{FY2021: Gross Profit Margin on Sales (Consolidated Basis)} = \frac{270{,}332 - 210{,}011}{270{,}332} \times 100 = 22.31\%$$

Comparing the ratio for FY2021 against the average ratios for Japanese industries (see Chart 4-36), the company's ratio is slightly below the average for all industries and the average for non-manufacturing industries of which the information services industry is a component.

Chart 4-36 Gross Profit Margin on Sales of Japanese Industries (Consolidated Basis)

(%)

Classification \ Fiscal year	2021
All Industries	25.36
Non-Manufacturing Industries	23.54

(Source) Calculated based on "Handbook of Industrial Financial Data 2022"

(3) Operating Profit Margin on Sales

$$\text{Operating Profit Margin on Sales (\%)} = \frac{\text{Operating Profit}}{\text{(Net) Sales}} \times 100$$

Operating profit margin on sales shows the level of profitability a company has been able to achieve through its sales activity in terms of the ratio between operating profit after deducting operating costs (*i.e.*, sales costs and general and administrative expenses) from gross profit on sales and sales.

This ratio will decline as operating costs increase and vice versa. Therefore, to ascertain the reasons for any increase or decrease in the rate of operating profit margin on sales requires a review of the increases and decreases in each item under operating costs.

[Application of Formula]

The following shows the results of operating profit margin on sales for the subject company based on Chart 4-5 above:

$$\text{FY2020: Operating Profit Margin on Sales (Consolidated Basis)} = \frac{24{,}549}{251{,}992} \times 100 = 9.74\%$$

$$\text{FY2021: Operating Profit Margin on Sales (Consolidated Basis)} = \frac{29{,}815}{270{,}332} \times 100 = 11.03\%$$

Here, in addition to paying attention to past trends for profit margin, it is also necessary to make a determination of whether the company's operating profit margin on sales is good or bad by making comparisons with the average ratios of all industries and the industry to which the company belongs.

(4) Ordinary Profit Margin on Sales

$$\text{Ordinary Profit Margin on Sales (\%)} = \frac{\text{Ordinary Profit}}{\text{(Net) Sales}} \times 100$$

This ratio measures the performance of a company in terms of its profit derived from its regular business activities as a percentage of its ordinary profit against sales of JPY100.

Ordinary profit is the profit from business activities pertaining to the business of the corporation (operating profit) plus/minus the income and expenses from the ancillary activities that are associated with such business activities such as financial activity (non-operating income and expenses). In that sense, the ordinary profit margin on sales can be said to be the best indicator of the profitability of a corporation derived from its regular business activities.

[Application of Formula]

The following shows the results of ordinary profit margin on sales for the subject company based on Chart 4-5 above:

$$\text{FY2020: Operating Profit Margin on Sales (Consolidated Basis)} = \frac{25{,}101}{251{,}992} \times 100 = 9.96\%$$

$$\text{FY2021: Operating Profit Margin on Sales (Consolidated Basis)} = \frac{30{,}811}{270{,}332} \times 100 = 11.40\%$$

As always, any determination as to whether the results according to this ratio are good or bad requires a comparison against the averages in Japan (c.f., Chart 4-37).

Chart 4-37 Ordinary Profit Margin on Sales of Japanese Industries (Consolidated Basis)

(%)

Classification \ Fiscal year	2021
All Industries	7.86
Non-Manufacturing Industries	6.22

(Source) Calculated based on "Handbook of Industrial Financial Data 2022"

8 Stability Analysis

8-1 Significance and Mechanism of Stability Analysis

Stability analysis provides a means for determining whether a corporation can continue its business operations over the long term. It includes both analysis of the corporation's ability to meet its obligations over the short term as well as analysis of its stability and soundness of its financial structure over the long term. Stability analysis provides for the analytical materials that are of keen concern for creditors who have a direct relationship with the subject company as well as for specialized analysts, current investors and future investors who keep close watch on the corporation's credit rating.

Central to stability analysis is the balance sheet, which shows **the financial condition** of a company, or in other words, the "proportional mix of assets, liabilities and equity." Specifically, as shown in Chart 4-38, these relationships can be treated in terms of the following three aspects:

(1) The mix of "Current Assets/Current Liabilities" in the upper portion shows the solvency of the company over the short term (*i.e.*, its liquidity).

(2) The mix of "Fixed Assets/Equity" in the lower portion shows the degree to which funds that are fixed over the long term are covered by funds that are not subject to repayment deadlines (*i.e.*, equity).

(3) The two relationships on the right side of "Total Liabilities/Equity" and "Total Capital/ Equity" shows the percentage of equity which is a component of the total capital.

Among these, (1) shows whether a corporation has the ability to repay its obligations from the standpoint of its financing activities, and (2) shows whether funds that have been procured are being managed appropriately in relation to the purpose of use. Moreover, (3) above shows whether the methods used for the procurement of funds are appropriate from the perspective of the corporation's overall capital structure.

Of these three aspects of corporate stability consisting of (1) liquidity (the corporation's ability to repay its short term obligations), (2) appropriateness of the source and use of funds, and (3) the soundness of the capital structure, when the latter two of these aspects in particular are used as indicators of financial soundness, stability analysis then consists broadly of "**liquidity analysis**" and "**analysis of financial soundness**."

Chart 4-38 Three Aspects of Stability Analysis

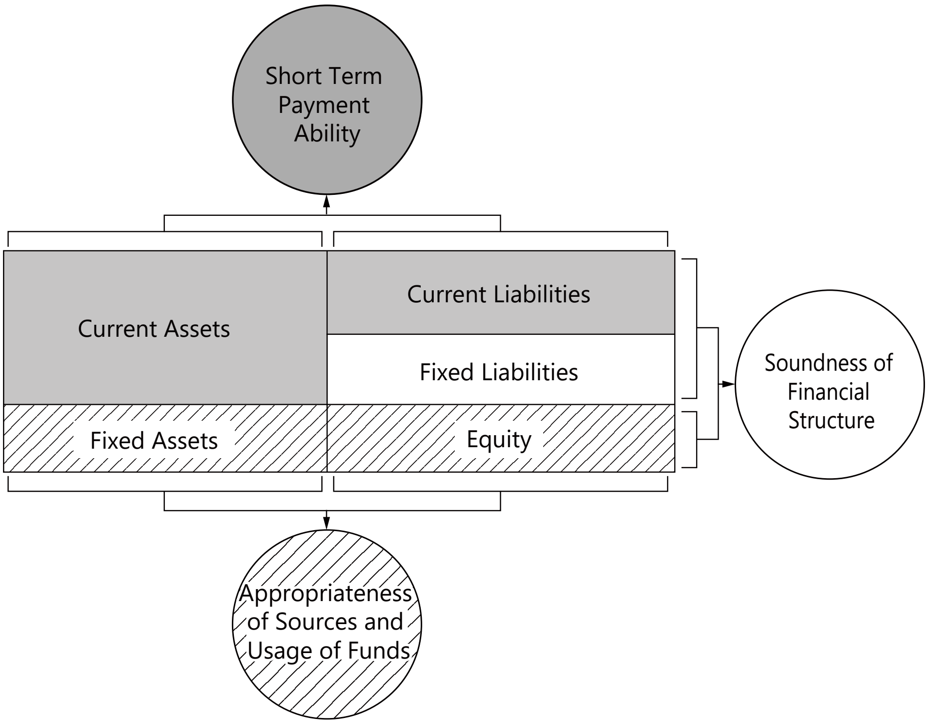
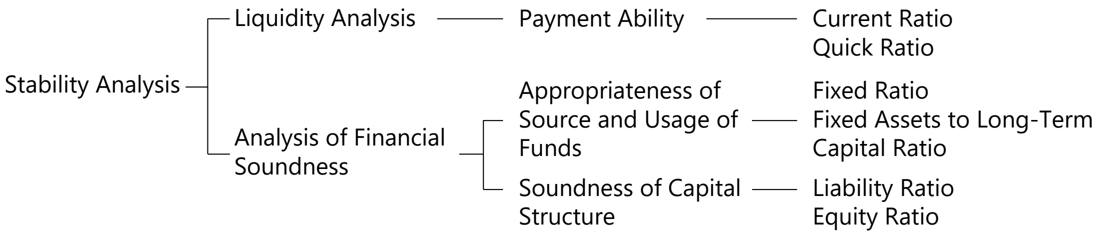


Chart 4-39 shows a breakdown of the mechanism used for stability analysis with each of the specific financial ratios for each component of analysis.

Chart 4-39 Mechanism of Stability Analysis



8 2 Liquidity Analysis

(1) Current Ratio

$$\text{Current Ratio (\%)} = \frac{\text{Current Assets}}{\text{Current Liabilities}} \times 100$$

[Explanation of Current Ratio]

The current ratio is the most widely used ratio for determining the ability of a company to repay its short term obligations by focusing on the degree to which current assets in the form of cash, deposits, short term securities, etc.

are available to cover current liabilities due within one year. The higher this ratio is, the better, and ideally, it is preferable to have a current ratio above 200%, also known as "two to one rule."

When this ratio is under 100%, it indicates that the amount of liabilities that must be repaid within one year is more than the amount of current assets, a situation that is generally viewed as unfavorable. However, there are certain industries such as the electric power and railway industries where the levels of current assets are much smaller relative to other industries. Here, the current ratios for almost all companies are far below 100%.

[Application of Formula]

The following shows the results when the liquidity ratio is calculated for the subject company based on Chart 4-4 above:

FY2020: Current Ratio (Consolidated Basis) $= \dfrac{171{,}834}{60{,}694} \times 100 = 283.12\%$

FY2021: Current Ratio (Consolidated Basis) $= \dfrac{187{,}686}{62{,}165} \times 100 = 301.92\%$

To determine whether this ratio is good or bad, Chart 4-40 has been prepared for the purpose of making a comparison with the averages in Japan for all industries and the subject company's own industry.

Chart 4-40 Changes in Current Ratio of Japanese Industries (Consolidated Basis)

(%)

Classification / Fiscal year	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021
All Industries	138.6	142.1	144.9	145.1	145.7	146.3	142.6	140.3	143.0	144.0
Information Services Industry	156.4	145.7	145.8	146.5	137.9	128.1	122.6	112.4	110.9	109.1

(Source) "Handbook of Industrial Financial Data 2022"

[Evaluating the Current Ratio]

The current ratio for the subject company in FY2021 is significantly above the average of 144.0% (FY2021) for all industries as well as the average of 109.1% (FY2021) for the information services industry in the same year.

In Japan, the current ratios for certain industries such as pharmaceuticals and electronics parts are comfortably above 200%, whereas in other industries such as retail and gas, the current ratios tend to be between 100% and 150%. Chart 4-41 clearly shows these differences in current ratios among different industries.

Chart 4-41 Comparison of Current Ratios Among Japanese Industries (Consolidated Basis)

(%)

Classification \ Fiscal year	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021
Pharmaceuticals Industry	274.6	260.8	244.1	252.9	217.3	256.1	202.0	186.1	226.7	207.9
Electronics Parts Industry	256.2	285.7	289.7	292.4	292.3	259.3	259.7	248.1	239.1	242.4
Retail Industry	109.2	113.3	114.6	118.6	120.6	123.3	125.2	124.4	123.0	123.8
Gas Industry	132.6	139.3	149.2	143.2	147.9	133.3	142.0	149.9	148.6	152.8

(Source) "Handbook of Industrial Financial Data 2022"

(2) Quick Ratio

$$\text{Quick Ratio (\%)} = \frac{\text{Quick Assets}}{\text{Current Liabilities}} \times 100$$

[Explanation of Quick Ratio]

Quick assets are current assets that can be quickly converted to cash, and the quick ratio is a measure of the ability to repay current liabilities with quick assets. For calculating the current ratio, the numerator (current assets) includes inventory assets such as merchandise, products, semi-finished goods and work in process. Conversion of these items into cash requires marketing activities thereby reducing their availability as a resource for payment of current liabilities. It is the quick ratio that shows liquidity in the shorter term by using quick assets that have greater liquidity in the numerator.

Quick assets refer to (i) means of payment (cash, deposits), (ii) operating monetary credits (notes receivable, accounts receivable), (iii) securities bought as temporary investments, and (iv) non-operating monetary credits (short-term loans, accrued items, deposits paid). These items are cash, deposits and quasi-cash items that can be converted to cash in a short period of time, and are, therefore, an extremely effective source of repayment for the current liabilities due within one year.

A desirable level for the quick ratio is considered to be 100% or higher. Chart 4-42 shows the average quick ratios that have existed in Japan.

Chart 4-42 Quick Ratios of Japanese Industries (Consolidated Basis)

(%)

Classification \ Fiscal year	2021
All Industries	90.66
Manufacturing Industry	96.67
Non-Manufacturing Industries	84.24

(Source) Calculated based on "Handbook of Industrial Financial Data 2022"

[Application of Formula]

Below is the calculation of the quick ratio for the subject company based on Chart 4-4 above.

First, it is necessary to calculate the amount of the subject company's quick assets for two years as follows:

FY2020: Cash and Deposits 5,255 + deposits paid 73,530
+ Notes Receivable & Accounts Receivable 61,074
+ Securities 1,000 - Allowance for Bad Debt 25 = Quick Assets 140,834

FY2021: Cash and Deposits 5,865 + deposits paid 90,216
+ Notes Receivable & Accounts Receivable 55,366
+ Contract Assets 11,592 + Securities 2,000 - Allowance for Bad Debt 120
= Quick Assets 164,919

Using these values yields the following for the quick ratio:

$$\text{FY2020: Quick Ratio (Consolidated Basis)} = \frac{140{,}834}{60{,}694} \times 100 = 232.04\%$$

$$\text{FY2021: Quick Ratio (Consolidated Basis)} = \frac{164{,}919}{62{,}165} \times 100 = 265.29\%$$

At 265.29%, the subject company's quick ratio in FY2021 is well above the averages in all industries in 2021, including the manufacturing industry and non-manufacturing industries. Therefore, the short-term solvency of the subject company can be regarded as extremely favorable.

8 3 Analysis of Financial Soundness

(1) Fixed Ratio

$$\text{Fixed Ratio (\%)} = \frac{\text{Fixed Assets}}{\text{Equity}} \times 100$$

[Explanation of Fixed Ratio]

The fixed ratio shows the relationship between the amount invested into fixed assets and the amount of equity. Fixed assets, the numerator in the above formula, are durable assets that are utilized over a period that is longer than one year. As such, from the standpoint of stability, it is best to cover these assets with equity, which has no due date for repayment.

In that sense, the ideal level for the fixed ratio is at 100% or below. However, as Chart 4-43 shows, the average fixed ratio for Japanese corporations exceeds 100% by a large margin. In most instances, the fixed ratios for

FY2021 were unusually high in those industries characterized by significant levels of fixed assets such as railways (273.5), general trading companies (170.0%) and air transportation (241.2%). In contrast, this ratio is low in other industries such as metering instruments (53.5) and electronics parts (76.3%), showing the wide disparity among different industries.

Chart 4-43 Changes in Fixed Ratios (Consolidated Basis)

(%)

Classification \ Fiscal year	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021
All Industries	155.0	151.7	147.4	146.9	144.6	140.0	141.7	149.2	147.6	142.2
Information Services Industry	76.7	84.4	88.1	87.4	93.2	101.6	113.4	141.2	140.6	143.2

(Source) "Handbook of Industrial Financial Data 2022"

[Application of Formula]

The following is a calculation of the fixed ratios of the subject company based on Chart 4-4 above:

$$\text{FY2020: Fixed Ratio (Consolidated Basis)} = \frac{100{,}388}{179{,}827^{*}} \times 100 = 55.82\%$$

$$\text{FY2021: Fixed Ratio (Consolidated Basis)} = \frac{109{,}103}{196{,}688^{*}} \times 100 = 55.47\%$$

* Equity = Total Net Assets – Non-Controlling Interest

The fixed ratio for the subject company was 55.47% in FY2021, which is significantly below the averages for all industries (FY2021) and the average for the information services industry (FY2021). Therefore, the subject company can be regarded as financially stable.

(2) Fixed Assets to Long-Term Capital Ratio

$$\text{Fixed Assets to Long-term Capital Ratio (\%)} = \frac{\text{Fixed Assets}}{\text{Equity + Minority Interests + Fixed Liabilities}} \times 100$$

[Explanation of Fixed Assets to Long-Term Capital Ratio]

The fixed assets to long-term capital ratio shows the relationship between the amounts invested in fixed assets and the amount of long-term capital (equity + non-controlling interests + fixed liabilities). In contrast, the fixed ratio discussed above shows how much of the equity (with no due date for repayment) is available to cover the fixed assets appearing in the numerator. Since fixed assets are durable assets that are utilized over the longer term, it is appropriate to use capital that is long term in nature which adds non-controlling interests and fixed liabilities to equity as the funds for this purpose.

As demonstrated above, since Japanese corporations are making use of long-term loans in the form of bank loans, issuances of corporate bonds, etc. to cover investment in fixed assets such as facilities, their fixed ratios tend to be well above 100%. Thus, in order to accurately reflect the unique Japanese corporate environment, it is more appropriate to incorporate both non-controlling interests and fixed liabilities into the evaluation of financial soundness rather than rely solely on the fixed ratio.

A desirable level of the fixed assets to long-term capital ratio is 100% or less, and the smaller this figure is, the better. If the ratio of fixed assets to long-term capital is assumed to be 100%, the following relationship will appear in the composition of the balance sheet:

Fixed Assets = Equity + Non-Controlling Interests + Fixed Liabilities

Thus, in this instance, a relationship exists whereby "Current Assets = Current Liabilities." In other words, a liquidity ratio of 100% makes the fixed assets to long-term capital ratio 100%, proving the correlation between the two ratios.

[Treatment of Non-Controlling Interests]

When using a consolidated balance sheet for the purpose of company analysis, particular care is required in the treatment of non-controlling interests. As discussed in the earlier explanation of the consolidated financial statements, the term "non-controlling interests" refers to the portion of the capital of a subsidiary company that is not associated with the parent corporation. For example, assuming a total value for capital of a subsidiary of 100 of which 60% belongs to the parent corporation, the remaining 40% is in the hands of shareholders other than the parent corporation. This 40% represents the non-controlling interests. In Japan, from the standpoint of the "parent company theory", which views the parent corporation shareholder as the main constituent in the accounting, non-controlling interests are not included in the scope of shareholders' equity (equity capital), but are separately recorded as any item of net assets other than shareholders' equity. Accordingly, although non-controlling interests do not count in the calculation of the fixed ratio, in the calculation of the ratio of fixed assets to long-term capital, they are incorporated in the calculation as an item equivalent to equity and fixed liabilities in light of the purpose of the calculation.

Chart 4-44 shows the average fixed assets to long-term capital ratios in Japan industries for the purpose of comparative analysis.

Chart 4-44 Fixed Assets to Long-Term Capital Ratios of Japanese Industries (Consolidated Basis)

(%)

Classification \ Fiscal year	2021
All Industries	81.73
Manufacturing Industry	76.01
Non-Manufacturing Industries	88.36

(Source) Calculated based on "Handbook of Industrial Financial Data 2022"

[Application of Formula]

Below, the fixed assets to long-term capital ratios of the subject company have been calculated based on Chart 4-4 above:

$$\text{FY2020: Fixed Assets to Long-term Capital Ratio (Consolidated Basis)} = \frac{100{,}388}{179{,}827^{*} + 6{,}301 + 25{,}400} \times 100 = 47.46\%$$

$$\text{FY2021: Fixed Assets to Long-term Capital Ratio (Consolidated Basis)} = \frac{109{,}103}{196{,}688^{*} + 6{,}741 + 31{,}195} \times 100 = 46.50\%$$

* Equity = Total Net Assets – Non-Controlling Interest

The fixed assets to long-term capital ratio for the subject company was 46.50 in FY2021, a figure that is below 100%, and is also lower than the average for all industries as well as non-manufacturing industries in the same year. Consequently, the financial soundness of the subject company can be interpreted as being favorable.

(3) Liability Ratio

$$\text{Liability Ratio (\%)} = \frac{\text{Liabilities}}{\text{Equity}} \times 100 = \frac{\text{Current Liabilities} + \text{Fixed Liabilities}}{\text{Equity}} \times 100$$

[Explanation of Liability Ratio]

The liability ratio shows the proportion of interest bearing liabilities against equity. Since equity represents capital for which there is no due date for repayment, the lower this ratio is, the more collateral is available to secure credit claims. Therefore, it is desirable that the ratio be less than 100%; the lower the ratio is, the higher the level of financial stability.

Chart 4-45 shows the averages for Japanese industries. As shown in Chart 4-46, since the liability ratio exhibits marked differences depending on the industry, any meaningful analysis must necessarily include careful consideration of the particular characteristics of the industry under examination.

Chart 4-45 Changes in Liability Ratios of Japanese Industries (Consolidated Basis)

(%)

Fiscal year / Classification	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021
All Industries	166.0	159.4	150.6	150.5	146.3	140.1	139.4	147.6	146.9	141.0
Information Services Industry	119.6	136.9	133.7	130.8	134.9	161.0	174.9	227.1	220.3	240.0

(Source) "Handbook of Industrial Financial Data 2022"

Chart 4-46 Comparison of Liability Ratios Among Industries (Consolidated Basis)

(%)

High Industries \ Fiscal year	2020	2021	Low Industries \ Fiscal year	2020	2021
General Trading Companies	212.4	195.7	Pharmaceuticals	75.9	71.8
Air Transportation	218.0	302.9	Electronics Parts	58.1	55.7
General Construction	135.9	143.4	Publishing & Printing	73.8	68.4

(Source) "Handbook of Industrial Financial Data 2022"

[Application of Formula]

Obtaining the liability ratios based on previously shown Chart 4-4 for the subject company yields the following:

$$\text{FY2020: Liability Ratio (Consolidated Basis)} = \frac{60{,}694 + 25{,}400}{179{,}827^*} \times 100 = 47.88\%$$

$$\text{FY2021: Liability Ratio (Consolidated Basis)} = \frac{62{,}165 + 31{,}195}{196{,}688^*} \times 100 = 47.47\%$$

* Equity = Total Net Assets – Non-Controlling Interest

Using a benchmark of 100%, the figure of 47.47% (FY2021) for the subject company's liability ratio is not only less than ideal, but also healthy relative to the average of 240.0% for the information services industry (FY2021).

8 4 Equity Ratio

$$\text{Equity Ratio (\%)} = \frac{\text{Equity}}{\text{Total Capital}} \times 100 = \frac{\text{Equity}}{\text{Equity + Share Options + Non-Controlling Interests + Liabilities}} \times 100$$

[Explanation of Equity Ratio]

The equity ratio shows the proportion of equity in total capital, that is the total of liabilities (third party capital) and equity. It represents one of the most fundamental indicators for judging the stability of a corporation. Since equity is capital that is not subject to any due date for repayment, the higher this ratio becomes, the more financially stable the company is considered to be, *i.e.*, the better its financial condition.

In conjunction with the rapid growth of the economy in the post-war period, equity ratios showed a steady decline in response to the dependence on borrowed capital as the source of funding for capital investment. A

Japanese-style financing system came into being following the war, in which it was comparatively easy for corporations to borrow from other companies that were members of the same corporate family. However, after the first oil shock hit in 1973, the economy settled into a more stabilized growth pattern and the equity ratio began a steady rise.

Chart 4-47 shows the average liquidity ratios for Japan's domestic industries for the past 10 years.

Chart 4-47 Comparison of Equity Ratios Among Japanese Industries (Consolidated Basis)

(%)

Classification \ Fiscal year	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021
All Industries	36.6	37.5	38.8	38.8	39.4	40.5	40.6	39.3	39.6	40.6
Manufacturing Industry	40.7	42.1	43.3	43.2	43.6	45.2	45.2	44.2	44.8	46.3
Non-Manufacturing Industries	31.8	32.0	33.2	33.7	34.5	35.0	35.3	33.8	33.7	34.1
Information Services Industry	45.0	41.7	42.4	42.7	42.1	37.8	36.0	30.0	30.7	29.0

(Source) Calculated based on "Handbook of Industrial Financial Data 2022"
(Note) Due to lack of data on the share option ratio, the formula, "equity ratio = net asset ratio – non-controlling interest ratio," is used to obtain a rough estimate.

[How to Evaluate the Equity Ratio]

Generally speaking, a company with a high equity ratio is considered to be in good condition to resist bad economic times and can be expected to be able to achieve sound growth from a long-term perspective.

A company with a high equity ratio also has a lower burden of fixed interest expenses on loans relative to one with a low equity ratio. As such, even during poor economic times when there are concerns over operating income, interest expenses relative to business income tend to be lower. In other words, a high equity ratio translates to high immunity against a routine economic slump. Conversely, a low equity ratio means a higher interest burden that can restrict the ability of a corporation to take advantage of higher risk business opportunities such as research and development or overseas investment. In that sense, a low equity ratio has the potential to impede a corporation's long-term growth.

In addition to the above, corporations with a high equity ratio often have high proportions of internal profit accumulation (retained earnings) within their equity. Chart 4-48 shows the internal composition of equity for three warehousing companies with high equity ratios. Note the fact that the consolidated surplus (profit reserve and other consolidated surplus) constitutes a high proportion of their internal capital.

More concretely, a company with a high equity ratio is one in which the proportion of retained earnings is high; over the long term such a company can be expected to proceed with sound development of its business.

Chart 4-48 Composition of Equity for Three Warehousing Companies (Consolidated Basis, FY2021)

(%)

	ST Co.	MB Co.	YD Co.
Stated Capital & Capital Reserve	7.30	7.47	4.03
Consolidated Surplus	32.29	44.56	25.20
Other	14.86	9.17	17.65
Total (Equity Ratio)	54.45	61.20	46.88

(Source) Calculated based on securities reports of the companies

[Application of Formula]

Obtaining the equity ratios based on Chart 4-4 above for the subject company yields the following:

$$\text{FY2020: Equity Ratio (Consolidated Basis)} = \frac{179{,}827^*}{272{,}223} \times 100 = 66.06\%$$

$$\text{FY2021: Equity Ratio (Consolidated Basis)} = \frac{196{,}688^*}{296{,}790} \times 100 = 66.27\%$$

* Equity = Total Net Assets – Non-Controlling Interest

The equity ratio for the subject company was 66.27% (FY2021). This was higher than the averages for all industries, the non-manufacturing industry and the information services industry (FY2021). Therefore, the financial condition of the subject company can be regarded as stable.

9 Analysis of Capital Efficiency and Break-Even Point Between Profit and Loss

9-1 Significance and Mechanism of Capital Efficiency Analysis

Capital efficiency analysis is used to determine whether and to what degree invested capital (assets) are being managed effectively by gaining a clear understanding of and evaluating the utilization of the capital's (assets) activities.

Capital efficiency analysis is usually expressed in terms of the "**turnover ratio**." The turnover ratio is usually calculated by taking annual sales as the numerator and the averages (or simple balance at the end of the term) of capital or assets as the denominator. Here, using total assets in the denominator generates the **total capital turnover ratio**.

Since total capital refers to the total amount of capital that is invested in a corporation, the following relationships can be established:

Total Assets = Total Capital

Total of Various Types of Assets = Total of Various Types of Capital

Therefore, the total capital turnover ratio yields the following capital turnover ratios according to the type of capital:

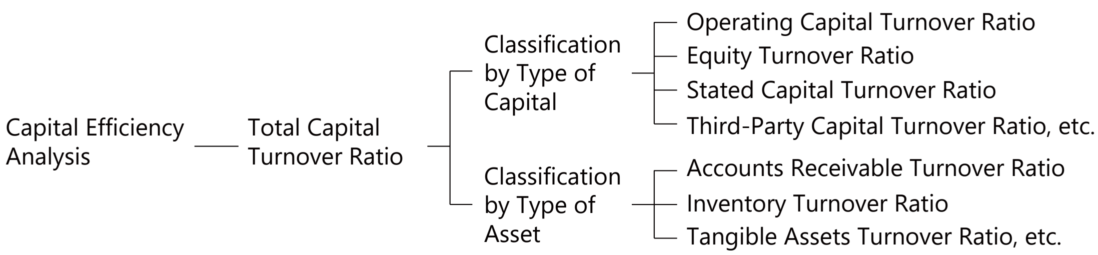
(i) Operating capital turnover ratio	(ii) Equity turnover ratio
(iii) Stated capital turnover ratio	(iv) Third-party capital turnover ratio
(v) Loan turnover ratio	(vi) Accounts payable turnover ratio

At the same time, the total capital turnover ratio can be segregated into the following types of asset turnover ratios according to the type of assets:

(a) Fixed assets turnover ratio	(b) Tangible assets turnover ratio
(c) Building and facility turnover ratio	(d) Inventory turnover ratio
(e) Products and merchandise turnover ratio	(f) Accounts receivable turnover ratio
(g) Cash and deposits turnover ratio	

Chart 4-49 shows several examples of the principal turnover ratios used in the system of capital efficiency analysis.

Chart 4-49 Mechanism of Capital Efficiency Analysis



The effectiveness of assets can also be expressed using the **turnover period**. This is the reciprocal of the turnover ratio, and shows the period of time required to rotate the asset or capital into new assets or capital, *i.e.*, the term needed for one rotation. In general, if the turnover ratio is high and the turnover period is short, asset efficiency is high.

(1) Total Capital Turnover Ratio

$$\text{Total Capital Turnover Ratio (Times/Year)} = \frac{\text{(Annual) Sales}}{\text{Total Capital (Average Between Beginning and End of the Term)}}$$

[Explanation of Total Capital Turnover Ratio]

The total capital turnover ratio measures how many times the average total capital invested in corporate activities is rotated through total sales, thereby indicating the effectiveness of capital utilization. It is concerned with the amount of total capital invested into corporate activity and is the most important turnover ratio in determining the efficiency of a company's business activities.

[Application of Formula]

Obtaining the total capital turnover ratios based on Chart 4-4 and Chart 4-5 above for the subject company yields is the following:

$$\text{FY2020: Total Capital Turnover Ratio (Consolidated Basis)} = \frac{251{,}992}{(240{,}448^* + 272{,}223) \div 2} = 0.98 \text{ Times/Year}$$

$$\text{FY2021: Total Capital Turnover Ratio (Consolidated Basis)} = \frac{270{,}332}{(272{,}223 + 296{,}790) \div 2} = 0.95 \text{ Times/Year}$$

* Total capital as of the end of FY2019 was JPY240,448 million.

To make a meaningful determination whether the above figures for total capital turnover ratio are good or bad requires both a comparison against the averages for all industries and the non-manufacturing industries together with the average for the company's own industry (information services industry). Chart 4-50 shows industry averages for total capital turnover ratios in Japan.

Chart 4-50 Changes in Total Capital Turnover Ratios of Japanese Industries (Consolidated Basis)

(Times/Year)

Classification \ Fiscal year	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021
All Industries	0.84	0.86	0.83	0.81	0.77	0.79	0.80	0.75	0.67	0.69
Information Services Industry	0.82	0.77	0.72	0.71	0.68	0.65	0.60	0.57	0.47	0.41

(Source) "Handbook of Industrial Financial Data 2022"

From this it can be seen that the total capital turnover ratio of 0.95 times a year for the subject company (FY2021) was higher than the averages for all industries and the information services industry (FY2021).

[Formulas for Calculation of the Turnover Period]

The total capital turnover period is the reciprocal of the total capital turnover ratio, and is, therefore, expressed as follows:

$$\text{Total Capital Turnover Period (Months)} = \frac{\text{Total Capital (Average Between Beginning and End of the Term)}}{\text{(Annual) Sales}} \times 12 \text{ …… Formula 1}$$

$$= \frac{\text{Total Capital (Average Between Beginning and End of the Term)}}{\text{(Annual) Sales} \div 12} \text{ …… Formula 2}$$

The difference between these two formulae is that in Formula 1, annual sales is used by itself in the denominator then multiplied by 12, whereas in Formula 2, the figure for annual sales is divided by 12 in the denominator to convert to monthly sales.

[Application of Formula]

Below, the total capital turnover ratio for FY2021 of the subject company is calculated according to the two formulae referred to above based on Chart 4-4 and Chart 4-5 above:

Formula 1: $\text{Total Capital Turnover Period (Consolidated Basis)} = \dfrac{(272{,}223 + 296{,}790) \div 2}{270{,}332} \times 12 = 12.63 \text{ Months}$

Formula 2: $\text{Total Capital Turnover Period (Consolidated Basis)} = \dfrac{(272{,}223 + 296{,}790) \div 2}{270{,}332 \div 12} = 12.63 \text{ Months}$

As shown above, the total capital turnover period for the subject company is 12.63 months.

[Relationship Between Ratio of Profit to Total Capital and Total Capital Turnover Ratio]

As shown below, the ratio of (net) profit to total capital discussed above can be expressed as the product of the (net) profit margin on sales and total capital turnover ratio (see “7.2.(1) Ratio of (Net) Profit to Total Capital” of this Chapter for details):

Ratio of (Net) Profit to Total Capital = (Net) Profit Margin on Sales × Total Capital Turnover Ratio

$$\frac{\text{(Net) Profit for the Term}}{\text{Total Capital}} = \frac{\text{(Net) Profit for the Term}}{\text{Total Sales}} \times \frac{\text{Total Sales}}{\text{Total Capital}}$$

As clearly shown in the above formulae, any determination as to whether the ratio of (net) profit to total capital is good or bad also requires analysis from the standpoint of both the (net) profit margin on sales and total capital turnover ratio.

Below, the ratio of (net) profit to total capital is calculated for the subject company based on Chart 4-4 and Chart 4-5 above:

FY2020: Ratio of (Net) Profit to Total Capital (Consolidated Basis)

$$= \frac{16{,}982}{(240{,}448^{*} + 272{,}223) \div 2} \times 100 = 6.62\%$$

$$= \frac{16{,}982}{251{,}992} \times 100 \times \frac{251{,}992}{(240{,}448 + 272{,}223) \div 2}$$

$$= 6.74\% \times 0.98 \text{ Times}$$

FY2021: Ratio of (Net) Profit to Total Capital (Consolidated Basis)

$$= \frac{19{,}977}{(272{,}223 + 296{,}790) \div 2} \times 100 = 7.02\%$$

$$= \frac{19{,}977}{270{,}332} \times 100 \times \frac{270{,}332}{(272{,}223 + 296{,}790) \div 2}$$

$$= 7.39\% \times 0.95 \text{ Times}$$

* Total capital as of the end of FY2019 = JPY240,448 million.

The increase in the ratio of (net) profit to total capital for the company from 6.62% to 7.02% in FY2021 was caused by both the impact of the total capital turnover ratio and the impact of the change in the (net) profit margin on sales. In other words, the reason why the ratio of (net) profit to total capital increased by only 0.4 points despite the increase in the (net) profit margin on sales by 0.65 points was that the total capital turnover ratio decreased from 0.98 times to 0.95 times. Therefore, if the (net) profit margin on sales stays constant, the ratio of (net) profit to total capital can be improved by improving the total capital turnover ratio. This clearly demonstrates that turnover ratio can play a significant role in improving profitability.

(2) Operating Capital Turnover Ratio

$$\text{Operating Capital Turnover Ratio (Times/Year)} = \frac{\text{Annual Sales}}{\text{Operating Capital (Average Between Beginning and End of the Term)}}$$

[Explanation of Operating Capital Turnover Ratio]

The operating capital turnover ratio is a measure of the efficiency with which the total capital amount is utilized directly in actual production and sales activity.

Operating capital refers to the portion of total capital that is used solely for the production and marketing activities of a corporation. It is calculated by deducting construction in progress, investments and other assets, and deferred assets from total capital (*i.e.*, total capital after the allowance for bad debts and accumulated depreciation expenses are deducted). Since these deductions do not have a direct relationship to the business activities of the corporation, they are also recognized as having no direct effect on sales.

[Application of Formula]

The following is the calculation of operating capital of the subject company based on Chart 4-4 above:

FY2020: Operating Capital = [Total Capital 240,448*1 – (Construction in Progress 1,280*2 + Investments and Other Assets 49,750*3 + Deferred Assets 0*4) + Total Capital 272,223 – (Construction in Progress 443 + Investments and Other Assets 75,776 + Deferred Assets 0)] ÷ 2
= 192,711

FY2021: Operating Capital = [(272,223 – 76,219) + (296,790 – 79,306)] ÷ 2
= 206,744

＊1 Total capital as of the end of FY2019 = JPY240,448 million
＊2 Construction in progress as of the end of FY2019 = JPY1,280 million
＊3 Investments and other assets as of the end of FY2019 = JPY49,750 million
＊4 Deferred assets as of the end of FY2019 = JPY0 million

From this, the operating capital turnover ratio can be calculated as follows:

$$\text{FY2020: Operating Capital Turnover Ratio (Consolidated Basis)} = \frac{251{,}992}{192{,}711} = 1.31 \text{ Times}$$

$$\text{FY2021: Operating Capital Turnover Ratio (Consolidated Basis)} = \frac{270{,}332}{206{,}744} = 1.31 \text{ Times}$$

For reference purposes, Chart 4-51 shows the average operating capital turnover ratios for all industries and the information services industry.

Chart 4-51 Changes in Operating Capital Turnover Ratios of Japanese Industries (Consolidated Basis)

(Times/Year)

Classification \ Fiscal year	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021
All Industries	1.06	1.09	1.06	1.03	0.98	1.01	1.02	0.97	0.86	0.91
Information Services Industry	0.93	0.89	0.85	0.85	0.83	0.81	0.77	0.73	0.60	0.52

(Source) "Handbook of Industrial Financial Data 2022"

(3) Equity Turnover Ratio

$$\text{Equity Turnover Ratio (Times/Year)} = \frac{\text{Annual Sales}}{\text{Equity (Average Between Beginning and End of the Term)}}$$

[Explanation of Equity Turnover Ratio]

The equity turnover ratio indicates the efficiency of the equity that belongs to the corporation's investors.

As shown in Chart 4-52, when the equity ratio is low for the tire manufacturers, the equity turnover ratio tends to be extremely high relative to the total capital turnover ratio. By contrast, when the equity ratio is high for the pharmaceutical industry, the equity turnover ratio tends to be extremely low.

Chart 4-52 Comparison of Equity Turnover Ratios (FY2021, Consolidated Basis)

	Tire Manufacturers		Pharmaceutical Companies	
	YH Co.	ST Co.	CG Co.	ON Co.
Equity Capital Ratio (%)	53.33	46.18	77.21	88.73
Total Capital Turnover Ratio (Times/Year)	0.73	0.91	0.72	0.49
Equity Turnover Ratio (Times/Year)	1.43	1.96	0.92	0.56

(Source) Calculated based on securities reports of the companies in accordance with the International Financial Reporting Standards (IFRS)

[Application of Formula]

Below, the equity turnover ratio of the subject company has been calculated based on Chart 4-4 and Chart 4-5 above:

$$\text{FY2020 : Equity Turnover Ratio (Consolidated Basis)} = \frac{251{,}992}{(149{,}448^{*1} + 179{,}827^{*2}) \div 2} = 1.53\ \text{(Times)}$$

$$\text{FY2021: Equity Turnover Ratio (Consolidated Basis)} = \frac{270{,}332}{(179{,}827^{*2} + 196{,}688^{*2}) \div 2} = 1.44\ \text{(Times)}$$

*1 Equity as of the end of FY2019 was JPY149,448 million.
*2 Equity = Total Net Assets – Non-Controlling Interest

Chart 4-53 shows the averages of Japanese industries.

Chart 4-53 Equity Turnover Ratios of Japanese Industries (Consolidated Basis)

(Times/Year)

Classification \ Fiscal year	2021
All Industries	1.72
Non-Manufacturing Industries	1.96

(Source) Calculated based on "Handbook of Industrial Financial Data 2022"

(4) Inventory Turnover Ratio

$$\text{Inventory Turnover Ratio (Times/Year)} = \frac{\text{Annual Sales}}{\text{Inventory (Average Between Beginning and End of the Term)}}$$

$$\text{Inventory Turnover Ratio (Month)} = \frac{\text{Inventory (Average Between Beginning and End of the Term)}}{\text{Annual Sales}} \times 12 \quad \text{...... Formula 1}$$

$$= 12 \div \text{Inventory Turnover Ratio} \quad \text{...... Formula 2}$$

[Explanation of Inventory Turnover Ratio]

Among trading companies, the inventory turnover ratio indicates how many times the average inventory is rotated through the "inventory → sale" cycle. In the manufacturing industry, it shows how many times the average balance of raw materials, semi-finished goods and merchandise rotated through the "inventory → manufacture → sale" cycle. In other words, this is the indication of the efficiency of inventory assets on hands. In addition, the amount of inventory assets is the total of the amounts of goods and merchandise, semi-finished goods, raw materials and stored goods.

The turnover period, which refers to a period of time for the inventory assets to go through the "inventory → sale" cycle, can be calculated by Formula 1. If the inventory turnover ratio (times/year) is available, this period can easily be calculated by Formula 2.

[Application of Formula]

Below, the inventory turnover ratios and inventory turnover periods are calculated based on Chart 4-4 and Chart 4-5 above:

FY2020: $\text{Inventory Turnover Ratio (Consolidated Basis)} = \frac{251{,}992}{(26{,}849^{*} + 28{,}386) \div 2} = 9.12 \text{ (Times)}$

Inventory Turnover Period = 12 ÷ 9.12 Times = 1.32 Months

FY2021: $\text{Inventory Turnover Ratio (Consolidated Basis)} = \frac{270{,}332}{(28{,}386 + 19{,}647) \div 2} = 11.26 \text{ (Times)}$

Inventory Turnover Period = 12 ÷ 11.26 Times = 1.07 Months

* Inventory assets as of the end of FY2019 were JPY26,849 million.

Chart 4-54 shows the average inventory turnover periods for Japan.

Chart 4-54 Changes in Inventory Turnover Periods of Japanese Industries

(Months)

Classification \ Fiscal year	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021
All Industries	1.40	1.34	1.36	1.37	1.41	1.39	1.41	1.48	1.60	1.59
Information Services Industry	0.34	0.34	0.33	0.30	0.29	0.29	0.29	0.29	0.30	0.31

(Source) "Handbook of Industrial Financial Data 2022"

9 2 Analysis of Break-Even Points Between Profit and Loss

$$\text{Sales at Break-Even Point} = \frac{\text{Fixed Costs}}{1 - \text{Variable Cost Ratio}} = \frac{\text{Fixed Costs}}{1 - (\text{Variable Costs} \div \text{Sales})}$$

[Explanation of Analysis by Break-Even Points Between Profit and Loss]

When formulating its plans for future profit, a company must have a full understanding of how costs and profits will change in response to increases or decreases in sales. Analysis of the break-even point between profit and loss is part of the process used in the interrelated analyses of these sales, costs and profit figures. The **break-even point** is the place where sales and costs are in equilibrium, in other words where there are neither profits nor losses. Restated, it is the line of demarcation between profits and losses in terms of sales in which profits will be generated if sales are above this line and losses will be incurred if sales are below this line.

Computing the break-even point requires that all costs be categorized as fixed costs or variable costs. Fixed costs are those which are unrelated to any change in sales, whereas variable costs are those which fluctuate in proportion to increases or decreases in sales. Examples of fixed costs are labor costs, depreciation expenses and interest on outstanding debt: examples of variable costs are cost of raw materials, outsourcing costs and commissions on sales.

[Formulae for Calculating the Break-Even Point]

Since the break-even point is the place where sales and costs are equal, the following relationships exist:

$$\text{Sales} = \text{Variable Costs} + \text{Fixed Costs}$$

$$\text{Sales} - \text{Variable Costs} = \text{Fixed Costs}$$

$$\text{Sales} \times \left(1 - \frac{\text{Variable Costs}}{\text{Sales}}\right) = \text{Fixed Costs}$$

$$\text{Sales} = \frac{\text{Fixed Costs}}{1 - \dfrac{\text{Variable Costs}}{\text{Sales}}}$$

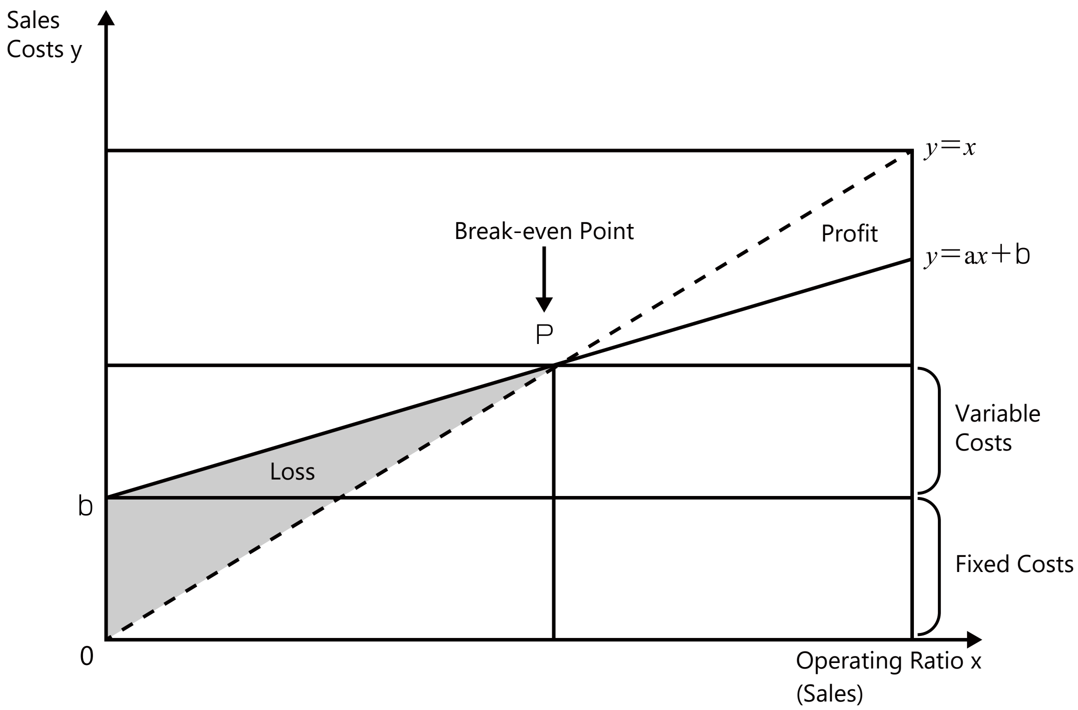
Here, the relationship of variable costs that change relative to sales (*i.e.*, variable costs/sales) is called the **variable cost ratio**, and the ratio described by the relationship "1－Variable Cost Ratio" is referred to as the **marginal profit ratio**. While the amount after deducting variable costs from sales is generally referred to as the **marginal profit** (meaning fixed costs and profit that contributes to net profit), the marginal profit per unit of sales is the marginal profit margin.

[Graph Illustrating Break-Even Point]

Chart 4-55 is a **graph illustrating the break-even point**, *i.e.*, how profit and expenses change together with increases and decreases in sales. "Sales" (x) is given as the independent variable representing the operating rate on the horizontal axis, and "costs" (y) appears as the dependent variable on the vertical axis that changes accordingly.

The intersection of the two lines given by the equations y = x and y = ax + b (where a=variable cost ratio and b=fixed costs) at Point P is the break-even point.

Chart 4-55 Break-Even Point Graph



[Simplified Application of Formula]

The following is a simplified application of the formula to determine the break-even point.

With sales given as JPY30 million, variable costs are JPY18 million and fixed costs are JPY10 million:

$$\text{Sales at Break-Even Point} = \frac{1{,}000}{1 - \frac{1,800}{3{,}000}} = \text{JPY25 million}$$

Consider in the example given above, when sales fall by JPY5 million to JPY25 million, since variable costs (JPY18 million) also fall by JPY3 million to JPY15 million so that the total of variable costs and fixed costs (JPY10 million) is JPY25 million, equalizing the sales after their decline.

The ratio obtained by dividing the break-even point by sales is called the **break-even point ratio**:

$$\text{Break-Even Point Ratio (\%)} = \frac{\text{Break-even Point}}{\text{Sales}} \times 100$$

A break-even point ratio above 100% means that a loss is being generated, and vice versa. The lower this ratio becomes, the greater the ability to withstand times of reduced income. To lower the breakeven point ratio, it is necessary to either increase sales (denominator) or decrease the break-even point (numerator) by reducing costs.

In recent years, as a result of large increases in profits attributable to enlarging sales not being expected, companies have been trying to improve the break-even point by way of reductions in personnel costs (fixed costs) through massive layoffs.

10 Cash Flow Analysis

[Explanation of Cash Flow Analysis]

In addition to the profit that appears in the profit and loss statement, more and more attention is being paid to the cash flow statement which focuses on the inflow and outflow of cash. Unless sales are carried out on a cash basis, an increase in sales does not generate cash flow for a company until collection of the accounts receivable. Thus, profit as it appears in the accounting and cash flow are not the same thing. Moreover, of special concern to both investors and creditors is whether a corporation has been able to assure sufficient cash flow to pay a dividend to its shareholders and repay its outstanding loan obligations.

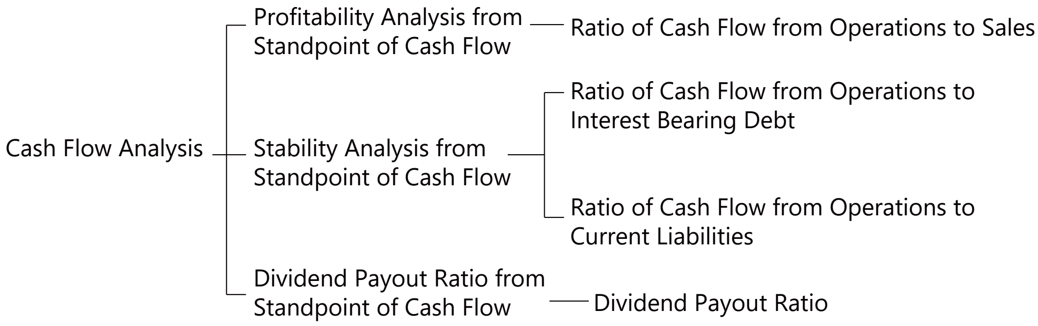
Cash flow analysis provides a close look as to whether a corporation has been able to effectively obtain and secure the cash flow it requires to meet its dividend payment and loan repayment obligations.

Cash flow analysis can be viewed in terms of the following three major aspects:

(1) Analysis of the level of cash flow generated in relation to sales over a certain period of time …. **profitability analysis** (*e.g.*, ratio of cash flow from operations to sales)
(2) Analysis of the level of ability to repay outstanding liabilities with the cash flow generated during the fiscal year …. **analysis of solvency** (*e.g.*, ratio of cash flow from operations to interest bearing debt and the ratio of cash flow from operations to current liabilities)
(3) Analysis of the level of dividends paid from cash flow generated during the fiscal year …. **analysis of dividend payout ratio**

Chart 4-56 is a diagram that shows the parameters involved in cash flow analysis.

Chart 4-56 Mechanism of Cash Flow Analysis



What follows is a look at the traditional approaches to cash flow analysis consisting of the ratio of cash flow from operations to sales and ratio of cash flow from operations to interest bearing debts.

[Ratio of Cash Flow from Operations to Sales]

$$\text{Ratio of Cash Flow from Operations to Sales (\%)} = \frac{\text{Cash Flow from Operations to Sales}}{\text{Sales}} \times 100$$

As with the sales profit margin, which attempts to show the level of profit achieved through core business activities in relation to sales, the ratio of cash flow from operations to sales shows the level of cash flow generated through sales activities in relation to sales over a certain period of time.

While an increase in sales will generally produce a corresponding increase in cash flow, unless sales are carried out on a cash basis, an increase in sales does not generate cash flow for a company until collection of the accounts receivable. As such, it cannot be said that an increase in sales by itself will produce increased cash flow from operations to sales. To accommodate this mismatch in profit as it appears in the accounting versus the actual cash flow, let us examine the cash flow situation for a corporation which cannot be evaluated solely on the basis of profit or loss.

Chart 4-57 shows the changes in the cash flow ratio from operations to sales for different industries during the past five years. Please also note the following point:

The ratio of cash flow from operations to sales exhibits wide disparities among industries, with communications, railroad and pharmaceuticals showing high ratios, and general construction, bakery and confectionery goods manufacturing and wholesaling companies showing low ratios. For the communications and railroad industries, one of the factors accounting for this in the cash flow is the high level of depreciation expense, which is one of the components of cash flow from operations, because of high levels of capital investment.

Chart 4-57 Ratio of Cash Flow from Operations to Sales by Industry Type

(%)

Classification \ Fiscal year		2017	2018	2019	2020	2021
Industries Where Ratio Is High	Communications	18.4	17.3	23.3	22.9	30.2
	Railroad	19.2	17.8	16.8	-3.3	8.4
	Pharmaceuticals	17.8	15.3	17.6	21.2	19.8
Industries Where Ratio Is Low	General Structure	7.7	-0.2	7.2	4.9	3.7
	Bakery and Confectionery Goods Manufacturing	6.3	6.3	7.3	6.1	7.5
	Wholesaling	4.2	3.3	4.3	5.3	3.3
All Industries		8.9	7.8	8.8	9.6	8.6

(Source) "Handbook of Industrial Financial Data 2022"

[Application of Formula]

Below, the ratios of cash flow from operations to sales are calculated for the subject company based on Chart 4-5 and Chart 4-8 above:

$$\text{FY2020: Ratio of Cash Flow from Operations to Sales (Consolidated Basis)} = \frac{17{,}544}{251{,}992} \times 100 = 6.96\%$$

$$\text{FY2021: Ratio of Cash Flow from Operations to Sales (Consolidated Basis)} = \frac{32{,}313}{270{,}332} \times 100 = 11.95\%$$

The rule of thumb is that the higher the ratio of cash flow from operations to sales, the better. For the subject company, in FY2021, the ratio of cash flow from operations to sales was higher than the average ratio for all industries (which was 8.6% in FY2021).

[Ratio of Cash Flow from Operations to Interest-Bearing Liabilities]

$$\text{Ratio of Cash Flow from Operations to Interest Bearing Debt (\%)} = \frac{\text{Cash Flow from Sales Activity}}{\text{Balance of Interest Bearing Debt}} \times 100$$

The ratio of cash flow from operations to interest-bearing liabilities shows to what degree a company is able to repay its interest-bearing loan obligations with cash flow generated from sales activity by the company during the fiscal year. Interest-bearing liabilities include short-term and long-term loans, various corporate bonds and CPs, and lease obligations. A higher ratio is viewed favorably as an indication that the company is in a superior position in terms of ability to repay its obligations.

Obtaining the ratios of cash flow from operations to interest-bearing liabilities based on Chart 4-4 and Chart 4-8 above yields the following for the subject company:

FY2020: Ratio of Cash Flow from Operations to Interest Bearing Debt (Consolidated Basis) $= \dfrac{17{,}544}{2{,}264} \times 100 = 774.91\%$

FY2021: Ratio of Cash Flow from Operations to Interest Bearing Debt (Consolidated Basis) $= \dfrac{32{,}313}{4{,}952} \times 100 = 652.52\%$

Chart 4-58 shows the average ratios of cash flow from operations to interest-bearing liabilities for all industries and the information services industry.

Chart 4-58 Ratios of Cash Flow from Operations to Interest-Bearing Liabilities

(%)

Classification \ Fiscal year	2019	2020	2021
All Industries	21.5	19.6	18.7
Information Services Industry	16.2	18.1	11.5

(Source) "Handbook of Industrial Financial Data 2022"

11 Growth Analysis

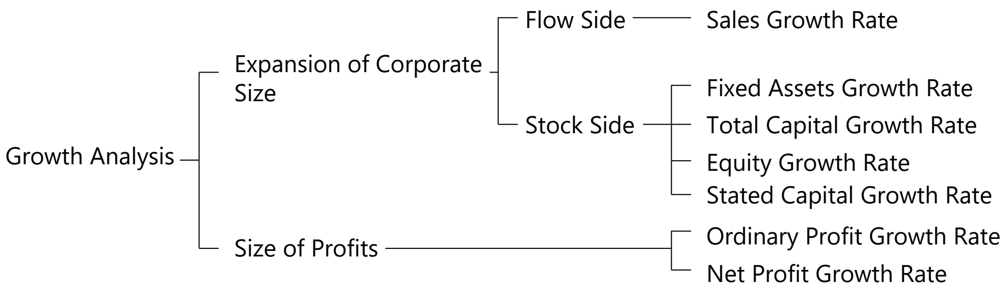
11 1 Approaches to Growth Analysis

Of paramount concern to an investor contemplating an investment is whether the target company is growing or is in decline. For this purpose, we will examine what are the indicators that can be used to measure a company's future growth prospects, and how growth should be analyzed and evaluated.

There are two principal approaches for understanding the growth of a corporation, one being **expansion of corporate size** and the other being **size of profits**. The former can be broken down into two categories, *i.e.*, either viewed in terms of volume of activities in the form of flow, or volume of holdings in the form of stock. While measurement of flow is by means of sales, the measurement of stock is by means of fixed assets, balance of total asset holdings, and the balances of equity and capital.

Chart 4-59 shows the arrangement of the indicators of growth within the mechanism of growth analysis. However, for a single given period of time, numerical values of such measures will not provide any answers as to the growth potential of a company. In general, this is determined after observing trends over at least the past five years.

Chart 4-59 Mechanism of Growth Indicators



11 2 Measurements of Growth

[General Measurements of Growth]

As a measure for determining whether there has been growth, the value in one term is compared to the value for the preceding term. The different values that are used for this purpose are the following:

(1) $$\text{Sales Growth Rate (\%)} = \frac{\text{Total Sales for the Current Term}}{\text{Total Sales for the Previous Term}} \times 100$$

(2) $$\text{Fixed Assets Growth Rate (\%)} = \frac{\text{Fixed Assets for the Current Term}}{\text{Fixed Assets for the Previous Term}} \times 100$$

(3) $$\text{Total Capital Growth Rate (\%)} = \frac{\text{Total Capital for the Current Term}}{\text{Total Capital for the Previous Term}} \times 100$$

(4) $$\text{Equity Growth Rate (\%)} = \frac{\text{Equity for the Current Term}}{\text{Equity for the Previous Term}} \times 100$$

(5) $$\text{Stated Capital Growth Rate (\%)} = \frac{\text{Stated Capital for the Current Term}}{\text{Stated Capital for the Previous Term}} \times 100$$

(6) $$\text{Profit Growth Rate (\%)} = \frac{\text{Profit for the Current Term}}{\text{Profit for the Previous Term}} \times 100$$

[Rate of Increase in Revenue and Rate of Increase in Profit]

The parameters, such as the rate of the increase in revenue and the rate of the increase in profit, are used to express the growth of a corporation.

Rate of increase in revenue relates to sales in terms of the degree of increase relative to the previous term, while rate of increase in profit relates to various forms of profit such as ordinary profit in terms of the degree of increase relative to the previous term. In short, rate of increase of revenue shows the rate of growth in sales, and rate of increase in profit shows the rate of growth in ordinary profit:

$$\text{Rate of Increase in Revenue (\%)} = \left(\frac{\text{Sales for the Current Term}}{\text{Sales for the Previous Term}} - 1 \right) \times 100$$

$$\text{Rate of Increase in Profit (\%)} = \left(\frac{\text{Ordinary Profit for the Current Term}}{\text{Ordinary Profit for the Previous Term}} - 1 \right) \times 100$$

[Application of Formulas]

Obtaining the figures for various measures of growth for the subject company for FY2021 (ended March 31, 2022) based on Chart 4-4 and Chart 4-5 above yields the following:

(1) Sales Growth Rate (%) (Consolidated Basis) $= \frac{270{,}332}{251{,}992} \times 100 = 107.28\%$

(2) Fixed Assets Growth Rate (%) (Consolidated Basis) $= \frac{109{,}103}{100{,}388} \times 100 = 108.68\%$

(3) Total Capital Growth Rate (%) (Consolidated Basis) $= \frac{296{,}790}{272{,}223} \times 100 = 109.02\%$

(4) Equity Growth Rate (%) (Consolidated Basis) $= \frac{196{,}688^*}{179{,}827^*} \times 100 = 109.38\%$

(5) Stated Capital Growth Rate (%) (Consolidated Basis) $= \frac{12{,}952}{12{,}952} \times 100 = 100.00\%$

(6) Ordinary Profit Growth Rate (%) (Consolidated Basis) $= \frac{30{,}811}{25{,}101} \times 100 = 122.75\%$

(7) Net Profit Growth Rate (%) (Consolidated Basis) $= \frac{19{,}977}{16{,}982} \times 100 = 117.64\%$

* Equity = Total Net Assets – Non-Controlling Interest

As a result of this analysis, in terms of the flow side of the subject company, sales, ordinary profit and net profit were all above those for the previous term, showing an increase in revenue. In addition, in terms of the stock side of the measurement of corporate size, the growth rates of fixed assets, total capital and equity capital exceeded 100%, which shows the company’s growth.

[Average Growth Rates in Japan]

Together with being a barometer for measuring growth in the short term relative to the previous year, growth analysis can also be applied over the long term by making a comparison of a series of periods. In the latter case, the value of a given year is used in the denominator by setting it as a benchmark of 100 and indexing the values for each subsequent year to this benchmark value.

Chart 4-60 shows the averages growth rates in Japan for sales, net profit after-tax, total capital and equity from FY2011 with this year set as the benchmark of 100 with the growth rates for successive years shown relative to this chart.

Chart 4-60 Changes in Growth Rates (Consolidated Basis)

Type of Industry	Item / Fiscal year	Growth Rate (FY2011 = 100) (%)			
		Sales	Net Profit (After Tax)	Total Capital	Equity
All Industries	2011	100.0	100.0	100.0	100.0
	2012	102.8	124.2	107.1	109.3
	2013	114.9	223.1	117.8	123.1
	2014	119.8	242.6	127.3	137.6
	2015	120.6	235.1	125.7	136.0
	2016	116.9	271.4	130.3	143.3
	2017	125.9	359.7	138.6	156.5
	2018	133.6	350.6	145.7	165.0
	2019	131.1	233.9	149.2	163.5
	2020	121.6	272.8	160.0	176.5
	2021	136.0	398.6	173.9	196.7
Information Services Industry	2011	100.0	100.0	100.0	100.0
	2012	107.6	130.1	109.4	108.5
	2013	115.7	137.3	131.5	121.2
	2014	125.0	157.3	146.7	136.9
	2015	136.6	193.2	161.1	152.0
	2016	144.7	195.4	175.9	163.2
	2017	158.6	225.9	211.0	176.1
	2018	167.5	235.6	230.7	182.9
	2019	180.5	194.9	276.1	182.8
	2020	187.9	175.2	360.1	244.3
	2021	203.6	243.7	428.9	274.6

(Source) "Handbook of Industrial Financial Data 2022"

12 Dividend Policy, Dividend Ratio and Dividend Payout Ratio

[Explanation of Dividend Ratio and Dividend Payout Ratio]

Generally speaking, investors conduct stock investment with an expectation of both profit from capital gain and profit in the form of dividends. As such, there are two indicators, the dividend ratio and the dividend payout ratio, that are used to judge whether the dividend situation for a company is good or bad.

The dividend ratio provides an indication of whether a dividend has been paid exclusively in relation to stated capital invested by the shareholders. In addition, dividend payout ratio provides an indication of the percentage of the dividend to (net) profit for the term:

$$\text{Dividend Ratio (\%)} = \frac{\text{Amount of Dividend (Annual)}}{\text{Stated Capital (Average During Term)}} \times 100$$

$$\text{Dividend Payout Ratio (\%)} = \frac{\text{Amount of Dividend (Annual)}}{\text{(Net) Profit for the Term}} \times 100$$

In the absence of a large change in the amount of stated capital appearing in the denominator, the dividend ratio should be a comparatively stable value if the dividend level remains stable.

On the other hand, even if the dividend level remains stable, the dividend payout ratio can show large increases or decreases year to year in response to the profit generated by the company. Assuming a fixed dividend level, the dividend payout ratio will generally be low in favorable times and high in unfavorable times.

Chart 4-61 illustrates the differences between dividend ratio and dividend payout ratio.

Chart 4-61 Status of Dividend Ratio and Dividend Payout Ratio (All Industries: Non-consolidated basis per company)

(Unit: million yen)

Item \ Fiscal year	2018	2019	2020	2021
Stated Capital	17,884	17,516	18,700	19,142
Net Profit for the Term	10,913	8,227	11,992	17,521
Dividend Amount	4,731	4,748	4,556	5,125
Dividend Ratio (%)	26.5	27.1	24.4	26.8
Dividend Payout Ratio (%)	43.4	57.7	38.0	29.3

(Source) Calculated in part based on "Handbook of Industrial Financial Data 2020, 2021 and 2022"

From this Chart, it is clear that the dividend ratio, after showing a mild upward trend during the period from FY2018 to FY2019, declined in FY2020 but then partially recovered in FY2021. On the other hand, the dividend payout ratio rose during the period from FY2018 to FY2019 but then significantly declined during the period from FY2020 to FY2021. One of the causes of this decline in the dividend ratio is considered to be the stagnation of economic activities due to the spread of the COVID-19 virus that occurred in FY2019, which brought about the second worst recession in the post-war period following the recession caused by Lehman's fall.

Although a high figure for dividend payout ratio implies that profit is being generously recycled back to the shareholders, it also means that less profit is retained internally by the company, which means that its financial base has become weaker.

On the other hand, a low figure for dividend payout implies that little profit is finding its way to the hands of current shareholders and the ratio of retained earnings is high, which means that there is potential for dividend payments in the future.

[Application of Formulas]

Let us assume Chart 4-62 for the dividend situation for the subject company.

Chart 4-62 Dividend Situation for Subject Company

(JPY)

Fiscal year	Annual Dividend Per Share			Total Dividend Amount (Annual)
		Interim	Period End	
FY2020 (Ended 3/21)	52.50	25.00	27.50	4,803 million
FY2021 (Ended 3/22)	66.00	30.00	36.00	6,039 million

(Note) The above indicates the dividend situation for the subject company on a non-consolidated basis.

Obtaining the figures for the dividend ratio and dividend payout ratio for the subject company based on the abovementioned Chart 4-62 yields the following:

FY2020:

$$\text{Dividend Ratio} = \frac{4{,}803}{12{,}952^{*1}} \times 100 = 37.08\%$$

$$\text{Dividend Payout Ratio} = \frac{4{,}803}{15{,}292^{*2}} \times 100 = 31.41\%$$

FY2021:

$$\text{Dividend Ratio} = \frac{6{,}039}{12{,}952^{*1}} \times 100 = 46.63\%$$

$$\text{Dividend Payout Ratio} = \frac{6{,}039}{18{,}079^{*2}} \times 100 = 33.40\%$$

＊1 The average amount of stated capital for the parent company of the subject company on a non-consolidated basis was JPY12,952 million in FY2020 and JPY12,952 million in FY2021.

＊2 The amount of net profit for the parent company of the subject company on a non-consolidated basis was JPY15,292 million in FY2020 and JPY18,079 million in FY2021.

The traditional pattern for the range for dividend payments adopted by listed corporations in Japan has generally been to set dividends at a maximum amount of JPY15 and an average dividend ratio of 11% to a maximum of 30% (30% dividend). However, in the first half of 1976, some companies were seen to break away from this pattern of stable dividend payments, notably Pioneer (annual dividend of JPY24 and dividend ratio of 48%) and Sony (annual dividend of JPY20 and dividend ratio of 40%). In addition, some companies are shifting their dividend policy from being based on non-consolidated settlements to a consolidated settlement basis after switching their corporate settlements to a consolidated basis.

In this manner, it is becoming more common in Japan as well to take a normal approach towards dividends with the variable dividend rate depending on the amount of profit.

13 Comprehensive Evaluation of Analysis Results

[Combining Results from Analyses]

Thus far, we have examined different methods conducting company analysis including profitability, stability, asset efficiency, cash flow and growth. Finally, we must study how to conduct a comprehensive analysis and evaluation of a corporation's management condition based on these various ratios. Although a large number of sophisticated approaches have been developed for carrying out this kind of comprehensive evaluation, what is discussed here is a method of comprehensive evaluation of analysis results that is based on the most fundamental and traditional methods.

Generally, when wishing to evaluate the results obtained through analysis, it is important to understand the following two points:

(1) Analysis of the unique characteristics of the specific industry of the subject company compared to all industries in terms of the financial aspects – **understanding the special characteristics of a given industry relative to all industries**.
(2) Analysis of the unique characteristics of the subject company within the specific industry – **understanding the special characteristics of the subject company relative to the specific industry**.

The most commonly employed method involves taking six fundamental indicators and arranging these in three pairs with each pair composed of mutually related indicators (complements).

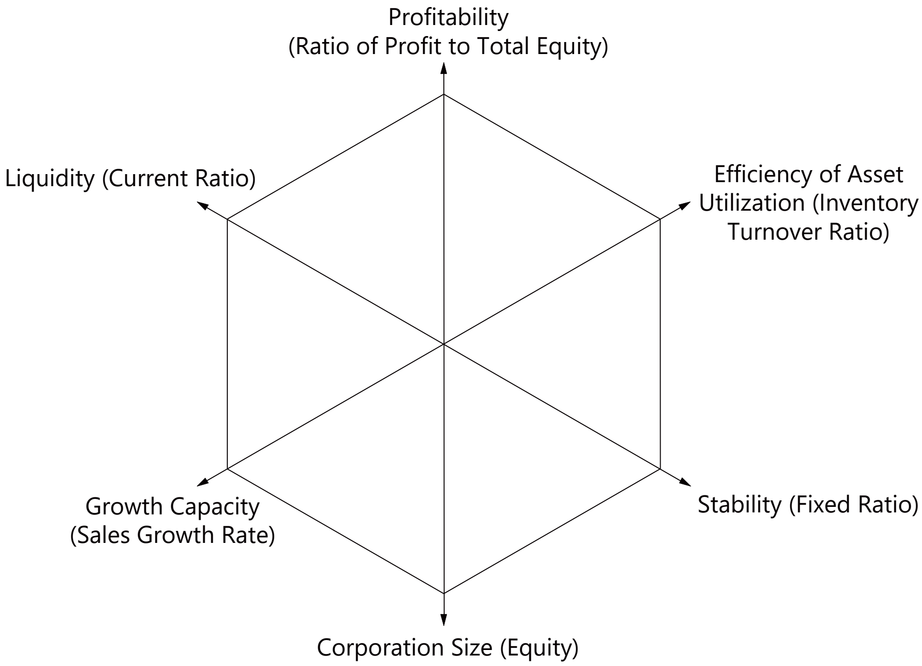
The following shows these combinations:

(a) Profitability (ratio of profit to equity) ....Corporation size (equity)
(b) Efficiency of assets (inventory turnover ratio).......Growth capacity (sales growth rate)
(c) Liquidity (current ratio) ....Stability (fixed ratio)

As an indicator of revenue, the ratio of profit to equity has a relationship such that it declines as the size of a corporation becomes larger and equity increases. When examining sales growth rates, it must be remembered that this is closely correlated with the inventory turnover ratio. In addition, liquidity and financial soundness are factors that contribute to stability.

Chart 4-63 shows how these six indicators are arranged into a hexagonal shape.

Chart 4-63 **Arrangement Showing Combinations of Indicators**



[Application of Graphic Representation]

Chart 4-64 shows the analysis results for the subject company in terms of the ratios for the company's specific industry and all industries as well as the subject company itself. Assuming a value of 100% for the ratio for all industries, Chart 4-65 shows where the values for the industry in which the subject company belongs (information services industry) fall in relation to the assumed values. Where the indices for the particular industry are more favorable relative to all industries, the graph will lie outside the hexagon that represents the benchmark for all industries (given by the dotted line). Conversely, where the indices are less favorable, they will fall within the hexagon (except that the fixed ratio is favorable when it is within the hexagon).

This graph shows the distinct features of the information services industry, the industry in which the subject company operates. In terms of size, this industry has a scale that is 40% of the average for all industries, and the efficiency of asset utilization (inventory turnover ratio) is extremely high at slightly over five times the average for all industries. On the other hand, the liquidity is around 80% of the average for all industries and profitability is around 90% of the average for all industries. The stability (fixed ratio) and growth capacity are the same as the average for all industries. From this, what can be said about the information services industry in which the subject company operates is that while it is smaller than the average for all industries, it is in a superior financial position in terms of its efficiency of asset utilization, while its growth capacity and profitability are similar to the average for all industries.

Similarly, based on Chart 4-64, Chart 4-66 shows the relationship between the values of the averages for the industry to which the subject company belongs, expressed as 100% for the industry (a regular hexagon shape) and the values for the subject company itself. From this chart, it can be said that the scale of the subject company is large and the liquidity and profitability are higher than the industry average. While its growth capacity is almost the same as the industry average, its efficiency of asset utilization is below the industry average.

The analysis above is an example of a comprehensive evaluation conducted by combining certain indicators. Using different combinations of indicators might very well produce different results. In addition to comparisons with the industry averages, any study must also examine the trends for the various ratios for the given company as well.

Chart 4-64 Summary of Indicators (Consolidated Basis, FY2021)

Characteristics of Indicator	Selected Indicators		Subject Company	Information Services Industry	All Industries
Profitability	Ratio of Profit to Equity	(%)	10.6	8.5	9.4
Corporation Size	Equity	(JPY million)	196,688	79,226	196,066
Efficiency of Asset Utilization	Inventory Turnover Rate	(Times/Year)	11.26	38.85	7.54
Growth Capacity	Sales Growth Rate	(%)	107.3	108.4	111.9
Liquidity	Current Ratio	(%)	301.9	109.1	144.0
Stability	Fixed Ratio※	(%)	55.5	143.2	142.2

(Source) Calculated in part based on "Handbook of Industrial Financial Data 2022"
※For fixed ratio, the smaller value is desirable.

Chart 4-65 Characteristics of Information Services Industry Relative to All Industries

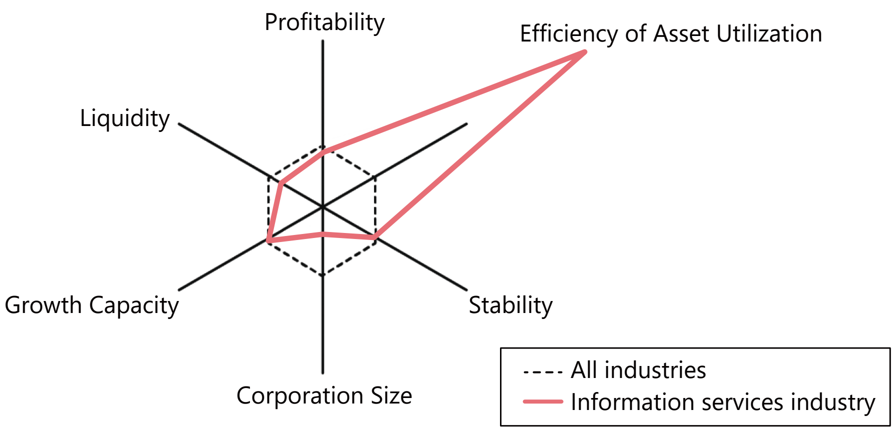
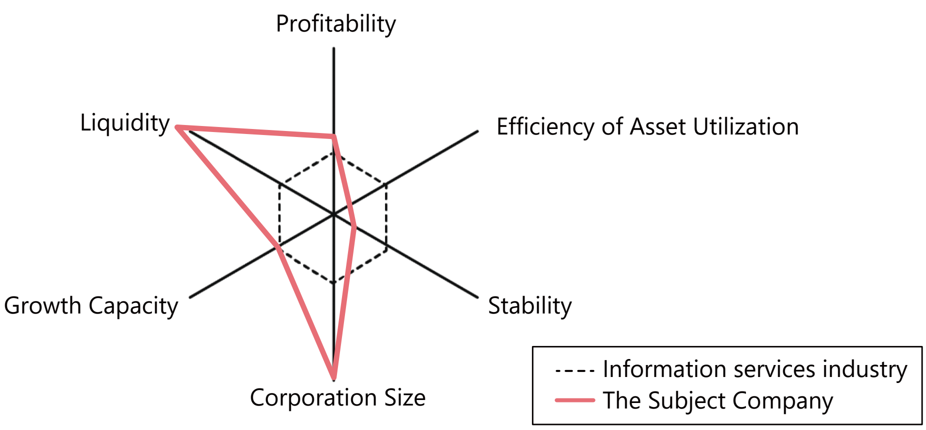


Chart 4-66 Characteristics of the Subject Company Relative to Information Services Industry



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Foreword

Nations and local governments have the authority to collect taxes from the people on an involuntary basis to cover the general expenses incurred by the government. Article 30 of the Constitution of Japan stipulates “the people shall be liable to tax as provided by law.”

These days there are numerous taxes collected by the central and local governments under the law. Investors must be fully aware of the applicable taxes when engaging in securities transactions or owning securities as assets.

However, in reality, ordinary investors are not very knowledgeable about the relevant taxation of investments and often start to worry only after problems arise.

Staff involved in the sale of financial instruments must be equipped with a wide range of knowledge regarding the taxation of securities to respond to these issues, as investment consultants to investors.

Tax regulations are amended almost every year, in particular the taxation of dividend income, such as the dividends received from listed shares or a securities investment trust, and the income realized on the sale of listed shares, etc. Readers should obtain accurate information concerning these changes and accurately transmit this knowledge when interacting with customers to enable them to invest with confidence.

Based on these considerations, the explanation in this Chapter focuses on the income tax, which is of most concern to individual investors, and in respect of local taxes, the discussion focuses on the individual inhabitant tax. For the various tax types and schemes, please refer to the Attachment at the end of this Chapter.

[Important Notes]

- In general, the description of this Chapter has been prepared on the basis of the law in force on September 1, 2023.
- In the 2013 tax reform, taxation methods for bonds and bond investment trusts were reviewed from the perspective of uniform taxation on financial income, and consequently the Income Tax Act, the Act on Special Measures Concerning Taxation and other related laws were amended. These amendments (including the amendments related to the amendments made in 2014 and thereafter) came into effect on January 1, 2016, and have been applicable from that day.
- On December 2, 2011, the “Act on Special Measures for Securing Financial Resources Necessary for Reconstruction from the Great East Japan Earthquake” was enacted, and new taxes such as the special corporate tax for reconstruction and special income tax for reconstruction were created.
  The special income tax for reconstruction applies as of January 1, 2013 until December 31, 2037 and thus the details thereof have been referred to in the relevant parts.

1 Income Tax

Income tax is a (national) tax that is assessed using income as the standard for calculating the amount of tax payable (the "tax base") on various types of gains which inure to an individual and become the individual's income.

Thus, the total amount of income for one year (calendar year) is calculated and the tax is applied to such income according to the individual's ability to pay. In general, the amount of taxable income is the aggregate income for one (calendar) year minus the expenses (necessary expenses) directly necessary to generate such income. However, cost of living expenses are not considered necessary expenses.

1 1 Outline

(1) Scope of Tax Liability and Taxable Income

(i) Individuals

An individual who is domiciled in Japan or has had an abode in Japan continuously for one year or more in the income tax enforcement area (Japan) is called a "**resident**." A person falling into the category of "resident" is subject to income tax on all of his/her income.

A resident individual who does not hold Japanese nationality, and who has had a residence or abode in Japan for a total of five years or less within the past ten years is called a "**non-permanent resident**." A non-permanent resident is subject to tax only on the total income other than foreign source income (including certain types of income arising from the transfer of securities located outside Japan) and on foreign source income that is paid in Japan or remitted to Japan from abroad.

An individual who is not a resident — an individual who has no residence in Japan and has not had an abode in Japan continuously for one year or more — is called a "**non-resident**." A non-resident must pay income tax on his/her income from sources within Japan.

A non-resident who has no residence or abode for one year or more in Japan but who has a branch, factory or other place of business, and engages in the construction business for more than one year in Japan, or has an agent or the like in Japan who fulfills certain conditions, is referred to as a "**non-resident with a permanent establishment**."

Since non-residents with permanent establishments are subject to the same taxation as residents with respect to their domestic source income, the expression "residents, or non-residents with a permanent establishment" (hereinafter collectively referred to as a "resident, etc." in this Chapter) is used in characterizing these taxpayers.

(Note) "Certain types of income arising from the transfer of securities located outside Japan" which are excluded from the scope of taxable income of an individual who is a nonresident refer to income arising from the transfer of any of the following securities for which the date of transfer does not fall within the period from the day following the day ten years before the date of transfer until the date of transfer (limited to the period during which the individual has been a nonresident):

(1) Securities transferred on a foreign financial instruments market;

(2) Securities transferred by entrusting the sale thereof to a foreign financial instruments business operator; or

(3) Securities for which entries or records are made in a register similar to a book-entry transfer account register that is located outside Japan and is related to an account opened at a business office, etc. of a foreign financial instruments business operator, etc. located outside Japan, or for which custody is entrusted via such account.

(ii) Corporations

"Corporations" refers to all entities other than natural persons, having certain legal rights and capacity, and which are accorded corporate status under the Companies Act and/or other laws.

Corporations are categorized into "**domestic corporations**" and "**foreign corporations**" according to whether or not the head or main office is located domestically. A domestic corporation is subject to withholding income taxes on certain categories of income such as interests and dividends.

Because a domestic corporation must pay "**corporation tax**" separately on all income earned by the corporation, the income tax withheld on deposit interest or dividends, etc. is treated as a prepayment of corporation tax and is deducted from the amount of corporation tax payable (as **an income tax credit**).

Unincorporated associations, etc. (an association or foundation that is not a corporation but for which a representative or manager is provided) are deemed to be corporations for tax purposes (this includes PTAs, alumni associations, industry associations, etc.).

A foreign corporation is only subject to income tax or corporation tax in certain categories of domestic source income.

(iii) Tax-Exempt Institutions

Public corporations ("*kōkyō hōjin*"), etc. are exempt from income tax. These include public interest foundations, public interest incorporated associations, educational corporations, social welfare corporations, religious corporations, and local public entities such as local governments.

The organizations deemed to be "**public corporations, etc**." are listed in Appended Table 1 attached to the Income Tax Act. In principle, interest, dividends, etc. that are received by public corporations, etc. are excluded from income tax and consequently tax is not withheld.

(2) Tax-Exempt Income

Individual income that is not subject to income taxation from the viewpoint of the nature of the income, the person's ability to pay and social policies, etc. is referred to as "**tax-exempt income**." This tax-exempt income is also not subject to inhabitant tax.

Tax-exempt income includes some items that are recognized as such without the need for any procedures, and others that are recognized after specified procedures have been taken.

(Note) Income which is exempt from income tax from the viewpoint of industrial policies, etc. ("tax-free income") requires explanation on the tax return filing.

Major tax-exempt income related to savings and investments are as follows:

(i) Relating to Interest Income:

a. Tax exemption for interest income on small-sum deposits held by disabled persons, etc. (so-called "*Maru*

Yu for Disabled Persons, Etc.");

b. Tax exemption for interest income on small-sum public bonds held by disabled persons, etc. (so-called "*Tokubetsu Maru Yu for Disabled Persons, Etc.*");

c. Tax exemption for interest income on workers' asset formation housing savings system (pension); and

d. Tax exemption for interest income on specified donation trusts (so-called "*Zaikei Jūtaku (Nenkin) Chochiku*").

(ii) Relating to Dividend Income:

a. Refunds of principal (special dividends) on open-ended securities investment trusts;

b. Tax exemption for dividend income from small-amount listed shares, etc. in a tax-exempt account; and

c. Tax exemption for dividend income from small-amount listed shares, etc. in a minor's account.

(iii) Relating to Capital Gain, Etc.:

a. Tax exemption for capital gains, etc. from small-amount listed shares, etc. in a tax-exempt account;

b. Tax exemption for capital gains, etc. from small-amount listed shares, etc. in a minor's account; and

c. Tax exemption for capital gains, etc., from the transfer of beneficial interests, etc. in loan trusts.

(3) Types of Income and Calculation of Income

(i) Types of Income

In accordance with the Income Tax Act, an individual's annual (calendar year) income is categorized into ten categories, each of which groups income with similar characteristics, as shown in the chart below. A separate method of calculation of the amount of income is provided for each category.

Chart 5-1 Outline of Each Type of Income

Type of Income	Outline of Income
Interest Income	• **Interest on bonds, deposits and savings (where bonds are separated into a principal-related part and an interest-related part which are both traded independently, this excludes interests on bonds which constituted such interest-related part), as well as distributions of gains from collective management trusts, bond investment trusts and publicly offered bonds, etc. management investment trusts.**
Dividend Income	• **Dividends on surplus, dividends on profits, distribution of surplus, interest income from funds, distributions of gains from investment trusts (excluding bond investment trusts and publicly offered bond management investment trusts), and distributions of gains from specified trusts issuing beneficial interests, etc.**
Real Estate Income	• Income from leasing a house, office, apartment, garage, land, neon sign location, etc.
Business Income	• Income from the business activities of retail sales, manufacturing, wholesale, service, etc. • Income from agricultural and livestock activities. • Income from the business activities of a lawyer, physician, dentist, judicial scrivener, registered representative, etc. • **Income from continuous transactions in securities such as shares, futures and options transactions that rise to the level of a business.**
Salary Income	• Income from salaries, wages, allowances, bonuses, etc. (excluding retirement allowances).
Retirement Income	• Income from the retirement allowances and lump-sum pension and lump-sum retirement payments paid by social insurance systems, etc.
Timber Income	• Income from the transfer of standing or felled timber. • However, income from the felling or transfer of timber made within five years from the date of acquisition is excluded (such income will be considered business income or miscellaneous income).
Capital Gains	• **Income from the transfer of securities such as shares** (in general this is considered capital gains income, but in some cases is considered business or miscellaneous income). • Income from the transfer of land, buildings, machinery, leaseholds, copyrights, etc., premiums (key money) for leasehold or easements (may be considered business income or miscellaneous income). • Income from the sale or transfer of inventory such as merchandise and products, or insignificant depreciable assets (assets whose value is less than JPY100 thousand or whose useful life is less than one year) are excluded (such income will be considered business income or miscellaneous income).
Occasional Income	• Income from prize winnings and contest winnings (excluding those received in connection with business), winnings from horse racing and bicycle racing (excluding those arising from continuous acts for profit), compensation for eviction received by the owner of a leasehold, lump-sum payments from life insurance (excluding those received in connection with business), assets granted as gifts from corporations, etc.
Miscellaneous Income	• Income that is payment for articles, lectures, media appearances, loan interest (limited to non-business loans), retirement pension, postal pension plans, life insurance pension plans, etc. (income that is not covered under any of the above categories). • **Income from continuous trading of shares, etc.** (although this would be business income if the volume is such that the transactions are carried out as a business) and **income from futures/options transactions.**

(Note) The main categories related to securities taxation have been shown in boldface.

(ii) Calculation of Income Amount

[Calculation of Amounts of Various Income Items]

As a rule, the amount of income for each of the ten types of income is calculated as shown below. Even when there are income taxes or special reconstruction income taxes withheld, the amounts before the withholding of taxes (*i.e.*, the "pretax income") are considered the income amounts:

a. Interest income:	All received amounts are left as is (no expenses deductions allowed)
b. Dividend income:	Amount of income－Interest expense (Limited to interest on loan incurred for the acquisition of the principal, for the period of holding of the principal)
c. Real estate income:	Amount of income－Necessary expenses (Special deduction for family employees and other deductions are applicable)
d. Business income:	Amount of income－Necessary expenses (Special deduction for family employees and other deductions are applicable)
e. Salary income:	Amount of income－Amount of deduction for salary income (added by the amount of specific expenses exceeding one half of the amount of deduction for salary income)
f. Retirement income:	(Amount of income－Amount of the deduction for retirement income)×1/2
g. Timber income:	[Amount of income－(Planting & management expenses)＋(Cutting fee/transfer expenses)]－JPY500,000 (special deduction)
h. Capital gains:	[Amount of income－(Acquisition cost, etc.＋Transfer expenses)]－JPY500,000 (special deduction)
i. Occasional income:	[Amount of income－Amount spent to earn income]－JPY500,000 (special deduction)
j. Miscellaneous income:	Amount of income－Necessary expenses

For salary income set forth in item e. above, deductions for income adjustment (for adjusting burden in consideration of the burden of childcare and long-term care upon the lowering of the maximum amount of salary income eligible for salary income deduction (from JPY 10 million to JPY 8.5 million)) will apply to salary income earned in 2020 and thereafter. In calculating the amount of gross income of a resident whose amount of revenue from salary, etc. for a given year exceeds JPY8.5 million, if the resident falls within any of the following cases, an amount equivalent to 10% of the amount of revenue from salary, etc. (or JPY10 million if the amount of revenue from the salary, etc. exceeds JPY10 million) minus JPY8.5 million (up to JPY150,000) is deducted from the amount of salary income.

- The resident is a special disabled person;
- The resident has a dependent relative aged under 23; or
- The resident has a spouse living in the same household or dependent relative who is a special disabled person.

The multiplication by 1/2 described in item f, *i.e.*, retirement income item above will not be applicable to the specified officer retirement allowance (in the case of short-term service retirement allowance, the part that exceeds JPY 3 million out of the amount that remains after deducting the amount of retirement income deduction). "Specified officer retirement allowance" is a retirement allowance, etc. which is received by a person whose number of years in service as an officer, etc. is five years or less as his/her retirement allowance, etc. corresponding to the number of years in service as an officer, etc. "Short-term service retirement allowance" is a retirement allowance, etc. which is received by a person whose number of years in service as a person other than an officer, etc. is five years or less, and which does not fall within the category of specified officer retirement allowance.

However, in cases where the miscellaneous income mentioned in j. above includes public pensions, etc. (meaning national pensions, employee pensions, pensions from aid societies, etc. paid to public employees, teachers of private schools, and those employed in agricultural, forest, and fishery organizations; retirement pensions from a qualified pension plan or a defined benefit corporate pension, etc. or a government employee pension), the amount of miscellaneous income for that year shall be the amount of public pension, etc. income for that year minus the deduction for public pension, etc., and plus the amount of other miscellaneous income.

[Aggregation of Profits and Losses]

When calculating the various categories of income, as can be seen in the income calculation formulae described above, no losses (minuses) will arise in the cases of interest income, employment income or retirement income, etc., but losses may arise in the case of other categories of income.

The amount of loss in such cases may be deducted from the amount of profit arising from other income. This is called "aggregation of profits and losses" and is to be carried out in a specified order. Any loss remaining after the aggregation of profits and losses (amount of net loss) may be carried forward and deducted for the next three years if the tax return is a blue return. This is referred to as a "deduction of net losses carried forward."

The amount of loss from dividend income, occasional income and miscellaneous income cannot be deducted from other income through the aggregation of profits and losses. The same applies to losses from assets that are not normally necessary for daily living, and no loss is recognized in connection with tax-exempt income.

(Note) Aggregation of Profits and Losses and Deduction for Carryover of Capital Loss related to Listed Shares, etc.

Capital losses arising from transfer of listed shares, etc. through a financial instruments business operator, etc. may be netted against interest income and dividend income in connection with dividends, etc. from the listed shares, etc. for the year (for dividend income, limited to cases where self-assessed separated taxation is chosen) by filing a final tax return. Any amount that remains undeducted after such aggregation of profits and losses may further be carried over and deducted in each of the following three years by filing a final tax return.

Through the tax reform in 2013, "specified bonds, etc." were added to the scope of listed shares, etc. eligible for aggregation of profits and losses and deduction for carryover of loss, and as a result, with regard to the amount of capital losses on transfer of specified bonds, etc. arising on or after January 1, 2016, it became possible to aggregate such losses with interest income and dividend income and to carry over and deduct such losses for the next three years (see 1-2 (8) and 1-4 (4) below for details).

(4) Taxation Method

(i) Aggregate Taxation

Tax is calculated based on the sum (aggregate) of the income derived from various sources (amount of income after the aggregation of profit and loss). This method is called "aggregate taxation," and the sum of the income is called the "gross income." For tax payment procedure, income tax is paid, in principle, by the **self-assessed tax payment** method based on a final tax return filing, which is the basis of assessment of income tax.

When computing the gross income, one half of the total of long-term capital gains and occasional income are added to other income.

(Notes) 1. Capital gains are classified into short-term capital gains in which the property is sold no more than five years after it has been acquired (excluding capital gains for copyrights and the like relating to the creative works of the taxpayer itself), and long-term capital gains, which refer to other capital gains. When calculating gross income, one-half of long-term capital gains is included in the total income.

2. Retirement income and timber income are not added to other income when aggregating income but are taxed separately according to their respective taxation standards (the amount of retirement income and the amount of timber income).

3. When calculating **gross income, retirement income** or **timber income**, the amount of the said income shall be the amount after deducting any losses carried forward or other applicable deductions carried forward that may exist.

(ii) Separated Taxation

As opposed to the generally applied method of aggregate taxation of income, "**separated taxation**" of the various categories of income is a taxation practice used to lower or increase tax liability according to the nature of the income or to comply with policy objectives. In separated taxation, certain income is separated from the scope of aggregate taxation.

Progressive tax rates (1-1 (5) (ii) below) are applied in the case of aggregate taxation, whereas proportional (or flat) tax rates are applied in the case of separated taxation.

There are two methods of separated taxation: taxation in which taxes due are collected through self-assessment and filing of a final tax return, known as "**self-assessed separated taxation**," and taxation in which taxes are collected through withholding tax, and taxpayers are not required to file a final tax return, known as "**separated withholding taxation at source**." The withholding tax methods applicable to each type of income are shown below:

a. Interest income (excluding certain interests, etc. such as interest on specified bonds, etc. set forth in b.) --- separated withholding taxation at source;
b. Interest income in connection with interest, etc. such as interest on specified bonds, etc. --- self-assessed (elective) separated taxation;
c. Dividend income in connection with listed shares, etc. --- self-assessed (elective) separated taxation;
d. Income from the transfer of shares, etc. or bonds, etc. (including redemption gains on discount bonds) --- self-assessed separated taxation;
e. Income from the transfer of land/buildings, etc. --- self-assessed separated taxation;
f. Timber income and retirement income --- self-assessed separated taxation;
g. Miscellaneous income from financial instruments, etc. --- separated withholding taxation at source; and
h. Income from commodity futures transactions and income from futures options transactions of securities, etc. --- self-assessed separated taxation.

(iii) Final Tax Return Non-Filing System

Under the final tax return non-filing system, a taxpayer has the discretion, when filing his/her final tax return, to either include in, or exclude from his/her gross income, etc. those items of income to which the system is applicable when computing taxable income and the amount of taxes owed.

Where the taxpayer includes these items in his or her final tax return, his or her taxes will increase correspondingly. However, the amount of taxes withheld upon receiving payments of that income will be able to be credited against the amount of taxes to be paid in the return (withholding tax credit). Additionally, the taxpayer can claim a refund of any excess amounts of taxes withheld.

(Note) If the taxpayer includes these items in his or her final tax return filing, in some cases an increase will occur in the taxpayer's insurance premiums, which are calculated on the basis of the taxpayer's income, such as national health insurance premiums.

Alternatively, if the taxpayer elects to exclude these items from his/her final tax return filing, the excluded income will not be included in computations of the gross income, etc., or the amount of taxes owed. However, the amount of any withholding taxes that were deducted from payments of those income items will not be able to be credited against the amount of taxes. In this case, the payment procedures and tax burden would be the same as the separated withholding taxation at source method.

Securities-related income that is eligible for this final tax return non-filing system is as follows (please see 1-3 (5) and 1-4 (6) (vii) below for details):

a. Petty dividends, etc. of unlisted shares, etc. for which payment is received from a domestic corporation;

(Note) "Petty dividends" refers to those for which the amount of one payment is no more than JPY100,000.

b. Interest, etc. or dividends, etc. on listed shares, etc., for which payment is received from a domestic corporation, etc. (excluding dividends, etc. received by large shareholders);
c. Distribution of revenue from investment trusts for which payment is received from a domestic corporation and the offering of beneficial interests is conducted through public offering;
d. Dividend, etc. from investment accounts for which payment is received from a specified investment corporation;
e. Distribution of revenue from specified trusts issuing beneficiary certificates for which the offering of beneficial interests is conducted through public offering;
f. Dividend of surplus from specified purpose trusts for which payment is received from a domestic corporation and the offering of bond-type beneficial interests is conducted through public offering;
g. Interest on specified bonds for which payment is received from a domestic corporation, etc.

If a specified account for which withholding taxation is elected (elective withholding account) is selected as a specified account to hold listed shares, etc., in principle, the procedure to pay income tax and inhabitant tax on capital gains as well as interest and dividend, etc. on listed shares, etc. can be completed without filing a final tax return.

h. Dividend, etc. in elective withholding accounts; and
i. Income from transfer of listed shares, etc. held in elective withholding accounts.

Additionally, salaried workers (persons with JPY20 million or less in annual salary (including bonuses)) normally settle their taxes through a year-end adjustment, and they may earn up to JPY200,000 in non-salary income per year without having to file a final tax return. In this case, the determination of whether these non-salary amounts are JPY200,000 or more is made by excluding such income from income subject to a separated withholding taxation at source, or the interest income and dividend income described in a. through h. above, or income from the transfer of listed shares, etc., described in i. above, which are not included in the final tax return. Thus, in general, a salaried worker's small-sum securities-related income not subject to the final tax return obligation.

Moreover, recipients of pubic pensions, etc. whose amount of earnings from public pensions, etc. in the relevant year do not exceed JPY4 million are not required to file a final tax return as in the aforementioned case, even if the relevant recipient has income other than from public pensions, etc., as long as the amount does not exceed JPY200,000 a year.

(Reference) Relationship with the Inhabitant Tax System

Under the inhabitant tax (Prefectural Inhabitant Tax and Municipal Inhabitant Tax), income subject to aggregate taxation is taxed as the "income-proportional amount" (self-assessed tax payment); however, income that would be subject to the self-assessed separated taxation under the income tax is similarly separated from other income in computing the income-proportional amount (tax amount) and subject to a proportional tax rate (or a flat tax rate). Additionally, the inhabitant tax contains the special withholding system (where the prescribed amount of tax is withheld by the payer of income and paid over to the prefectural government, etc.), which corresponds to the withholding system for income taxes. Individual inhabitant tax for 2024 and thereafter will be levied by the same method as that for levying income tax; it will no longer be possible to select different taxation methods for income tax and for individual inhabitant tax (this rule will start to apply from income tax and individual inhabitant tax to be levied in 2024 on income gained in 2023).

(5) Deductions from Income, Tax Rates and Tax Credits

(i) Deductions from Income

Under aggregate taxation, the following deductions are made from the gross income according to each taxpayer's actual condition to derive the final "**total taxable income**."

When deductions exceed gross income, these amounts are deducted from the amount of income from transfer of land/buildings which is subject to self-assessed separated taxation, the amount of income from transfer of shares, etc. which is subject to self-assessed separated taxation, timber income or retirement income, in that order.

(Notes) 1. The following 15 types of deductions from income are prescribed: deduction for miscellaneous loss, deduction for medical expenses, deduction for social insurance premiums, deduction for contributions to small-scale enterprise mutual aid, deduction for life insurance premiums, deduction for earthquake insurance premiums, deduction for donations, deduction for disabled persons, deduction for widows, deduction for single parents, deduction for working students, deduction for spouses, special deduction for spouses, deduction for dependents, and the basic deduction.

2. There are limits on the above deductions, *e.g.,* the total gross income of the taxpayer in the case of deduction for spouses and special deduction for spouses must not exceed JPY10 million and the total gross income of the spouse living in the same household or dependent in the case of spouse and dependent deductions must not exceed JPY480,000. In computing the gross receipts of the taxpayer, his/her spouse or dependents, income subject to a separated withholding taxation at source, or income that is eligible to use the final tax return non-filing system, is excluded.

(ii) Tax Rates

Income taxes are levied at progressive rates according to the class of taxable income described in the following chart:

Chart 5-2 Table of Tax Amounts (Quick Calculation Table)

Total Taxable Income	Tax Rate	Amount of Deduction
JPY1.95 million or less	5%	—
More than JPY 1.95 million, but not more than JPY 3.30 million	10%	JPY 97,500
More than JPY 3.30 million, but not more than JPY 6.95 million	20%	JPY 427,500
More than JPY 6.95 million, but not more than JPY 9.00 million	23%	JPY 636,000
More than JPY 9.00 million, but not more than JPY18.00 million	33%	JPY1,536,000
More than JPY18.00 million, but not more than JPY40.00 million	40%	JPY2,796,000
More than JPY40.00 million	45%	JPY4,796,000

(Notes)1. Amounts of less than JPY1,000 of taxable income are discarded.
2. In the case of fluctuating or occasional income, an average taxation formula is used to mitigate the progressive tax rates and the amount of tax applicable to such adjusted income amount can be found in this chart.
3. The tax formula for calculating timber income is as follows: The above-mentioned tax rate is applied to the taxable timber income divided by five. Then, the result is multiplied by five to derive the amount of taxes due (the "divide by five and multiply by five" method).
4. Retirement income is separated from the amounts of total income and timber income, and the tax rates shown in this chart are then applied to the taxable retirement income to derive the amount of taxes due.

For certain income that is subject to self-assessed separated taxation, the amount of tax is calculated using a fixed rate instead of the above Chart of Tax Amounts. Categories of income to which this applies include interest income and dividend income in connection with dividends, etc. on listed shares, capital gains on sale of shares, etc., income from the transfer of land and buildings, etc., and miscellaneous income from futures transactions.

For the purpose of ensuring equity in the imposition of tax, a measure has been introduced to impose a proper level of taxation on extremely high levels of income; if the amount calculated by deducting JPY 330 million from the base income amount (the total income amount calculated without applying the non-filing system, etc.) for the year and multiplying the result by the tax rate of 22.5% exceeds the base income tax amount (the normal amount of income tax on the base income amount), income tax will be levied in an amount equivalent to the amount of such excess (applicable to income tax for 2025). The total income amount will not include the amount of income subject to separated withholding taxation at source and will also not include the amount of tax-exempt income under the NISA program.

(iii) Tax Credits [“*zeigaku kōjo*”]

The following amounts are deducted from the tax amount calculated (calculated tax amount) as described in (ii) above (referred to as “tax credits”):

a. Tax credits for dividends;
b. Tax credits for an amount equivalent to foreign tax adjusted upon distribution;
c. Foreign tax credits;
d. Special income tax credits for borrowings for acquisition of a home (housing loan credit); or
e. Other Tax Credits Provided in the Act on Special Measures Concerning Taxation:
   (a) Special credits for acquisition of machinery, etc. by small or medium business;
   (b) Special credits for increase in the amount of salaries, etc. paid; and
   (c) Special credits for donation to authorized specific non-profit organizations or public interest incorporated associations.

(6) Self-Assessed Tax Payment and Withholding at Source

(i) Final Tax Return Filing

The final tax return filing on income tax is a procedure for the taxpayer to carry out the calculation of the amount of income and the amount of tax based on that year’s income and settle any overs and shorts between the final tax amount and the total of the estimated tax payments and withholding tax payments after filing his/her tax return with the tax office having jurisdiction over his/her address during the period from February 16 through March 15 the following year (tax returns for refunds, etc. may be filed on or after January 1 of the following year). This procedure is also referred to as “**self-assessed tax payment**.”

If a taxpayer leaves the country without registering his/her tax manager or dies during the year, a final tax return (quasi final tax return) must be filed prior to his/her embarkation or within four months from the following day of the date his/her heirs became aware of the commencement of inheritance, respectively.

When no final tax return is filed, or an incorrect return is filed, the tax office makes a correction or determination.

(ii) Estimated Tax Payment

The estimated tax prepayment is a procedure where estimated tax payments are calculated based on the results of the previous year (final tax return filing, etc.) and where persons with the amounts so calculated are JPY150,000 or more must pay an amount equal to one-third of such amount in July and November. The amounts of the estimated tax payment are notified in advance by the tax office.

An application for reduction of the estimated tax payment may be filed if the amount of income tax for that year is expected to fall below the amount of income tax for the previous year due to termination of business or catastrophic circumstances.

(iii) Withholding at Source

The payers of interest, dividends, salaries, public pensions and retirement allowances withhold income tax according to the given tax rate at the time of the payment and pay the withheld amount to the government generally by the 10th of the following month. This system is called “**withholding at source**.”

For securities, interest received via a person handling payment in Japan from bonds, etc. issued outside of Japan as well as profits on redemptions of discount bonds, etc. in addition to general interest on savings and deposits are subject to separated withholding taxation at source, which means the taxation procedure is completed by withholding at source for such income. Withholding at source also applies to capital gains on shares and other securities that fulfill certain conditions (capital gains from listed shares, etc. in custody in specified accounts for which the notification of election of withholding taxation at source of specified accounts has been submitted (or the information to be contained in that notification has been provided by electronic or magnetic means)).

The taxes withheld at source from the various types of income that are subject to self-assessed tax payment are prepayments of income tax, and therefore, are settled through a final tax return.

(Reference) Withholding at Source and Special Withholding

For national taxes, the system wherein the payer of certain types of income deducts the income tax at the time of the payment is called "**withholding at source**," and the party withholding the tax is called the "**withholding agent**."

For local taxes, the inhabitant tax is withheld from interest, etc., salaries or retirement allowances. The withholding is called the "**special withholding**," and the party withholding the tax is called the "**special withholding agent**." Often the term "withholding at source" is used in a broad sense that includes special withholding.

As applied to securities, the special withholding is referred to as the "interest withholding rate" for interest income from deposits, etc., the "dividend withholding rate" for dividend income from publicly offered share trusts and listed shares, etc. (but not including dividends received by large shareholders), and the "capital gain withholding rate" for income from the transfer of listed shares, etc., recorded in a specified account for which the taxpayer has made a withholding election.

Moreover, when a bond investment trust, etc., is cancelled early (*i.e.,* monetized pursuant to a redemption request), a certain amount is subtracted as a "special deduction," which is equivalent to the income tax and inhabitant tax on the amount exceeding the principle. It is important to understand that this special deduction is not a withholding or special withholding of tax.

(7) Taxation of Special Income Tax for Reconstruction

Following the enactment of the "Act on Special Measures for Securing Financial Resources Necessary for Reconstruction from the Great East Japan Earthquake," a new tax, namely the Special Income Tax for Reconstruction, was created. Accordingly, certain taxpayers are required to pay, as a special income tax for reconstruction, the amount obtained by multiplying the tax rate of 2.1% by the basic income tax amount for the income tax of each year starting from 2013. This is expected to be continued until 2037.

(Note) The "basic income tax amount" refers to the amount of income tax which shall be calculated for each income taxpayer in accordance with their category. However, this amount of income tax shall not take into account foreign tax credit and additional penalty tax.

Any person filing an income tax return will also be required to submit to the district director of the tax office, a return of the special income tax for reconstruction which contains information on the amount of basic income tax and special income tax for reconstruction together with the income tax return.

Moreover, any person who is to withhold income tax will be required to collect the special income tax for reconstruction upon the collection of withholding tax for the income gained during the period from January 1, 2013 to December 31, 2037 and to pay it together with such withholding tax by the statutory due date for payment of the income tax, and any person who makes year-end adjustments shall also make a year-end tax adjustment for the special income tax for reconstruction.

Furthermore, special income tax for reconstruction shall be imposed on corporations as well, in regard to the amount withheld from the interest, etc. or dividends, etc. to be paid thereto.

Please note that the descriptions on the withholding tax rate in the relevant parts below will be the total tax rate of the income tax rate and the rate of special income tax for reconstruction on the basis that the relevant income will be gained until December 31, 2037.

(Reference)

Since the special income tax for reconstruction is to be withheld together with the income tax, the amount calculated by multiplying the payment amount subject to tax withholding by the total tax rate shall be withheld.

At the same time, the fractions of the amounts of income tax and special income tax for reconstruction are to be calculated based on the total amount of income tax and special income tax for reconstruction.

Accordingly, the amount which has been calculated by multiplying the payment amount subject to tax withholding by the combined tax rate of income tax rate and rate of special income tax for reconstruction and rounded off of the fractional amount below JPY 1 shall be withheld.

[The Amount of Income Tax and Special Income Tax for Reconstruction to Be Withheld]

Payment amount, etc. × total tax rate (%) (*) = Amount of Income Tax and Special Income Tax to be Withheld(Note)

(Note) Where there are any fractions less than one yen in the amount of income tax and special income tax for reconstruction calculated, such fractions shall be rounded off.

*1 Calculation formula for the total tax rate

Total tax rate (%) = Income tax rate (%) × 102.1%

*2 Example of the total tax rate according to the income tax rate

Income tax rate (%)	5	7	10	15	16	18	20
Total tax rate (%) (Income tax rate (%)×102.1%)	5.105	7.147	10.21	15.315	16.336	18.378	20.42

In addition, the total amount of income tax and special income tax for reconstruction shall be stated in the column of “Amount of Withholding Tax” in the legal records, which may alternatively be titled “withholding slip of salary income”, “payment record of interests, etc.”

1 2 Taxation of Interest Income, Etc.

(1) Basic Method of Taxation of Interest Income, Etc.

Interest income includes the interest from bonds, deposits and savings (where bonds are separated into a principal-related part and an interest-related part which are both traded independently, this excludes interest on bonds which constituted such interest-related part), the distribution of earnings from collective management trusts (meaning loan trusts, specified monetary trusts, but excluding certain trusts where in substance the trustors are not numerous), bond investment trusts and publicly offered bond investment trusts.

The deposits mentioned above include so-called deposits with employers and deposits with financial instruments business operators (limited to persons carrying out type 1 financial instruments business) made under employees' asset formation contracts (pension saving or housing saving) in order to purchase securities.

Bond investment trusts are one kind of securities investment trust having the object of investing trust assets in bonds (not shares, etc.), while publicly offered bond investment trusts are investment trusts other than securities investment trusts for which the trust funds are invested exclusively in bonds, promissory notes, etc., of which the certificates of bond-type beneficial interests were publicly offered at inception.

Distributions of profits from bond investment trusts and publicly offered bond investment trusts are classified as "interest income," while the distributions of profits for other investment trusts (share investment trusts, privately offered bond investment management trusts, etc.) are classified as "dividend income." The same classifications also apply to investment trusts created in foreign countries based on foreign law.

The definition of interest income is narrower than the general definition for interest and excludes interest on school bonds and union bonds, mortgage securities, interest on loans to friends or companies, and income from gold savings accounts, etc. (income of this nature is considered miscellaneous income, etc.)

In general, interest income is taxed by withholding at source at the time of payment at a rate of 15.315% at source, and after the taxable period (one calendar year), the interest income is aggregated with other income earned during the year to calculate the annual tax due (aggregate taxation). As special measures, various kinds of special treatment discussed in (2) through (9) below (separated withholding taxation at source on general interest, etc., self-assessed separated taxation on dividend income, etc. (interest income) from listed shares, etc., special treatment where the filing of a final tax return is not required, and tax-exempt interest income) apply to interest income.

(2) Separated Withholding Taxation at Source on General Interest, Etc.

(i) Outline of the System

If a resident, etc. receives interest on or distribution of proceeds in Japan from "deposits or savings, loan trusts, public and corporate bonds, bond investment trusts, or publicly offered bond investment trusts" other than interest, etc. regarding specified bonds, etc. subject to self-assessed separated taxation discussed in (3) below (excluding interest on bonds for which income tax is not to be withheld at source under a convention or law; hereinafter referred to as "general interest, etc."), such interest income is separated from other income and is subject to the separated taxation system under which the taxation procedure is completed by withholding at source ("separated withholding taxation at source") at a rate of 15.315% (plus an inhabitant tax of 5% if the taxpayer is a resident).

Recipients of general interest, etc. subject to separated withholding taxation at source are not required to submit notification or payment records.

(ii) Scope of General Interest, Etc. Subject to the System

The following types of interest, etc. are regarded as general interest, etc. and subject to separated withholding taxation at source:

a. Interest on deposits (including interest accrued upon cancellation before maturity and interest accrued after the maturity date);
b. Distribution of earnings from loan trusts and jointly operated money trusts (including advance payment of earnings, post-maturity earnings, and distribution of earnings upon cancellation before maturity);
c. Interest on public and corporate bonds (excluding interest on specified bonds);
d. Distributions of earnings from bond investment trusts (excluding those for which the offering of beneficial interests upon establishment has been conducted through public offering or for which beneficial interests fall under the category of listed shares, etc.).;
e. Interest on deposits managed at workplace;
f. Interest on mutual aid savings, namely, savings that are accepted by mutual aid associations of national public service personnel, mutual aid associations of local public service personnel, etc., or by the Promotion and Mutual Aid Corporation for Private Schools of Japan from their members as part of their welfare programs under the respective governing laws;
g. Amount set forth in Article 60-2, Paragraph 1, Item 1 (Inclusion in deductible expenses of dividends from business with cooperative association) of the Corporation Tax Act to be paid by cooperatives, etc. prescribed in Article 2, Item 7 (Definitions) of the said Act in relation to deposits and savings that they accept;
h. Interest payable for interest-bearing finance bonds before the expiration of the period of secondary distribution in cases where banks and other financial institutions issue such bonds by secondary distribution, according to the period until the day preceding the date of expiration;
i. Gains on insurance claims for life insurance, non-life insurance or mutual aid life insurance under workers' property accumulation savings contracts; and
j. Gains on insurance claims for life insurance, non-life insurance or mutual aid life insurance under workers' property accumulation (pension) savings contracts for housing, which are excluded from tax exemption for workers' property accumulation (pension) savings for housing.

(Note) If a certain type of shareholder, such as one who is an officer, etc. of a family company, receives interest on public and corporate bonds set forth in c. above (excluding interest on specified bonds) which are issued by the family company, income from such interest is subject to aggregate taxation (i.e., the progressive income tax rate applies). If an individual controls the family company indirectly via a corporation that is controlled by the individual (by holding more than 50% of the corporation's issued shares, etc.), interest on bonds received by the individual from the family company is also subject to aggregate taxation.

Such interest income generated domestically is only subject to the 20.315% tax rate for both the national tax and local tax (if the taxpayer is a resident), which are collected through withholding at source (or special withholding) without any extra procedures needing to be followed.

Moreover, general interest income, etc. subject to separated withholding taxation at source is not included in the income of a person for the purposes of determining whether that person constitutes a spouse or dependent family member eligible for deduction, or for the purposes of calculating the amount of miscellaneous loss, the deduction for medical costs, and the special deduction for a spouse.

(Note) The interest income earned by corporations is subject to withholding at source of income tax and special income tax for reconstruction as in the case above. However, separated taxation is not applicable to this interest income, and the interest income earned by corporations is added to other income to derive the corporation tax.

(3) Self-Assessed Separated Taxation on Dividend Income, Etc. from Listed Shares, Etc. (Interest Income)

Upon the FY2013 tax reform, in order to push forward unification of financial income taxation including that on income from bonds, certain interest, etc. on bonds were excluded from application of separated withholding taxation at the source and were made subject to aggregation with losses on transfer of shares and bonds, etc. on and after January 1, 2016. In line with this measure, the following special treatment is provided for certain interest, etc. from bonds, as well as for dividends, etc. on listed shares, etc.

(i) Outline of the System

In the case where a resident, etc. has interest, etc. or dividends, etc. on listed shares, etc. (hereinafter referred to as "dividends, etc. on listed shares, etc.") to be received on or after January 1, 2016, with regard to interest income or dividend income from the said dividends, etc. on listed shares, etc., income tax is to be imposed on the amount of interest income and the amount of dividend income from the dividends, etc. on listed shares, etc. (hereinafter referred to as the "amount of dividend income, etc. from listed shares, etc.") during the year at a rate of 15.315% of the amount of taxable dividend income, etc. from listed shares, etc. (meaning the amount of dividend income, etc. from listed shares, etc. after making deductions from the income) (and an additional inhabitant tax of 5%) separately from other income.

(ii) Scope of Interest, etc. on Listed Shares, Etc. That Are Subject to the System

Interest, etc. on listed shares, etc. that are subject to this special treatment are interest, etc. (excluding general interest, etc. that are subject to separated withholding taxation at source, interest, etc. on foreign-issued general bonds, etc.,(Note 1) and other certain interest, etc.(Note 2)) that fall under any of a. through c. below:

a. Interest, etc. on shares, etc. listed on a financial instruments exchange or equivalents thereof:

The scope of the "shares, etc. listed on a financial instruments exchange or equivalents thereof" is the same as that of listed shares, etc. that are subject to the special treatment of self-assessed separated taxation for dividend income from listed shares, etc. (for details, see 1-3(3) below).

b. Interest, etc. on distributions of earnings from bond investment trusts and bond investment management trusts for which the offering of beneficial interests upon establishment has been conducted through a certain type of public offering:

"Conducted through a certain type of public offering" means the same type of public offering that is subject to the special treatment of self-assessed separated taxation for dividend income from listed shares, etc.

(Notes) 1."Interest, etc. on foreign-issued general bonds, etc." means interest, etc. in connection with bonds issued outside Japan or interest on or distributions of earnings from beneficial interests of bond investment trusts or publicly offered bond investment trusts issued outside

Japan which do not fall under any of the following: (i) the interest on specified bonds set forth in c. above; (ii) distributions of earnings from bond investment trusts or bond investment trusts that have been established through public offering; or (iii) distributions of earnings from publicly offered bond investment trusts.

2. “Other certain interest, etc.” means the following: (i) the interest, etc. set forth in Article 161, Item 8 of the Income Tax Act to which the provisions of Article 212, Paragraph 2 of the said Act apply and (ii) the interest on foreign-issued company bonds prescribed in Article 6, Paragraph 1 of the Act on Special Measures Concerning Taxation and interest on foreign currency denominated bonds prescribed in Paragraph 13 of the said Article to which the provisions of Paragraph 2 of the said Article apply.

c. Interest on specified bonds:

The term “specified bonds” means the following bonds:

(a) Bonds listed on a financial instruments exchange, bonds traded on a foreign financial instruments market and equivalents thereto;

(b) National government bonds and municipal bonds;

(c) Bonds issued or guaranteed by a foreign state or local public entity thereof;

(d) Bonds that a corporation other than a company issues under special Acts (excluding those pertaining to foreign corporations, investment corporation bonds under the Act on Investment Trusts and Investment Corporations, short-term investment corporation bonds under the said Act, specified bonds under the Act on the Securitization of Assets and specified short-term bonds under the said Act);

(e) Bonds for which public offering of securities at the time of their issuance was conducted through a certain type of public offering;

(f) Corporate bonds issued by a corporation that has submitted a registration statement, annual report, etc. prescribed in the Financial Instruments and Exchange Act to the Prime Minister within nine months (within 12 months in the case of a foreign corporation) prior to the day of their issuance;

(g) Bonds which are issued on a financial instruments exchange (including an equivalent thereto that was established under laws and regulations of a foreign state) based on bond information (meaning the classes and the total issue value of bonds that are issued within a certain period, the financial conditions and the business details of the issuer of the bonds, and other basic information about the bonds and the issuer that should be clarified) published under rules of the said financial instruments exchange, and for which the prospectus prepared at the time of their issuance states that the said bonds are issued based on the said bond information;

(h) The following bonds that are issued outside Japan:

[a] Bonds which are acquired through secondary distribution of securities that was conducted with a large number of persons as the other parties thereto and are continuously entrusted to the custody of the financial instruments business operator, etc. that conducted the secondary distribution to be kept at its business office, from the time of the acquisition of the bonds; and

[b] Bonds which are acquired through the offer to sell, etc. prescribed in Article 2, Paragraph 4 of the Financial Instruments and Exchange Act (excluding the bonds referred to in [a] above) and which are issued by a company that has submitted a registration statement, annual report, etc. to the

Prime Minister within nine months (within 12 months in the case of a foreign corporation) prior to the day of their acquisition (limited to those that are continuously entrusted to the custody of the financial instruments business operator, etc. that made the offer to sell, etc. to be kept at its business office, from the time of the acquisition of the bonds).

(i) The following bonds issued or guaranteed by a foreign corporation:

[a] Bonds issued or guaranteed by the following foreign corporation:

i. A foreign corporation for which 50 percent or more of its capital contributions or obligations were made by a foreign government; and

ii. A foreign corporation established based on the provisions of the special laws and regulations in a foreign state whose business is conducted under the management of the government of the said foreign state.

[b] Bonds issued or guaranteed by an international organization established based on an international agreement between governments.

(j) Corporate bonds issued by a person engaged in a banking business or a type I financial instruments business or a corporation engaged in a banking business or a financial instruments business in a foreign state based on laws and regulations of the said state (hereinafter referred to as a “bank, etc.”) or by either of the following corporations (excluding certain bonds where in substance the acquirers are not numerous):

[a] A corporation that has a relationship whereby a bank, etc. directly or indirectly holds the whole of the issued shares of or capital contributions for the said corporation; and

[b] A corporation that has a relationship whereby a parent corporation (meaning a corporation that directly or indirectly holds the whole of the issued shares of or capital contributions to a bank, etc.) directly or indirectly holds the whole of the issued shares of or capital contributions for the said corporation, and that is not the said bank, etc.

(k) Bonds issued on or prior to December 31, 2015 (excluding those issued by a company that falls under the category of a family company at the time of their issuance).

(iii) Other

The amount of interest income from listed shares, etc. subject to self-assessed separated taxation is to be calculated in accordance with the provisions of the Income Tax Act, so the revenue arising from interest, etc. on listed shares, etc. will be the amount of interest income from listed shares, etc.

In cases other than above, calculation, etc. of the amount of interest income from listed shares, etc., calculation of the amount of income tax imposed on the amount of interest income from listed shares, etc., and documents to be attached when declaring interest income from listed shares, etc. are basically the same as those for self-assessed separated taxation on dividend income regarding listed shares, etc. (see 1-3 (3) below for details).

(4) Interest Income for Which Filing of a Final Tax Return Is Not Required

In the case where a resident, etc. has interest, etc. to be received on or after January 1, 2016 (excluding “general interest, etc. and other certain interest, etc.”) which fall under any of the following categories, the said person may file a final tax return by excluding the said interest etc. from the amount of gross income when calculating the income tax of each year from the said year onward. Also, in the case of the special treatment of self-assessed separated taxation on dividends, etc. on listed shares, etc. or the special treatment of aggregation of losses on transfer and dividend income relating to listed shares, etc. that is applied, a final tax return may be filed by excluding this interest, etc. The same applies when judging whether or not the person has a final tax return obligation; also, this interest, etc. is to be excluded when the district director of the tax office makes a determination:

(i) The interest, etc. set forth in (3) (ii) a. above that is received from the government, local government, or any other domestic corporation (referred to as a "domestic corporation, etc." in (iii).);

(ii) The interest, etc. on distributions of earnings from bond investment trusts and bond investment management trusts for which the offering of beneficial interests upon establishment has been conducted through a certain type of public offering set forth in (3) (ii) b. above that are received from a domestic corporation; and

(iii) The interest on specified bonds set forth in (3) (ii) c. that is received from a domestic corporation, etc.

Meanwhile, "general interest, etc. and other certain interest, etc." set forth above that are excluded from application of this special treatment are as follows:

(i) The general interest, etc. prescribed in Article 3, Paragraph 1 of the Act on Special Measures Concerning Taxation (Separate Taxation on Interest Income);

(ii) Interest on bonds other than specified bonds that are received from a certain type of family company;

(iii) Interest on or distributions of earnings from bonds or beneficial interests of bond investment trusts or publicly offered bond investment trusts issued in Japan that are paid outside Japan (excluding those received by a non-resident with a permanent establishment);

(iv) Interest, etc. on the foreign-issued general bonds, etc. prescribed in Article 3-3, Paragraph 1 of the Act on Special Measures Concerning Taxation that are delivered via a person in charge of handling payment in Japan (excluding those received by a non-resident with a permanent establishment); and

(v) Interest, etc. on the foreign bonds, etc. prescribed in Article 3-3, Paragraph 2 of the Act on Special Measures Concerning Taxation (excluding those delivered via a person in charge of handling payment in Japan and those received by a non-resident with a permanent establishment).

Other matters are basically the same as dividend income for which filing of a final tax return is not required (see 1-3 (5) below for details).

(5) Special Treatment for Withholding Obligation, Etc. Regarding Interest, Etc. on Listed Shares, Etc.

A person in charge of handling payment in Japan with regard to interest, etc. on listed shares, etc. paid to an individual, domestic corporation (excluding a public corporation, etc.) or foreign corporation on or after January 1, 2016 is to withhold, upon the delivery of the interest, etc. on listed shares, etc. to the individual, domestic corporation or foreign corporation, income tax equivalent to the amount calculated by multiplying the amount to be delivered by a withholding tax rate of 15.315%, and pay it to the State no later than the tenth day of the month following the month that includes the date of withholding.

The interest, etc. on listed shares, etc. subject to this special treatment is the following types of interest, etc. which are paid to an individual, domestic corporation or foreign corporation in Japan on or after January 1, 2016 and which satisfy certain requirements:(Note)

(i) The interest, etc. set forth in (3) (ii) a. above;

(ii) The interest, etc. on distributions of earnings from bond investment trusts and bond investment management trusts for which the offering of beneficial interests upon establishment has been conducted through a certain type of public offering set forth in (3) (ii) b. above; and

(iii) The interest on specified bonds set forth in (3) (ii) c. above.

> (Note) The "Interest, etc., which satisfy certain requirements" mentioned above means interest, etc. specified below for the respective categories of persons who receive the interest, etc. set forth therein:
> (a) A resident or domestic corporation: the interest, etc. set forth in (i) through (iii) above; or
> (b) A non-resident or foreign corporation: interest, etc. which is domestic source income (the interest, etc. set forth in Article 161, Paragraph 1 of the Income Tax Act) and which fall under the categories of interest, etc. set forth in (i) through (iii) above.

Other matters are basically the same as special treatment for withholding obligation, etc. regarding dividends, etc. on listed shares, etc. (see 1-3 (7) below for details).

> (Note) The interest, etc. set forth in a. through c. below is interest income which is subject to aggregate taxation, but not to separated withholding taxation at source or self-assessed separated taxation:
> a. Interest on corporate bonds issued by a family company and which is received by a certain type of shareholder, such as one who is an officer, etc. of the family company;
> b. Interest on bonds issued by the International Bank for Reconstruction and Development (the World Bank), the Asian Development Bank, the Inter-American Development Bank, the Africa Development Bank and the International Finance Corporation, where the issuers (banks) are free of the tax withholding obligation under a treaty (establishment charter) (excluding interest, etc. on foreign bonds subject to separated withholding taxation at source or self-assessed separated taxation); and
> c. Interest on deposits held at a bank, etc. outside Japan and interest on bonds, etc. issued outside Japan where the interest payments are made and delivered overseas and received by the recipients directly.

(6) Separated Taxation on Interest Income from Bonds, Etc. Issued Outside Japan

(i) Outline of the System

Where bonds or beneficial interests of bond investment trusts or publicly offered bond investment trusts are issued outside Japan for residents, with regard to the interest on the said bonds or interest, etc. on distributions of earnings from the said beneficial interests paid outside Japan (referred to as "interest, etc. on foreign bonds, etc.") which does not fall under the category of interest on specified bonds or distributions of earnings from bond investment trusts established through public offering or listed bond investment trusts (interest, etc. on foreign-issued general bonds, etc.), a person in charge of handling payment in Japan (a financial instruments business operator, etc.) withholds tax at a rate of 15.315% on the delivered amount (and an additional inhabitant tax of 5% if the taxpayer is a resident) upon delivery of the said interest, etc., and the interest is subject to separated withholding taxation at source, similar to the case of domestic general interest, etc.

Since the issuers of bonds, etc. which are subject to withholding tax include not just foreign corporations, etc., but also Japanese corporations, etc., withholding tax is also applied to the so-called "reflux portion of bonds issued by residents overseas" (such as Euro-yen bonds).

Interest, etc. on foreign bonds, etc. which is delivered via a person in charge of handling payment in Japan (a financial instruments business operator, etc.) is subject to a withholding tax at a rate of 15.315% on the delivered amount upon delivery of the said interest, etc.

Withholding tax levied on domestic corporations is netted with corporation tax paid by filing a tax return.

(ii) Application of Special Treatment of Not Requiring the Filing of a Final Tax Return for Interest, Etc. on Foreign Specified Bonds, Etc.

When receiving delivery of interest, etc. on foreign bonds, etc. other than interest, etc. on foreign-issued general bonds, etc. (referred to as "interest, etc. on foreign specified bonds, etc.") via a person in charge of handling payment in Japan (*i.e.,* when income tax is withheld), the interest, etc. may be deemed as specified below for the respective cases set forth therein when calculating the income tax of the recipient, and may be made subject to application of the special treatment of not requiring the filing of final tax return for interest income:

a. In the case where the interest, etc. on foreign specified bonds, etc. is received from a domestic corporation:

With regard to the amount of the said interest, etc. on foreign specified bonds, etc. to be received via a person in charge of handling payment in Japan, the special treatment of not requiring the filing of final tax return for interest income is applied by deeming the amount to be received per delivery as interest, etc. that is subject to the special treatment of not requiring the filing of final tax return for interest income.

b. In the case where the interest, etc. on foreign specified bonds, etc. is received from a person other than a domestic corporation:

With regard to the amount of the said interest, etc. on foreign specified bonds, etc. to be received via a person in charge of handling payment in Japan, the special treatment of not requiring the filing of final tax return for interest income is applied by deeming the amount to be received per delivery as interest, etc. that is subject to the special treatment of not requiring the filing of final tax return for interest income and as interest, etc. to be received from a domestic corporation.

(iii) Deduction of the Amount of Foreign Income Tax

The withholding tax rate to be applied when a person in charge of payment delivers interest, etc. on foreign bonds, etc. to a resident or domestic corporation in Japan is 15.315%. However, since it is possible to file a final tax return for interest, etc. on foreign specified bonds, etc. that is subject to self-assessed separated taxation, deduction of the amount of the foreign income tax imposed upon payment for the said foreign bonds, etc. is calculated as follows:

a. In the case of interest, etc. on foreign-issued general bonds, etc.:

Income tax is withheld at a rate of 15.315% of the amount to be received (including the amount of any foreign income tax that has been imposed), but the amount of the foreign income tax is deducted from the income tax up to the amount of the income tax withheld. In this case, a resident may not receive application of the foreign tax credit for the said amount of foreign income tax.

b. In the case of interest, etc. on foreign specified bonds, etc.:

Income tax is withheld at a rate of 15.315% of the amount to be received (the amount obtained by deducting the amount of foreign income tax from the amount of interest, etc. to be received). The foreign income tax is not deducted when withholding income tax, but a resident may receive application of the foreign tax credit for the said amount of foreign income tax by filing a final tax return.

(7) Special Treatment for Income Calculation and Withholding, Etc. Regarding Dividends, Etc. (Interest, Etc.) in an Elective Withholding Account

If a resident, etc. has an elective withholding account, the amount of interest income from interest, etc. on listed shares, etc. for which the said person receives payment into this account (dividends, etc. (interest, etc.) in an elective withholding account) is to be calculated separately from the amount of interest income from interest, etc. other than the dividends, etc. (interest, etc.) in an elective withholding account.

Meanwhile, a person who intends to receive application of this special treatment for interest, etc. on listed shares, etc. which are received via a business office of the financial instruments business operator, etc., at which the elective withholding account is opened or other interest, etc. on listed shares, etc. that satisfies certain requirements must submit a notification of commencement of receiving dividends, etc. in an elective withholding account that contains certain information (hereinafter referred to as a "notification of commencement of receiving dividends, etc.") or, instead of submitting this notification, must provide by electronic or magnetic means the information that is required to be contained in the notification, to the head of the business office of the financial instruments business operator, etc., at which the elective withholding account is opened.

The head of a business office of a financial instruments business operator, etc. who receives a notification of commencement of receiving dividends, etc. or the information required to be contained in that notification must accept, in the specified account for dividends on listed shares, etc. in connection with the elective withholding account of the resident, etc. who submitted the notification or provided the relevant information, all interest, etc. on listed shares, etc. to be paid to the said resident, etc. for which payment is determined on or after the day of receiving the said notification or information (in the case of interest on bearer bonds or distributions of earnings relating to bearer beneficiary certificates of investment trusts or specified trusts issuing beneficiary certificates, those which are paid on or after the said day) and for which payment is handled by the said financial instruments business operator, etc. (limited to those that satisfy certain requirements).

When a financial instruments business operator, etc. calculates the amount of income to be collected and paid with regard to dividends, etc. (interest, etc.) in an elective withholding account delivered to a resident, etc. during the year, if there is any amount of losses on transfer of listed shares, etc. in the elective withholding account of the said resident, etc., the amount of income tax to be collected and paid with regard to the said dividends, etc. (interest, etc.) in an elective withholding account is to be the amount obtained by deducting the amount of the losses on transfer of listed shares, etc. from the total amount of dividends, etc. (interest, etc.) in an elective withholding account during the year and multiplying the remaining amount by the withholding tax rate.

In this case, the difference between the total amount of income tax already collected by the financial instruments business operator, etc. upon delivery of the interest, etc. on listed shares, etc. and the amount of income tax to be collected and paid that is calculated as above is to be refunded by the financial instruments business operator, etc. to the resident, etc. receiving the dividends, etc. (interest, etc.) in an elective withholding account.

The interest, etc. on listed shares, etc. subject to this special treatment are the same as the interest, etc. on listed shares, etc. subject to "(3) Self-Assessed Separated Taxation on Dividend Income, Etc. from Listed Shares, Etc. (Interest Income)" above.

(8) Aggregation and Carrying Forward of Losses on Transfer of Listed Shares, Etc.

If a resident, etc. who submits a tax return has any amount of losses on transfer of listed shares, etc. for 2016 and each year thereafter, the amount of the losses on transfer of listed shares, etc. is to be deducted when calculating the amount of dividend income, etc. from listed shares, etc. for the year, up to the amount of the dividend income, etc. from listed shares, etc. (limited to the amount for which self-assessed separated taxation has been elected).

Meanwhile, if a resident, etc. has an amount of losses arising from transfer of listed shares, etc. which remains after making deduction when calculating the amount of capital gains, etc. from listed shares, etc. for the year containing the day of the transfer, the remaining amount may be carried forward and deducted from the amount of capital gains, etc. from listed shares, etc. and the amount of dividend income, etc. from listed shares, etc. (limited to the amount for which self-assessed separated taxation has been selected) in each year within three years from the year following the relevant year, under certain requirements. For interest income, however, this treatment is applied for such income for 2016 and thereafter.

The amount of dividend income, etc. from listed shares, etc. subject to this special treatment is the amount of interest income subject to "(3) Self-Assessed Separated Taxation on Dividend Income, Etc. from Listed Shares, Etc. (Interest Income)" above.

(9) Tax-Exempt Interest Income, Etc.

The following special treatment tax exemption schemes are provided for tax-exempt interest income, etc. that is not subject to withholding tax. Such tax-exempt interest income is not counted when calculating the taxpayers' gross income and determining the tax status of the qualified spouse or dependents for deduction.

(i) Tax-Exempt Interest Income from Small-Sum Deposits of Disabled Persons, Etc. (*Maru Yu for Disabled Persons, Etc.*)

An income tax exemption is available only to disabled persons, etc. who reside in Japan, which states that interest on a principal amount of JPY3.5 million or less per person in interest on savings deposits, loan trusts or the interest on collective management trusts, interest bearing bonds, bond investment trusts, publicly offered bond investment trusts (limited to investments trusts without instructions from the settlor), and distributions of gains from specified purpose trusts of individuals domiciled in Japan, and who fall within the definition of "disabled" shall be tax-exempt under certain conditions.

(ii) Tax-Exempt Interest on Small-Sum Government Bonds for Disabled Persons, Etc. (*Tokubetsu Maru Yu for Disabled Persons, Etc.*)

For disabled persons, etc. domiciled in Japan and who hold bonds with a total face value of up to JPY3.5 million, the interest on public bonds (limited to the yen-denominated interest bearing national government bonds and publicly offered municipal bonds that are issued in Japan), are exempted from taxation in addition to the exemption on interest income, etc. for small-sum savings ("*Maru Yu*") described in (i) above under certain conditions.

Chart 5-3 Summary of the Systems of *Maru Yu* for Disabled Persons, Etc. and *Tokubetsu Maru Yu* for Disabled Persons, Etc.

Category	Tax-Exempt Interest Income, Etc. from Small-Sum Savings (*Maru Yu for Disabled Persons, Etc.*)	Tax-Exempt Interest on Small-Sum Government Bonds (*Tokubetsu Maru Yu for Disabled Persons, Etc.*)
Applicable Savings	Deposits, loan trusts, bond investment trusts, government bonds, publicly offered municipal bonds, bonds issued by special corporations, bank debentures, government guarantee bonds, corporate bonds, domestically issued Yen-denominated foreign bonds, beneficiary certificates of certain share investment trusts, etc. purchased prior to December 31, 2003.	Government bonds, publicly offered municipal bonds
Applicable Users	Must qualify as "disabled person"	Same as on the left
Procedures	(i) The tax-exempt line must be established through a "Notification of Tax-Exempt Savings." (ii) Submission of an "Application for Tax-Exempt Savings" upon making the deposit, etc. (iii) Bonds and bond investment trusts, etc. must be placed in custody (safekeeping) or entered or registered in the customer's book-entry transfer account as provided by the Act on Book-Entry Transfer of Corporate Bonds and Shares. (iv) Verification of qualification as disabled person, etc. and identification.	(i) The tax-exempt line must be established through a "Notification of Special Tax-Exempt Savings." (ii) Submission of an "Application for Special Tax-Exempt Savings" at the time of purchase. (iii) Same as on the left. (iv) Same as on the left.
Maximum Allowable Amount	Principal of JPY3.5 million	Same as on the left

(Note) Documents that are required to be submitted for each business office of a financial institution such as "Application for Tax-Exempt Savings" and "Application for Special Tax-Exempt Savings" may be submitted by providing the relevant information by electronic or magnetic means instead.

(iii) Tax Exemption System of Interest Income from Asset Formation Housing Savings

Deposits, entrustments, purchases or payments made by way of deduction from wage paid by the employer in accordance with the Employees' Asset Formation Savings Earmarked for House Acquisition Contract can be exempt from tax on the interest on such deposits, collective management trusts and bonds, or gain from life or fire and casualty insurance, etc. under certain conditions.

However, the tax exemption is applicable up to the **principal of JPY5.5 million per person** for the sum of the accumulated principal of such savings and the asset formation pension savings as set forth in (iv) below.

(iv) Tax Exemption on Interest Income for Asset Formation Pension Savings

Taxation is waived under certain conditions for interest on deposits, collective management trusts, bonds and postal pensions, or gains from life insurance, fire and casualty insurance, etc. that are deposited, etc. by way of a deduction from wages paid by the employer in accordance with the Employees' Asset Formation Savings Earmarked for House Acquisition Contract, for the period that the deposits were made as well as the period after the retirement where the interest, etc. is paid as pension benefits.

The maximum allowable amount for tax exemption is an accumulated principal of JPY5.5 million in combination with the employees' Asset Formation savings earmarked for house acquisition as set forth in (iii) above. However, because the return on the installment savings under a life insurance or postal pension is not attributable to the policyholder during the period of accumulation of deposits or premiums, the maximum allowable amount of total deposits or premium payments is JPY3.85 million.

Chart 5-4 Summary of the Asset Formation Housing Savings and the Asset Formation Pension Savings Systems

Category	Tax Exemption on Interest Income for Asset Formation Housing Savings	Tax Exemption on Interest Income for Asset Formation Pension Savings
Applicable Savings	(i) Deposits, collective management trusts, securities. (ii) Life insurance, fire and casualty insurance, etc.	(i) Same as on the left. (ii) Same as on the left as well as endowment insurance.
Applicable Users	Employees under 55 years of age.	Same as on the left.
Procedures	(i) One branch of one type of financial institution may be used. (ii) Establishment of an exemption limit by the "Notification for Asset Formation Tax-Exempt Housing Savings." (iii) Submission of an "Application for Asset Formation Tax-Exempt Housing Savings" upon making the deposit, etc.	(i) Same as on the left. (ii) Establishment of an exemption limit by the "Notification for Asset Formation Tax-Exempt Pension Savings." (iii) Submission of an "Application for Asset Formation Tax-Exempt Pension Savings" upon making the deposit, etc." (iv) Submission of a "Notification on Confirmation of Application of Exemption on Asset Formation Tax-Exempt Pension Savings" at the maturity of the deposits.
Maximum Allowable Amount	JPY5.5 million including Asset Formation Pension Savings.	JPY5.5 million in combination with the Asset Formation Housing Savings (JPY3.85 million for life and fire and casualty insurance, etc.)
Other	Violations of the criteria such as withdrawal for purposes other than the intended purpose (excluding withdrawal for purposes such as a disaster) shall be taxed. The interest, etc. paid during the five years prior to the violation of the criteria are taxed retroactively.	Same as on the left

(Note) Documents that are required to be submitted for each business office of a financial institution such as "Application for Asset Formation Tax-Exempt Housing Savings" and "Application for Asset Formation Tax-Exempt Pension Savings" may be submitted by providing the relevant information by electronic or magnetic means instead.

(v) Tax Exemption on Interest Income from Specific Donation Trust

Interests, etc. on bonds, etc. generated in relation to a trust property of a trust which has been created pursuant to a specific donation trust agreement (limited to the portion of interests, etc. generated corresponding to the period in which the bonds, etc. continuously belonged to the trust property) may be exempt from tax under certain conditions.

(Note) The portion of the amount of donation made to a public interest incorporated association, etc. under a specific donation trust agreement, which is equivalent to the interests, etc. that have been exempted from tax, shall not be covered by deductions for donation, etc.

(10) Separated Withholding Taxation at Source for the Proceeds of Financial Instruments, Etc.

There are many financial instruments or quasi-financial instruments that produce income other than interest income. The proceeds of these products are classified as miscellaneous income or occasional income. However, they are similar to interest income in economic substance, and taxation comparable to that of interest income is applied.

In other words, the proceeds with respect to the financial instruments, etc. listed below are subject to the uniform separated withholding taxation at source based on a rate of 15.315% (and an additional inhabitant tax of 5% if the taxpayer is a resident), as in the case of interest.

(i) Interest on Mortgage Securities

The interest on mortgage securities means the interest on the principal of securities described as mortgage securities under the Mortgage Securities Act.

Mortgage securities companies make loans to persons who need funds (debtors) based on real estate collateral, and the companies create mortgages on the real estate of the debtors and receive mortgage securities issued by the Regional Legal Affairs Bureau. In many cases, mortgage securities companies issue “mortgage certificates” by securitizing and dividing these mortgage securities into small lots to sell them to general investors. The interest is considered miscellaneous income.

(ii) Profit in Gold Savings Accounts, Etc.

The profit in gold savings accounts means the profit from the resale of precious metals such as gold and other goods for a certain price pursuant to an agreement for the purchase and sale back of precious metals such as gold and other goods. For example, a gold savings account is utilized as a fixed income product, taking advantage of the difference between the spot price of the gold at the time of sale and the futures price of the gold to be repurchased after a certain period. The proceeds from this are treated as capital gain (or miscellaneous income).

(iii) Bonds with Prizes and Prizes of Beneficial Interests of Bond Investment Trusts

This refers to money and goods offered by lottery on condition that bonds and/or beneficial interests of bond investment trusts are owned continuously for a certain period. Proceeds from these are treated as occasional income.

(iv) Others

In addition to those mentioned in (i) through (iii) above, there are the following:

a. Compensation payments for fixed-term deposits (miscellaneous income);
b. Compensation payments for installments of mutual societies (miscellaneous income);

c. Exchange gains on foreign currency denominated fixed-term deposits (those for which a FOREX contract has been executed) that pay the principal and interest converted into yen at a certain rate prescribed in the contract (miscellaneous income);

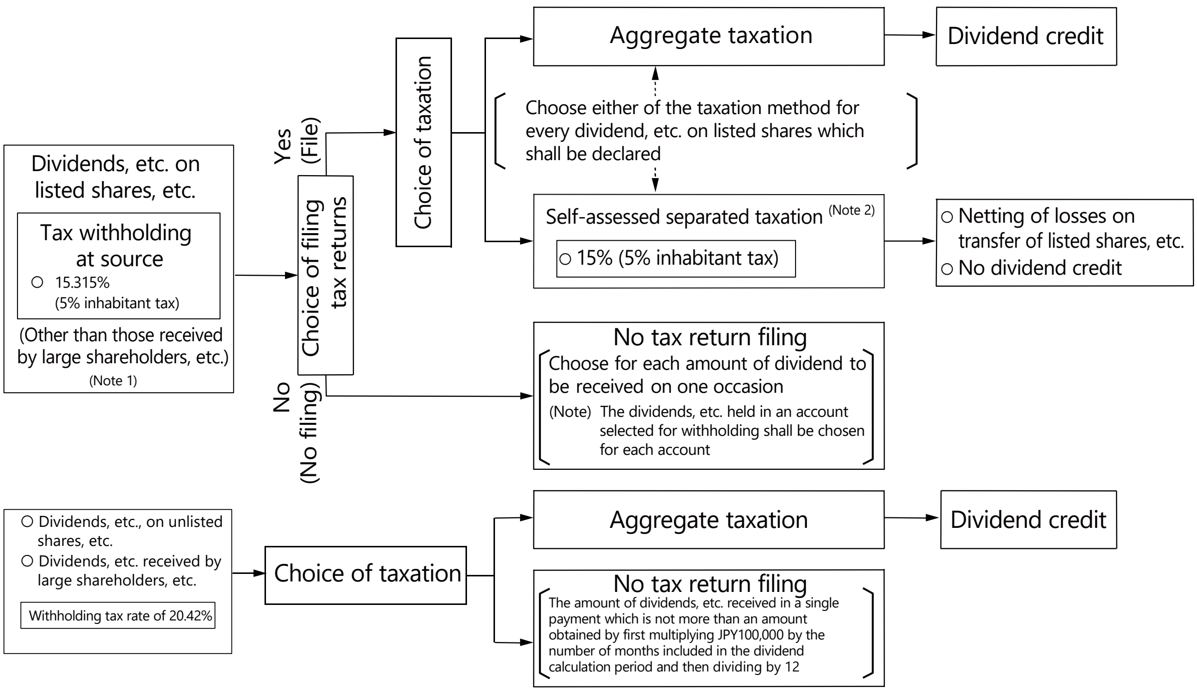
d. Gains on single-premium endowment insurance and single-premium fire and casualty insurance, etc. (with an insurance period of less than five years or cancellation within five years of an insurance period of more than five years) (occasional income); and

e. Prize money and goods awarded to holders of fixed-term deposits, etc. (occasional income).

(Note) A domestic corporation is subject to withholding tax with regard to the above financial instruments in the same way that it is with respect to interest income.

13 Taxation of Dividend Income, Etc.

Chart 5-5 Outline of the Taxation on Dividends, Etc. on Listed Shares, Etc.



(Notes) 1. "Large shareholders, etc." refer to shareholders whose holding ratio of shares, etc. amounts to 3% or more of the total number, etc. of outstanding shares, etc. (with regard to dividends, etc. received on or after October 1, 2023, including a shareholder for which the aggregate holding ratio of shares held by the shareholder and shares held by a family company in which that shareholder holds more than 50% of the family company's shares, etc. amounts to 3% or more).

2. During the period from 2013 to 2037, the amount obtained by multiplying 2.1% by the amount of withholding tax calculated by applying a withholding income tax rate of 15% as mentioned above shall be imposed as a special income tax for reconstruction, together with withholding tax.

3. With regard to residents, inhabitant tax will also be imposed, as described in the brackets in the chart above.

(1) Basic Taxation of Dividend Income

(i) Scope of Dividend Income

Dividend income means income in the nature of dividends from surplus (limited to dividends related to shares or capital contributions (including the beneficial interests of a bond investment trust other than a publicly offered bond investment trust, and company bond-type beneficial interests) and excluding dividends which result from a decrease in capital surplus and a split-off-type company split (including a trust split in a trust subject to corporation taxation), and share distribution), dividends of profits (including the distribution of money prescribed in the Act on the Securitization of Assets, and excluding dividends resulting from a split-off type company split and share distribution), distribution of surplus connected with equity contributions, distribution of money, interest on funds and distributions of proceeds from investment trusts (excluding proceeds of bond investment trusts and publicly offered bond investment trusts, which are deemed to be interest income) and specified trusts issuing beneficiary certificates (excluding those concerning tax-qualified distributions in-kind; hereinafter called "**dividends, etc**."), all of which are to be received from corporations (excluding public interest corporations and associations without legal personality).

Income such as dividends from land trusts (real estate income or capital gain by using the trust management method, etc.) and ex-dividend adjustment amounts (a factor for profit calculation on margin transactions) are not included in dividend income.

Dividends on shares issued by foreign companies and from foreign investment trusts are included.

(Notes) 1. A "share distribution" refers to a distribution in kind (limited to dividends of surplus or dividends of profit), in which all the issued shares, etc. of a corporation (meaning issued shares or capital contributions of a corporation, excluding its shares or capital contributions held by itself; such corporation is referred to as a "wholly-owned subsidiary company") held by a distribution-in-kind corporation immediately before the distribution in kind, are transferred.

2. While the archetype of the "investment trust," distributions of earnings from which are considered to be dividend income, is the share investment trust (this includes publicly offered share investment trusts and private placement share investment trusts), Nikkei 300 Stock Price Index-linked listed investment trusts and other stock price index-linked listed investment trusts ("ETF") are also included. The tax law collectively defines these as "**specified share investment trusts**," and the beneficial interests and distributions of earnings from a specified share investment trust are, in principle, treated in respectively the same manner as shares or dividends with respect to shares.

3. Another investment trust structure is the share investment trust by means of the investment corporation (the "corporate-type share investment trust") in which the investment corporation solicits investors and issues investment securities (corresponding to share certificates) that represent investment units that are in turn further subdivided into even units of equal proportions. Investment units of investment corporations can be of the following two types, and the type must be specified in the regulations of the corporation.
Investment units of investment corporations can be of the following two types, and the type must be specified in the regulations of the corporation:

・Open-end type: Investors can request refund of investment units; or

・Closed-end type: Investment units are not refunded during the life of the corporation.
Open-end type investment corporations for which the investment units were publicly offered upon establishment are defined as "specified investment corporations."

4. "Specified trusts issuing beneficiary certificates" refers to trusts that satisfy certain conditions among trusts issuing beneficiary certificates as provided in Article 185, Paragraph 3 of the Trusts Act.
5. "Tax-qualified distributions in-kind" refers to distributions in-kind distributed by a domestic corporation where the corporation receiving the transfer of assets through the distributions in-kind is only a domestic corporation (limited to ordinary corporations or cooperative associations, etc.) and where the recipient completely controls the domestic corporation making the distribution immediately prior to the distribution of the distributions in-kind.

(ii) Deemed Dividends

Even if it is not considered a dividend of surplus or of profit under the Companies Act, if the economic substance is a distribution of profit, the Income Tax Act deems a dividend of surplus, etc. to have been made and taxes this as dividend income. This is what is called a "**deemed dividend**."

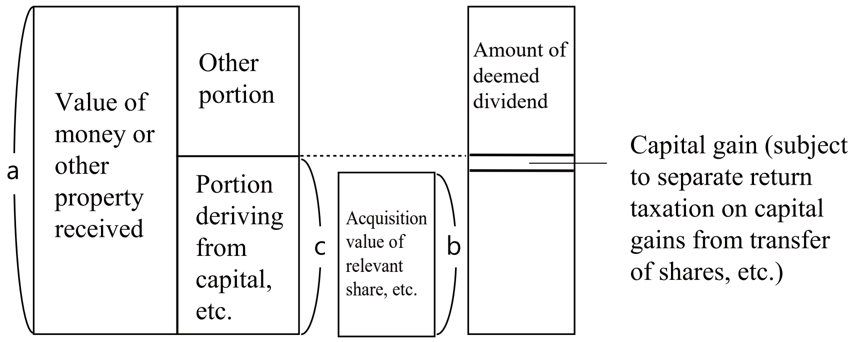
A deemed dividend means, in cases where any of the following facts have occurred with respect to the issuing corporation of the shares held, the portion of the amount of cash and/or other assets delivered which exceeds the amount of those shares corresponding to the amount of capital, etc. of such corporation which were the basis of the delivery:

a. Merger (including consolidations of trusts that are taxed as corporations but excluding tax-qualified merger);
b. Split-off-type company split (*bunkatsugata-bunkatsu*) (excluding tax-qualified split-off-type company split);
c. Share distribution (excluding qualified share distribution);
d. Pay back of capital (meaning dividends of surplus with a decrease in the amount of capital surplus arising from causes other than a split-off-type company split and a share distribution, as well as distribution accompanying a decrease in capital contributions, etc.);
e. Distribution of residual assets upon dissolution;
f. Acquisition of treasury stock or acquisition of equity contributions (excluding certain circumstances such as cases in which these are purchased on the market);
g. Cancellation of investment (excluding cancellation on equity contributions acquired) or pay back of equity contributions, pay back of equity upon retirement or withdrawal of membership or other contributor from corporation; extinguishment of shares or equity contributions without acquisition by a corporation; and
h. Reorganization (limited to cases of distribution upon reorganization of assets other than shares or equity contributions of the corporation that is changing its organization).

When a non-qualified merger or non-qualified split-off-type company split wherein delivery of consideration is found to have been omitted is conducted, calculation is carried out by deeming that the shareholders, etc. of the acquired corporation or splitting corporation in the non-qualified merger or non-qualified split-off-type company split have been delivered shares and other assets, and deeming the consideration, the delivery of which has been omitted, as dividends, etc., as in the case where consideration has been delivered.

Deemed dividends can be pictured as set forth in the chart below:

Chart 5-6 Image of Deemed Dividends



a – c = Deemed dividend, c – b = Capital gain (if c < b, then c – b = Capital loss)

(iii) Special Tax Treatment of Deemed Dividends

If during the period of time between the day following the day of commencement of an inheritance and the date on which three years have elapsed from the day following the deadline of submission of the inheritance tax return, an individual who has made acquisition of property by succession or legacy (for succession or legacy on or after January 1, 2015, this includes an act that is deemed to be acquisition of property by succession or legacy), and has an amount of inheritance tax liability assigns to an unlisted company shares issued by that company and which were included in the calculation of the taxable value for inheritance tax, and if the amount of consideration for transfer received from the unlisted company exceeds the amount corresponding to the shares assigned, the excess portion of the said money shall not be subject to taxation of deemed dividends, but rather the entire amount of the consideration for transfer shall be treated as income involving capital gains income, etc. on shares, etc. upon taxation.

(Note) In order to apply for such special treatment, a document stating certain matters must be submitted through the unlisted company to the district director of the tax office having jurisdiction over the unlisted company.

(iv) Calculation of Amount of Dividend Income, Withholding at the Source

With respect to the amount of dividend income, if interest has been incurred by borrowing funds which are used to acquire the principal to be paid for the year (excluding interest on the borrowed fund used to acquire securities that are the basis for the business income or miscellaneous income, etc.; this will be treated as a necessary expense to separately calculate business income, etc.), the interest on the borrowed fund during the corresponding period of ownership of the principal should be deducted from the amount of revenue (prior to deduction of withholding tax) to calculate the income (deduction of interest on borrowed funds) and, in principle, the amount is aggregated with other income and the aggregate taxation is applied.

In principle, income tax and the special income tax for reconstruction, at the rate of 20.42% (special collection of inhabitant tax is not applicable in principle) are withheld at the source when dividend payments and the like are received, provided that the withholding rate will be 15% (15.315% during the period from January 1, 2013 to December 31, 2037; and an additional inhabitant tax of 5%, if the taxpayer is a resident) on dividends on listed shares, etc. (excluding payments received by large shareholders) that are received on or after January 1, 2009.

See the descriptions below with respect to "large shareholders, etc." (See Note 2. in (3) (i) a. below for details).

(v) Tax Credits for Dividends

Since dividends of surplus or of profits with respect to shares or equity contributions, distributions of surplus and distributions of earnings from share investment trusts (excluding those received from foreign corporations) are distributed from net profits after corporate tax of the source corporation, taxpayers may by filing a final tax return claim a **dividend tax credit** with respect to the dividends included in income under the aggregate taxation method in order to prevent double taxation of the same income in the hands of both the corporation and individual shareholders.

The amount of the dividend tax credit is calculated by multiplying the dividend income received by residents (excluding dividends of interest and interest on funds) by certain credit rates. The maximum amount of the dividend tax credit is limited to the total tax owed by the taxpayer, and the taxpayer cannot claim a refund for any excess credits.

(Note) Even if they are included in the taxpayer's gross income, the dividend tax credit does not apply to dividends, etc. received from a foreign corporation, distribution of earnings from foreign ETF, etc., and from a foreign-currency denominated securities investment trust (certain securities investment trusts that have a high inclusion ratio of foreign currency-denominated assets), dividends, etc. on beneficial interests of certain bond investment management trusts and corporate bond-type beneficial interests of certain specified purpose trusts, dividends, etc., received from a specified purpose company and dividends from an investment corporation.

Specifically, the credit rate (dividend credit rate) is the sum of the amounts computed by multiplying the following credit rates enumerated for each category by the amount of dividend income in that category such as whether the taxpayer's total taxable income, etc., is greater than JPY10 million, etc.

[Cases Where the Taxpayer's Total Taxable Income, Etc. Is JPY10 Million or Less]

Depending on the categories of dividend income, the dividend credit is the sum of the amount computed by multiplying the following enumerated credit rate by the amount of dividends in that category:

a. Dividend income from shares, etc. and specified share investment trusts --- 10% (plus 2.8% for inhabitant tax); and
b. Dividend income from securities investment trusts (other than a specified share investment trust) --- 5% (plus 1.4% for inhabitant tax; however, for ordinary foreign currency-denominated securities investment trusts this is 2.5% (plus 0.7% for inhabitant tax).

[Cases Where the Taxpayer's Taxable Income, Etc. Is More Than JPY10 Million]

The dividend credit is the sum of the amount computed by multiplying the credit rate below by the amount of dividend income pertaining to the portion of total taxable income, etc. that exceeds JPY10 million and the amount computed under the above formula for the portion of total taxable income, etc. that is JPY10 million or less:

a. Dividend income from shares, etc. and specified share investment trusts --- 5% (plus an inhabitant tax of 1.4%); and
b. Dividend income from securities investment trusts (other than specified share investment trusts) --- 2.5% (plus 0.7% for inhabitant tax; however, for ordinary foreign currency-denominated securities investment trusts this is 1.25% (plus 0.35% for inhabitant tax)).

(Note) A "specified share investment trust" is a securities investment trust which has as its purpose investing its trust assets solely in shares, and which meets certain requirements such as that its beneficial interests are listed on a financial instruments exchange.

Chart 5-7 Dividends Tax Credit Rates Concerning Shares, Etc.

Total Taxable Income, Etc.	JPY10 million	Dividend Deduction Rate
(i) Less than JPY10 million	Income other than dividend income / Dividend income	(i) Income tax: 10% (ii) Inhabitant tax: 2.8%
(ii) Over JPY10 million when dividend income is added	Income other than dividend income / Dividend income (a) (b)	(i) Income tax Portion (a): 10% Portion (b): 5% (ii) Inhabitant tax Portion (a): 2.8% Portion (b): 1.4%
(iii) Income other than dividend income is over JPY10 million	Income other than dividend income / Dividend income	(i) Income tax: 5% (ii) Inhabitant tax: 1.4%

(Note) "Total taxable income, etc." refers to the sum of total taxable income as well as, *inter alia*, any additional "taxable capital gains, etc. on shares, etc.," or "taxable short-term capital gains," or "taxable long-term capital gains" on the transfer of land and building that the taxpayer has, which are subject to self-assessed separated taxation.

(2) Special Treatment for Taxation on Dividends, Etc. Related to Wholly-Owned Subsidiary Shares, Etc.

No income tax is levied on the following dividends, etc. related to shares, etc. to be received by a certain type of domestic corporation other than a general incorporated association, etc. (applicable to dividends, etc. to be received on or after October 1, 2023), and such dividends, etc. are excluded from the scope of the tax withholding obligation. A domestic corporation that pays such dividends, etc. has the obligation to notify the payment agent if the dividends, etc. on listed shares, etc. paid by the domestic corporation include those subject to this special treatment.

(i) Dividends, etc. on shares, etc. that fall within the category of wholly-owned subsidiary shares, etc. (limited to those held by the domestic corporation in its own name).

(ii) Dividends, etc. on shares, etc., held by the domestic corporation, of another domestic corporation (except for a general incorporated association, etc.) (limited to those held by the domestic corporation in its own name) where the shares, etc. held by the domestic corporation amounts to more than one-third of the total number of issued shares, etc. in the other domestic corporation as of the reference date.

(Note) 1. "Those held in its own name" means shares, etc. other than those held through a partnership or trust. The shares mentioned in (ii) above fall within the category of "affiliated corporation shares, etc." They are limited to those held by the domestic corporation in its own name. As the withholding agent needs to make a determination on this point at the stage of withholding at source, the domestic corporation's holding ratio is determined on the reference date, etc. regarding the amount of dividends, etc.

2. The term "certain type of domestic corporation" means a domestic corporation other than a general incorporated association, etc. The term "general incorporated association, etc." means a domestic corporation which is a general incorporated association or general incorporated foundation (excluding a public interest incorporated association and a public interest incorporated foundation), an association without legal personality, or certain types of corporations that are deemed to be public interest corporations, etc. under laws other than the Corporation Tax Act (specifically, certified community-based organizations, incorporated management associations, incorporated housing complex management associations, political parties, etc., associations of disaster prevention block improvement projects, corporations engaging in specified non-profit activities, associations for reconstruction of condominiums, associations for sale of the grounds of condominiums, and associations for partition of grounds).

(3) Special Treatment for Self-Assessed Separated Taxation on Dividend Income Regarding Listed Shares, Etc.

Netting of negative capital gains on transfer of listed shares, etc. against dividend income thereon has become possible. Since it is necessary to even out the taxation formula when netting income and losses, self-assessed separated taxation applies as the method of taxing dividend income relating to dividends, etc. on listed shares, etc., in the same manner as for capital gains on transfer of listed shares, etc.

As a practical matter, a resident, etc. may select aggregate taxation of dividend income in connection with dividends, etc. on listed shares, etc., (excluding those for which payment is received by a large shareholder, etc.) for which payment is to be received on or after January 1, 2016 (and in the case that a negative capital gain on transfer of listed shares, etc. has been deducted, the amount after deduction), or may choose to segregate this income from other income, with this income taxed separately on the return at a rate of 15% (and 5% inhabitant tax if the taxpayer is a resident).

Even in the case of self-assessed separated taxation, the amount obtained by multiplying 2.1% by the amount of base income tax for each year from 2013 to 2037 shall be imposed as a special income tax for reconstruction, together with withholding tax.

(i) Scope of Dividends, Etc. on Listed Shares, Etc. Subject to the System

Dividend, etc. in connection with listed shares, etc. that are covered by this special treatment consists of those dividends, etc. (excluding: distributions of earnings of privately placed bond investment trusts as well as dividends, etc., on investment trusts, etc., in foreign private placement bonds, etc. which are subject to separated withholding taxation at source) that are listed below:

a. Dividends, etc. regarding shares, etc. that are listed on a financial instruments exchange and instruments similar thereto, and that are to be received by a person other than a large shareholder, etc.;

(Notes) 1. "Instruments similar thereto" means shares that are registered as OTC traded issues, Bank of Japan investment securities, OTC convertible bond type bonds with share options, or shares, etc. traded on a foreign financial instruments exchange.

2. A "large shareholder, etc." means an individual shareholder who, on the record date in connection with payment of dividends, etc. that are to be received from a domestic corporation, holds shares (including investment units in the event of an investment corporation) or equity contributions (shares, etc.) of at least 3% of the total number of shares (with regard to dividends, etc. received on or after October 1, 2023, including a shareholder where the aggregate holding ratio of shares held by the shareholder and shares held by a family company in which that shareholder holds more than 50% of the family company's shares, etc. amounts to 3% or more).
A system has been introduced to require reporting of a large individual shareholder who receives payment of dividends, etc. on listed shares, etc. Under this system, a domestic corporation that pays dividends, etc. on listed shares, etc. must prepare a "report on a large individual shareholder who receives payment of dividends, etc. on listed shares, etc." which specifies the name, address, individual number and holding ratio of the resident, etc. who receives dividends, etc. and whose holding ratio of shares, etc. is 1 percent or more as of the reference date of the dividends, etc., and submit this report to the district director of the tax office having jurisdiction over the location of the domestic corporation's head office or principal office (an optical disc in which the matters to be specified in the report are recorded may be submitted in lieu of submitting the report) within one month from the day on which the payment is determined.

b. Dividends, etc. in connection with distributions of earnings of beneficial interests in investment trusts for which the offering of beneficial interests upon establishment is conducted through public offering, such as securities investment trusts in publicly offered shares, etc. (excluding specified share investment trusts);

(Note) Beneficial interests in specified share investment trusts are included within the scope of a. listed shares, etc.

c. Dividends, etc. in (publicly offered open-end type) investment units of a specified investment corporation;
d. Distributions of earnings from beneficial interests of specified trusts issuing beneficiary certificates for which the offering of beneficial interests to be acquired by the settlor at the time of conclusion of the trust agreements has been conducted through a certain type of public offering; and
e. Dividends of surplus of corporate bond-type beneficial interests of specified purpose trusts (limited to those for which the offering of the corporate bond-type beneficial interests held by the originator at the time of conclusion of the trust contract has been conducted through public offering).

Interest, etc. on certain specified bonds, etc. that are to be received by a resident, etc. on or after January 1, 2016 are subject to self-assessed separated taxation, which is similar to this special treatment of self-assessed separated taxation for dividend income (see 1-2 (3) above for details).

(ii) Final Tax Return Filing, Etc.

In order to use the exceptional treatment, it is necessary to file a final tax return, stating that the taxpayer desires to use the exceptional treatment for dividend income in connection with dividends, etc. on listed shares, etc. At that time, the entire amount of dividend income in connection with dividends on listed shares, etc. that are reported must be selected. In other words, the taxpayer has to select either aggregate taxation or self-assessed separated taxation for the entire amount of dividend income in connection with dividends on listed shares, etc. to be reported. However, the dividend credit does not apply to the taxpayer who enjoys this treatment.

(Note) With regard to dividend income from dividends, etc. on listed shares, etc., a taxpayer may also select to file no final tax return by seeking another exceptional treatment through which the taxation procedure can be completed by withholding taxation at source, in addition to aggregate taxation or self-assessed separated taxation.

The amount of dividend income in connection with dividends, etc. on listed shares, etc. that are subject to self-assessed separated taxation is to be calculated in accordance with the provisions of the Income Tax Act (the deduction for interest on borrowed funds applies), but the amount of dividend income in connection with the dividends, etc. on listed shares, etc. for which self-assessed separated taxation has been chosen cannot be netted with the amount of losses that have been booked in calculating income that is covered by aggregate taxation.

A determination of whether the income requirements are satisfied for a deductible spouse or dependent relative, etc. shall include the amount of dividend income in connection with dividends, etc. on listed shares etc. for which self-assessed separated taxation has been taken.

(Note) Amounts of income deductions such as medical expenses deduction and dependents deduction may be deducted from the amount of dividend income relating to the dividends, etc. on these listed shares, etc. that are covered by self-assessed separated taxation, if there was no other income during that year or if any part of such deductions remains undeducted from the amount of other income such as regular salary income or business income during that year.

(iii) Payment Notification

Since the self-assessed separated taxation is the method to be used in taxing dividends, etc. of listed shares, etc., a person who pays dividends, etc. of listed shares, etc. within Japan to a resident, etc. is required to deliver a “Notice of Payment on Listed Shares, Etc.” to the person who receives the payment in order to enable the taxpayer and the tax office to make an accurate identification of the amount of dividends, etc. on listed shares, etc., and the amount of taxes withheld thereon.

This notice of payment shall be delivered within one month from the date of final determination of payment (or on the date of payment in the case of dividends, etc. on surpluses of bearer shares, etc., or by January 31 of the following year in the event of preparation of the total amount of dividends, etc. paid within the year).

(Note) If the notice of payment is prepared by the trustee of a trust or an executive partner, etc. receiving the payment as the titleholder in connection with the business, the deadline above is changed from "within one month" to "within 45 days" and "January 31" to "February 15."

(4) Separated Withholding Taxation at Source for Dividend Income Relating to Distributions of Earnings from a Privately Placed Bond Management Investment Trust

When a resident, etc. is to receive dividends on surplus that are paid within Japan on or after January 1, 2016 in relation to distributions of earnings from the following beneficial interests (referred to as "dividends, etc. relating to distributions of earnings from privately placed bond management investment trusts, etc."), dividend income from these dividends, etc. is separated from other income and is subject to separated withholding taxation at source through which the taxation procedure can be completed by withholding at source at a rate of 15.315% (plus an inhabitant tax of 5%, if the taxpayer is a resident):

(i) Beneficial interests of bond investment management trusts (excluding such trusts for which the offering has been conducted through public offering; and excluding such beneficial interests that are listed on a financial instruments exchange or are equivalent thereto); and

(ii) Corporate bond-type beneficial interests of specified purpose trusts (excluding such trusts for which the offering has been conducted through a public offering; and excluding such corporate bond-type beneficial interests that are listed on a financial instruments exchange or are equivalent thereto).

Furthermore, in cases where distributions of earnings with respect to these beneficial interests that are issued outside Japan are received via a domestic payment agent, the payment agent is required to withhold 15.315% of the payment (plus an inhabitant tax of 5%, if the taxpayer is a resident), with the resident receiving the payment being subject to a separated withholding taxation at source.

(5) Special Treatment of Not Requiring Filing of Final Tax Return on Dividend Income

In principle, withholding taxes are collected at the source at a rate of 20.42% on dividend income in connection with dividends, etc. for which payment is received by a resident, etc., and taxes are then paid through the final tax return filing (the income is aggregated with other income and the taxes assessed thereon, with the dividend credit also being taken; this is referred to as "aggregate taxation"). Yet, for reasons that include encouraging investment, an exceptional treatment has been enacted with respect to this general principle of aggregate taxation, and under this exceptional treatment filing on a final tax return is not required with respect to dividends, etc. set forth below.

Moreover, the exceptional treatment set forth in (6) below has been enacted in connection with the withholding tax rate on dividends, etc. on listed shares, etc. out of the dividends, etc. for which filing of a final tax return is not required:

(i) Small-sum dividends of unlisted shares, etc. (dividends, etc. that do not fall within (ii) through (vi) below, and for which the amount to be received from a domestic corporation in a single payment is not more than the resulting amount when JPY100,000 is multiplied by the number of months in the dividend calculation period [refers to the period from the day following the record date for the immediately preceding dividend payment until the record date for the dividend payment] and divided by 12);

(ii) Dividends, etc. that are received from a domestic corporation, etc. with respect to listed shares, etc. (excluding those received by a large shareholder, etc.);

(Note) The scope of "dividends, etc., on listed shares, etc." and "large shareholder, etc." shall be the same as those covered by the "Self-Assessed Separated Taxation on Dividend Income Regarding Listed Shares, Etc." discussed in (3) above.

(iii) Distributions of earnings from investment trusts: ([i] securities investment trusts other than bond investment trusts; and [ii] investment trusts other than securities investment trusts (excluding publicly offered bond investment trusts) for which the offering of beneficial interests upon establishment is conducted through public offering (excluding specified shares investment trusts);

(iv) Dividends, etc. with respect to the investment units received from a specified investment corporation ("specified investment corporations" are publicly offered open-end type investment corporations that stand ready to repurchase their investment units upon the requests from investors);

(Note) In cases where the investment units of an investment corporation that does not meet the definition of a specified investment corporation are listed, the distributions of earnings are treated the same as the dividends, etc. with respect to listed shares, etc. Dividends, etc. received from investment corporations that are not listed are subject to a withholding tax of 20.42% at the time of payment, and are taxed by aggregate taxation through filing a return. Nevertheless, dividends, etc. that fall within small-sum dividends discussed below, however, are covered by the exceptional treatment of not requiring statement on the final return.

(v) Distributions of earnings from beneficial interests of specified trusts issuing beneficiary certificates for which the offering of beneficial interests to be acquired by the settlor at the time of conclusion of trust agreements has been conducted through a certain type of public offering; and

(vi) Dividends of surplus of corporate bond-type beneficial interests of specified purpose trusts (limited to those for which the offering of the corporate bond-type beneficial interests held by the originator at the time of conclusion of the trust contract has been conducted through a certain type of public offering) to be received from a domestic corporation.

(Note) Interest, etc. on certain specified bonds, etc. to be received by a resident, etc. on or after January 1, 2016 are subject to special treatment of not requiring the filing of a final tax return which is similar to this special treatment of not requiring the filing of a final tax return for dividend income (see 1-2 (4) for details).

This exceptional treatment of not requiring filing of the final tax return may be used for each amount of dividends, etc. for which a single payment is to be received. Thus, whether or not to file the final tax return may be selected for each issue, and for each amount of dividends, etc. for which payment is to be received.

If the exceptional treatment of not requiring statement on the final tax return is used for dividends, etc. within an account for which withholding at the source is selected, this can be carried out for each of the dividends, etc. in the account for which withholding at the source is selected (by unit of account for which withholding at the source is selected).

(Note) Even when a final tax return is filed in order to utilize the "Self-Assessed Separated Taxation on Dividend Income Regarding Listed Shares, Etc." as well as the "Netting and Carry-Forward of Losses on Transfer and Dividend Income, Etc. on Listed Shares, Etc.", it is possible to apply the exceptional treatment of not requiring final statement on the return and to exclude the dividends, etc. in (i) through (vi) above in the calculation of the amount of dividend income. The Income Tax Act separately provides that salary earners and pensioners are not required to file a final tax return if: [i] the amount of income other than salary income and retirement income, such as dividend income; or [ii] the amount of income other than miscellaneous income related to public pension, etc. is not more than 200,000 yen. In this case as well, dividend income for which the filing of a final tax return is not required is excluded when judging whether or not the amount of such income does not exceed JPY 200,000.

(6) Special Treatment for Withholding Tax Rate on Dividends, Etc. on Listed Shares, Etc.

Under the Income Tax Act, the tax withholding rate of income tax and the special income tax for reconstruction with respect to dividend income is 20.42%. Nevertheless, withholding at the source is to be conducted at a tax rate of 15.315% (plus inhabitant tax of 5%, if the taxpayer is a resident) in connection with the following dividends, etc. to be received on or after January 1, 2016:

(i) Dividends, etc. on listed shares, etc.; however, this excludes such dividends, etc. to be received from a domestic corporation by an individual who, on the record date in connection with payment of the dividends, etc., holds shares (or investment units in the event of an investment corporation) or equity contributions of at least 3% of the total number of shares (or investment units) or equity contributions issued by the domestic corporation (such individual is referred to as a "large shareholder, etc.") (for details, see Note 2 for (3)(i)(a) above).

(ii) Dividends, etc. on distributions of earnings from the following investment trusts for which the offering of beneficial interest upon establishment has been conducted through public offering (excluding specified shares investment trusts):

a. Securities investment trusts other than publicly offered bond investment trusts; and

b. investment trusts other than securities investment trusts (excluding publicly offered bond investment trusts);

(iii) Dividends, etc. on investment units of a specified investment corporation;

(iv) Distributions of earnings from beneficial interests of specified trusts issuing beneficiary certificates for which the offering of beneficial interests to be acquired by the settlor at the time of conclusion of the trust agreements has been conducted through a certain type of public offering; and

(v) Dividends, etc. which are dividends of surplus of corporate bond-type beneficial interests of specified purpose trusts (limited to those for which the offering of the corporate bond-type beneficial interests held by the originator at the time of conclusion of the trust contract has been conducted through a certain type of public offering).

(7) Special Treatment for Withholding Obligation Regarding Dividends, Etc. of Listed Shares, Etc.

In consideration of the convenience of investors, dividends, etc. of listed shares, etc. that are paid through a financial instruments business operator, etc., are received in an account selected for withholding (specified account) and the income and losses are netted within the account selected for withholding. In order to facilitate the implementation thereof, a special treatment has been put in place which makes the financial instruments business operator, etc. (with whom an elective withholding account has been opened), act as a person with a duty to withhold on dividends, etc. of listed shares, etc.

Specifically, from January 1, 2016, a person (financial instruments business operator, etc.) who handles payments within Japan of dividends, etc. of listed shares, etc. to an individual or a domestic corporation (excluding a government-owned corporation (*kōkyō hōjin*)) or a foreign corporation must, when it pays dividends, etc. on listed shares, etc. to an individual, a domestic corporation or a foreign corporation, collect income taxes (together with the special income tax for reconstruction during the period from January 1, 2013 to December 31, 2037) in the amount calculated by multiplying the amount to be paid by the withholding tax rate, and pay these taxes to the government by the 10th day of the month following the month containing the date of payment.

Meanwhile, the issuing company of the shares which is the payer of the dividends, etc. of the listed shares, etc., or the trust bank, etc., which distributes the earnings on a publicly offered share investment trust will be released from the obligation to withhold in connection with the dividends, etc. in listed shares, etc. for which payment is made through a payment handler.

(i) Scope of Dividends, Etc. of Listed Shares, Etc. Subject to the System

The dividends, etc. of listed shares, etc. that are covered by this special treatment are the following dividends, etc. which are paid in Japan (and in the case of non-residents or foreign corporations, limited to dividends that are domestic source income):

a. Dividends, etc. on shares, etc. that are listed on a financial instruments exchanges, shares of OTC traded registered issues, Bank of Japan investment securities, and shares, etc. that are traded on foreign financial instruments markets;

> (Note) This special treatment also applies to dividends, etc. that large shareholders, etc. receive on listed shares, even though these are excluded from the special treatment for the Self-Assessed Separated Taxation

b. Dividends, etc. in connection with distribution of earnings from investment trusts ([i] securities investment trusts other than bond investment trusts and [ii] investment trusts other than securities investment trusts (excluding publicly offered bond investment trusts)) for which the offering of beneficial interests upon establishment is conducted through public offering (excluding specified shares investment trusts);

c. Dividends, etc. on investment units of specified investment corporations;

d. Distributions of earnings from beneficial interests of specified trusts issuing beneficiary certificates for which the offering of beneficial interests to be acquired by the settlor at the time of conclusion of trust agreements has been conducted through a certain type of public offering; and

e. Dividends, etc. which are dividends of surplus of corporate bond-type beneficial interests of specified purpose trusts (limited to those for which the offering of the corporate bond-type beneficial interests held by the originator at the time of conclusion of the trust contract has been conducted through a certain type of public offering).

(ii) Withholding at Source

Under this special treatment, the handler of payment of dividends, etc. of listed shares, etc. will withhold taxes at the withholding tax rate of 15.315% (and an additional inhabitant tax of 5% if the taxpayer is a resident) (20.42% for such dividends, etc. to be delivered to a large shareholder, etc.) upon delivery of the dividends, etc. (for details, see Note 2 for (3)(i)(a) above).

When a large shareholder, etc. is an individual, the basic rate of 20% (20.42% during the period from January 1, 2013 to December 31, 2037, 0% inhabitant tax) will apply to the withholding taxes in connection with dividends, etc. for which the large shareholder, etc. is to receive payment in connection with listed shares, etc., and consequently, a domestic corporation which pays dividends, etc. on listed shares must notify the payment agent of necessary matters such as the names and addresses of large shareholders, etc., and that they are large shareholders. If any part of the dividends, etc. on listed shares, etc. to be paid by the domestic corporation is subject to the special treatment for taxation on dividends, etc. related to wholly-owned subsidiary shares, etc., the domestic corporation, when paying such dividends, etc. on listed shares, etc., must notify the payment agent of necessary matters such as the name of the domestic corporation, the location of its head office or principal office, and the fact that the payment is subject to the special treatment.

Furthermore, listed companies, etc. making payments of money, etc. taxed as deemed dividends must notify the person who handles payments that is obliged to withhold the tax on the deemed dividends information necessary for the withholding with respect to such deemed dividends.

(iii) System for Crediting Foreign Withholding Income Tax, Etc. Against Withholding Income Tax

If there is any amount specified in the following according to the categories set forth regarding dividends, etc. on listed shares, etc. delivered by a person in charge of handling payment, the said amount is credited against the amount of withholding income tax related to the said dividends, etc. on listed shares, etc. to be withheld by that person, to the extent of the said amount of withholding income tax:

a. Distribution of revenue from an investment trust (limited to the trust set forth in Article 2, Item 29(b) of the Corporation Tax Act; hereinafter referred to as a "securities investment trust, etc.") or specified trust issuing beneficiary certificate: the sum of the following amounts, which is the amount of the portion corresponding to the distribution of revenue out of the amount of income tax, special income tax for reconstruction, and foreign withholding income tax (meaning a tax equivalent to withholding income tax imposed under foreign laws and regulations; the same applies hereinafter) which has been paid by the domestic corporation or foreign corporation that has underwritten the said securities investment trust, etc. or specified trust issuing beneficiary certificate with regard to the trust property of the said securities investment trust, etc. or specified trust issuing beneficiary certificate (excluding any portion of the distribution of revenue which would correspond only to special distribution money if the revenue subject to income tax or foreign withholding income tax were to be distributed):

(a) The amount calculated by multiplying the amount of foreign withholding income tax by the ratio of the amount of the distribution of revenue to be delivered by the person in charge of handling payment to the person receiving payment to the total amount of the distribution of revenue from the securities investment trust, etc. or specified trust issuing beneficiary certificate (excluding any portion of the distribution of revenue which would correspond only to special distribution money if the revenue subject to income tax or foreign withholding income tax were to be distributed) (up to the amount calculated by multiplying the sum of the amount of withholding income tax and the amount of special income tax for reconstruction related to the distribution of revenue to be delivered, by the ratio of foreign currency-denominated assets of the securities investment trust, etc. or specified trust issuing beneficiary certificate); and

(b) The amount calculated by multiplying the sum of the amount of income tax and the amount of special income tax for reconstruction by the ratio of the amount of the distribution of revenue to be delivered by the person in charge of handling payment to the person receiving payment to the total amount of the distribution of revenue from the securities investment trust, etc. or specified trust issuing beneficiary certificate (excluding any portion of the amount of the distribution of revenue which would correspond only to special distribution money if the revenue subject to income tax or foreign withholding income tax were to be distributed);

b. Dividends of profit from a specified purpose company (including distribution of money prescribed in Article 115, Paragraph 1 of the Act on the Securitization of Assets): the amount of credited foreign corporation tax related to the dividends of profit which is the amount of the portion corresponding to the said amount of dividends of profit out of the amount of foreign corporation tax which has been paid by the specified purpose company;

c. Dividends, etc. on investment equity in an investment corporation: the amount of credited foreign corporation tax related to the dividends, etc. which is the amount of the portion corresponding to the said dividends, etc. out of the amount of foreign corporation tax which has been paid by the investment corporation; or

d. Dividends of surplus based on beneficial interests in a specified purpose trust: the amount of credited foreign corporation tax related to the dividends of surplus which is the amount of the portion corresponding to the said dividends of surplus out of the amount of foreign corporation tax which has been paid by the trustee corporation regarding the said specified purpose trust.

If any of the amounts specified in a. to d. above is credited against the amount of withholding income tax related to dividends, etc. on listed shares, etc., the amount of withholding income tax after the tax credit shall be deemed to be income tax withheld at source pursuant to the provisions of the Income Tax Act. Similarly, if such amount is credited against the amount of special income tax for reconstruction, the amount after the tax credit shall be deemed to be the amount of special income tax for reconstruction.

(Note) "Special distribution money" mentioned above means the distribution of revenue to be delivered under an agreement as revenue regarding a revenue adjustment amount, out of the revenue from an open-end securities investment trust.

(iv) Credit of Foreign Withholding Income Tax, Etc. Against Special Income Tax for Reconstruction

The amount of the tax credit mentioned in (iii) above is limited to the amount of withholding income tax related to dividends, etc. on listed shares, etc. Any amount exceeding this maximum amount which is to be credited as prescribed in (iii) above is credited against the amount of special income tax for reconstruction related to the dividends, etc. on listed shares, etc., to the extent of the said amount of special income tax for reconstruction.

(v) Addition to the Amount Delivered

If there is any amount to be credited as prescribed in (iii) above, the amount specified in the following items according to the categories set forth respectively therein regarding dividends, etc. on listed shares, etc. delivered by a person in charge of handling payment shall be added to the amount of the said dividends, etc. on listed shares, etc.:

a. Distribution of revenue from a securities investment trust, etc. or specified trust issuing beneficiary certificate: the amount calculated by multiplying the amount of income tax, special income tax for reconstruction, and foreign withholding income tax which has been paid by the domestic corporation or foreign corporation that has underwritten the said securities investment trust, etc. or specified trust issuing beneficiary certificate with regard to the trust property of the said securities investment trust, etc. or specified trust issuing beneficiary certificate by the ratio of the amount of the distribution of revenue to be delivered by the person in charge of handling payment to the person receiving payment to the total amount of the distribution of revenue from the securities investment trust, etc. or specified trust issuing beneficiary certificate (excluding any portion of the distribution of revenue which would correspond only to special distribution money if the revenue subject to income tax or foreign withholding income tax were to be distributed); and

b. Dividends of profit from a specified purpose company, dividends, etc. on investment equity in an investment corporation, or dividends of surplus based on beneficial interests in a specified purpose trust: the amount to be credited as prescribed in (iii) or (iv) above.

(vi) Special Treatment for Notice of Recipients of Dividends and Payment Records, Etc. Regarding Dividends, Etc.

When payment of dividends, etc. of listed shares, etc. is made through a payment agent in Japan, the payment agent must, on behalf of the payer of the dividends, etc. of listed shares, etc., carry out the procedures regarding notice of the recipient of the dividends, etc., submission of the payment record or delivery of the payment notice of dividends, etc., submission of the statement of dividend income received by the nominee shareholders, and delivery of the notice of payment of dividends, etc. in listed shares, etc.

Meanwhile, the payer of the dividends, etc. on listed shares, etc. shall not be required to deliver a notice of payment or submit a payment record in connection with dividends, etc. on listed shares, etc.

(vii) System of Notification by the Person in Charge of Handling Payment on Foreign Withholding Income Tax, Etc.

If a person in charge of handling payment (including a quasi-payer (meaning a trustee of a trust and a person who receives payment in connection with operations as a registered person on behalf of another person; the same applies hereinafter)) credits the amount of tax credit as mentioned in (iii) above when delivering dividends, etc. on listed shares, etc., the said person must notify the person who receives the dividends, etc. on listed shares, etc. of the prescribed matters in writing within one month (or 45 days if the quasi-payer makes the notification) from the day on which the payment has been determined.

(viii) Duty to Preserve Documents on the Amount of Tax Paid

If a person in charge of handling payment has credited income tax, special income tax for reconstruction, or foreign withholding income tax paid thereby with regard to the trust property of a securities investment trust, etc. or specified trust issuing beneficiary certificate, against withholding income tax related to dividends, etc. on listed shares, etc., the person must preserve a document certifying such tax credit and other matters and a detailed statement concerning the calculation of these amounts at the place for tax payment for seven years from the year following the year that includes the day on which the relevant amount was credited.

(8) Special Treatment for Withholding, Etc. on Dividend Income of Shares Issued Outside of Japan

When a resident or a domestic corporation receives delivery of dividends, etc. (such as dividends, etc. on foreign shares, etc. or distributions of earnings, etc. in an investment trust or a specified purpose trust) payable on shares issued outside of Japan through a payment agent in Japan, the payment agent must, upon such payment, withhold income taxes at a tax rate of 20% (that is, however, at a tax rate of 20.42% during the period from January 1, 2013 to December 31, 2037 due to the combined income taxes and the special income tax for reconstruction), in principle, on the amount delivered (the amount remaining after deducting any amounts of foreign income taxes withheld by the foreign country).

Nevertheless, the special treatment for the withholding tax rate as discussed in (6) above also applies to dividends, etc. on listed shares, etc., even though these are dividends, etc. on shares issued outside Japan.

In addition, the final tax return non-filing system applies to dividends, etc. on shares issued outside Japan regardless of the number of shares held (the restrictions on individual shareholders who are large shareholders only apply to the shares of domestic corporations). In cases where aggregate taxation applies (other than where the taxpayer can opt not to file a final tax return), income tax paid overseas will be eligible for tax credit, and income tax and the special income tax for reconstruction equivalents withheld domestically will be adjusted in the final tax return. However, because the dividends in question are foreign, no dividend credit is allowed.

14 Taxation on Capital Gains, Etc. from Transfer of Shares, Etc.

When a resident, etc. transfers shares, etc. on or after January 1, 2016, the business income, capital gains and miscellaneous income arising from the transfer of shares, etc. (capital gains, etc. from shares, etc.) will be subject to the self-assessed separated taxation for general shares, etc. or the self-assessed separated taxation for listed shares, etc. depending on whether the transferred shares, etc. are general shares, etc. or listed shares, etc.

Specifically, when a resident, etc. transfers general shares, etc., the business income, capital gains and miscellaneous income arising from the transfer of the general shares, etc. (capital gains, etc. from general shares, etc.) will be separated from other income and taxed at a rate of 15% (plus 5% inhabitant tax) of the amount of capital gains, etc. from general shares, etc. When a resident, etc. transfers listed shares, etc., the business income, capital gains and miscellaneous income arising from the transfer of the listed shares, etc. (capital gains, etc. from listed shares, etc.) will be separated from other income and taxed at a rate of 15% (plus 5% inhabitant tax) of the amount of capital gains, etc. from listed shares, etc. Aggregation of profits and losses may not be carried out between capital gains, etc. from general shares, etc. and capital gains, etc. from listed shares, etc.

Even in the case of these instances of self-assessed separated taxation, the amount obtained by multiplying 2.1% by the amount of base income tax for each year from 2013 to 2037 shall be imposed as a special income tax for reconstruction, together with withholding tax.

(1) Self-Assessed Separated Taxation for Capital Gains, Etc. from General Shares, Etc.

When a resident, etc. transfers general shares, etc. (meaning shares, etc. other than listed shares, etc.) on or after January 1, 2016, the capital gains, etc. from the transfer of the general shares, etc. will be separated from other income, and instead of being subject to aggregate taxation, in principle, capital gains, etc. for the year from the transfer of general shares, etc. will be subject to self-assessed separated taxation at a rate of 15% (plus 5% inhabitant tax, if the taxpayer is a resident) of the amount of capital gains, etc. from general shares, etc.

Even in the case of self-assessed separated taxation, the amount obtained by multiplying 2.1% by the amount of base income tax for each year from 2013 to 2037 shall be imposed as a special income tax for reconstruction, together with withholding tax.

(i) Scope of General Shares, Etc. Subject to Self-Assessed Separated Taxation

a. General shares, etc. subject to the self-assessed separated taxation through this exceptional treatment are “shares, etc.” listed in b. below which are not listed shares, etc.

For example, the following shares, etc. fall within the category of “general shares, etc.”:

(a) Shares or investment equity not listed on financial instruments exchanges;

(b) Beneficial interests in investment trusts for which the offering of beneficial interests upon establishment has been conducted through a method other than public offering (private placement);

(c) Corporate bond-type beneficial interests of specified purpose trusts (limited to those for which the offering of the corporate bond-type beneficial interests to be acquired by the settlor at the time of conclusion of the trust agreement has been conducted through a method other than public offering (private placement)); and

(d) Corporate bonds issued by companies whose shares are not listed, for which the offering of securities upon issuance has been conducted through a method other than public offering (private placement).

b. The scope of “shares, etc.” subject to the self-assessed separated taxation through this exceptional treatment is as follows: “Shares, etc.” include equity securities of foreign corporations such as shares issued by a foreign corporation:

(a) Shares (including the right to become a shareholder or investor, rights to receive allotments of shares, share options (including investment equity subscription rights of investment corporations) and rights to receive allotments of share options);

(b) Equity interests of investors in corporations established by special laws, of members of general partnerships (*gōmei kaisha*) limited partnerships (*gōshi kaisha*) and limited liability companies (*gōdō kaisha*), of members (*kumiaiin* or *kaiin*) of cooperative associations (*kyōdōkumiai*), or of other corporations (including the rights to become investors or members (*shusshisha, shain, kumiaiin* or *kaiin*) and rights to receive allotments of equity contributions, but excluding those listed in (c));

(c) Preferred equity investment as prescribed in the Act on Preferred Equity Investment by Cooperative Structured Financial Institution as well as the Act on the Securitization of Assets (including rights to become preferred investors and rights to receive allocations of preferred equity investment);

(d) Beneficial interests of investment trusts;

(e) Beneficial interests of specified trusts issuing beneficiary certificates;

(f) Bond-type beneficial interests of specified purpose trusts; and

(g) Bonds (excluding the following):

[a] The Long-Term Credit Bank bonds prescribed in the Deposit Insurance Act;

[b] Norinchukin Bank bonds prescribed in the Agricultural and Fishery Cooperation Savings Insurance Act; and

[c] Discount bonds for which the redemption gain is withheld at source at the time of issuance.

Investment equity of investment corporations is included in the scope of “shares.”

Shares or equity in the form of a usage right (membership) in a golf course is excluded from the scope of shares, etc. that is subject to self-assessed separated taxation, and gains arising from the transfer of such rights are taxed under aggregate taxation in the same manner as golf club memberships based on the deposit method.

If a large shareholder of a corporation, the assets of which mainly consist of land, transfers a significant number of shares within a certain period, this will be deemed to be in substance a transfer of land, etc. held for a short term and subject to the "Special Tax Treatment for Short-Term Capital Gains from Land, Etc." and outside the scope of this self-assessed separated taxation.

Meanwhile, transfers of shares, etc. through the transactions set forth in Article 28, Paragraph 8, Item 3, a. of the Financial Instruments and Exchange Act (the so-called securities futures transactions) are excluded from this transfer of general shares, etc., and are taxed in the same manner as commodity futures transactions.

(Note) "Acquisition of a corporation's own shares or capital contributions by a certain method" and "transfer relating to redemption through purchase of bonds" are excluded from the scope of transfer of general shares, etc. These acts are temporarily excluded from the scope of transfer because Article 37-10, Paragraph 3 of the Act on Special Measures Concerning Taxation provides that the amount received due to acquisition of a corporation's own shares or capital contributions by a certain method and the amount of redemption money which a person other than a family company's officer, etc. receives from the said family company due to redemption through purchase of bonds other than specified bonds are to be deemed to be a revenue arising from capital gains, etc. from general shares, etc.

(ii) Computation of the Amount of Capital Gains, Etc. from General Shares, Etc.

The "amount of capital gains, etc. on general shares, etc." that is subject to self-assessed separated taxation is the sum total of each of business income, capital gains and/or miscellaneous income derived in the year in question from the transfer of general shares, etc. and separately calculated in accordance with the respective calculation methods prescribed by the Income Tax Act (after aggregation of profit and loss among these categories of income).

(Note) Given that the concessions such as the rules for computing the capital gains on listed shares, etc. in specified accounts are available, and since it is necessary to compute the amount that is eligible for each concession, in practice the income is separated according to eligibility for each concession.

The basic computation method is as follows:

[Amount of business income or miscellaneous income] = (Total income from transfer) — (Basis of transferred assets and other necessary expenses)

[Capital gains] = (Total income from transfer) — (Acquisition expense of the transferred assets and transfer expenses)

→ [Amount of capital gains, etc. from transfers of general shares, etc.]

(Note) "Necessary expenses" and "transfer expenses" means interest accrued for debt incurred for acquisition of the general shares, etc., trading fees, management fees and other expenses.

a. Amount of Total Income from Transfer of General Shares, Etc.

The total income from the transfer of general shares, etc. is the amount of the sales proceeds realized during the year as consideration of the transfer of general shares, and the recognized time of receipt is determined according to the date of delivery of the general shares. In such cases, the taxpayer is allowed to include those proceeds as income of the year in which the contract for transfer of the general shares, etc. comes into effect (contract date). In the case of margin transactions and date-of-issue trading, the income will be recognized in the year in which the date of settlement falls.

The following types of income that arise in the process of holding shares or bonds are deemed to be revenue arising from capital gains, etc. from general shares, etc. and are subject to self-assessed separated taxation. This is because, although these amounts are delivered based on facts such as mergers, and do not arise from transfers of shares or bonds, they are practically considered to have a nature similar to capital gains from shares or bonds:

(a) The sum of the amount of money and the value of the assets other than money delivered due to grounds such as a merger or split of a corporation, share distribution, refund of the capital, distribution of residual assets due to dissolution of a corporation, acquisition of treasury stock or contributions, cancellation of capital contributions, refund of capital contributions, refund of equity due to the retirement or withdrawal from a corporation, or reorganization of a corporation (excluding the portion deemed to be dividends);

(b) The sum of the amount of the money and the value of the assets other than money received due to redemption of the principal of bonds (including redemption through purchase of bonds);

(Note) Money and assets other than money (hereinafter referred to as “money, etc.”) received due to redemption of bonds other than specified bonds are subject to aggregate taxation as miscellaneous income when it is received by: [i] an individual who is a shareholder and who serves as the basis for judging whether the corporation in question is a family company prescribed in Article 2, Item 10 of the Corporation Tax Act where the corporation that delivers the money, etc. will fall under the category of a family company if such judgment is made under the Corporation Tax Act on the day of the redemption; or [ii] a certain class of relatives of the individual as set forth below:

[a] A relative of the individual;

[b] A person in a relationship with the individual where the marital relationship is de facto, though a marriage has not been registered;

[c] An employee of the individual;

[d] A person other than those set forth in [a] through [c] above who maintains his/her living by receiving money or any other assets from the individual; and

[e] A relative of any of the persons set forth in [b] through [d] above who depends on such person for his/her livelihood.

In addition, if an individual receives redemption money, etc. of bonds issued by a family company, and a corporation that is a shareholder that serves as the basis for judging whether the corporation in question is a family company has a special relationship with the individual (in which the individual holds more than 50% of controlling interests in the corporation) (that is, a corporation is placed between the individual and the family company), the redemption money, etc. received by the individual and a certain class of relatives, etc. of the individual is subject to aggregate taxation. In this case, there can be three tiers of corporations that are placed between the individual and the family company, i.e., a corporation controlled by the individual who receives redemption money, etc., or another corporation controlled by the individual and the corporation that is controlled by the individual.

(c) Amount of interest on bonds of the separated interest component (meaning bonds which constituted the interest component of bonds whose principal component and interest component are separated and traded independently);

(Note) "Bonds whose principal component and the interest component are separated and traded independently" include the so-called STRIPS (Separate Trading of Registered Interest and Principal of Securities) bonds, but since STRIP bonds are actually traded as instruments similar in nature to discount bonds, interest on bonds which constituted the interest component of STRIPS bonds is to be taxed as capital gains, etc. Meanwhile, bonds which constituted the principal component of STRIPS bonds correspond to the redemption of the principal of bonds referred to in (b) above, and are subject to 15% self-assessed separated taxation.

(d) The sum of the amount of the money and the value of the assets other than money to be received due to a merger of corporations where a holder of share options of the merged corporation in the merger receives money or other assets in lieu of the share options of the merged corporation which the holder of share options had held (excluding the case of receiving only share options of the merging corporation in the merger); and

(Note) (d) above also applies to the case where an investment corporation, that has issued investment equity subscription rights, effects a merger.

(e) The amount of money to be received due to an entity conversion of a corporation where a holder of share options of the corporation that has effected the entity conversion receives money in lieu of the share option of the corporation which the holder of share options had held.

(Note) In the case of termination or partial cancellation of investment trusts or specified trusts issuing beneficiary certificates, beneficial interests thereof are deemed to be revenue arising from general shares, etc., similar to the above, since the termination or partial cancellation is not regarded as a transfer as-is.

b. Computation of Basis (Acquisition Cost) of Transferred Shares, Etc.

The required expenses to be deducted from total income in relation to the transfer of general shares, etc. mainly consist of the basis of the general shares, etc. (in the case of capital gains this is referred to as the "acquisition cost").

Situations in which shares of the same issue are acquired on a number of occasions at different prices, or in which shares acquired by inheritance are included in the taxpayer's holdings of shares, present a problem concerning how the basis (acquisition cost) should be calculated if some of these shares are sold.

(a) General Principles of Calculating the Acquisition Cost of General Shares, Etc.

The cost price (or acquisition cost) is basically the "acquisition cost" of the general shares, etc., and is calculated as follows according to the mode of acquisition:

[a] Purchased general shares, etc. --- Purchase price (including brokerage and handling charges of change in the registration paid to the financial instruments business operator and other fees required for the purchase);

[b] General shares, etc. obtained by payment --- Amount paid (including expenses required for the acquisition);

[c] Specified shares with restriction on transfer or taken-over shares with restriction on transfer ---Value of such shares on the date on which the restriction on transfer is lifted;

(Notes) 1. The shares on the item [c] include not only restricted stocks given in exchange for rights to claim distributions that were granted to an individual as a form of compensation for working for a corporation, but also restricted stocks that are substantially deemed to be given as a form of compensation for working for a corporation.

2. If an individual to whom specified shares with restriction on transfer, etc. were delivered dies before the date on which the restriction on transfer is lifted (in the case where such an individual dies on or after April 1, 2020), and it is determined that the specified shares with restriction on transfer, etc. do not fall under the case in which the issuing corporation, etc. is to acquire these shares without consideration at the time of the individual's death, the value of those specified shares with restriction on transfer, etc. as of the date of the individual's death is treated as the value of economic benefits from those specified shares with restriction on transfer, etc.

[d] General shares, etc. acquired by exercise of share options, etc. for a favorable issue value (excluding those obtained on the basis of the shareholders' rights) ---Value of such shares, etc. on the date of exercise of such share options, etc.;

[e] Shares or share options acquired without any requirement to pay money or other consideration --- JPY0;

[f] General shares, etc. obtained by methods other than those described above --- The price normally required to obtain the general shares, etc. at the time that it was acquired (the so-called market price); and

[g] General shares, etc. acquired on or before December 31, 1952 (only with respect to capital gain) --- Monthly average of daily public closing price in December 1952. (For non-listed shares, the amount calculated by dividing the amount of net assets of the issuer by the total number of outstanding shares as of January 1, 1953.)

If general shares, etc. are acquired by inheritance, etc., the heir, etc. is deemed to have held such shares, etc. continuously from the time that they were acquired by the deceased, etc. and to have succeeded to the acquisition cost of the deceased. (However, in the case of a limited acceptance of inheritance, the cost is the price at the time of inheritance, and if the donation is from a corporation, the cost is the price upon receipt.)

(Note) If shares, etc. obtained through inheritance are transferred within three years from the day following the due date of filing a tax return for the inheritance tax, the acquisition cost to calculate the capital gain is the acquisition cost by which the deceased obtained it plus the inheritance tax attributable to the transferred shares.

Furthermore, if there is a stock split (or reverse stock split), merger or split-off-type company split, etc., the acquisition cost and the number of the old shares will change, so an adjustment calculation is to be made in order to average the unit price of the old share and that of the new share that has been acquired in accordance with a specified formula.

For example, if the taxpayer holds 10,000 shares for which the per share value is JPY110, and there is a one-for-one capital increase during the period and JPY50 is paid in on each new share, then the total acquisition price of the new and old shares will be JPY1,600,000, or JPY80 per share after adjustment, and if the taxpayer later transfers 1,000 shares, the purchase price will be set at JPY80,000 (1,000 shares at JPY80 per share).

(b) Calculation Method When the Same Issue of Shares is Acquired Twice or More

When the same issue of general shares is acquired two or more times, in the case the transfer of shares, etc. is categorized as business income, the cost price (or acquisition cost) is calculated in accordance with the "**Weighted Average Cost Method**"; and in the case of capital gains or miscellaneous income, the cost price is calculated in accordance with the "**Weighted Average Cost Equivalent Method**." Since the method is being applied to a single individual's holdings of each issue of general shares, if there are two or more transacting financial instruments business operators, all of the taxpayer's holdings of an issue with such firms must be tallied up (*nayose*).

The "Weighted Average Cost Method" is a method to calculate the acquisition cost of the general shares, etc. as follows by classifying them according to type and issue, totaling the acquisition cost of general shares, etc. of the same type, etc., to obtain the acquisition cost per unit.

$$\left(\begin{array}{c}\text{Acquisition cost of}\\ \text{general shares, etc.}\\ \text{owned as of January}\\ \text{1 of the year (A)}\end{array} + \begin{array}{c}\text{Total acquisition}\\ \text{cost of general}\\ \text{shares, etc.}\\ \text{obtained during}\\ \text{the year (B)}\end{array}\right) \div \left(\begin{array}{c}\text{Total number of}\\ \text{general shares, etc.}\\ \text{owned as of}\\ \text{January 1 of the}\\ \text{year}\end{array} + \begin{array}{c}\text{Total number}\\ \text{of general}\\ \text{shares acquired}\\ \text{during the}\\ \text{year}\end{array}\right) = \begin{array}{c}\text{Basis}\\ \text{(Acquisition}\\ \text{Cost)}\end{array}$$

A further method is the "Weighted Average Cost Equivalent Method." This is based on the period from when general shares, etc. are obtained initially (when such general shares, etc. are already transferred at that time, it means the time of the immediately preceding transfer) to the time of transfer. General shares, etc. obtained initially (or at the time of the immediately preceding transfer) and those obtained during such period are calculated by analogy with the Weighted Average Cost Method to obtain the acquisition price (or acquisition cost) per unit. In other words, regardless of the calendar year, the average unit price (average acquisition cost per unit) of general shares, etc. obtained before transfer per type and issue is calculated every time a transfer occurs.

The "holding period" can be an issue in determining the applicability of concessions (special treatment) and the principle of "first in, first out" applies; however, the calculation of the cost price is carried out in accordance with the method described above.

<Reference> Calculation Example of the Acquisition Cost in Case of the Weighted Average Cost Equivalent Method (Commissions and other expenses are excluded for calculation purposes)

(Example)

Trading of Share Issue A	(No. of Shares)	(Unit Cost)	(Total Amount)
Acquired May last year	3,000 shares	JPY400	JPY1.2 million
Acquired April this year	5,000 shares	JPY1,000	JPY5.0 million
Sold June this year	4,000 shares	JPY1,300	JPY5.2 million
Acquired November this year	1,000 shares	JPY1,200	JPY1.2 million

First, the basis of the 4,000 shares sold in June of this year is calculated based on the period from May of last year when the shares were initially acquired to June of this year when they were sold, and the shares purchased in November of this year are not included in the basis for calculating the basis.

The acquisition cost per one share in this case is derived using the following formula:

$$\frac{\text{JPY1.2 million} + \text{JPY5 million}}{\text{3,000 shares} + \text{5,000 shares}} = \text{JPY775 (Cost per share sold)}$$

Therefore, the capital gain for these shares sold in June this year is as follows:

(No. of sold shares)				(Basis)
4,000 shares	×	JPY775	=	JPY3.1 million
(Transfer earnings)		(Capital gain)		(Basis)
JPY5.2 million	−	JPY3.1 million	=	JPY2.1 million

c. Special Treatment for Margin Transactions, Etc.

When shares are purchased or sold through margin transactions, date-of-issue transactions or futures transactions, and settled by a closing transaction, the acquisition cost is the acquisition cost of the shares underlying such transactions and no calculation is made using the weighted average cost method, etc. discussed above. In other words, each acquisition cost is based on each individual share. Even if there are multiple short positions over same-issue shares with different unit prices which have not been settled, there is no need to make a calculation using the weighted average cost method, etc., unlike in the case of spot transactions.

Therefore, the amount described in the margin transaction settlement report issued by financial instruments business operators is the amount of the capital gain.

Income generated by share trading through margin transactions/date-of-issue transactions or futures transactions is taxed as income (either business income or miscellaneous income) for the year in which the settlement date of such margin transactions, etc. falls.

d. Treatment Where the Computation of the Acquisition Cost Is Difficult

If it is difficult to compute the acquisition cost accurately in accordance with (b) above such as cases where the general shares, etc. were held for a long time or where the general shares, etc. were acquired by inheritance or donation, etc., a tax return may be filed by computing the acquisition cost of the general shares, etc. as an amount equal to 5% of the amount of capital gain in the amount of capital gain, etc.

(2) Self-Assessed Separated Taxation on Capital Gains, Etc. from Listed Shares, Etc.

When a resident, etc. transfers listed shares, etc. on or after January 1, 2016, the capital gains, etc. from the transfer of the listed shares, etc. will be separated from other income, and capital gains, etc. for the year from the transfer of listed shares, etc. will be subject to self-assessed separated taxation at a rate of 15% (and an additional inhabitant tax of 5% if the taxpayer is a resident).

Even in the case of self-assessed separated taxation, the amount obtained by multiplying 2.1% by the amount of base income tax for each year from 2013 to 2037 shall be imposed as a special income tax for reconstruction, together with withholding tax.

The taxation mechanism of this self-assessed separated taxation for capital gains, etc. from listed shares, etc. is almost the same as that of the self-assessed separated taxation for capital gains, etc. from general shares, etc. referred to in (1) above, although their scope of application differs (accordingly, the explanation for overlapping parts will be omitted).

Aggregation between capital gains from the transfer of listed shares, etc. that are subject to this self-assessed separated taxation and the capital gains from transfer of general shares, etc. referred to in (1) above is not permitted.

(i) Scope of Transfer of Listed Shares, Etc.

The scope of listed shares, etc. subject to this self-assessed separated taxation is all transfers of listed shares, etc., in principle, regardless of whether they are sales entrusted to a financial instruments business operator, etc. or negotiated transactions.

However, transfers through the so-called securities futures transactions (the transactions set forth in Article 28, Paragraph 8, Item 3, a. of the Financial Instruments and Exchange Act) are excluded from application of this taxation.

Capital gains, etc. from listed shares, etc. through futures transactions are separately subject to self-assessed separated taxation together with income from commodity futures transactions and financial instruments futures transactions.

Meanwhile, “Acquisition of a corporation’s own shares or capital contributions by a certain method” and “transfer relating to redemption through purchase of bonds” are excluded from the scope of transfer of listed shares, etc. These acts are temporarily excluded from the scope of transfers because the amount received due to acquisition of a corporation’s own shares or capital contributions by a certain method and the amount of redemption money received due to redemption through purchase of bonds are to be deemed to be revenue arising from capital gains, etc. from listed shares, etc.

(ii) Scope of Listed Shares, Etc.

Listed shares, etc. subject to this self-assessed separated taxation are the shares, etc. set forth in (1) (i) above (meaning shares, beneficial interests of bond investment trusts and other shares, etc. subject to taxation on capital gains from shares, etc.) which fall under the following categories:

(Note) The benchmark set for bonds, etc. among the listed shares, etc. subject to this special treatment is that information on the bond issuer is disclosed to the general public and information on the contents of the instruments can be easily obtained, so that fair access is ensured for general individual investors.

a. Shares, etc. listed on a financial instruments exchange and shares, bonds, etc. equivalent thereto as shown below:

(a) Shares registered as issues registered for over-the-counter trading (including capital contributions and investment units of investment corporations), over-the-counter convertible type bonds with share options (meaning bonds with share options that have been designated by an authorized financial instruments business association, in accordance with the rules it defined, as bonds whose sales prices for over-the-counter trading shall be publicized and for which materials concerning the issuing corporation of bonds with share options shall be open to the public);

(Note) The bonds with share options mentioned above include the convertible specified bonds and the specified bonds with preferred equity subscription rights under the Act on the Securitization of Assets.

(b) Shares (including capital contributions and investment units of investment corporations) of over-the-counter managed issues (meaning shares which have been delisted from a financial instruments exchange or whose registration as issues registered for over-the-counter trading has been canceled and which have been designated by an authorized financial instruments firms association in accordance with the rules it defined);

(c) Bank of Japan contribution certificates registered in a register kept at an authorized financial instruments business association as registered issues in accordance with the rules defined by the authorized financial instruments business association; and

(d) Shares, etc. traded on a foreign financial instruments market.

b. Beneficial interests of investment trusts for which the offering of beneficial interests upon establishment has been conducted through a certain type of public offering (excluding specified share investment trusts);

(Note) "Certain type of public offering" above is the same as public offering of publicly offered investment trusts which are subject to the special treatment of taxation on dividend income, etc. from listed shares, etc.

c. Investment units of specified investment corporations;

(Note) The specified investment corporations above are the same as specified investment corporations which are subject to the special treatment of taxation on dividend income, etc. from listed shares, etc.

d. Beneficial interests of specified trusts issuing beneficiary certificates (limited to those for which the offering of the beneficial interests to be acquired by the settlor at the time of conclusion of the trust agreements has been conducted through a certain type of public offering);

(Notes) 1. "Certain type of public offering" mentioned above is the same as public offering of publicly offered investment trusts which are subject to the special treatment of taxation on dividend income, etc. from listed shares, etc.

2. "Specified trusts issuing beneficiary certificates" refers to specified trusts issuing beneficiary certificates prescribed in Article 185, Paragraph 3 of the Trust Act, which meet all of the following requirements:

(i) The trust has been accepted by a corporation that has obtained approval from the district director of the tax office to the effect that the corporation meets certain requirements for carrying out trust affairs;

(ii) It is provided by the terms of trust that the ratio of the amount calculated as the amount of undistributed profit at the end of each accounting period to the total amount of principal as of that time (hereinafter referred to as the "retained profit ratio") shall not exceed 2.5%;

(iii) The calculated retained profit ratio has not exceeded 2.5% at any time the retained profit ratio has been calculated, prior to the start of each accounting period;

(iv) The accounting period does not exceed one year; and

(v) The trust has never fallen under the category of trusts for which there are no beneficiaries (limited to those who actually hold the rights of a beneficiary).

e. Corporate bond-type beneficial interests of specified purpose trusts (limited to those for which the offering of the corporate bond-type beneficial interests held by the originator at the time of conclusion of the trust contract has been conducted through a public offering);

(Note) The publicly offered corporate bond-type beneficial interests above are the same as publicly offered corporate bond-type beneficial interests which are excluded from the separated taxation, etc. for dividend income from distributions of earnings from privately placed bond investment management trusts, etc.

f. National government bonds and municipal bonds;
g. Bonds issued or guaranteed by a foreign state or local public entity thereof;
h. Bonds that a corporation other than a company issues under special Acts (excluding those pertaining to foreign corporations, investment corporation bonds, short-term investment corporation bonds, specified bonds under the Act on the Securitization of Assets and specified short-term bonds under the said Act);

(Note) Specifically, they include such bonds as the so-called FILP agency bonds and bonds issued by an incorporated administrative agency based on the Act governing its establishment. If investment corporation bonds or specified bonds fall under another category, such as those issued by public offering, they will be categorized as listed shares, etc.

i. Bonds for which public offering of securities at the time of their issuance was conducted through a certain type of public offering;

This "bonds for which public offering of securities was conducted through a certain type of public offering" means bonds for which public offering was conducted through the following solicitation of offers to acquire in the respective cases set forth therein:

(a) In the case where the public offering of the bonds is made in Japan

Where the solicitation of offers to acquire prescribed in Article 2, Paragraph 3 of the Financial Instruments and Exchange relating to the public offering falls under the cases set forth in Item 1 of the said Paragraph (cases where the solicitation is issued to a large number of persons, but excluding cases where the solicitation is made only to qualified institutional investors) and where the fact that the solicitation of offers to acquire falls under the cases set forth in the said Item is stated in the prospectus; and

(b) In the case where the public offering of the bonds is made outside Japan

Where the solicitation of offers to acquire relating to the public offering is equivalent to solicitation that falls under the cases set forth in Article 2, Paragraph 3, Item 1 of the Financial Instruments and Exchange Act and the fact that the solicitation of offers to acquire is equivalent to that which falls under the cases set forth in the said Item is stated in the prospectus or a document equivalent thereto.

j. Corporate bonds issued by a corporation which has submitted a registration statement, securities report, quarterly report, semiannual report, foreign company registration statement, foreign company report, foreign company quarterly report or foreign company semiannual report (hereinafter referred to as a "securities report, etc.") to the Prime Minister, pursuant to the provisions of the Financial Instruments and Exchange Act, within nine months (within 12 months in the case of a foreign corporation) prior to the issuance;

(Notes) 1. Specifically, these bonds include privately placed bonds issued by a company that lists its shares on a financial instruments exchange and corporate bonds issued by a company that does not list its shares on a financial instruments exchange but submits a securities report, etc.

2. Under the Financial Instruments and Exchange Act, the time limit for submission of a securities report or semiannual report, etc. is within three months (within six months in the case of a foreign corporation) after the end of the business year. However, the time limit of "within nine months" is specified here in consideration of a situation where a domestic corporation whose business year ends in March submits its semiannual report for the April-September 2016 term on October 1, 2016 and submits its securities report for FY2016 on June 30, 2017, in which case there will be approximately a nine-month interval at the most between the submissions.

k. Bonds which are issued on a financial instruments exchange (including an equivalent thereto that was established under laws and regulations of a foreign state) based on bond information (meaning the classes and the total issue value of bonds that are issued within a certain period, the financial conditions and the business details of the issuer of the bonds, and other basic information about the bonds and the issuer that should be clarified) published under rules of the said financial instruments exchange and for which the prospectus prepared at the time of their issuance states that the said bonds are issued base on the said bond information;

> (Note) This bond information includes the program information on the TOKYO PRO-BOND Market Rule (Article 2, Item 41 of the Special Regulations of Securities Listing Regulations Concerning Specified Listed Securities) and the MTN (medium-term note) program on the European market.

l. The following bonds issued outside Japan;

(a) Bonds acquired in response to secondary distribution of securities (limited to secondary distribution where the offer to sell, etc. falls under a certain case) (referred to as “bonds acquired through secondary distribution” in (b)) that are continuously entrusted to the custody of the financial instruments business operator (limited to one engaged in type I financial instruments business), registered financial institution, or settlor company of an investment trust (hereinafter referred to as the “financial instruments business operator, etc.”) that made the secondary distribution of securities to be kept at its business office, from the time of the acquisition of the bonds; and

“A certain case” above means a case where the offer to sell, etc. prescribed in Article 2, Paragraph 4 of the Financial Instruments and Exchange Act relating to secondary distribution of securities falls under the cases set forth in Item 1 of the said Paragraph (cases where the offer to sell, etc. is made to a large number of persons, but excluding cases where the offer to sell, etc. is made only to qualified institutional investor) and where the fact that the offer to sell, etc. falls under the cases set forth in the said Item is stated or recorded in the prospectus or the foreign securities information.

> (Note) “Foreign securities information” above means information about securities sold through secondary distribution of foreign securities and about the issuer of the securities that must be disclosed (Article 27-32-2, Paragraph 1 of the Financial Instruments and Exchange Act).

(b) Bonds acquired in response to the offer to sell, etc. prescribed in Article 2, Paragraph 4 of the Financial Instruments and Exchange Act (excluding bonds acquired through secondary distribution) issued by a corporation which has submitted a securities report, etc. within nine months (within 12 months in the case of a foreign corporation) prior to the day of the acquisition (limited to those that are continuously entrusted to the custody of the financial instruments business operator, etc. that made the offer to sell, etc. to be kept at its business office, from the time of the acquisition of the bonds).

> (Notes) 1. The bonds referred to in (a) above include bonds issued outside Japan which are sold by a domestic financial instruments business operator, etc. through secondary distribution to a large number of persons (50 persons or more). The bonds referred to in (b) above include bonds issued outside Japan which are sold by a domestic financial instruments business operator, etc. through secondary distribution to less than 50 persons and which have been issued by a company that has submitted a securities report, etc. within nine months (within 12 months in the case of a foreign corporation) prior to the day of the acquisition.

2. "Bonds issued outside Japan" mentioned in l. above refers to public and corporate bonds for which public offering or secondary distribution has been conducted outside Japan, not limited to those denominated in foreign currency.
3. If bonds acquired in response to secondary distribution of securities mentioned in (a) above or bonds acquired in response to the offer to sell, etc. mentioned in (b) above are not continuously entrusted to the custody of the financial instruments business operator that made the secondary distribution of securities or the offer to sell, etc. (hereinafter referred to as "secondary distribution of securities, etc.") in order to be kept at its business office from the time of the acquisition of the bonds, these bonds are deemed not to fall within the categories mentioned in l. above. Consequently, if, due to the change, etc. of the financial instruments business operator, etc. dealing in the bonds, the relevant bonds are not deemed to have been continuously entrusted to the custody of the financial instruments business operator that made the secondary distribution of securities, etc. in order to be kept at its business office from the time of the acquisition of the bonds, these bonds are deemed not to fall within the said categories. However, those bonds that have been transferred from another business office of the financial instruments business operator, etc. that made the secondary distribution of securities, etc. are treated as having been continuously entrusted to the custody of the said financial instruments business operator, etc. in order to be kept at its business office.

m. The following bonds issued or guaranteed by a foreign corporation:
(a) Bonds issued or guaranteed by the following foreign corporations:
[a] A foreign corporation for which 50 percent or more of the capital contributions or obligations were made by a foreign government; and
[b] A foreign corporation established based on the provisions of the special laws and regulations in a foreign state whose business is conducted under the management of the government of the said foreign state.
(b) Bonds issued or guaranteed by an international organization established based on an international agreement between governments.

(Note) As for the actual bonds being distributed, (a) [a] above includes bonds issued by Municipality Finance Plc (Finland), Queensland Treasury Corporation (Australia), etc. (a) [b] above includes bonds issued by FNMA (U.S. Federal National Mortgage Association), GNMA (U.S. Government National Mortgage Association), FHLB (U.S. Federal Home Loan Banks), etc., and (b) above includes bonds issued by the World Bank, International Bank for Reconstruction and Development, Asian Development Bank, etc.

n. Corporate bonds issued by a person engaged in banking business or type I financial instruments business (excluding type I small amount electronic offering handling business operator) or a corporation engaged in banking business or financial instruments business in a foreign state based on laws and regulations of the said state (hereinafter referred to as a "bank, etc.") or any of the persons listed below as an affiliated company of the bank, etc. (excluding certain bonds where in substance the acquirers are not numerous):

(a) Scope of an affiliated company:
The affiliated company mentioned above means any of the following corporations:

[a] A corporation that has a certain relationship whereby a bank, etc. directly or indirectly holds the whole of the issued shares of or capital contributions to the said corporation (such relationship is referred to as "full controlling interest" in [b]) (subsidiary company, second-tier subsidiary company, etc.):

This "certain relationship" means the relationship between a bank, etc. and a corporation whereby the bank, etc. holds the whole of the issued shares of or capital contributions to the corporation (excluding the shares or capital contributions held by the said corporation; hereinafter referred to as "issued shares, etc.") (hereinafter referred to as "direct controlling interest"). In this case, if the bank, etc. and one or more corporations in which the bank, etc. has direct controlling interest jointly hold or one or more corporations in which the bank, etc. has direct controlling interest hold the whole of the issued shares, etc. of the said other corporation, the said bank, etc. is deemed to hold the whole of the issued shares, etc. of the said other corporation.

[b] A corporation other than the bank, etc. in which the parent corporation (meaning a corporation that has a certain relationship whereby it directly or indirectly holds the whole of the issued shares of or capital contributions to the bank, etc.) has full controlling interest (the so-called fellow subsidiary company):

This "certain relationship" means the relationship between a corporation and a bank, etc. whereby the corporation holds the whole of the issued shares of or capital contributions to the bank, etc. (excluding the shares or capital contributions held by the said bank, etc.). In this case, if the said corporation (hereinafter referred to as the "determined corporation") and one or more corporations in which the determined corporation has direct controlling interest (meaning the relationship between the determined corporation and a corporation(s) whereby the determined corporation holds the whole of the issued shares, etc. of the corporation(s)) jointly hold or one or more corporations in which the determined corporation has direct controlling interest hold the whole of the issued shares, etc. of the bank, etc., the determined corporation is deemed to hold the whole of the issued shares, etc. of the bank, etc.

(b) Corporate bonds where in substance the acquirers are not numerous:

"Certain bonds where in substance the acquirers are not numerous" mentioned above are corporate bonds that have been tailor-made since the acquirer is one person or a person related thereto and are not financial instruments in which general individual investors invest, so they are excluded from the scope of the bonds that are regarded as listed shares, etc.

This "certain bonds where in substance the acquirers are not numerous" means corporate bonds where, on the day of issuance of the corporate bonds, all of the corporate bonds have been acquired by one person who has acquired the said corporate bonds (hereinafter referred to as the "acquirer subject to determination") and the following persons:

[a] The following individuals:

i. A relative of the acquirer subject to determination;

ii. A person in a relationship with the acquirer subject to determination where the marital relationship is de facto, though a marriage has not been registered;

iii. An employee of the acquirer subject to determination;

iv. A person other than those set forth in i. through iii. above who maintains his/her living by receiving money or any other assets from the acquirer subject to determination; and

v. A relative of any of the persons set forth in ii. through iv. above who depends on such person for his/her livelihood.

[b] Where the acquirer subject to determination and another person has a relationship whereby either one (if the person is an individual, including any of the individuals set forth in [a] i. through v. above relating to that person) has direct or indirect controlling interest in the other (limited to a corporation), the said other person; and

[c] Where the acquirer subject to determination and another person (limited to a corporation) has a relationship whereby the same person (if the person is an individual, including any of the individuals set forth in [a] i. through v. above relating to that person) has direct or indirect controlling interest in the acquirer subject to determination and the said other person, the said other person.

(Note) The “direct or indirect controlling interest” referred to in [b] and [c] above means a relationship between two persons whereby the former person falls under the category of any of the following corporations in relation to the latter person:

(i) Where the former person controls a corporation (meaning the case of controlling the corporation prescribed in Article 14-2, Paragraph 2, Item 1 of the Order for Enforcement of the Corporation Tax Act), the said corporation;

(ii) Where the corporation set forth in (i) above or (iii) below controls or the former person and the corporation set forth in (i) above or (iii) below jointly control another corporation (meaning the case of controlling another corporation as prescribed in Article 14-2, Paragraph 2, Item 2 of the Order for Enforcement of the Corporation Tax Act), the said other corporation; and

(iii) Where the corporation set forth in (ii) above controls or the former person and the corporation set forth in (ii) above jointly control another corporation (meaning the case of controlling another corporation as prescribed in Article 14-2, Paragraph 2, Item 3 of the Order for Enforcement of the Corporation Tax Act), the said other corporation.

o. Bonds issued on or before December 31, 2015 (excluding those issued by a company that fell under the category of a family company at the time of the issuance).

(Note) Bonds issued on or before December 31, 2015 are regarded as listed shares, etc. even if they do not fall under any of a. through n. above. The question of whether bonds can be regarded as listed shares, etc. is determined based on the conditions, etc. at the time of their issuance, but such conditions, etc. at the time of issuance are not necessarily clear with regard to bonds that were issued before income from transfer of bonds became taxable. Considering such circumstances, bonds issued on or before December 31, 2015 are included in the scope of specified bonds as a transitional measure until the bonds that were already issued by January 1, 2016 are redeemed.

However, corporate bonds issued by a company that fell under the category of a family company at the time of their issuance were excluded from the scope of specified bonds upon the FY2014 tax reform, because when all bonds issued on or before December 31, 2015 were positioned as specified bonds and their interest was to become subject to separated withholding taxation at source at a uniform rate of 20%, etc., family companies rushed to issue corporate bonds by December 2015. Also, it was not desirable to induce such acts from the viewpoint of neutrality of taxation. As a result of this reform, all interest on corporate bonds issued by a family company which are not specified bonds which is to be received by the family company's officer, etc. on or after January 1, 2016 became subject to aggregate taxation. Meanwhile, income arising from transfer of corporate bonds issued by a family company which are not specified bonds on or after January 1, 2016 is subject to self-assessed separated taxation at a rate of 20% as capital gains, etc. from general shares, etc.

(iii) Computation of the Amount of Capital Gains, Etc. from Listed Shares, Etc.

The "amount of capital gains, etc. from listed shares, etc." that is subject to self-assessed separated taxation is the sum of the amount of business income, the amount of capital gains and the amount of miscellaneous income relating to listed shares, etc. The amount of business income, the amount of capital gains and the amount of miscellaneous income are calculated in accordance with the provisions of the Income Tax Act, in principle.

Specifically, for the respective categories of business income, capital gains and miscellaneous income, the amounts of business income, capital gains and miscellaneous income are obtained by deducting the total amount of the acquisition cost of the listed shares, etc., interest on borrowings, commission fees, etc. from the total revenue arising from transfer of listed shares, etc. in accordance with the provisions of laws and regulations related to income tax, and the sum of those amounts is the "amount of capital gains, etc. from listed shares, etc."

a. Revenue

Whereas the revenue of capital gains, etc. from listed shares, etc. is the amount of money to be received during the year in consideration for transfer of the listed shares, etc., a certain amount of money or value of other assets to be received due to grounds such as a merger or company split of the corporation that issued the shares being held and the amount of money and value of other assets to be received due to redemption of the principal of bonds are also to be deemed to be the revenue of capital gains, etc. from listed shares, etc., similar to the case of capital gains, etc. from general shares, etc. This is because, although these are not revenues arising from transfer of shares or bonds, they are found in practice to be capital gains or capital losses from shares or bonds.

(Note) Due to this treatment, profit from redemption of discount bonds and profit from the discount or premium of coupon bonds issued below or above the par value are also to be taxed as capital gains, etc. from listed shares, etc. Thus, when there is a profit, it is subject to self-assessed separated taxation, and when there is a loss, it may be aggregated with other capital gains, etc. from listed shares, etc.

The scope of such amount of money or value of other assets that are deemed to be the revenue of capital gains, etc. from listed shares, etc. is roughly as follows (excluding a part that is deemed to be a dividend upon taxation):

(a) The amount of money, etc. which a shareholder, etc. of a corporation (excluding a public interest corporation, etc.; the same applies hereinafter) receives due to a merger of the said corporation (excluding a merger in which no assets are delivered to a shareholder, etc. of the corporation, except for the shares or capital contributions of either the merging corporation or a corporation that has a relationship with the merging corporation whereby the said corporation directly or indirectly holds all of the issued shares, etc. of the merging corporation);

(b) The amount of money, etc. which a shareholder, etc. of a corporation received due to a split of the said corporation (excluding a split in which no assets are delivered to a shareholder, etc. of the said corporation as assets as consideration for a split prescribed in the Corporation Tax Act, except for the shares of or capital contributions of either the corporation succeeding in the split or a corporation that has a relationship with the corporation succeeding in the split whereby the said corporation directly or indirectly holds all of the issued shares, etc. of the succeeding corporation in the split, and the said shares or capital contributions have been delivered according to the ratio of the number or amount of shares of the split corporation held by each shareholder, etc. to the total number or total amount of the issued shares, etc. of the split corporation);

(c) The amount of money, etc. which a shareholder, etc. of a corporation received due to a share distribution by the said corporation (excluding a share distribution in which no assets have been delivered to a shareholder, etc. of the said corporation except for the shares of or capital contributions to the wholly owned subsidiary corporation, and the said shares or capital contributions have been delivered according to the ratio of the number or amount of shares of a distribution-in-kind corporation held by each shareholder, etc. to the total number or total amount of the issued shares, etc. of the said distribution-in-kind corporation);

(d) The amount of money, etc. which a shareholder, etc. of a corporation receives due to refund of the capital of the said corporation (meaning dividends of surplus of shares (limited to those which are caused by a decrease in the amount of capital surplus) which do not result from a split-off-type company split, and a share distribution) or as residual assets due to dissolution of the said corporation;

(e) The amount of money, etc. which a shareholder of a corporation receives through acquisition of the corporation’s own shares or capital contributions (excluding those acquired through purchase on a market opened by a financial instruments exchange or by another certain method);

(f) The amount of money, etc. which a shareholder of a corporation receives due to cancellation of capital contributions of the said corporation (excluding a cancellation with regard to acquired capital contributions), refund of capital contributions of the said corporation, refund of equity due to the retirement or withdrawal from the corporation, or extinguishment of shares of or capital contributions to the said corporation without the corporation having acquired them;

(g) The amount of money, etc. which a shareholder, etc. of a corporation receives due to an entity conversion of the said corporation (limited to the case where assets other than shares of or capital contributions to the said corporation that has effected the entity conversion are delivered upon the entity conversion);

(h) The sum of the amount of money received due to redemption of the principal of bonds (including redemption through purchase of bonds) and the value of assets other than money (including the amount of money or value of assets other than money that are delivered together with the said money or assets other than money which arises due to fluctuations in the value of the principal);

(i) The amount of money, etc. to be delivered as interest on bonds of the separated interest component (meaning bonds which constituted the interest component of bonds whose principal component and the interest component are separated and traded independently);

(j) The sum of the amount of the money and the value of the assets other than money to be received due to a merger where a holder of share options of the merged corporation in the merger receives money or other assets in lieu of the share options of the merged corporation which the holder of share options had held (excluding the case of receiving only share options of the merging corporation in the merger); and

(Note) (j) above also applies to the case where an investment corporation that issued investment equity subscription rights certificates carries out a merger.

(k) The amount of money which a holder of share options of a corporation that has effected the entity conversion receives due to the entity conversion in lieu of the share options of the corporation which the holder of share options had held.

With regard to redemption or cancellation of investment trusts or specified trusts issuing beneficiary certificates (hereinafter referred to as “investment trusts, etc.”) of which beneficial interests fall under the category of listed shares, etc. or redemption of the principal of corporate bond-type beneficial interests that fall under the category of listed shares, etc., the redemption money or cancellation money shall be deemed to be revenue such as capital gain, as in the case of “a certain amount of money, etc. to be received due to grounds such as a merger or split of the corporation, since the redemption or cancellation is not regarded as a transfer as-is.

(Note) Beneficial interests of investment trusts, etc. that fall under the category of listed shares, etc. or corporate bond-type beneficial interests that fall under the category of listed shares, etc. include beneficial interests of investment trusts, etc. listed on a financial instruments exchange, corporate bond-type beneficial interests, beneficial interests of investment trusts, etc. issued through public offering, and publicly offered corporate bond-type beneficial interests.

With regard to the amount received due to termination or partial cancellation of investment trusts, etc., the Income Tax Act provides that the portion exceeding the amount of the principal of the trust is to be taxed as interest income or dividend income. Therefore, the amount to be taxed as capital gains, etc. should be no more than the amount of the principal of the trust. However, in the case of investment trusts, etc. of which beneficial interests fall under the category of listed shares, etc., such trusts are subject to unification of financial income taxation whereby aggregation of profits and losses may be carried out among the categories of interest income, dividend income and capital gains, etc. under self-assessed separated taxation, so the ultimate tax burden would basically be the same even if the redemption money or cancellation money were entirely deemed to be capital gains, etc.

The specific rules are as follows:

(a) In the case of termination or partial cancellation of investment trusts, etc.:

The sum of the amount of money and value of assets other than money received due to termination of partial cancellation of investment trusts, etc. of which beneficial interests fall under the category of listed shares, etc. is entirely deemed to be revenue arising from capital gains, etc. from listed shares, etc. and is subject to self-assessed separated taxation.

However, when the termination of an investment trust, etc. relates to consolidation of trusts, the amount of money and value of assets other than money received will be taxed as revenue arising from capital gains, etc. only if the termination relates to consolidation of trusts where beneficiaries of the investment trust, etc. have received assets other than beneficial interests of the new trust involved in the said consolidation of trusts (excluding money or other assets to be delivered to the said beneficiaries who oppose the consolidation of trusts as consideration delivered based on their purchase demand). Accordingly, if beneficiaries of the investment trusts, etc. have only received beneficial interests of the new trust involved in the said consolidation of trusts, capital gain taxation is not applied, and taxation is deferred by carrying over the acquisition cost of the beneficial interests of the former trust to the beneficial interests of the new trust.

(b) In the case of a split of a trust relating to a specified trust issuing beneficiary certificates:

When a split of a trust is effected in relation to a specified trust issuing beneficiary certificates of which beneficial interests fall under the category of listed shares, etc., the sum of the amount of money and value of assets other than money received due to the said split is to be deemed to be revenue arising from capital gains, etc. from listed shares, etc., and is subject to self-assessed separated taxation.

However, taxation under this provision is only applicable when, as a result of a split of a trust, beneficiaries of the split trust (meaning a trust that transfers, as a result of a trust split, a part of its trust property as the trust property of another trust managed by the same trustee or a new trust) have received assets other than beneficial interests of a succeeding trust (meaning a trust that receives the transfer of a part of the trust property of another trust managed by the same trustee as a result of a trust split) (such assets exclude money or other assets to be delivered to the said beneficiaries who oppose the trust split as consideration delivered based on their purchase demand in accordance with Article 103, Paragraph 6 of the Trust Act). Accordingly, if beneficiaries of the split trust have only received beneficial interests of the succeeding trust, this provision is no applied, and taxation is deferred by carrying over the acquisition cost of the beneficial interests of the split trust to the beneficial interests of the succeeding trust.

There is no such provision to deem money or assets other than money received as revenue with regard to investment trusts, because it is construed under the Act on Investment Trusts and Investment Corporations that investment trusts cannot be split.

(c) In the case of redemption of the principal of corporate bond-type beneficial interests:

The sum of the amount of money and value of assets other than money received through the redemption of the principal of corporate bond-type beneficial interests that fall under the category of listed shares, etc. is deemed to be revenue arising from capital gains, etc. from listed shares, etc., and is subject to self-assessed separated taxation. This treatment is the same as in the case of redemption of bonds.

Under the Income Tax Act, the portion of the money, etc. received due to termination or partial cancellation of investment trusts, etc. as referred to in (a) or due to a split of a specified trust issuing beneficiary certificates as referred to in (b) above which exceeds the amount of principal of the trust is to be taxed as revenue arising from dividend income, etc. However, the amounts referred to in (a) and (b) above which are to be taxed as revenue arising from capital gains, etc. from listed shares, etc. may be excluded from the portion taxed as revenue arising from dividend income, etc. as a special treatment. In this case, withholding at source and submission of payment records relating to interest and dividends, etc. will be unnecessary, and the amount of such portion will be subject to the requirement for notification by recipients of redemption money of the investment trusts, etc. and the system of payment records.

b. The Amount of the Acquisition Costs, Etc.

With regard to valuation of the cost of shares, etc. that is to be included in necessary expenses in the calculation of the amount of business income, the gross average method is applied under the Income Tax Act, while it is also possible to apply the moving average method instead. Meanwhile, in calculating the business income from transfer of listed shares, etc. which is subject to self-assessed separated taxation, the moving average method may not be selected, and only the gross average method is applied, as in the case of calculation of the business income from transfer of general shares, etc.

Besides the above, matters concerning calculation of the acquisition cost of listed shares, etc. are the same as those for general shares, etc. (see (1) (ii) b. above for details).

c. Others

The amount of capital gains, etc. from listed shares, etc. which is subject to self-assessed separated taxation is the amount of capital gains, etc. from listed shares, etc. that is obtained by deducting costs, etc. from the revenue. Even when the transfer falls under the category of capital gains under the Income Tax Act, the special capital gain deduction of JPY500,000 and the taxation on 50% of the amount of long-term capital gains are not applied.

Capital gains, etc. from listed shares, etc. which are income arising from transfer of a considerable number of shares within a certain period by a certain large shareholder of the issuing corporation whose assets mainly consist of land, etc. continue to be subject to the special treatment of taxation on short-term capital gains from land, etc. as in the past, due to the reason that from a practical standpoint the transfer corresponds to transfer of land, etc. held in the short term.

(iv) Processing in the Case of Capital Losses

When losses arise from transfer of listed shares, etc., the losses may only be aggregated with other capital gains, etc. from listed shares, etc., and they may not be deducted from income other than that arising from capital gains, etc. from listed shares, etc. In other words, when there is any amount of loss in the calculation of the amount of business income, capital gains, or miscellaneous income relating to transfer of listed shares, etc., the amount of loss is to be deducted from the two other amounts of income among these three amounts of income. In doing so, if there is an amount of capital gains, etc. from publicly held or other specified shares,(Note) the amount of loss is to be first deducted from the amount of capital gains from publicly held or other specified shares. The specific calculation method is as follows:

a. Any amount of loss which remains after deduction in the calculation of the amount of “business income” is to be deducted from the following amounts of income in the following order:
   (a) The amount of income relating to publicly held or other specified shares from among “capital gains” and “miscellaneous income”; and
   (b) The amount of income other than that relating to publicly held or other specified shares from among

"capital gains" and "miscellaneous income".

b. Any amount of loss which remains after deduction in the calculation of the amount of "capital gains" is to be deducted from the following amounts of income in the following order:
   (a) The amount of income relating to publicly held or other specified shares from among "business income" and "miscellaneous income"; and
   (b) The amount of income other than that relating to publicly held or other specified shares from among "business income" and "miscellaneous income."

c. Any amount of loss which remains after deduction in the calculation of the amount of "miscellaneous income" is to be deducted from the following amounts of income in the following order:
   (a) The amount of income relating to publicly held or other specified shares from among "business income" and "capital gains"; and
   (b) The amount of income other than that relating to publicly held or other specified shares from among "business income" and "capital gains."

(Note) The "amount of capital gains, etc. from publicly held or other specified shares" above means the amount of capital gains, etc. from transfer of shares, etc. which is subject to the special treatment of taxation on capital gains, etc. from shares issued by a specified small or medium company. This special treatment was abolished upon the FY2008 tax reform, but remains applicable to specified shares of a specified small or medium company which a resident, etc. acquired through payment before April 30, 2008.

If, as a result of the calculation above, there still remains a loss in the calculation of the amount of capital gains, etc. from listed shares, etc., such amount of loss is deemed not to have existed with regard to application of the provisions of the Income Tax Act or other laws and regulations relating to income tax, in principle. However, with regard to aggregation with other income and carry forward deduction of the loss to the following year, it is possible to aggregate the amount of losses on transfer of listed shares, etc. with the amount of dividend income, etc. from listed shares, etc. and make carry forward deduction of losses on transfer of listed shares, etc. for a period of three years (see 1-2 (8) above for details).

(v) Others

Similar to the case of capital gains, etc. from general shares, etc., there are adjustment provisions concerning application of the provisions of the Income Tax Act. The major adjustment provisions are as follows:

a. When determining the income requirements for a spouse living in the same household, qualifying spouse for tax deduction, qualifying spouse for source deduction, qualifying dependent relatives for tax deduction, widows (widowers), working students, etc., the amount of capital gains, etc. from listed shares, etc. is to be included;

b. In calculating the amount of dividend income, interest on liabilities required to acquire listed shares, etc. that have generated the business income, capital gains, or miscellaneous income is excluded from the "interest on liabilities required to acquire shares or any other principal which is to generate dividend income" to be deducted from the revenue from dividends;

c. The amount of capital gains, etc. from listed shares, etc. is not subject to the special capital gain deduction of JPY500,000 and the taxation on 50% of the amount of long-term capital gains;

d. The amount of loss arising in the calculation of the amount of real property income, business income, timber income, or capital gains which is subject to aggregate taxation may not be aggregated with the amount of capital gains, etc. from listed shares, etc.

However, through the measure of aggregation and carry forward deduction of losses on transfer of listed shares, etc., it is possible to aggregate the losses with the amount of dividend income, etc. from listed shares, etc. and make carry forward deduction of the amount of losses on transfer of listed shares, etc. for a period of three years; and

e. The amount of taxable capital gains, etc. from listed shares, etc. is usually the amount of capital gains, etc. from listed shares, etc., but when there is no other income or when there is any amount that remains after deduction from income, such as carry forward deduction of casualty loss that remains after deduction from the amount of gross income, deduction for casualty loss, basic exemption, exemption for spouses, and deduction for dependents, it is possible to deduct the amount of income deduction or the amount that remains after deduction from the amount of capital gains, etc. from listed shares, etc.

(3) Special Treatment of Taxation on Capital Gains, Etc. from Shares, Etc. in the Case Where Specified Management Shares, Etc. Lose Value

The special treatment of taxation on capital gains, etc. from shares, etc. in the case where specified management shares, etc. lose value is applied when a certain situation occurs to a resident, etc. that will be regarded as a case where specified management shares, etc., or bonds held in a specified account have lost the value of shares or bonds, such as completion of liquidation of a domestic corporation that has issued the specified management shares, etc., or bonds held in a specified account. When such situation occurs, the provisions of laws and regulations related to income tax are applied by deeming the occurrence of the situation to be the transfer of the specified management shares, etc., or bonds held in a specified account, and deeming the amount of loss to be the amount of loss arising from the transfer of the specified management shares, etc., or bonds held in a specified account.

Through this special treatment, the loss arising from specified management shares, etc., or bonds held in a specified account losing the value of shares or bonds will be deducted in the calculation of the amount of business income, capital gains, or miscellaneous income from the transfer of listed shares, etc. by being regarded as the amount of loss arising from the transfer of listed shares, etc., and any amount that remains after the deduction will be subject to specific measures such as aggregation and carry forward deduction of losses on transfer of listed shares, etc.

(i) Specified Management Shares, Etc.

"Specified management shares, etc." subject to this special treatment are shares or bonds issued by a domestic corporation which were listed shares, etc. in custody in a specified account (excluding certain shares, etc.) but have ceased to fall under the category of listed shares, etc., and which have continued to be entered or recorded in the book-entry transfer account register (meaning the book-entry transfer account register prescribed in the Act on Book-Entry Transfer of Corporate Bonds and Shares; the same applies hereinafter) relating to the specified management account or whose custody in the specified management account continues to be entrusted after the day on which the shares, etc. ceased to fall under the category of listed shares, etc.

The "certain shares, etc." excluded from the listed shares, etc. in custody in a specified account above are the following listed shares, etc.:

a. Listed shares, etc. in a tax-exempt account or listed shares, etc. in a minor's account which are transferred, based on rules established by the financial instruments exchange on which the said shares, etc. are listed, from the tax-exempt account or the minor's account in which the relevant shares, etc. are held to a specified account, within the period during which the shares, etc. are designated as securities that have been chosen to be delisted (securities to be delisted) or securities with a risk of being delisted (securities under supervision) from the financial instruments exchange; and

b. Listed shares, etc. in a tax-exempt account or listed shares, etc. in a minor's account which are transferred, based on rules established by an authorized financial instruments business association (Japan Securities Dealers Association), from the tax-exempt account or the minor's account to a specified account within a period during which the relevant shares, etc. are designated as shares of over-the-counter managed issues.

(ii) Bonds Held in a Specified Account

The "bonds held in a specified account" mean bonds issued by a domestic corporation which are entered or recorded in the book-entry transfer account register relating to a specified account or whose custody in the specified account has been entrusted.

Bonds which are specified management shares, etc. include bonds, etc. that were listed on a financial instruments exchange but have been transferred to a specified management account due to being delisted, but the bonds held in a specified account include bonds, etc. issued through public offering which are managed in a specified account.

(4) Special Treatment of Aggregation of Capital Losses and Dividend Income, Etc. from Listed Shares, Etc.

This special treatment applies as follows: notwithstanding the principle of taxation on capital gains on shares, etc. under which "any amount of loss arising from the calculation of the amount of capital gains, etc. on listed shares, etc. is deemed not to have occurred" (the second sentence of Article 37-11, Paragraph 1 of the Act on Special Measures Concerning Taxation), if a resident, etc. filing a tax return has incurred any losses on transfer of listed shares, etc. in any year from 2016, an amount equivalent to such capital losses is deducted in the calculation of the amount of dividend income, etc. in connection with listed shares, etc. for the year, up to the amount of dividend income, etc. in connection with listed shares, etc.

(Note) This special rule on netting cannot be used in connection with the portion of years for which aggregate taxation has been selected with respect to the amount of dividend income, etc. in connection with listed shares, etc.

The "amount of loss on transfer of listed shares, etc." subject to the special treatment of aggregation of loss and income shall mean the amount that the resident, etc. is still unable to deduct even after making the deduction in (2) (iv) above in calculating the amount of income on transfer, etc. of listed shares, etc. to be taxed through self-assessed separated taxation, out of the amount of loss that has occurred as a result of transferring the listed shares, etc. set forth below:

(i) Transfer of listed shares, etc. that is carried out by entrustment of sale to a financial instruments business operator (meaning a person who engages in the type 1 financial instruments business; the same applies in (ii)), or a registered financial institution;

(ii) Transfer of listed shares, etc. to financial instruments business operators;

(iii) Certain transfers of listed shares, etc. to a registered financial institution or an investment trust management company;

(iv) Transfers of listed shares, etc. due to a merger, split-off-type company split or any other events involving a corporation that issued the listed shares, etc.;

(v) A transfer by a corporation that issued listed shares, etc. of its listed shares, etc. to a wholly owning parent company in an exchange of shares or in a replacement of shares;

(vi) Transfer, etc. of odd lot shares or other listed shares, etc. similar to the same, pursuant to a buyback request that is made to the corporation that issued the listed shares, etc.;

(vii) Transfer of fractional shares that is made to the corporation that issued the listed shares, etc.;

(viii) Transfer of listed shares, etc. by an auction of listed shares, etc. in connection with fractional shares that is carried out by the corporation that issued the listed shares, etc.;

(ix) Transfer of listed shares, etc. entrusted to a domestic business office of a trust company (including financial institutions engaged in a trust business), which shall be conducted by the entrustment of sales to foreign securities brokers or conducted to foreign securities brokers through such business office; and

(x) Transfer of listed shares, etc. that is deemed to have been made under the system of taxation at the time of moving out from Japan or the system of taxation at the time of the gift, etc.

This special treatment can only be used if a statement to that effect is made on the final tax return, with the attachment of documents such as a detailed statement in connection with calculation of the amount of loss on transfer of listed shares, etc.

(Note) A special treatment has been established which allows losses that could not be deducted by way of aggregation of income above to be carried forward for three years and deducted from capital gains, etc., as a result of transfer of listed shares, etc., as well as amounts of dividend income, etc. in listed shares, etc. (for details, see “(5) Special Treatment of the Carry Forward Deduction of Capital Losses from Listed Shares, Etc.”).

Use of the Dependents Deduction, Etc.

The determination of the income requirement for the spousal deduction and the dependents deduction is calculated on the basis of the amount of income after aggregating income and losses as discussed above.

Moreover, income deduction amounts such as the medical cost deduction or dependents deduction can be deducted from the amount of capital gains on transfer, etc. of listed shares, etc. after the aggregation discussed above if there was no other income during that year or if any part of such deductions remains undeducted from other amounts of income such as general salary income or business income during that year. The amount after this adjustment is referred to as the “taxable capital gains income, etc. on listed shares, etc.” This amount is multiplied by the tax rate to calculate the amount of taxes.

(5) Special Treatment of the Carry Forward Deduction of Capital Losses from Listed Shares, Etc.

In calculating gains from transfer of shares, etc. held by a resident, etc., in principle, loss arising in the calculation of the amount of capital gains from transfer of shares, etc. is deemed “not to have occurred.” However, a special measure has been enacted whereby capital losses on transfer of listed shares, etc. (meaning the amount of losses that could not be deducted from capital gains, etc. on transfer of listed shares, etc. in that year, as a result of aggregation of gains and losses) may, under certain conditions, be carried forward and deducted from the amount of capital gain, etc. from transfer of listed shares, etc., as well as the amount of dividend income, etc. in connection with listed shares, etc. that occur within three years from the year following that year.

(i) Amount of Capital Losses from Listed Shares, Etc.

The "Amount of Capital Losses from Listed Shares, etc." means the amount of loss that has occurred in the transfer of shares, etc. (meaning the transfer of listed shares, etc. as set forth in (4) above), that still cannot be deducted even after making the deduction from the amount of capital gains, etc. on transfer of listed shares, etc., in the year containing the date of transfer (excluding amounts that are deducted from dividend income, etc. from listed shares, etc. in that year if such income exists).

If within a single year there are transfers of both listed shares that are eligible for carry forward deduction and of non-eligible shares, etc., only losses arising from the transfer of the eligible listed shares, etc. will be allowed to be carried forward.

(ii) Method of Carry Forward Deduction

Capital losses arising from listed shares, etc. in any of the three years preceding the year of filing (excluding amounts already deducted pursuant to this concession in any year preceding the year of filing) should first be deducted from the capital gains, etc. on transfer of listed shares, etc., and the remainder that cannot be deducted from this category of income will be deducted from the amount of dividend income, etc. in connection with listed shares, etc.

In this event, if losses on transfer of listed shares, etc. occur in two or more of the three years preceding the year of filing, the deduction is made in order from the oldest year to the most recent.

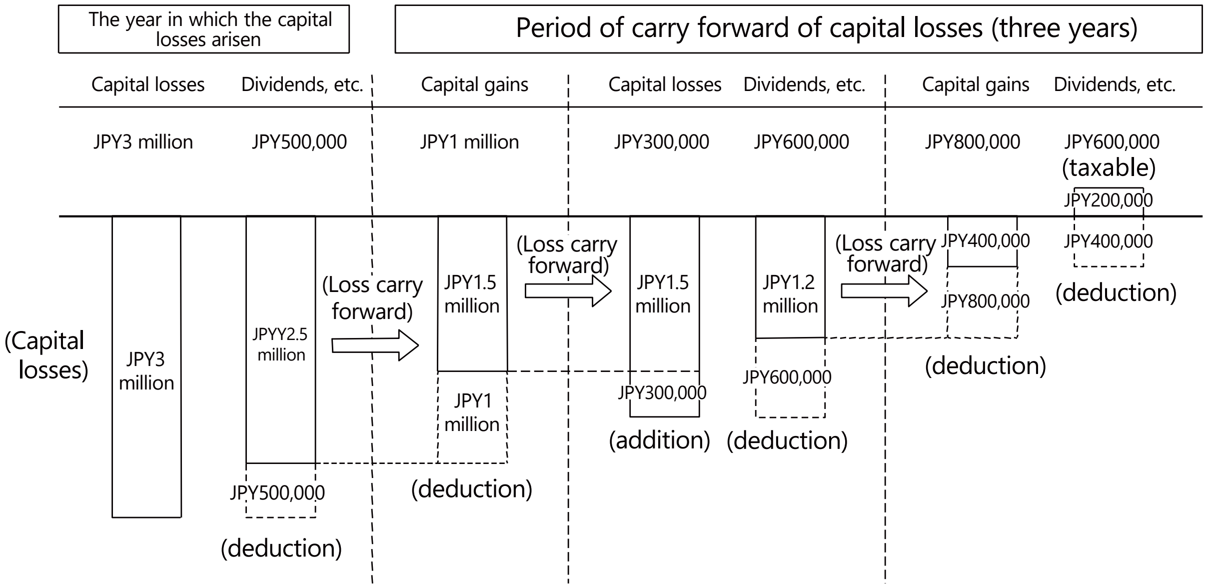
Capital losses from transfer can only be deducted from capital gains, etc. from transfer of listed shares, etc. or dividend income, etc. in connection with listed shares, etc., and cannot be deducted from other income (such as salary income or real estate income).

(Note) If the deduction on carried forward miscellaneous losses is used, this deduction should be taken after taking the carry forward deduction of losses from transfer of listed shares, etc.

(iii) Conditions for Eligibility

In order to be eligible for the carry forward deduction, accounting documents relating to the calculation of the capital loss must be filed together with the final tax return for the year in which the loss arises and for each succeeding year in which the loss is deducted.

Chart 5-8 Aggregation and Carry Forward Deduction of Capital Losses from Listed Shares, Etc.



(Note) In order to carry forward capital losses to the next year, a final tax return must be filed continuously in that year even if no transfer of listed shares, etc. occurred in that year.

(6) Special Treatment for Calculation, Etc. of Income from Listed Shares, Etc. in Custody in Specified Accounts

(i) Outline of Special Treatment

The special treatment described below applies, separately from other listed shares, etc., to the income, etc. from the transfer of listed shares, etc. of which the custody is entrusted by a resident, etc. to specified accounts established at the business office of a financial instruments business operator (hereinafter referred to as "listed shares, etc. in custody in a specified account"):

a. Calculation of income tax on transfers of listed shares, etc. in custody in a specified account may be done on the basis of the amount of income, acquisition cost and other expenses noted in the "Report of annual transactions in specified account" issued by the financial instruments business operator;

b. Withholding taxation at source of capital gains of listed shares, etc. in custody in a specified account may be elected by submitting the form, Notification of election of withholding taxation at source of specified account, or instead of submitting this notification, by providing by electronic or magnetic means the information that is required to be contained in the notification, to the financial instruments business operator with which the specified account is opened; and

c. Income from the transfer of listed shares, etc. in custody in a specified account that has been subjected to withholding taxation at source may be reported without filing a final tax return. If such income is filed in the final tax return, the tax withheld at source will be credited (refunded if it cannot be fully credited) from the amount of reported tax.

These special treatments also apply to the cash used to settle margin transactions or date-of-issue transactions (hereinafter referred to as "margin transaction, etc.") conducted through specified accounts.

(ii) Opening of Specified Accounts and Entrustment of Establishment and Custody of the Account

In order to use this special treatment, a "Specified Account Application" must be submitted to the business office of a financial instruments business operator (limited to those located in Japan) and a "Custodian Agreement for Listed shares, Etc." meeting the eligibility requirements must be entered into. In the case of margin transactions, etc., an “Agreement on Margin Transactions in Listed Shares, Etc.” must be executed.

The account subject to such agreements (“specified account”) is to be used solely for the management of transactions in shares, etc. that fulfill the conditions for special treatment, and transactions involving shares that are ineligible for this treatment must be managed in other accounts (“ordinary account”).

A single individual investor is allowed to open only one specified account with a financial instruments business operator (the “one broker/one account” rule). If the investor retains more than one financial instruments business operator, a separate account can be opened with each one.

However, the head of a business office of a financial instruments business operator, etc. may accept a Specified Account Application, etc. from a resident, etc. who has already opened a specified account if:

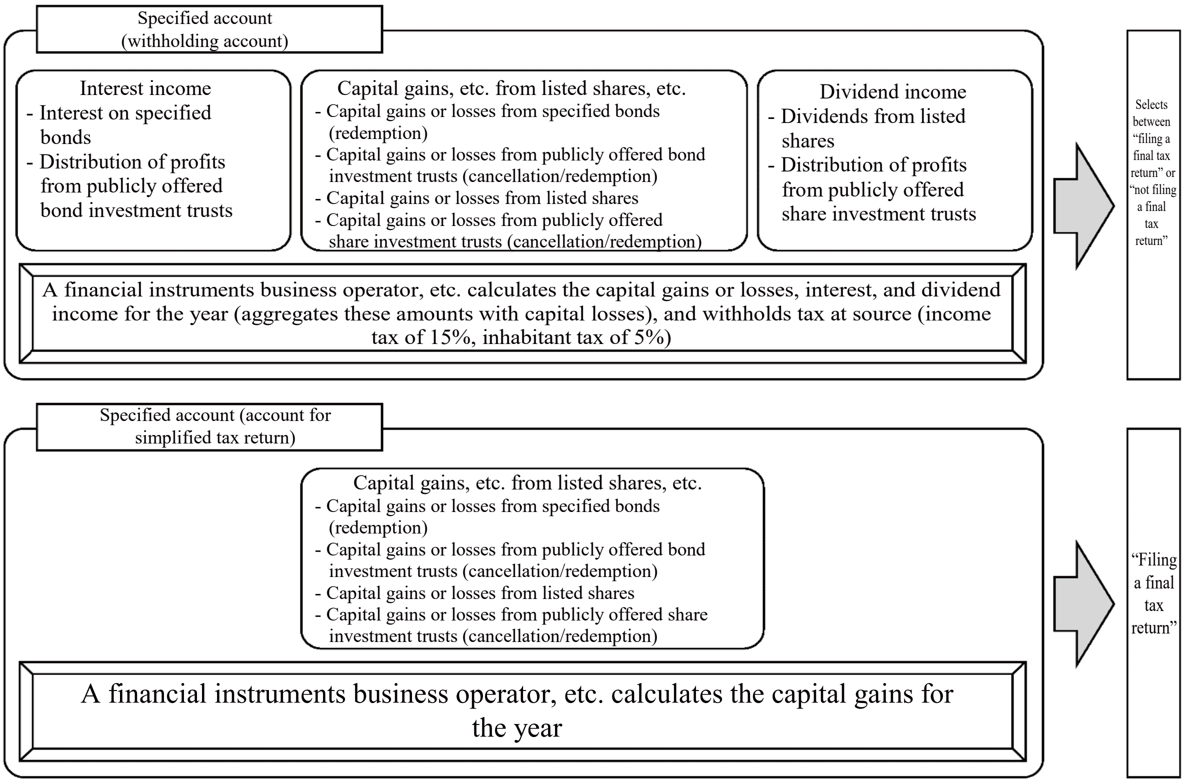
a. The specified account already opened is a taxable minor’s account; or
b. The Specified Account Application has been submitted in order to open a taxable minor’s account.

(Note) Upon submitting the Specified Account Application, the taxpayer must fill in his/her full name, date of birth, residence address and Individual Number, and have his/her identity verified by submitting a copy of his/her residency certificate or other identifying documentation.
Instead of submitting this application, the taxpayer may provide by electronic or magnetic means the information that is required to be contained in the application.

The business office of the financial instruments business operator where shares, etc. are held in custody pursuant to a Custodian Agreement for Listed Shares, Etc., must establish a “specified custody account” in order to segregate records concerning listed shares, etc. under the agreement from other transactions and must monitor the transfer, time of acquisition and sale, sale profits, acquisition cost, etc. of eligible shares. Listed shares, etc. that are acquired must be immediately deposited (placed into custody) into the specified account.

Furthermore, margin transactions, etc. shall be managed in an “account for specified margin transactions, etc.”

Chart 5-9 Specified Accounts from January 1, 2016 Onward



(Note) When filing a final tax return or withholding income tax at source for income arising during the period from 2013 through 2037, special income tax for reconstruction (2.1% of the amount of income tax, in principle) is imposed in addition to income tax.

(iii) The Scope of Listed Shares, Etc. Eligible for Special Account and Transfer

Listed shares, etc. that are accounted for in specified accounts (specified custody accounts) are listed shares, etc. that are subject to self-assessed separated taxation of capital gains, etc. on transfer of shares, etc. (excluding listed shares, etc. acquired by exercising tax-qualified stock options), which fall under any of the following cases.

a. Listed shares, etc. acquired through entrustment, etc. to the relevant financial instruments business operator, etc. with a purchase (including acquisition by way of intermediary, brokerage or agency services for entrustment of the said purchase) or acquired from the relevant financial instruments business operator, etc. after submitting a Specified Account Application, which are accepted in the said account immediately after the acquisition;

b. Listed shares, etc. transferred in the case where listed shares, etc. in custody in a specified account which have been deposited in a specified account opened by the relevant resident, etc. with another financial instruments business operator, etc. are transferred in whole or in part (if the said listed shares, etc. are transferred in part, the transferred listed shares, etc. must include all of the listed shares, etc. in custody in a specified account of the same issue);

c. Listed shares, etc. acquired through the public offering of securities conducted by a financial instruments business operator, etc. with which the specified account has been opened, or listed shares, etc. acquired through the secondary distribution of securities conducted by the said financial instruments business operator, etc.;

d. Among listed shares, etc. purchased in margin transactions conducted via the account for specified margin transactions, etc. established in the specified account, those which have been delivered through the settlement of the said margin transactions and are accepted in the specified custody account by book-entry transfer upon delivery;

e. [i] Listed shares, etc. acquired by way of a gift, inheritance (excluding inheritance subject to qualified acceptance; the same applies in f.) or legacy (excluding universal legacy subject to qualified acceptance; the same applies in f.), which have been listed shares, etc. in custody in a specified account opened by the donor, decedent or universal legator (hereinafter referred to as the “decedent, etc.”; the same applies in f.), listed shares, etc. in a tax-exempt account opened by the decedent, etc., or listed shares, etc. in a minor’s account opened by the decedent, etc., or [ii] listed shares, etc. which have been entered or recorded in a book-entry transfer account register related to an account other than a specified account opened by the decedent, etc. (excluding a tax-exempt account and minor’s account; hereinafter referred to as a “general account for inheritance, etc.”(Note 1)) or for which custody in the said account has been entrusted (limited to those which continue to be entered or recorded in the book-entry transfer account register related to these accounts (hereinafter referred to as an “account for inheritance, etc.”)), where these listed shares, etc. are accepted by transferring them from the account for inheritance, etc. to a specified account opened by the donee, heir or universal legatee (hereinafter referred to as the “heir, etc.”) with the financial instruments business provider, etc. with which the account for inheritance, etc. has been opened, and they satisfy the following requirements:

i) Listed shares, etc. acquired by way of a gift

If all of the listed shares, etc. of the same issue among the listed shares, etc. acquired by way of a gift are transferred from the account for inheritance, etc. to the specified account held by the heir, etc., and the listed shares, etc. thus transferred from part of the listed shares, etc. related to the account for inheritance, etc. (Note 2): the heir, etc. does not hold listed shares, etc. of the same issue as the listed shares, etc. thus transferred to the specified account of the heir, etc.; and

ii) Listed shares, etc. acquired by way of inheritance or legacy

Among the listed shares, etc. acquired by way of inheritance or legacy, all of the listed shares, etc. of the same issue are transferred from the account for inheritance, etc. to the specified account held by the heir, etc.

(Notes) 1. The “general account for inheritance, etc.” means an account, other than a specified account, which has been opened by a donor, decedent, or universal legator (excluding a tax-exempt account and a minor’s account). The same applies hereinafter.

2. The “account for inheritance, etc.” means a general account for inheritance, etc. in the case where, with regard to listed shares, etc. which have been entered or recorded in a book-entry transfer account register related to a general account for inheritance, etc. or for which custody in the said account has been entrusted, such shares continue to be entered or recorded in the book-entry transfer account register related to the said account or their custody in the said account continues to be entrusted. The same applies hereinafter.

f. Listed shares, etc. acquired by way of a gift, inheritance or legacy, which are transferred to the specified account held by the heir, etc. from the specified account opened by the decedent, etc. with a different financial instruments business provider, etc. (limited to those listed shares, etc. that satisfy the requirements mentioned in i) or ii) under e. above).

g. Listed shares, etc. acquired through the split or consolidation of shares or beneficial interests in an investment trust or specified trust issuing beneficiary certificate with regard to listed shares, etc. in custody in a specified account, which are accepted in a specified account by making entries or records in a book-entry transfer account register or entrustment of custody (hereinafter referred to as "entries, etc.");
h. Listed shares, etc. acquired through the allotment of shares without contribution prescribed in Article 185 of the Companies Act, allotment of share options without contribution prescribed in Article 277 of the same Act, or allotment of investment equity subscription rights without contribution prescribed in Article 88-13 of the Act on Investment Trusts and Investment Corporations with regard to listed shares, etc. which have been entered or recorded in a book-entry transfer account register of a financial instruments business provider, etc. with which a specified account has been opened, or listed shares, etc. for which custody is entrusted to the said financial instruments business operator, etc. (excluding listed shares, etc. in a tax-exempt account and listed shares, etc. in a minor's account), where these listed shares, etc. are accepted at the time of allotment by making entries or records in a book-entry transfer account register related to the said specified account or entrusting custody in the said specified account;
i. Shares or capital contributions in a merging corporation or shares or capital contributions in a merging parent corporation acquired with regard to listed shares, etc. in custody in a specified account through a merger of the issuing corporation (limited to certain types of merger in which only either the shares or capital contribution in the merging corporation or the shares or capital contributions in the merging parent corporation are delivered to the shareholders, etc. of the issuing corporation), where these shares or capital contributions are accepted in a specified account by making entries, etc. in a book-entry transfer account register;
j. Beneficial interests in a new investment trust acquired with regard to listed shares in custody in a specified account through the consolidation of investment trusts (limited to certain types of consolidation in which only the beneficial interests in the new investment trust created by the consolidation are delivered to the beneficiaries of the former investment trusts), where these beneficial interests are accepted in a specified account by making entries, etc. in a book-entry transfer account register;
k. Shares or capital contributions in a corporation succeeding in the split or shares or capital contributions in a parent corporation succeeding in the split acquired with regard to listed shares, etc. in custody in a specified account through a split of the issuing corporation (limited to certain types of split in which only either the shares or capital contribution in the corporation succeeding in the split or the shares or capital contributions in the parent corporation succeeding in the split are delivered to the shareholders, etc. of the issuing corporation), where these shares or capital contributions are accepted in a specified account by making entries, etc. in a book-entry transfer account register;
l. Shares or capital contributions in a wholly owned subsidiary corporation acquired by shareholders, etc. of a corporation with regard to listed shares, etc. in custody in a specified account through the share distribution conducted by the said corporation (limited to certain types of share distribution in which only the shares of the wholly owned subsidiary corporation are delivered to the shareholders, etc. of the said corporation), where the shares of the wholly owned subsidiary corporation are accepted in the said specified account by making entries, etc. in a book-entry transfer account register;
m. Shares of a wholly owning parent corporation resulting from share exchange or shares of a parent

corporation of a wholly owning parent corporation resulting from share exchange acquired with regard to listed shares, etc. in custody in a specified account through a share exchange prescribed in Article 57-4, Paragraph 1 of the Income Tax Act, or shares of a wholly owning parent corporation resulting from share transfer acquired with regard to the said listed shares, etc. through a share transfer prescribed in Paragraph 2 of the same Article, where these shares are accepted in a specified account by making entries, etc. in a book-entry transfer account register;

n. Where a merger, split, share exchange or share transfer is carried out with the corporation issuing share options or bonds with share options, which are listed shares, etc. in custody in a specified account, being involved as a merged corporation, split corporation, wholly owned subsidiary corporation resulting from share exchange or wholly owned subsidiary corporation resulting from share transfer (limited to certain types of merger, split, share exchange or share transfer in which only the share options or bonds with share options of the merging corporation, corporation succeeding in the split, wholly owning parent corporation resulting from share exchange or wholly owning parent corporation resulting from share transfer (hereinafter referred to as "share options, etc. of the merging corporation, etc.") are delivered): share options, etc. of the merging corporation, etc. acquired through the said merger, split, share exchange or share transfer, which are accepted in a specified account by making entries, etc. in a book-entry transfer account register;

o. Listed shares, etc. acquired with regard to listed shares, etc. in custody in a specified account through the exercise of the option of shares with put option prescribed in Article 57-4, Paragraph 3, Item 1 of the Income Tax Act, the occurrence of the acquisition event of shares subject to call prescribed in Item 2 of the same Paragraph, the resolution of acquisition of shares subject to class-wide call prescribed in Item 3 of the same Paragraph, or the occurrence of the acquisition event of bonds with share options accompanied by share options subject to call prescribed in Item 6 of the same Paragraph, where these listed shares, etc. are accepted in a specified account by making entries, etc. in a book-entry transfer account register;

p. Listed shares, etc. acquired through the exercise of any of the following rights or the satisfaction of any of the following conditions which triggers acquisition, where all of the listed shares, etc. acquired through the exercise of the right or the satisfaction of the condition which triggers acquisition are accepted at the time of the exercise of the right or the satisfaction of the condition by making entries or records in a book-entry transfer account register related to a specified account or entrusting custody of such shares in a specified account:
    i) The exercise of share options (including the conventional right of conversion of convertible bonds) attached to listed shares, etc. in custody in a specified account;
    ii) The exercise of the right to receive an allotment of shares or exercise of share options (including investment equity subscription rights), where such right or share options have been granted with regard to listed shares, etc. in custody in a specified account (excluding those set forth in iv));
    iii) The exercise of share options which are listed shares, etc. in custody in a specified account, listed shares in a tax-exempt account or listed shares, etc. in a minor's account;
    iv) The exercise of the rights under Article 84, Paragraph 2, Items 1 to 4 of the Order for Enforcement of the Income Tax Act (limited to those to which the same Paragraph applies); or
    v) Satisfaction of the condition which triggers acquisition or the exercise of share options subject to call prescribed in Article 57-4, Paragraph 3, Item 5 of the Income Tax Act, where such share options

have been granted with regard to listed shares, etc. in custody in a specified account;

q. Listed shares, etc. acquired through the public offering of securities conducted by a financial instruments business operator, etc. with which a specified account has been opened, or listed shares, etc. acquired through the redemption of bonds under agreement on redemption of listed shares, etc. (exchangeable bonds) which have been acquired from the said financial instruments business operator, etc. and which have continued to be entered or recorded in a book-entry transfer account register related to the said account or for which custody in the said account has continued to be entrusted since the day following the date of acquisition, where these listed shares, etc. are accepted by making entries, etc. in a book-entry transfer account register;

r. Listed shares, etc. acquired through the exercise of rights or performance of obligations in the transactions set forth in Article 28, Paragraph 8, Item 3 (c) of the Financial Instruments and Exchange Act (what is generally called securities options transactions) which have been conducted via an account opened with a financial instruments business operator, etc. with which a specified account has been opened, where these listed shares, etc. are accepted by making entries, etc. in a book-entry transfer account register;

s. Listed shares, etc. which have been entered or recorded in a book-entry transfer account register related to a departure account opened upon establishing a specified account or which have been in custody in the said departure account (excluding listed shares, etc. of the same issue as the listed shares, etc. accepted in the departure account or withdrawn from the departure account after the departure), where all of these listed shares, etc. are accepted by transferring them from the said departure account to the said specified account by submission of a “written request for transfer of listed shares, etc. in custody in a departure account”;

t. Where listed shares, etc. in custody in a specified account are lent to a financial instruments business operator, etc. with whom the specified account has been opened: listed shares, etc. of the same issue as the said listed shares, etc. in custody in the specified account, which are returned under the securities lending agreement and accepted by making entries, etc. in a book-entry transfer account register;

u. Shares, etc. other than listed shares, etc., where all of the shares, etc. of the same issue as the said shares, etc. which are held on the day preceding the day of listing of the said shares, etc. are accepted on the day of the listing, etc., by making entries or records in a book-entry transfer account register related to a specified account (limited to a specified account in the case where documents including a document certifying the date of acquisition of the said shares, etc. and the amount incurred for the acquisition are submitted to the head of the business office of the financial instruments business operator, etc. with which the specified account has been opened) or entrusting custody in a specified account;

v. Shares or capital contributions in a merging corporation or shares or capital contributions in a merging parent corporation which are acquired with regard to shares, etc. other than listed shares, etc. by the shareholders, etc. through a merger of the issuing corporation of the said shares, etc. (limited to certain types of merger in which only either the shares or capital contribution in the merging corporation or the shares or capital contributions in the merging parent corporation are delivered to the shareholders, etc. of the issuing corporation), where all of the shares or capital contributions in the merging corporation or the shares or capital contributions in the parent merging corporation thus acquired are accepted on the day of the merger by making entries or records in a book-entry transfer account register related to a specified account (limited to a specified account in the case where documents including a document certifying the date of acquisition of the said shares, etc. and the amount incurred for the acquisition are submitted to the head of the business office of the financial instruments business operator, etc. with which the specified account has been opened) or entrusting custody in a specified account;

w. Shares or capital contributions in a corporation succeeding in the split or shares or capital contributions in a parent corporation succeeding in the split which are acquired with regard to shares, etc. other than listed shares, etc. by the shareholders, etc. through a split of the issuing corporation of the said shares, etc. (limited to certain types of split in which only either the shares or capital contribution in the corporation succeeding in the split or the shares or capital contributions in the parent corporation succeeding in the split are delivered to the shareholders, etc. of the issuing corporation), where all of the shares or capital contributions in the corporation succeeding in the split or the shares or capital contributions in the parent corporation succeeding in the split thus acquired are accepted on the day of the split by making entries or records in a book-entry transfer account register related to a specified account (limited to a specified account in the case where documents including a document certifying the date of acquisition of the said shares, etc. and the amount incurred for the acquisition are submitted to the head of the business office of the financial instruments business operator, etc. with whom the specified account has been opened) or entrusting custody in a specified account;

x. Shares of a wholly owned subsidiary corporation which are acquired with regard to shares, etc. other than listed shares, etc. by the shareholders, etc. of a corporation through share distribution conducted by the corporation (limited to certain types of share distribution in which only the shares of the wholly owned subsidiary corporation are delivered to the shareholders, etc. of the said corporation), where all of the shares of the wholly owned subsidiary corporation thus acquired are accepted on the day of the share distribution by making entries or records in a book-entry transfer account register related to a specified account (limited to a specified account in the case where documents including a document certifying the date of acquisition of the said shares, etc. and the amount incurred for the acquisition are submitted to the head of the business office of the financial instruments business operator, etc. with which the specified account has been opened) or entrusting custody in a specified account;

y. Shares of a wholly owning parent corporation resulting from share exchange or shares of a parent corporation of a parent corporation acquired with regard to shares, etc. other than listed shares, etc. through a share exchange prescribed in Article 57-4, Paragraph 1 of the Income Tax Act, or shares of a wholly owning parent corporation resulting from share transfer acquired with regard to the said shares, etc. through a share transfer prescribed in Paragraph 2 of the same Article, where all of the shares of the wholly owning parent corporation resulting from share exchange, shares of the parent corporation, or shares of the wholly owning parent corporation resulting from share transfer thus acquired are accepted on the day of the share exchange or share transfer by making entries or records in a book-entry transfer account register related to a specified account (limited to a specified account in the case where documents including a document certifying the date of acquisition of the said shares, etc. and the amount incurred for the acquisition are submitted to the head of the business office of the financial instruments business operator, etc. with whom the specified account has been opened) or entrusting custody in a specified account;

z. Listed shares, etc. which are to be acquired as a result of the exercise of the option of shares with put option, the occurrence of the acquisition event of shares subject to call, or the resolution of acquisition of shares subject to class-wide call with regard to shares, etc. other than listed shares, etc. held by a resident, etc., where all of the listed shares, etc. to be acquired are accepted on the date of acquisition;

aa. Shares, etc. which are to be allotted from a life insurance company upon its conversion from a mutual company to a stock company, where all of the shares thus allotted are accepted on the day of the listing of the said shares by making entries or records in a book-entry transfer account register related to a specified account (limited to a specified account in the case where a certificate of the number of shares allotted is submitted to the head of the business office of the financial instruments business operator, etc. with which the specified account has been opened) or entrusting custody in a specified account;

bb. Shares, etc. which have been allotted from a life insurance company upon its conversion from a mutual company to a stock company (limited to those which are to be entered or recorded in a special account, and including shares acquired due to certain grounds with regard to the shares thus allotted which have been entered or recorded in the special account), where all of the shares thus allotted are accepted within ten years from the day of the allotment by transferring them from the special account to a specified account;

cc. Listed shares, etc. acquired based on an employee shareholding association agreement, etc., which are accepted by book-entry transfer from an employee shareholding association account opened based on the employee shareholding association agreement to a specified account;

dd. Listed shares, etc. acquired based on a stock benefit trust agreement, etc., which are accepted by book-entry transfer from the trustee's account opened based on the stock benefit trust agreement to a specified account;

ee. Specified shares with restriction on transfer, etc. (meaning specified shares with restriction on transfer or taken-over shares with restriction on transfer prescribed in Article 84, Paragraph 1 of the Order for Enforcement of the Income Tax Act) which have continued to be entered or recorded in a book-entry transfer account register related to another specified account or for which custody in such other specified account has continued to be entrusted since the date of acquisition, where all of the said shares are accepted by book-entry transfer from such other specified account;

ff. Listed shares, etc. acquired by a resident, etc. from the issuing corporation, etc. upon providing services to the issuing corporation, etc., which satisfy the following requirements:

i) Those listed shares, etc. that are delivered to the resident, etc. in exchange for the payment of a claim that the resident, etc. is to acquire as the consideration of the provision of the services; and

ii) In addition to those set forth in i) above, those listed shares, etc. that are substantially regarded as consideration for the provision of services.

(Note) "Listed shares, etc. that are substantially regarded as consideration for the provision of services" are listed shares, etc. acquired as remuneration for directors, etc. through the delivery of shares for which payment of money or delivery of property other than money is not required upon the offering of issued shares. This has been made possible through the amendment to the Companies Act (Act No. 70 of 2019).

gg. Listed shares, etc. in a tax-exempt account (meaning those related to a tax-exempt management account, cumulative investment account, specified cumulative investment account or specified tax-exempt management account established within a tax-exempt account), which are accepted by transferring them from the said tax-exempt account to a specified account opened with a financial instruments business operator, etc. with which the said tax-exempt account has been opened, where these listed shares, etc. satisfy certain requirements;

hh. Listed shares in a minor's account, which are accepted by transferring them from the said minor's account to a specified account opened with a financial instruments business operator, etc. with which the said minor's account has been opened, where these listed shares, etc. satisfy certain requirements;

ii. Listed shares, etc. entered or recorded in the book-entry transfer account register related to an account that was opened by submitting a notification of opening of a tax-exempt account but has been treated as not being a tax-exempt account since its opening, where all of the listed shares, etc. are accepted from that account through the book-entry transfer to the specified account opened by the resident, etc. at the business office of the financial instruments business operator, etc. where that account has been opened; and

jj. Listed shares, etc. in custody in a specified account related to a specified account that constitutes a taxable minor's account, where all of the said listed shares, etc. in custody in the specified account are accepted by transferring them to another specified account opened with a financial instruments business operator, etc. with which the said taxable minor's specified account is held as of the day of abolition of the said specified account pursuant to the provisions of Article 37-14-2, Paragraph 5, Item 2(g) or Item 6(e) of the Act on Special Measures Concerning Taxation.

The types of transfer of shares in custody in specified accounts that are covered by this special treatment are limited to, inter alia, the method of entrustment to financial instruments business operators to sell, the method of transfer to a financial instruments dealer, and the method of transfer to the issuing corporation by making a demand, through a financial instruments business operator, for the purchase of fractional shares or odd lots.

(iv) Special Treatment for Computation of Amount of Income

Computation of income from transfer of listed shares, etc. in custody in a specified account is carried out separately for each account, separating the income from transfers of other listed shares, etc., and focusing only on the transfers of the listed shares in custody in the specified account and based on total income, basis (acquisition cost) and other expenses in the relevant account.

Accordingly, for custodian agreements over listed shares, etc., (or in the case of margin transactions, etc., the agreement governing margin transactions, etc., in Listed Shares, Etc.) involving a specified account, there is a requirement that it must be possible to make a fair calculation of income, and to identify the value that is eligible for the special treatment. Moreover, a special account (specified custody account or specified margin transactions account) must be created for this purpose, and must be managed at the business office of the financial instruments business operator, in accordance with the conditions prescribed.

(Note) The basis (acquisition cost) that is the basis of computation of the amount of income of the capital gains from transfer of listed shares, etc. in custody in a specified account is to be computed using a method equivalent to the weighted average cost method, and the cost price of shares outside the specified account held by the taxpayer that are of the same issue as the listed shares, etc. inside the said account will be computed as if they were different issues. For margin transactions, etc., the tax law requires the basis (acquisition expense) to be computed for each issue separately.

If some or all listed shares, etc. in custody in a specified account are withdrawn (other than due to transfer or rollover to another specified account), the financial instruments business operator must give notice in writing to that person of the acquisition price of the shares, etc., withdrawn (computed using the weighted average cost equivalent method as if there had been a transfer) and the date of acquisition thereof. A transfer of shares, etc., that were withdrawn from the specified account will be subject to self-assessed separated taxation, and the individual investor will compute his/her capital gains, etc. on the basis of the acquisition price and date shown in the afore-mentioned notice.

(v) Filing of Annual Trading Report for Specified Account

For each specified account opened in any year, the financial instruments business operator, etc. shall prepare two "**specified account annual trading reports**" noting the name, address and Individual Number (only in the report to be submitted to the competent tax office) of the person opening the account together with the sales amount, acquisition cost, transfer expenses, income amount, amount of differential gain, amount of dividends, etc. and other required particulars of transfers of shares, etc. in that account over the year. One copy of this report shall be submitted to the competent tax office and the other sent to the account holder not later than January 31 in the following year (if a notice of closure of specified account, etc. has been submitted (or if the relevant information is provided by electronic or magnetic means), by the end of the month following the month in which such event occurs). (With the consent of the account holder, the matters required to be noted in the report may be sent by electronic means instead of delivering the paper report.)

When filing a final tax return for the year in which no transfer of shares, etc. has been made other than the transactions in a specified account, the taxpayer may attach the "specified account annual trading report" or a document created by outputting the information recorded in an electronic certificate, etc. by a certain method (if there are two or more specified accounts, the "specified account annual trading report" for each account and the total table thereof), instead of attaching the detailed statement of account of capital gains, etc. from listed shares, etc.

With respect to a specified account which is opened at a financial instruments business operator, etc., and for which there was no trading during the relevant year, the financial instruments business operator, etc. is not required to send the specified account annual trading report for such specified account unless the relevant specified account holder so requests.

(vi) Withholding Tax at Source on Capital Gains from Listed Shares, Etc. in Custody in Specified Accounts

An individual who opens a specified account may opt for a withholding tax to apply to his/her capital gains, etc. on listed shares, etc. held in the specified account or to cash used in settling margin transactions conducted via the specified account by submitting the "notification of election of withholding taxation at source of specified accounts" or providing by electronic or magnetic means the information to be contained in that notification, to the business office of the financial instruments business operator, etc. with whom the account is opened. Such specified account for which withholding at source is elected is referred to as an "elective withholding account."

The submission of the election notification or the provision of the relevant information must be completed no later than the first transfer of listed shares, etc., held in the specified custody account or net cash settlement, whichever comes first, every year for each specified account (if withholding is elected for an account for a particular year, the election cannot be withdrawn during that year).

If an election notification is submitted or the relevant information is provided, the financial instruments business operator, etc. shall, upon the payment of the consideration for the transfer of the listed shares, etc. or the payment of marginal gain in a net cash settlement of a margin transaction, etc. in listed shares, etc. in that year, collect income tax and the special income tax for reconstruction from the capital gain or the differential gain from the net cash settlement and pay the same to the government.

Where income tax and the special income tax for reconstruction are withheld, if tax turns out to have been overpaid upon comparison of the amount of tax on the income derived through the specified account over the whole year, and the total amount of tax withheld on the other hand, such surplus will be refunded by the financial instruments business operator, etc.

This withholding tax collection or refund is performed each day a capital gain occurs upon the revaluation of the capital gains/losses. Each time a withholding tax is either collected or refunded, and any taxes due are paid once per year (single lump-sum payment).

Specifically, the withholding procedures are as follows:

a. Each time the financial instruments business operator pays the proceeds from the transfer of the listed shares, etc. held within a specified account related to an elective withholding account or an amount of cash to settle a transaction, for each specified account, it will compute the total capital gains/losses from the start of the year for the listed shares, etc. (the net income amount in the withholding account), and deduct from the total amount of capital gains/losses including those proceeds the total amount of capital gains/losses immediately prior to the payment of those proceeds or amounts (the net income amount in the withholding account immediately prior to the transaction). If the result is positive (adjusted income amount in the withholding account), the financial instruments business operator withholds (or, in the case of inhabitant tax, special withholding applies) 15.315% in income tax and the special income tax for reconstruction, and 5% in inhabitant tax (capital gain withholding rate);

b. If the result of deducting the net income amount in the withholding account immediately prior to the transaction from the net income amount in the withholding account after the transaction is a negative number, or there is an amount of specified expenses, the financial instruments business operator refunds to the accountholder the amount calculated by multiplying the negative amount or the amount of specified expenses (up to the net income amount in the withholding account related to the last subject transfer, etc. conducted during the year) by the above-mentioned tax rate upon payment of the sales proceeds or cash used to settle the transaction, for an amount up to the maximum of the amounts already withheld; and

(Note) "Specified expenses" are expenses paid by a customer to a financial institution under a discretionary investment contract (meaning a contract under which an investor fully or partly entrusts a financial instruments business operator, etc. with the discretion to make investment decisions, and also entrusts the financial instruments business operator, etc. with the authority necessary to make investments on behalf of the investor based on such investment decisions), such as fixed fee and performance fee.

c. Any remaining amounts after deducting the amount of the refund from the amount of the tax withheld (specially withheld) is paid over to the government by January 10th of the following year.

(vii) Special Treatment of Final Tax Return Non-Filing (Transfer of Listed Shares, etc. Not Required to Be Reported in a Final Tax Return)

The amount of income, etc. or loss realized upon the transfer of the listed shares, etc. held in an elective withholding account is eligible for the final tax return non-filing system. Thus, the taxpayer may elect whether to exclude these amounts when filing his/her final tax return (not include such amounts when computing his/her income on the final return) or to include these amounts on a final tax return.

A separate election may be made for each elective withholding account but cannot be made for only a part of the capital gain or loss for an elective withholding account.

Furthermore, the amount of income, etc. realized upon the transfer of listed shares, etc. held in a specified account for which the taxpayer has made the withholding election and chosen not to file a final tax return for income tax purpose will also be excluded from computations of the income-proportional tax portion of the inhabitant tax, with the taxpayer similarly not being required to file a final tax return.

As this special treatment "may be applied," a taxpayer may choose to file a final tax return to report the amount of income or loss that has arisen even in an elective withholding account, without enjoying this special treatment. The special treatment of non-filing may not be applied in the following cases: [i] netting (offsetting) the amount of income or loss in the elective account against the amount of capital gains, etc. on shares, etc. in an account other than the specified account; or [ii] seeking the application of the special treatment regarding the aggregation and carrying forward of losses on transfer of listed shares, etc. in terms of the amount of income or loss in the elective account.

(7) Special Treatment for Calculation and Withholding, Etc. Regarding Dividends, Etc. Within an Account for Which Withholding Has Been Elected

Under the specified account system, financial instruments business operators, etc. calculate income and perform the tax payment procedure on behalf of investors who have transferred a certain type of listed shares, etc. via specified accounts established with the financial instruments business operators, etc., thereby enabling the investors to complete the tax payment procedure by filing a simple tax return or by using tax withholding (which does not require the filing of a tax return). Among such specified accounts, elective withholding accounts can be used to accept dividends on listed shares, etc., and in accordance with the special rules on the calculation of the amount of dividend income, etc. and the withholding amount, profits and losses on listed shares, etc. can be netted within the elective withholding account to complete the tax payment process.

(i) Receipt of Dividends, Etc. on Listed Shares, Etc. in an Elective Withholding Account

a. Segregated Calculation of Interest Income and Dividend Income Regarding Dividends, Etc. in an Elective Withholding Account

If a resident, etc. has an elective withholding account, the amounts of interest income and dividend income regarding dividends, etc. which the said person receives as payment into this account are to be calculated separately from the amounts of interest income and dividend income regarding interest, etc. and dividends, etc. other than those in an elective withholding account (and in the event that there are interest costs in connection with the dividends, etc., these shall be allocated in accordance with reasonable criteria).

"Dividends, etc. in an elective withholding account" refers to those dividends, etc. on listed shares, etc., that are received into a specified listed shares dividend, etc. account (an account that is for the purpose of segregating the records in connection with dividends on listed shares, etc. from others) that has been created within an elective withholding account pursuant to an agreement delegating receipt of dividends, etc. in listed shares (an agreement in connection with delegating the receipt of dividends, etc. in listed shares, etc.) that has been entered into with the financial instruments business operator, etc. with which the elective withholding account has been opened.

The scope of dividends, etc. on listed shares, etc. is the same as those for dividends, etc. on “listed shares, etc.” that are covered by the special treatment for self-assessed separated taxation on dividend income regarding listed shares, etc. (see 1-3 (3)(i) above for details).

(Note) Only listed shares, etc. for which payment is handled by the financial instruments business operator at which the elective withholding account is opened are eligible to be received into the elective withholding account, and in the event of domestic shares it is necessary to select the “method of distribution proportional to quantity of shares” as the method to receive the dividends.

b. Submission of Notification on Commencement of Receiving Dividends, Etc. in an Elective Withholding Account, and Receipt Thereof

A person who intends to receive the treatment under the special treatment in connection with dividends, etc. on listed shares, etc. must submit a notification of commencement of receiving dividends, etc. in an elective withholding account or provide by electronic or magnetic means the information that is required to be contained in the notification of commencement, to the financial instruments business operator, etc., at which the elective withholding account is opened.

The financial instruments business operator, etc. which has received the notification of commencement or the information to be contained in the notification shall, in the specified account for dividends on listed shares, etc., in connection with the elective withholding account, receive all dividends for which this treatment is to be made among the dividends, etc. in listed shares, etc., for which payment has become fixed on or after the date on which the notification or information has been received.

(Note) Except for cases in which a notice of closing specified account is filed or the information to be contained in the notice is provided by electronic or magnetic means, cancellation of the application of the special treatment is made by filing a notification of termination of receipt of dividends into an elective withholding account or providing by electronic or magnetic means the information to be contained in the notification.

(ii) Special Treatment for Withholding on Dividends, Etc. in an Elective Withholding Account

a. Aggregation of Dividends, Etc. and Losses on Transfer of Listed Shares, Etc.

If losses occur on transfer of listed shares, etc. in an elective withholding account in connection with dividends, etc., the amount of income tax and the special income tax for reconstruction to be collected and paid in connection with the dividends, etc. in the elective withholding account shall be the amount calculated by taking the balance of the amount of dividends, etc. in the elective withholding account minus (net of) the amount of losses on transfer of listed shares, etc., and multiplying this balance by the withholding tax rate of 15.315% (plus 5% inhabitant tax, if the taxpayer is a resident).

The special treatment for non-filing of a final tax return (special treatment for non-filing of a final tax return regarding dividends, etc. on listed shares, etc. (Act on Special Measures Concerning Taxation, art.

8-5)) may also be used with respect to dividends, etc. in an elective withholding account that is covered by these special treatment. Consequently, by using the special treatment of non-filing of a final tax return it is possible to complete the procedures concerning the aggregation of dividends, etc. and losses on transfer of listed shares, within the elective withholding account.

In addition, since this special treatment is special treatment for the calculation of the amount of withholding taxes, if a final tax return is to be filed with respect to these dividends, etc., or losses on transfer even though netting has been carried out within the elective withholding account, the amounts of interest income and dividend income in connection with the dividends, etc. in the elective withholding account, and the amount of losses on transfer of listed shares, etc. shall be calculated based on the amounts prior to netting.

b. Special Treatment for the Due Date of Income Tax, Etc. Withheld

The deadline for payment of income tax and the special income tax for reconstruction that have been withheld and collected in connection with dividends, etc. in accounts for which elective withholding has been selected is, in principle, January 10 of the year following the year containing the date on which collection was carried out.

If the amount that has already been collected in that year at the time of payment of the dividends, etc. into the elective withholding account exceeds the amount of tax that is to be paid under a. above, a refund must be made on the tax equivalent to this excess portion.

(8) Special Tax Treatment for Shares Issued by Specified Small or Medium Sized Companies (So-called Angel Tax System), Etc.

The special treatment described below applies to cases where residents, etc. acquire, by payment of cash (*haraikomi*), certain types of shares ("Specified Shares," "Specified Shares for Establishment," or "Specified New Shares") issued by specified small or medium companies, stock companies categorized as specified new small or medium enterprises, or specified new small or medium companies.

(Note) The types of shares that are eligible for these special treatments ("Specified Shares" or "Specified New Shares" are shares issued upon the establishment of a specified small or medium company or a specified new small or medium company or thereafter; and "Specified Shares for Establishment" are shares issued upon the establishment of a stock company categorized as a specified new small or medium enterprise) are shares acquired for cash (excluding those subject to the application of tax qualified stock options). The shares listed below do not fall within the scope of "acquired for cash":

a. Shares acquired for contribution in kind;
b. Shares acquired by substituted payment in cash upon exercise of rights under bonds with share options, etc.;
c. Shares acquired by exercise of conversions rights of convertible type bonds with share options;
d. Shares acquired from a merging company that is a Specified Small or Medium Company or a Specified New Small or Medium Company on account of an absorption merger;
e. Shares purchased under a negotiated transaction, etc.; and
f. Shares acquired by gift, succession or legacy.

(i) Special Exception Allowing Deduction of Amounts Required to Acquire Specified Shares or Specified Shares for Establishment

If a resident, etc. has acquired Specified Shares or Specified Shares for Establishment for cash, they may deduct the amount necessary to acquire the Specified Shares or Specified Shares for Establishment acquired by cash in that year (limited to specified shares held as of December 31 of that year) in the calculation of the amount of capital gains on transfer of shares, etc. If the acquisition value for the acquired Specified Shares or Specified Shares for Establishment calculated through such deduction exceeds JPY 2 billion, the amount of such excess shall be deducted from the amount incurred for the acquisition.

(ii) Special Exception of Amount of Loss Regarding Shares That Have Lost Their Value

Where a Resident, etc. has acquired Specified Shares by payment of cash and a certain event as specified below occurs between the date of establishment of the specified small or medium company and the day preceding the date of the listing, etc. of the said Shares, that is deemed to constitute loss arising from the Specified Shares losing their value as shares, such as the completion of liquidation of the specified small and medium company, the occurrence of such event will be deemed to be a transfer of the Specified Shares, and that certain amount that is deemed to be the amount of such loss will be deemed to be the amount of loss arising from the transfer of such Shares (capital loss).

(Note) The “specified events” the occurrence of which is deemed to constitute loss arising from the Specified Shares losing their value as shares shall be either of the events described below:

a. The Specified Small or Medium Company that issued the Specified Shares has been wound up (excluding winding-up due to merger) and its liquidation has been completed; or
b. A decision has been made to commence bankruptcy proceedings in relation to the Specified Small or Medium Company that issued the Specified Shares.

(iii) Special Treatment of Carrying Forward of Amount of Capital Loss Relating to Specified Shares

Where a resident, etc. who files a tax return has any amount of capital loss related to Specified Shares, the resident, etc. may deduct such amount when calculating the amount of capital gains, etc. on listed shares, etc. for the year relevant to the tax return, up to that amount of capital gains, etc. on listed shares, etc. Any part of the amount of loss that could not be deducted may be carried forward and deducted from capital gains derived from shares, etc. in each of the three following years, subject to certain conditions.

(iv) Special Treatment of Gift Deduction of Acquisition Amount of Specified New Shares

Residents, etc. who have acquired Specified New Shares of a Specified New Small or Medium Company (limited to Specified New Shares held as of December 31 of that year; referred to as “Deductible Specified New Shares”) by payment shall be permitted to take the gift deduction in connection with the amount required to acquire the Specified New Shares (up to a maximum of JPY 8 million (or JPY10 million for the shares acquired until 2020)).

(Note) The amount required to acquire the Specified New Shares mentioned in (v)b.(g) is still up to JPY10 million for the shares acquired in or after 2021.

The amount of the gift deduction shall be calculated as follows:

$$\text{Amount of Gift Deduction} = \underbrace{\left(\begin{array}{l}\text{The amount of}\\ \text{the gift}\\ \text{deduction that is}\\ \text{spent within the}\\ \text{year}\end{array} + \begin{array}{l}\text{The amount required to}\\ \text{acquire the Deductible}\\ \text{Specified New Shares that}\\ \text{were acquired in that year (to}\\ \text{a maximum of JPY 8 million}\\ \text{(or JPY10 million for the}\\ \text{shares acquired until 2020))}\end{array} \right)}_{\text{Maximum of 40\% of gross income, etc.}} - \text{JPY2,000}$$

Shares that are the same issue as the Specified Shares of Sock for which this special treatment has been applied, and are acquired within the same year as that for which the special treatment is applied are not eligible for the Special Exception Allowing Deduction of Amounts Required to Acquire Specified Shares as discussed in (i) above. Moreover, the amounts subject to this special treatment shall be deducted from the acquisition price of shares acquired in each year subsequent to the year receiving this exceptional treatment which are the same issue as the Specified New Shares. Thus, reduction of the acquisition price occurs.

(Note) If a transfer or gift is made by a resident, etc. in a subsequent year to the year in which the same issues are acquired as the Specified New Shares of a Specified New Small or Medium Company, and the transfer or gift becomes known to the Small or Medium Company by way of, *inter alia*, notice pursuant to an agreement in connection with investment, the Specified Small or Medium Company must by January 31 of the year following the year the date to which the Specified Small or Medium Company became aware of the same belongs, notify the competent district director of the tax office having jurisdiction over the Small or Medium Company, stating matters including the fact of having become aware of transfer or gift, the number of shares that are assigned or donated, and the date of the transfer or gift.

(v) Requirements for Application of the Special Treatment

a. The Meaning of Specified Small or Medium Companies and Their Specified Shares

The applicable Specified Shares for (i) through (iii) above are as follows in accordance with the categories of the Specified Small or Medium Companies below:

(a) A stock company that falls within the category of specified new small or medium-sized enterprise as provided in Article 6 of the Small and Medium-sized Enterprises Business Enhancement Act: shares issued by such stock company;

(b) A domestic corporation, being a certain type of stock company that falls within the category of small or medium-sized enterprise for which ten years have not passed since the day of establishment: shares issued by the stock company, which fall under either of the following:

(A) shares acquired under an agreement on a limited liability partnership for investment relevant to a limited liability partnership for investment that meets certain requirements; or

(B) shares acquired by a person engaging in the type I small amount electronic offering handling service (limited to those certified by the Minister of Economy, Trade and Industry) in the course of the service;

(c) A domestic corporation, which has been designated under the Act on Special Measures for the

Promotion and Development of Okinawa during the period between April 1, 2014, and March 31, 2025: shares issued by such designated company.

b. Stock Companies Categorized as Specified New Small or Medium Enterprises, and Specified Shares for Establishment

Specified Shares for Establishment to which the special treatment explained in (i) above applies are shares issued by a stock company categorized as a specified new small or medium enterprise under Article 6 of the Small and Medium-sized Enterprises Business Enhancement Act (limited to certain stock companies for which one year has not passed since their establishment) at the time of its establishment.

c. Specified New Small or Medium Companies, and Specified New Shares

A "Specified New Small or Medium Company" in (iv) above shall mean the following stock companies, and "Specified New Shares" shall mean the following shares issued according to the categories of stock companies. Specified New Shares that are covered by this special treatment shall be those acquired by payment at the time of issue of the shares:

(a) A stock company that falls within the category of specified new small or medium-sized enterprise as provided in Article 6 of the Small and Medium-sized Enterprises Business Enhancement Act (limited to certain specified new small or medium-sized stock companies for which one year has not passed since their establishment): shares issued by such stock company;

(b) A domestic corporation, being a certain type of stock company that falls within the category of small or medium-sized enterprise for which five years have not passed since the day of establishment: shares issued by the stock company and acquired under a limited liability partnership agreement for investment relevant to a limited liability partnership for investment (limited to those certified by the Minister of Economy, Trade and Industry);

(c) A domestic corporation, being a certain type of stock company that falls within the category of small or medium-sized enterprise for which five years have not passed since the day of establishment: shares issued by the stock company and acquired by a person engaging in the type I small amount electronic offering handling service (limited to those certified by the Minister of Economy, Trade and Industry) in the course of the service;

(d) A domestic corporation, which has been designated under the Act on Special Measures for the Promotion and Development of Okinawa during the period between April 1, 2014, and March 31, 2025: shares issued by such designated company;

(e) A stock company as prescribed in Article 27-5 of the Act on National Strategic Special Zones: shares which will be issued by such stock company at any time during a period from the day on which the provisions set forth in Article 1, item (i) of the Supplementary Provisions of the Act for Partial Amendment of the Act on National Strategic Special Zones and the Act on Special Zones for Structural Reform become effective (July 25, 2015) to March 31, 2024; and

(f) A domestic corporation, being a stock company prescribed in Article 16 of the Local Revitalization Act and engaged in the business prescribed in that Article: shares issued by such company within the period starting from the date of enforcement of the Act for Partial Amendment of the Local Revitalization Act and ending on March 31, 2024.

(Note) The special system for taxation on the acquisition of shares issued by a company designated for reconstruction was abolished upon the expiration of the designation period (March 31, 2021). Reconstruction shares issued by a company designated for reconstruction before April 1, 2021, are subject to the special taxation system if they are issued during the period from the date of designation until the day on which five years have passed since the date of designation.

d. Scope of Resident, Etc.

The persons eligible for the special treatment described at (i) through (iv) above shall be residents, etc. who have acquired Specified Shares, Specified Shares for Establishment or Specified New Shares by payment of cash; in the case of Specified Shares for Establishment, they are limited to residents, etc. who are incorporators of the stock company.

However, the persons listed below shall not be eligible for the special treatment:

(a) A shareholder of a specified small and medium-sized company or specified new small and medium-sized company that falls within the definition of "family company" as provided in Article 2, Item 10 of the Corporation Tax Act, where such shareholder, if treated as an officer as prescribed in Article 71, Paragraph 1 of the Order for Enforcement of the Corporation Tax Act, would fulfill the conditions listed in Item 5 a. of the said Paragraph;

(b) An individual who, upon the establishment of the specified small and medium-sized company, specified stock company or specified new small and medium-sized company that issues the Specified Shares, Specified Shares for Establishment, or Specified New Shares, transferred the whole of the business that the individual ("Former Business Proprietor") was managing to the specified small and medium-sized company, specified stock company or specified new small and medium-sized company;

(c) A relative, employee, or common-law spouse of a Former Business Proprietor, or a person who is supported by money, etc. received from a Former Business Proprietor or a relative or who shares a common livelihood with any of these persons; and

(d) In addition to the above, a person who has not entered into an agreement providing conditions relating to investment in Specified Shares or Specified Shares for Establishment with a specified small and medium-sized company or specified new small and medium-sized company.

(9) Special Treatment for Taxation on Capital Gains from Transfer of Shares in Exchange for Shares, Etc.

When an individual transfers shares held thereby under the share delivery system prescribed in the Companies Act and receives the delivery of shares of a parent company resulting from a share delivery, such transfer of shares shall be treated as having not occurred and taxation on business income, capital gains and miscellaneous income related to such transfer shall be deferred.

(i) Outline of the System

When an individual has transferred shares held thereby (hereinafter referred to as the "shares held") through a share delivery in which the corporation that issued these shares is involved as a subsidiary company resulting from a share delivery (see Note 1 below), and has received the delivery of shares of a parent company resulting from that share delivery (except in cases where the ratio of the value of the shares of the parent company resulting from the share delivery that have been delivered as a result of the share delivery to the sum of the amount of money and the value of other assets delivered as a result of the share delivery is less than 80 percent (see Note 2 below), or where the parent company resulting from the share delivery falls within the category of a certain family (see Note 4 below) company at the time immediately after the share delivery), such transfer of the shares held shall be treated as having not occurred and taxation on business income, capital gains and miscellaneous income related to such transfer shall be deferred.

However, if the individual has received money or assets other than money through the share delivery (excluding the shares of the parent company resulting from the share delivery), this system applies only to a certain part (see Note 3 below) of the shares held other than the part corresponding to the sum of the amount of money and the value of other assets delivered as a result of the share delivery (excluding the shares of the parent company resulting from the share delivery).

(Notes) 1. "Subsidiary company resulting from a share delivery" refers to a subsidiary company resulting from a share delivery prescribed in Article 774-3, Paragraph 1, Item 1 of the Companies Act, and "parent company resulting from that share delivery" refers to a parent company resulting from that share delivery prescribed in the same item.

2. The value of the shares of the parent company resulting from that share delivery, which serves as the basis for judging whether the ratio mentioned above is "less than 80 percent" is, in principle, assumed to be the value as of the day on which the share delivery takes effect. As long as taxation is not hindered, the value of the shares which served as the basis for calculation of the exchange ratio specified in the share delivery plan related to the share delivery (the value calculated by a reasonable method based on the value of the shares of the parent company resulting from that share delivery as of the calculation reference date) may be used as such value.

3. "A certain part" of the shares held as mentioned above refers to a part of the shares held that have been transferred through a share delivery eligible for this system, which corresponds to the amount calculated by multiplying the value of the shares held by the share delivery ratio. The share delivery ratio is the ratio of the value of the shares of the parent company resulting from that share delivery that have been transferred through the share delivery to the sum of the amount of money and the value of other assets delivered as a result of the share delivery (excluding the sum of the amount of money and the value of other assets delivered as dividend of surplus).

4. The case where the parent company resulting from the share delivery immediately after the delivery falls within the scope of a certain family company means the case where such parent company falls within the category of a "family company." The term "family company" used herein is limited to a company that would still be determined to be a family company even if the determination as to whether it has the status of a family company is made while excluding a corporation (including an association, etc. without legal personality) that is not a family company from among the shareholders, etc. selected as the basis for making such determination. In other words, so-called non-family family companies are excluded. This treatment will start to apply to share deliveries carried out on or after October 1, 2023.

(ii) Acquisition Value of Shares of the Parent Company Resulting from the Share Delivery

In the calculation of the amount of business income, the amount of capital gains or the amount of miscellaneous income from the shares of the parent company resulting from the share delivery that an individual has received through the share delivery eligible for this system, the sum of the following amounts is regarded as the acquisition value of the shares of the parent company resulting from the share delivery:

a. The amount specified in the following according to the categories of cases set forth respectively therein:
   (a) If the individual has received money or assets other than money through the share delivery (excluding the shares of the parent company resulting from the share delivery): the amount calculated by multiplying the acquisition value of the shares held that the individual has transferred through the share delivery by the share delivery ratio relevant to the share delivery; and
   (b) In cases other than the case set forth in (a) above: the acquisition value of the shares held that the individual has transferred through the share delivery; and

b. If the individual has incurred any expenses for receiving the delivery of the shares of the parent company resulting from the share delivery: the amount of such expenses.

(10) Special Treatment for Capital Gains from Share Exchange

(i) Share Exchange

With regard to the shares held by a resident (hereinafter referred to as the "Old Shares"), in each year, the transfer or donation of the Old Shares shall be treated as having not occurred in the following cases: if a resident has transferred the Old Shares through a share exchange (in principle, limited to a qualified share exchange wherein no assets have been delivered other than the shares of either the wholly owning parent corporation resulting from share exchange or a corporation that has a relationship with the wholly owning parent corporation resulting from share exchange whereby it directly or indirectly holds all of the issued shares of the wholly owning parent corporation resulting from share exchange (referred to as the "shares of the wholly owning parent corporation resulting from share exchange, etc.")) carried out by the issuing corporation of the Old Shares to the wholly owning parent corporation resulting from share exchange, and has received shares of the wholly owning parent corporation resulting from share exchange, etc.; or if the resident has ceased to hold the Old Shares due to a specified share exchange without consideration carried out by the corporation issuing the Old Shares.

(Note) 1. "Wholly owning parent corporation resulting from a share exchange" refers to a corporation that becomes the holder of all the issued and outstanding shares of another corporation by acquiring the shares of such corporation by share exchange.
2. "Specified share exchange without consideration" refers to a share exchange wherein assets such as shares of the wholly owning parent corporation resulting from share exchange have not been delivered and the relationship of holding the same ratio of shares among shareholders prescribed in Article 4-3, Paragraph 18, Item 2 of the Enforcement Order of the Corporation Tax Act exists between the wholly owned subsidiary company resulting from a share exchange and the wholly owning parent corporation resulting from share exchange, which is specified as a share exchange for which the delivery of shares of the wholly owning parent corporation resulting from share exchange is found to have been omitted.

(ii) Share Transfer

If a resident assigns the shares owned by the resident through a share transfer (in principle, limited to a qualified share exchange where no assets other than shares of the wholly owning parent corporation resulting from share exchange are delivered) carried out by the issuer of the Old Shares, to a company that will become a wholly owning parent company under the share transfer and the resident receives shares in the said wholly owning parent company under the share transfer, the transfer of the Old Shares shall be treated as having not occurred.

(Note) A "wholly owning parent company under the share transfer" here refers to a company that becomes the holder of all the issued and outstanding shares of another company by acquiring the shares of such company by means of a share transfer.

(iii) Transfers for Other Reasons

If a resident assigns securities listed at (a) through (f) below for the respectively noted grounds (events) and moreover for that reason receives shares of the corporation that is being acquired (except in cases where it is determined that the price of the shares, etc. received is not roughly the same as that of the securities assigned), the transfer will be deemed not to have occurred:

a. Shares with a put option (*shutoku seikyūkentsuki kabushiki*): exercise of the right to demand repurchase, in cases where only shares of the corporation are delivered as the consideration upon the exercise of the right;
b. Shares subject to call (*shutoku jōkōtsuki kabushiki*): occurrence of an acquisition event, in cases where only shares of the corporation are delivered as the consideration upon the occurrence of the acquisition event;
c. Classes shares subject to wholly call: the resolution for acquisition, in cases where by virtue of such resolution, as the consideration, only shares of the corporation are delivered;
d. Bonds with share options: exercise of the warrants, in cases where shares of the corporation are delivered, as consideration for the acquisition, upon the exercise of warrants;
e. Share options subject to call: occurrence of an acquisition event, in cases where only shares of the corporation is delivered as the consideration, upon the occurrence of the acquisition event; and
f. Bonds with share options subject to call: occurrence of an acquisition event, in cases where only shares of the corporation is delivered, as the consideration for acquisition, upon the occurrence of the acquisition event.

(11) Taxation at the Time of Moving Out from Japan

Taxation at the time of moving out from Japan was introduced upon the FY2015 tax reform. Under this system, if a certain resident who moves out from Japan (meaning losing the domicile or residence in Japan) on or after July 1, 2015 owns, etc. target assets with a value of JPY100 million or more, the unrealized profits on the target assets will be subject to income tax and the special income tax for reconstruction.

Also, in the case where a certain resident who owns, etc. target assets with a value of JPY100 million or more transfers all or part of the target assets to a relative, etc. living outside Japan (nonresident) as a gift, inheritance, or testamentary gift, the unrealized profits on the target assets that were transferred as a gift, inheritance, or testamentary gift will be subject to income tax and the special income tax for reconstruction.

(i) Person Subject to Taxation at the Time of Moving Out from Japan

A person subject to taxation at the time of moving out from Japan is a resident who meets both of the conditions set forth in a. and b. below at the time of moving out from Japan:

a. A person who owns, etc. target assets for which the total value is JPY100 million or more

b. A person who has had a domicile or residence in Japan for more than five years within ten years prior to the day of moving out from Japan, in principle

A person subject to taxation at the time of moving out from Japan needs to follow procedures including the filing of a final tax return for income tax. In certain cases, the person may receive such measures as a grace of tax payment and reduction of the tax amount (hereinafter referred to as the “tax reduction measures, etc.”). Both of these tax reduction measures, etc. require certain procedures to be followed by the time of moving out from Japan, such as submitting a written notification of the tax agent to the competent district director of the tax office.

(ii) Target Assets

Target assets of taxation at the time of moving out from Japan are securities (shares, investment trusts, etc.), equity investments based on silent partnership contracts, and unsettled margin transactions, when-issued transactions, and derivative transactions.

(iii) Procedures for Final Tax Return and Tax Payment, Etc.

The following procedures are required to be completed according to the following categories of the persons subject to taxation at the time of moving out from Japan:

a. If the person has submitted a notification of a tax agent by the time of moving out from Japan:

The person must file a final return and pay tax for each type of income for the year when the person moves out from Japan, including income subject to taxation at the time of moving out from Japan, by the due date for filing of a final return for the year (March 15 of the following year); the person may be granted a grace period of tax payment by following the predetermined procedure; or

b. If the person has not submitted a notification of tax agent by the time of moving out from Japan:

The person must file a quasi-final return and pay tax for each type of income for the period from January 1 to the date of moving out of Japan, including income subject to taxation at the time of moving out from Japan, by the time of moving out from Japan.

(iv) Grace of Tax Payment

If a person who has made notification of a tax agent by the time of moving out of Japan files a tax return by the deadline for filing a return and posts collateral equivalent to the amount of the portion of income tax eligible for a grace of tax payment and interest tax, the person is granted a grace period of five years from the time of moving out of Japan for the payment of the said amount of income tax (during the grace period, a notification of continued application must be submitted by March 15 (the following Monday if the date falls on a Saturday or Sunday) of each year). If the person needs to stay outside Japan for a long term, the grace period may be extended by another five years by making notification of extension of the grace period.

(Note) If a certain situation, such as transfer of the target assets, occurs during the grace period, the tax amount under a grace period (including the amount of interest tax for the elapsed grace period) relating to the target assets for which such situation occurred must be paid within four months from the day on which such situation occurred.

When a person related to a startup company moves out from Japan along with the company’s overseas expansion, and the person is subject to the system of taxation at the time of moving out from Japan, the person may be granted a grace period by submitting to the district director of the tax office having jurisdiction over the place for tax payment a prescribed document by which the person promises to furnish the unlisted shares, etc. in the company as collateral. In such case, it is not necessary to issue share certificates of unlisted shares when submitting them as collateral, and the equity interest of members in a general partnership company (*gōmei kaisha*), limited partnership company (*gōshi kaisha*), or limited liability company (*gōdō kaisha*) can be furnished as collateral.

(v) Revocation of Taxation on Deemed Transfer, Etc. Under the System of Taxation at the Time of Moving Out from Japan

If a person to whom taxation at the time of moving out from Japan has been applied returns to Japan within five years (or ten years if the person has been granted a grace period for tax payment) from the date of moving out from Japan, taxation on the target assets that the person has continuously held until the time of return may be revoked by deeming that these assets have not been subject to taxation at the time of moving out from Japan.

Also, in the following cases a. and b., taxation on the target assets that have been transferred by way of a gift, inheritance or testamentary gift may be revoked by deeming that these assets have not been subject to taxation at the time of moving out from Japan:

a. If the target assets held at the time of moving out from Japan are transferred to a resident by way of a gift within five years (or ten years if the person has been granted a grace period for tax payment) from the date of moving out from Japan; or
b. If, due to the death of the person who filed a final return for taxation at the time of moving out from Japan, all of the heirs or donees who acquired, by way of inheritance or testamentary gift, the target assets held by that person at the time of moving out from Japan, within five years (or ten years if the person has been granted a grace period for tax payment) from the date of moving out from Japan.

(vi) In Case of Person Moving Out from Japan, with a Plan to Return to Japan Within Five Years

Even in cases where a person who moves out from Japan plans to return to Japan within five years from the date of moving out from Japan, the person is still subject to taxation if the person meets the requirements for taxation at the time of moving out from Japan as of that time.

Therefore, if the person has been treated under the system for taxation at the time of moving out from Japan or granted a grace period for tax payment under the said system, the person must make a request for correction or apply for revocation of the grace period after returning to Japan.

(vii) Procedure for Revocation of Taxation

If a person who has been subject to taxation at the time of moving out from Japan seeks revocation of taxation by reason of his/her return to Japan, the person must make a request for correction within four months after returning to Japan.

(viii) In the Case of Making a Gift, Etc. of Target Assets to a Relative, Etc. Living Outside Japan

If a donor (limited to a person who has had a domicile or residence in Japan for more than five years within ten years prior to the day of making a gift, in principle, and who owns, etc. target assets for which the value is JPY100 million or more at the time of making the gift) makes a gift of all or part of the target assets (hereinafter referred to as “target assets as a gift”) to a relative, etc. living outside Japan (nonresident) on or after July 1, 2015, the unrealized profits on the target assets as a gift is subject to income tax by deeming that the donor has transferred the target assets as a gift at the time of making the gift.

Also, when an heir, etc. living outside Japan acquires all or part of the target assets as an inheritance or testamentary gift (hereinafter referred to as “target assets as an inheritance”) from a decedent (limited to a person who has had a domicile or residence in Japan for more than five years within ten years prior to the day of commencement of inheritance, in principle, and who owns, etc. target assets for which the value is JPY100 million or more at the time of commencement of inheritance), the unrealized profits on the target assets as an inheritance is subject to income tax by deeming that the decedent has transferred the target assets as an inheritance at the time of commencement of inheritance.

The person subject to the respective taxation needs to follow procedures including the filing of a final tax return (quasi-final tax return in the case of an inheritance or testamentary gift) for income tax.

If the system of taxation at the time of the gift, etc. has been applied to the target assets transferred to a nonresident through inheritance or legacy, and the nonresident furnishes collateral worth the amount of income tax eligible for a grace period of tax payment due to the gift or amount of income tax being eligible for such grace period of tax payment due to the inheritance, the nonresident may be granted a grace period for tax payment. In this case, unlisted shares are handled in the same manner as that under the system of the grace period of tax payment explained in (iv) above.

15 Tax Exemption of Dividend Income and Capital Gains, Etc. from Small-Amount Listed Shares, Etc. in Tax-Exempt Accounts

(1) Outline of the NISA Program

The tax exemption scheme for dividend income and capital gains, etc. from small-amount listed shares, etc. received via tax-exempt accounts is a scheme for granting residents, etc. (limited to those who are 18 years of age or older as of January 1 of the year of opening the account) tax exemption for dividends, etc. and capital gains from listed shares and stock investment trusts received via the specified cumulative investment account ("installment investment quota") or specified tax-exempt management account (this is supposed to be established together with a specified cumulative investment account; "growth investment quota") established in the tax-exempt accounts ("NISA accounts") opened at business offices of financial instruments business operators, etc. (including tax-exempt management accounts and cumulative investment accounts established by 2023). Listed shares, etc. may be acquired via tax-exempt accounts.

Through the tax reform in FY2023, the NISA program was fundamentally expanded and made into a permanent program. Under the new program, dividends, etc. and capital gains on listed shares, etc. (listed shares, listed ETFs, listed REITs, publicly offered stock investment trusts, etc.) received in the installment investment quota and the growth investment quota established in a tax-exempt account are exempt from taxation. Thus, the NISA account consists of the "installment investment quota," which can be used for long-term, installment and diversified investment in certain types of investment trusts, and the "growth investment quota," which can be used for investment in listed shares. The annual investment limit is JPY1.2 million for the installment investment quota and JPY2.4 million for the growth investment quota. In addition to the annual investment limit, there is a maximum amount of tax-exempt holdings which is set at JPY18 million (of which JPY 12 million is for the growth investment quota). The amount of investment must not exceed this maximum amount. The amount of tax-exempt holdings is reduced when the products held in the NISA account are sold. The reduced portion can be used for new investment in the next year and thereafter up to the annual investment limit.

(Note) 1. Products eligible for investment using the installment investment quota are specified as listed ETFs, publicly offered stock investment trusts, and publicly offered foreign stock investment trusts which have certain characteristics suitable for long-term, installment and diversified investment. Listed shares, REITs, public or corporate bonds, and bond investment trusts, etc. are excluded. Products which have certain characteristics suitable for long-term, installment and diversified investment are limited to those for which the basic terms and conditions of an investment trust managed under instructions from the settlor provide that (i) the trust agreement period is indefinite or 20 years or longer, (ii) the trust property is not managed by conducting derivatives transactions except for certain cases (*e.g.*, hedging transactions), and (iii) the dividends are not paid on a monthly basis, and the products satisfy the requirements specified by Cabinet Office public notice regarding matters such as the indexes to be tracked and the level of fees. A list of products eligible for investment using the instalment investment quota is posted on the website of the Financial Services Agency.

2. Products eligible for investment using the growth investment quota are listed shares, etc., except for public and corporate bonds and bond investment trusts, etc. (i) Shares designated as securities under supervision or securities to be delisted, (ii) investment trusts with a trust period of less than 20 years or monthly-paid investment trusts, and certain investment trusts using derivatives transactions are ineligible for investment using the growth investment quota.

Listed shares, etc. received in a NISA account or a minor's account (Junior NISA account) by 2023 under (a) the tax-exempt scheme for tax-exempt listed shares management agreements ("general-type NISA"), (b) the tax-exempt scheme for tax-exempt cumulative investment agreements ("Dollar-Cost Averaging NISA"), and (c) the tax-exempt scheme for a minor's account management agreements (Junior NISA) may continue to be held in the existing NISA account or Junior NISA account until the period of tax-exempt holding expires. Dividends, etc. and capital gains from these listed shares, etc. are exempt from taxation during this period, but they will be paid out to taxable accounts upon the expiration of the period of tax-exempt holding. Listed shares, etc. held in specified accounts or general accounts or under the general-type NISA, Dollar-Cost Averaging NISA or Junior NISA may not be received in the installment investment quota or the growth investment quota.

New NISA Program

<table>
<tr><th></th><th>Installment Investment Quota</th><th>Combined use allowed</th><th>Growth Investment Quota</th></tr>
<tr><td>Annual investment limit</td><td colspan="2">JPY 1,200,000</td><td>JPY 2,400,000</td></tr>
<tr><td>Period of tax-exempt holding (Note 1)</td><td colspan="2">No limit</td><td>No limit</td></tr>
<tr><td rowspan="2">Maximum amount of tax-exempt holdings (total)(Note 2)</td><td colspan="3">JPY 18,000,000
* Managed under a book value balance method</td></tr>
<tr><td colspan="2"></td><td>JPY 12,000,000 (included in the total)</td></tr>
<tr><td>Account validity period</td><td colspan="2">Permanent</td><td>Permanent</td></tr>
<tr><td>Products eligible for investment</td><td colspan="2">A prescribed scope of investment trusts suitable for long-term, installment and diversified investments
(Same as the scope of products eligible for the existing Dollar-Cost Averaging NISA)</td><td>Listed shares, investment trusts, etc. (Note 3)
(Excluding: (i) securities under supervision or securities to be delisted, (ii) investment trusts with a trust period of less than 20 years or monthly-paid investment trusts, and (iii) certain investment trusts using derivatives transactions)</td></tr>
<tr><td>Eligible age</td><td colspan="2">18 years or older</td><td>18 years or older</td></tr>
<tr><td>Relationship with the existing NISA</td><td colspan="3">The products in which investment has been made under the existing general-type NISA or Dollar-Cost Averaging NISA before the end of 2023 are outside the framework of the new program and the existing tax exemption rules are applicable.
* Rollover from the existing program to the new program is not allowed.</td></tr>
</table>

(Note 1) Following the abolishment of the limit to the period of tax-exempt holding, the appropriate operation of the program will be ensured by periodically checking the address and other details of users as in the case of the existing Dollar-Cost Averaging NISA.

(Note 2) Regarding the maximum amount of tax-exempt holdings for each user, information provided by financial institutions using a cloud system will be managed by the National Tax Agency.

(Note 3) To prevent financial institutions from engaging in soliciting customers into the practice of churning using the growth investment quota, the Financial Services Agency has revised the supervisory guidelines to implement supervision and monitoring based on laws and regulations.

(Note 4) Regarding products in which investment has been made through Junior NISA before the end of 2023, those persons who made the investment continue to be eligible for tax exemption until the age of 18 after the expiry of the period of tax-exempt holding, which is 5 years, if appropriate procedures are implemented. The need to implement those procedures has been eliminated to improve user convenience.

(Reference) Existing NISA Programs

	Dollar-Cost Averaging NISA (established in 2018)	Optional	General-Type NISA (established in 2014)
Annual investment limit	JPY 400,000		JPY 1,200,000
Period of tax-exempt holding	20 years		5 years
Maximum amount of tax-exempt holdings	JPY 8,000,000		JPY 6,000,000
Account validity period	Until 2023		Until 2023
Products eligible for investment	A prescribed scope of investment trusts suitable for long-term, installment and diversified investments (Limited to investment trusts that satisfy the criteria specified by the Financial Services Agency)		Listed shares, investment trusts, etc.
Eligible age	18 years or older		18 years or older

(Source) Financial Services Agency website (Home page > Policies & Councils > NISA website > What Is NISA? > New NISA) (in Japanese only)

(2) Details of Tax Exemption Measures

(i) Details of Tax Exemption Measures for Dividend Income

No income tax shall be levied on the following dividends, etc. from listed shares, etc. in a tax-exempt account in which a resident, etc. who has opened a tax-exempt account at a business office of a financial instruments business operator, etc. is to receive payment (limited to certain dividends, etc. where the financial business operator, etc. is in charge of payment in Japan).

(a) Certain dividends, etc. from listed shares, etc. in a tax-exempt account related to a tax-exempt management account established in the tax-exempt account, in which the resident, etc. is to receive payment within five years from January 1 of the year in which the tax-exempt management account was established in the tax-exempt account.

(b) Certain dividends, etc. from listed shares, etc. in a tax-exempt account related to a cumulative investment account established in the tax-exempt account, in which the resident, etc. is to receive payment within 20 years from January 1 of the year in which the cumulative investment management account was established in the tax-exempt account.

(c) Certain dividends, etc. from listed shares, etc. in a tax-exempt account related to a specified cumulative investment account established in the tax-exempt account, in which the resident, etc. is to receive payment on or after the day on which the specified cumulative investment account was established in the tax-exempt account.

(d) Certain dividends, etc. from listed shares, etc. in a tax-exempt account related to a specified tax-exempt management account established in the tax-exempt account, in which the resident, etc. is to receive payment on or after the day on which the specified tax-exempt management account was established in the tax-exempt account.

(ii) Details of Tax Exemption Measures for Capital Gains, Etc.

If a resident, etc., who has opened a tax-exempt account at a business office of a financial instruments business operator, etc., has transferred listed shares, etc. in a tax-exempt account in any of the following ways, no income tax may be levied on the business income, capital gains or miscellaneous income from such transfer.

(a) Transfer implemented pursuant to the tax-exempt listed shares management agreement within five years from January 1 of the year in which the tax-exempt management account was established in the tax-exempt account; or

(b) Transfer implemented pursuant to the tax-exempt cumulative investment agreement within 20 years from January 1 of the year in which the cumulative investment account was established in the tax-exempt account.

(c) Transfer implemented pursuant to the specified cumulative investment agreement on or after the day on which the specified cumulative investment account was established in the tax-exempt account; or

(d) Transfer implemented pursuant to the specified tax-exempt cumulative investment agreement on or after the day on which the specified tax-exempt management account was established in the tax-exempt account.

If the amount of income from the transfer of listed shares, etc. in a tax-exempt account pursuant to a tax-exempt listed shares management agreement, tax-exempt cumulative investment agreement or specified tax-exempt cumulative investment agreement is less than the total amounts of costs required for acquiring the listed shares, etc. in the tax-exempt account and for implementing such transfer or necessary expenses for such transfer, such amount of shortfall (or loss) is deemed to have never arisen.

Therefore, no amount of capital loss is eligible for aggregation of profit and loss or deduction for carryover of capital loss from listed shares, etc.

(Notes) 1. The scope of “listed shares, etc.” eligible for this tax exemption scheme is the same as the scope of listed shares, etc. eligible for self-assessed separated taxation on dividend income regarding listed shares, etc., discussed in 1-3(3) above.

2. The “transfer” referred to in the above (ii) includes common types of transfer of listed shares, etc. and also the transfer or extinguishment of rights of the portion corresponding to the amount deemed as the consideration for the transfer of listed shares, etc. if an amount deemed as consideration for transfer of listed shares, etc. arises with respect to the listed shares, etc. due to causes as a corporate merger or corporate split, refund of capital, share distribution, distribution of residual assets, such cancellation and refund of equity contributions, refund of equity interest as a result of withdrawal from a corporation, and entity conversion of a corporation. However, a transfer conducted through securities futures trading is not included in this scope.

3. “Listed shares, etc. in a tax-exempt account” refers to the following listed shares, etc.

(a) Certain listed shares, etc. which are entered or recorded in the book-entry transfer account register for the tax-exempt account pursuant to a tax-exempt listed shares management agreement or which are received in a tax-exempt management account, the custody of which is entrusted to the tax-exempt account;

(b) Certain listed shares, etc. which are entered or recorded in the book-entry transfer account register for the tax-exempt account pursuant to a tax-exempt cumulative investment agreement or which are received in a cumulative investment account, the custody of which is entrusted to the tax-exempt account; and

(c) Certain listed shares, etc. which are entered or recorded in the book-entry transfer account register for the tax-exempt account pursuant to a specified tax-exempt cumulative investment agreement or which are received in a specified cumulative investment account or specified tax-exempt management account, the custody of which is entrusted to the tax-exempt account.

(Reference) **Method of Receiving Dividends, Etc. from Listed Shares, and Taxation on Such Dividends, Etc. via Tax-Exempt Accounts**

Investors may receive dividends, etc. from listed shares by the following methods.

(i) at Japan Post Bank or post offices, etc. (using receipts of dividends);

(ii), (iii) via designated bank accounts (using a registered dividend receiving account or an account designated for each issue(Note 1))

(iv) via transactions accounts held at securities companies (allocated in proportion to the number of shares(Note 2))

However, if investors purchase listed shares via tax-exempt management accounts in tax-exempt accounts and receive dividends, etc. by method (i) (at Japan Post Bank or the post office, etc., or method (ii) or (iii) (via designated bank accounts), such dividends, etc. are not eligible for tax exemption but subject to withholding taxation at source at a rate of 20%.(Note 3)

When investors receive dividends, etc. by methods (i) to (iii) above, they are not required to file a tax return but if they do so, they may select aggregate taxation and receive a tax credit for dividends, or select self-assessed separate taxation and aggregate any capital loss from listed shares, etc. in the NISA account with the profit and loss from listed shares, etc. held in specified or general accounts or carry it over to the next term.

In any of the cases mentioned in (i) to (iv) above, proceeds from the sale of listed shares, etc. that have been purchased via tax-exempt management accounts in tax-exempt accounts are exempt from taxation.

Method of receiving dividends, etc.	Where to receive	Dividends, etc. received via tax-exempt accounts	Sales proceeds received via tax-exempt accounts
(i) Using a receipt of dividends	At Japan Post Bank or post offices, etc.	20% tax (Note 3) (Incl. local tax)	Tax-exempt
(ii) Using a registered dividend receiving account	Designated bank accounts	20% tax (Note 3) (Incl. local tax)	Tax-exempt
(iii) Using an account designated for each issue		20% tax (Note 3) (Incl. local tax)	Tax-exempt
(iv) Receiving dividends by allocation in proportion to the number of shares	Transaction accounts at securities companies	Tax exempt	Tax-exempt

(Notes) 1. Using a registered dividend receiving account to receive dividends is a method whereby dividends from the issues held by the shareholder, etc. are received via a single bank account. Using an account designated for each issue is a method whereby dividends are received via a bank account

designated by the shareholder, etc. for each issue held by the same.
2. Receiving dividends by allocation in proportion to the number of shares is a method whereby dividends, etc. from listed shares are received via the transaction account held by the shareholder, etc. at a securities company. When this method is selected for receiving dividends, etc. under the NISA scheme, it will automatically be selected as well for receiving dividends, etc. from all listed shares purchased or held via the specified or general accounts other than the NISA account.
3. The tax rate including the special income tax for reconstruction is 20.315% (including local tax).

(3) Tax-Exempt Account

A "tax-exempt account" means an account (limited to accounts in which matters related to transactions other than the transactions based on a tax-exempt listed shares management agreement, tax-exempt cumulative investment agreement and specified tax-exempt cumulative investment agreement are not dealt with) to be used to enter or record listed shares, etc. in the book-entry transfer account register or entrust custody of listed shares, etc., which is opened by a resident, etc. (limited to persons who are aged 18 or older; persons eligible to open NISA accounts in 2024 are those whose date of birth is on or before January 2, 2006; hereinafter simply referred to as persons who are aged 18 or older) as of January 1 of the relevant year) within the following respective periods, pursuant to the following agreements entered into with a financial instruments business operator, etc., for the purpose of enjoying the tax exemption scheme described in (2) above, by submitting a "notification of opening of a tax-exempt account" to the head of the business office of the financial instruments business operator, etc., pursuant to the procedures described in (7) below.

(i) Tax-exempt listed shares management agreement: from January 1, 2014, to December 31, 2023;
(ii) Tax-exempt cumulative investment agreement: from January 1, 2018, to December 31, 2023; or
(iii) Specified tax-exempt cumulative investment agreement: on or after January 1, 2024.

(4) Tax-Exempt Listed Shares Management Agreement

A tax-exempt listed shares management agreement refers to an agreement involving book-entry settlement, etc. of listed shares, etc. entered into by a resident, etc. with a financial instruments business operator, etc. for the purpose of enjoying the tax exemption scheme described in (2)(i)(a) and (ii)(a) above, which describe the following matters. The NISA program under this agreement is called the "general-type NISA."

(i) Book-entry settlement, etc. of listed shares, etc. must be made on a tax-exempt management account established in the tax-exempt account concerning the book-entry settlement, etc.;
(ii) Only the following listed shares, etc. of the resident, etc. are received in the tax-exempt management account:

(Note) Listed shares, etc. received in the NISA account by 2023 under the tax-exempt scheme based on tax-exempt listed shares management agreements (general-type NISA) may continue to be held in the existing NISA account until the period of tax-exempt holding expires. Dividends, etc. and capital gains from these listed shares, etc. are exempt from taxation during this period, but they will be paid out to taxable accounts upon the expiration of the period of tax-exempt holding. Listed shares, etc. held under the general-type NISA may not be received in the installment investment quota or the growth investment quota.

a. The following listed shares, etc. wherein the total amount of consideration for acquiring the listed shares, etc. received during the period from the day on which the tax-exempt management account was established in the account until December 31 of the year to which the first-mentioned day belongs (meaning the amount of consideration for purchase, payment for purchase or withdrawal from the account for transfer (market value); the same applies through (6)) is less than JPY1.2 million (when there are listed shares, etc. set forth in b. below, the amount obtained by deducting the market value of the listed shares, etc. at the time of withdrawal made for transfer)

(a) Listed shares, etc. acquired through entrustment of purchase to the financial instruments business operator, etc. (including intermediation, brokerage or agency for entrustment of purchase; the same applies to (6)), listed shares, etc. acquired from the financial instruments business operator, etc. or listed shares, etc. acquired through offering (limited to public offering; the same applies to (6)) of listed shares, etc. conducted by the financial instruments business operator, etc., which are received in the account immediately after their acquisition;

(b) Listed shares, etc. transferred from a tax-exempt management account for another year (meaning a tax-exempt management account for another year related to an account in which the relevant tax-exempt management account was established or a tax-exempt management account established in a minor's account opened at the business office of the financial instruments business operator, etc.; the same applies in b. below) (excluding those listed in b. below).

b. Listed shares, etc. to be transferred from a tax-exempt management account for another year on the day on which five years have passed since January 1 of the year including the day on which the tax-exempt management account for another year was established

c. In addition to those set forth in a. and b. above, listed shares, etc. acquired due to certain grounds such as listed shares, etc. acquired through split or consolidation of shares or beneficial interests conducted with respect to the listed shares, etc. in a tax-exempt account or shares of a merging corporation or merging parent corporation acquired through merger of a corporation that issued the listed shares, etc. in the tax-exempt account.

(iii) Listed, shares, etc. in a tax-exempt management account shall, except for those which will be transferred as described in (ii)b. above, be transferred from an account in which the tax-exempt management account was established to another custody account held as of the day on which five years have passed from January 1 of the year in which the tax-exempt management account was established.

(Note) If a specified account is opened with a financial instruments business operator, etc. within which a tax-exempt account has been opened, listed shares, etc. will be transferred to the specified account except for those that will be transferred to another custody account.

(iv) Other certain matters

(Note) 1. The "tax-exempt management account" refers to an account used to make records on the book-entry settlement, etc. of listed shares, etc. for which book-entry settlement, etc., is to be made based on a tax-exempt listed shares management agreement separately from records on other transactions. It must satisfy certain requirements such as that it was established only in each year during the period from January 1, 2014, to December 31, 2023 (excluding the years in which a cumulative investment account was established).

2. "Listed shares, etc." eligible for tax exemption measures based on a tax-exempt listed shares management agreement are shares, etc. prescribed in Article 37-10, Paragraph 2 of the Act on Special Measures Concerning Taxation (those set forth in Items 1 to 5 of the same paragraph; in the case of beneficial interests in investment trusts, limited to beneficial interests in securities investment trusts other than bond investment trusts, and beneficial interests in investment trusts other than securities investment trusts that do not fall within the scope of bond management investment trusts), or bonds with share options listed on financial instruments exchanges, etc. Therefore, public and corporate bonds, beneficial interests in bond investment trusts and bond management investment trusts, and bond-type beneficial interests in specified purpose trusts are not included.

(5) Tax-Exempt Cumulative Investment Agreement

A tax-exempt cumulative investment agreement refers to an agreement involving book-entry settlement, etc. of listed shares, etc. acquired through a cumulative investment agreement which has been entered into by a resident, etc. with a financial instruments business operator, etc. for the purpose of enjoying the tax exemption scheme described in (2)(i)(b) and (ii)(b) above, which describes the following matters. The NISA program based on this agreement is called the "Dollar-Cost Averaging NISA."

(i) Book-entry settlement, etc. of listed shares, etc. shall be made on a cumulative investment account established in the account concerning the book-entry settlement, etc.

(ii) Among the listed shares, etc. of the resident, etc., only the following are received in a cumulative investment account (limited to those that satisfy certain requirements for promoting property accumulation of an individual through periodic and continuous acquisition of the listed shares, etc.; hereinafter referred to as "cumulative investment listed shares, etc.")

a. Among the cumulative investment listed shares, etc. acquired through entrustment of purchase with the financial instruments business operator, etc., cumulative investment listed shares acquired from the financial instruments business operator, etc. or cumulative investment listed shares, etc. acquired through offering of cumulative investment listed shares, etc. by the financial instruments business operator, etc. within the period from the day on which a cumulative investment account was established in the account to December 31 of the year to which the first-mentioned day belongs (hereinafter referred to as the "receiving period"), those which are received in the account immediately after their acquisition and the total amount of consideration for acquiring the cumulative investment listed shares, etc. received during the receiving period does not exceed JPY400,000.

b. In addition to those set forth in a. above, cumulative investment listed shares, etc. acquired due to certain reasons such as listed shares, etc. acquired through split or consolidation of beneficial interests conducted with the listed shares, etc. in a tax-exempt account or new beneficial interests in investment trusts acquired through consolidation of investment trusts in relation to the listed shares, etc. in a tax-exempt account.

(iii) Cumulative investment listed, shares, etc. in a tax-exempt management account held as of the day on which 20 years have passed from January 1 of the year in which the cumulative investment account was established shall be transferred from an account in which the cumulative investment account was established to another custodial account.

(iv) Other certain matters

(Notes) 1. The "cumulative investment agreement" refers to an agreement in which the resident, etc. promises to acquire a certain amount of listed shares, etc. from a financial instruments business operator, etc. by entrusting the purchase of such listed shares, etc. to such financial instruments business operator or to acquire a certain amount of listed shares, etc. through the offering conducted by the financial instruments business operator, etc. on a periodic and continuous basis, wherein the issue of the listed shares, etc., whose purchase will be entrusted or which will be acquired, is fixed in advance.

2. The "cumulative investment account" refers to an account used to make records on the book-entry settlement of cumulative investment listed shares, etc. for which book-entry settlement, etc. is to be made based on a tax-exempt cumulative investment agreement (meaning listed shares, etc. (limited to beneficial interests in securities investment trusts other than bond investment trusts which are listed or traded on a financial instruments market, and beneficial interests in securities investment trusts other than bond investment trusts for which the offering of beneficial interests for the creation thereof was conducted through a public offering) that satisfy the following requirements where their periodical acquisition will promote asset building by individuals) separately from other records on other transactions. It must satisfy certain requirements such as that it was established only in each year during the period from January 1, 2018, to December 31, 2023 (excluding the years in which a cumulative investment account was established).

(1) The basic terms and conditions of an investment trust managed under instructions from the settlor regarding the beneficial interest in the publicly offered stock investment trust (or a document similar to the basic terms and conditions of an investment trust managed under instructions from the settlor if the publicly offered stock investment trust is a foreign investment trust) provide for the following matters:

(i) The trust agreement period is not specified or the trust agreement period is specified as 20 years or more;

(ii) The trust property is not to be managed for investment in rights involved in derivatives transactions, commodity derivatives transactions, forward foreign exchange transactions or other derivatives transactions, except in the case of making investments for the purposes specified by the Prime Minister through consultation with the Minister of Finance as investments for securing stable income and conducting efficient management; and

(iii) The distribution of proceeds is not to be made for a term of one month or shorter, but it is to be made for each accounting period for the trust (or for each accounting period for distribution of proceeds if the publicly offered stock investment trust is a foreign investment trust); and

(2) Other requirements specified by the Prime Minister through consultation with the Minister of Finance.

(6) Specified Tax-Exempt Cumulative Investment Agreement

A specified tax-exempt cumulative investment agreement refers to an agreement involving book-entry settlement, etc. of listed shares, etc. which has been entered into by a resident, etc. with a financial instruments business operator, etc. for the purpose of enjoying the tax exemption scheme described in (2)(i)I and (d) and (I(c) and (d) above, which describes the following matters.

(i) Book-entry settlement, etc. of listed shares, etc. shall be made on a specified cumulative investment account or specified tax-exempt management account established in the account concerning the book-entry settlement, etc.

(ii) Among a certain scope of cumulative investment listed shares, etc. (hereinafter referred to as "specified cumulative investment listed shares, etc."), only the following are received in a specified cumulative investment account. However, the listed shares, etc. described in a. below are limited to those acquired through a cumulative investment agreement. No listed shares, etc. may be transferred to a specified cumulative investment account from other accounts. The same applies to the specified tax-exempt management account described in (iii) below.

a. Among the specified cumulative investment listed shares, etc. acquired through entrustment of purchase with the financial instruments business operator, etc., specified cumulative investment listed shares acquired from the financial instruments business operator, etc. or specified cumulative investment listed shares, etc. acquired through offering (limited to public offering) of specified cumulative investment account listed shares, etc. by the financial instruments business operator, etc. within the period from the day on which a specified cumulative investment account was established in the account to December 31 of the year to which the first-mentioned day belongs (hereinafter referred to as the "receiving period"), those which are received in the account immediately after their acquisition and the total amount of consideration for acquiring the specified cumulative investment listed shares, etc. received during the receiving period does not exceed JPY 1.2 million (excluding specified cumulative investment listed shares, etc. in the case where the sum of the total amount of specified cumulative investment listed shares, etc. received in the account, the total of the amounts of consideration for the acquisition of the listed shares, etc. set forth in (iii) a. below that are held in the account in the same year, and the total of the specified cumulative investment account base amount (see (7) "Meanings of the Specified Cumulative Investment Account Base Amount and the Specified Tax-Exempt Management Account Base Amount" below) exceeds JPY 18 million).

b. In addition to those set forth in a. above, specified cumulative investment listed shares, etc. acquired due to certain reasons such as listed shares, etc. acquired through split or consolidation of beneficial interests conducted with the listed shares, etc. in a tax-exempt account or new beneficial interests in investment trusts acquired through consolidation of investment trusts in relation to the listed shares, etc. in a tax-exempt account.

(Note) A "certain scope of cumulative investment listed shares, etc." refer to cumulative investment listed shares, etc., other than those set forth in a. above, that a person who has submitted a written notification of continued application and left Japan (hereinafter referred to as a "person submitting a written notification of continued application") has acquired during the period from the day of departure until the day on which a written notification of return regarding that person is submitted.

(iii) Only the following listed shares, etc. are received in the specified tax-exempt management account:

a. Among (1) the listed shares, etc. acquired through the entrustment of purchases to the financial instruments business operator, etc.; (2) the listed shares, etc. acquired from the financial instruments business operator, etc.; or (3) the listed shares, etc. acquired through the offering of listed shares, etc. conducted by the financial instruments business operator, etc.; during the period from the day on which the specified tax-exempt management account was established in the account until December 31 of the year to which the first-mentioned day belongs (hereinafter referred to as the “receiving period”), those that were received in the account immediately after their acquisition wherein the total amount of consideration for acquisition during the receiving period does not exceed JPY2.4 million, excluding listed shares, etc. which fall under any of the following cases when received in the account:

(a) The sum of the total amount of the listed shares, etc. and the total of the specified tax-exempt management account base amount (see (7) “Meanings of the Specified Cumulative Investment Account Base Amount and the Specified Tax-Exempt Management Account Base Amount” below) exceeds JPY 12 million; or

(b) The sum of the total of the amounts of consideration for acquisition of listed shares, etc. received in the account during the receiving period, the total of the amounts of consideration for acquisition of specified cumulative investment listed shares, etc. set forth in (ii) a. above that are held in the account in the year including the day on which the specified tax-exempt management account relating to the receiving period was established, and the total of the specified cumulative investment account base amount exceeds JPY 18 million.

b. In addition to those set forth in a. above, listed shares, etc. acquired due to certain grounds such as listed shares, etc. acquired through a split or consolidation of shares or beneficial interests conducted with respect to the listed shares, etc. in a tax-exempt account or shares of a merging corporation or merging parent corporation acquired through merger of a corporation that issued the listed shares, etc. in the tax-exempt account.

(iv) Certain other matters.

(Notes) 1. A “specified cumulative investment account” refers to an account used to keep records on the entries or records in the book-entry transfer account register for specified cumulative investment listed shares, etc. that are made based on a specified tax-exempt cumulative investment agreement, separately from records on other transactions, which satisfies the following requirements:

(1) The specified cumulative investment account is established only in each year from 2024 and onwards (each year within the account establishment period).

(2) The specified cumulative investment account is established as of January 1 of each year within the account establishment period, except in cases where a notification of opening of a tax-exempt account is submitted in the middle of the year.

2. A “specified tax-exempt management account” refers to an account used to keep records on the entries or records in the book-entry transfer account register for listed shares, etc. that are made based on a specified tax-exempt cumulative investment agreement, separately from records on other transactions, which is established concurrently with a specified cumulative investment account.

3. The following listed shares, etc. may not be received in a specified tax-exempt management account:
   (1) Listed shares, etc. acquired by the submitter of a notification of continued application during the period of continued application, which are set forth in (iii) a. above;
   (2) Listed shares, etc. relating to specified share options acquired under the provisions of the main clause of Article 29-2, Paragraph 1 of the Act on Special Measures Concerning Taxation (Tax exemption for economic benefits related to acquisition of shares resulting from exercise of share options received by specified directors, etc.);
   (3) Listed shares, etc. set forth in (iii) a. above, which fall under any of the following:
      (i) Listed shares, etc. designated as securities that are determined to be delisted or securities that are likely to be delisted from the financial instruments exchange according to the rules established by the financial instruments exchange on which the listed shares, etc. are listed, and other listed shares, etc. specified by the Prime Minister through consultation with the Minister of Finance;
      (ii) Beneficial interests in securities investment trusts other than bond investment trusts, investment equity prescribed in Article 2, Paragraph 14 of the Act on Investment Trusts and Investment Corporations, or beneficial interests in specified trusts that issue beneficiary certificates, for which it is provided in the basic terms and conditions of an investment trust managed under instructions from the settlor, the bylaws, or the trust agreement prescribed in Article 3, Item 1 of the Trust Act that they are to be managed for investment in rights involved in derivatives transactions prescribed in Article 61-5, Paragraph 1 of the Corporation Tax Act (excluding investment for purposes specified by the Prime Minister through consultation with the Minister of Finance as investment for securing stable income and conducting efficient management), or for which other matters specified by the Prime Minister through consultation with the Minister of Finance are provided in the basic terms and conditions, etc.; or
      (iii) Beneficial interests in securities investment trusts other than bond investment trusts, other than those for which the basic terms and conditions of an investment trust managed under instructions from the settlor provide for the following matters:
         (a) The trust agreement period is not specified or the trust agreement period is specified as 20 years or more; and
         (b) The distribution of proceeds is not made for a term of one month or shorter, but it is made for each accounting period for the trust.

(7) Meanings of the Specified Cumulative Investment Account Base Amount and the Specified Tax-Exempt Management Account Base Amount

(i) Specified Cumulative Investment Account Base Amount

The specified cumulative investment account base amount refers to the total amount of the purchase prices, etc. of listed shares, etc. held in the specified cumulative investment account and the specified tax-exempt management account as of the end of the preceding year, and it is calculated in accordance with the method for calculating the amount of acquisition costs for listed shares, etc.

Specifically, the specified cumulative investment account base amount is the amount calculated by totaling the amounts specified in the following(Note) according to the respective categories regarding the listed shares, etc. in the tax-exempt account related to the specified cumulative investment account and the specified tax-exempt management account established in the eligible tax-exempt account (meaning a tax-exempt account opened by a resident, etc. at the business office of a financial instruments business operator, etc. as of December 31 (referred to as the "base date") of the year preceding the year including the day on which the specified cumulative investment account and the specified tax-exempt management account are established in the tax-exempt account) (referred to as "listed shares, etc. in the eligible tax-exempt account") (Note: Referred to as the "total amount of the purchase prices of listed shares, etc. in the eligible tax-exempt account").

a. Specified cumulative investment listed shares, etc. related to the specified cumulative investment account: The amount equivalent to the amount of acquisition costs for the specified cumulative investment listed shares, etc. calculated in accordance with the provisions of the Enforcement Order of the Income Tax Act (Valuation of Securities) by deeming the amount of purchase prices of specified cumulative investment listed shares, etc. (or the paid-in amount in the case of listed shares, etc. acquired by payment) to be the acquisition value of the specified cumulative investment listed shares, etc., classifying the specified cumulative investment listed shares, etc. by issue, and by assuming that the specified cumulative investment listed shares, etc. held in the specified cumulative investment account are transferred as of the base date.

b. Listed shares, etc. related to the specified tax-exempt management account: The amount equivalent to the amount of acquisition costs of the listed shares, etc. calculated in accordance with the provisions of the Enforcement Order of the Income Tax Act (Valuation of Securities) by deeming the amount of purchase prices of listed shares, etc. to be the acquisition value of the listed shares, etc., classifying the listed shares, etc. by issue, and assuming that the listed shares, etc. held in the specified tax-exempt management account are transferred as of the base date.

(ii) Specified Tax-Exempt Management Account Base Amount

The specified tax-exempt management account base amount refers to the amount of the portion of the "total amount of purchase prices of listed shares, etc. in the eligible tax-exempt account," which corresponds to the amount specified in b. above.

The "total amount of purchase prices of listed shares, etc. in the eligible tax-exempt account" is to be calculated as described below.

a. If the listed shares, etc. in the eligible tax-exempt account of the same issue which are held by the resident, etc. contain specified cumulative investment listed shares, etc. related to the specified cumulative investment account established in the eligible tax-exempt account and the listed shares, etc. related to the specified tax-exempt management account established in the eligible tax-exempt account, these listed shares, etc. in the eligible tax-exempt account are treated as those of different issues.

b. If the resident, etc. has two or more eligible tax-exempt accounts, and the listed shares, etc. in the eligible tax-exempt accounts of the same issue which are held by the resident, etc. contain listed shares, etc. in one of these eligible tax-exempt accounts and listed shares, etc. in the other eligible tax-exempt account, these listed shares, etc. in the eligible tax-exempt accounts are treated as those of different issues.

c. The listed shares, etc. of the same issue which are held by the resident, etc. contain listed shares, etc. in the eligible tax-exempt account and listed shares, etc. other than the listed shares, etc. in the eligible tax-exempt account, these listed shares, etc. are treated as those of different issues.

d. If the listed shares, etc. in the eligible tax-exempt account are listed shares, etc. from which business income or miscellaneous income arises, these listed shares, etc. in the eligible tax-exempt account are deemed to be listed shares, etc. from which capital gains arise.

(iii) Provision of Base Amount-Related Information by the Head of the Business Office of the Financial Instruments Business Operator, etc. and Provision of the Specified Cumulative Investment Account Base Amount and the Specified Tax-Exempt Management Account Base Amount by the District Director of the Tax Office

The head of the business office of a financial instruments business operator, etc. is to provide the district director of the tax office having jurisdiction over the location of the business office with information including the amount equivalent to the amount of purchase prices of listed shares, etc. necessary for the calculation of the specified cumulative investment account base amount and the specified tax-exempt management account base amount mentioned in (i) and (ii) above. The district director of the tax office is to provide the head of the business office of the financial instruments business operator, etc. with the specified cumulative investment account base amount and the specified tax-exempt management account base amount as calculated based on such information.

Specifically, the following process is conducted.

a. If, as of December 31 (referred to as the "base date") of each year from 2025 and onwards, any listed shares, etc. are held in the specified cumulative investment account or specified tax-exempt management account established in a tax-exempt account opened at the business office of a financial instruments business operator, etc., the head of the business office of the financial instruments business operator, etc. must provide the following information (referred to as the "base amount-related information") to the district director of the tax office having jurisdiction over the location of the business office of the financial instruments business operator, etc. by January 31 of the year following the year including the base date (referred to as the "base year") by certain methods such as using an electronic data processing system after submitting a notification of use to the district director of the tax office in advance. The head of the business office of the financial instruments business operator, etc. must keep books for base date-related information, and enter or record base date-related information in the books for each resident, etc.

(a) Name, date of birth, address and individual number of the resident, etc. who holds the tax-exempt account;

(b) Reference number;

(c) Name of the business office of the financial instruments business operator, and corporate number of the financial instruments business operator, etc.;

(d) Out of the amount specified in (i) a. above related to the listed shares, etc. held in the specified cumulative investment account as of the base date, the amount of the portion related to the tax-exempt account;

(e) Out of the amount specified in (i) b. above related to the listed shares held in the specified tax-exempt management account as of the base date, the amount of the portion related to the tax-exempt account; and

(f) Other matters of reference.

b. If the district director of the tax office who has received the base date-related information is different from the district director of the tax office having jurisdiction over the business office of the financial instruments business operator, etc. at which the tax-exempt account held by the resident, etc. pertaining to the base date-related information is opened with the specified cumulative investment account for the year following the base year pertaining to the base data-related information being established within that account, the district director of the tax office who has received the base date-related information is to notify the district director of the tax office having jurisdiction over the location of the business office of the base data-related information.

c. The district director of the tax office having jurisdiction over the location of the business office of the financial instruments business operator, etc. at which the tax-exempt account held by the resident, etc. is opened with the specified cumulative investment account for the year following the base year being established within that account must provide the head of the business office of the financial instruments business operator, etc. with the following information pertaining to the specified cumulative investment account and the specified tax-exempt management account established concurrently with the specified cumulative investment account, by using an electronic data processing system. Having received such information, the head of the business office of the financial instruments business operator, etc. must notify the resident, etc. of the specified cumulative investment account base amount and the specified tax-exempt management account base amount. Having made such notification, the head of the business office of the financial instruments business operator, etc. must keep books and enter the fact of the notification and the notified information in the books to clarify the relevant matters for each resident, etc.

(a) Name and date of birth of the resident, etc. who has opened the tax-exempt account;

(b) Reference number;

(c) Specified cumulative investment account base amount and specified tax-exempt management account base amount; and

(d) Other matters of reference.

(8) Procedures Related to Opening of a Tax-Exempt Account

(i) Submission of a notification of opening of a tax-exempt account

A resident, etc. who intends to open a tax-exempt account at a business office of a financial instruments business operator (limited to persons who are aged 18 or older as of January 1 of the year in which the account is opened) must submit to the head of the business office of the financial instruments business operator, etc. at which they intend to open the account, a notification of opening of a tax-exempt account describing their name, date of birth, address and personal ID number as well as other certain information, during the period from January 1 of the account opening year to the day on which the listed shares, etc. with respect to which the resident, etc. intends to enjoy the abovementioned tax exemption schemes (2)(i) and (ii) will be received in the account for the first time in the account opening year (including the case of providing by electronic or magnetic means the information that is required to be contained in that notification in lieu of submitting the notification).

A resident, etc. who intends to submit a notification of opening of a tax-exempt account must, upon making the submission, notify his/her name, date of birth, address and individual number to the head of the business office of the financial instruments business operator, etc. by presenting a copy of his/her resident record or other identity verification document or by transmitting an electronic signature certificate, etc., and have the financial instruments business operator, etc. confirm the matters notified.

(ii) Provision of notification information from the head of the business office of a financial instruments business operator to the competent district tax office director

A head of the business office of a financial instruments business operator, etc. who received submission of a notification of opening of a tax-exempt account must, promptly after receiving such submission, provide information described in the notification of opening of a tax-exempt account (including electronic or magnetic records which contain the information that is required to be contained in the notification submitted by electronic or magnetic means; hereinafter referred to as the "notification information") to the competent district tax office director who has jurisdiction over the location of the business office of the financial instruments business operator, etc. by a method using a specific electronic data processing system (e-Tax).

(iii) Provision of confirmed information

The competent district tax office director who received provision of notification information shall confirm whether or not the notification information has been provided to them or to another tax office director prior to the receipt of provision of such notification information with respect to the resident, etc. who submitted a notification of opening of a tax-exempt account containing such notification information (*i.e.*, whether or not notification has been filed redundantly). The competent district tax office director who made such confirmation must provide the head of the business office of the financial instruments business operator, etc. who received submission of a notification of opening of a tax-exempt account containing such notification information with the information regarding whether the notification of opening of a tax-exempt account may be accepted, by a method of using an electronic data processing system.

(iv) Prohibition of redundant submission of a notification of opening of a tax-exempt account

A head of the business office of a financial instruments business operator, etc. may not accept a notification of opening of a tax-exempt account which contains the name, date of birth, address and individual number that are different from those notified, or a notification of opening of a tax-exempt account which has been redundantly submitted by a resident, etc. who has already opened a tax-exempt account at the financial instruments business operator, etc.

When a resident, etc. who opens or opened a tax-exempt account submits a notification of opening of a tax-exempt account to the head of the business office of a financial instruments business operator, etc. other than the financial instruments business operator, etc. with which that tax-exempt account is or was opened, the resident, etc. must attach a notice of abolition of account or notice of abolition of tax-exempt account to the notification of opening of a tax-exempt account. Such resident, etc. may not submit a notification of opening of a tax-exempt account (except for one with a notice of abolition of account or notice of abolition of tax-exempt account) to the head of the business office of a financial instruments business operator, etc. other than the financial instruments business operator, etc. with which that tax-exempt account is or was opened.

If a notification of opening of a tax-exempt account is one that may not be accepted or submitted, the account related to the book-entry settlement of listed shares that has been opened by submitting such notification of opening of a tax-exempt account is deemed not to have been a tax-exempt account from the time of its opening. Therefore, any dividends, etc. or capital gains on listed shares, etc. in such account that is deemed not to be a tax-exempt account are not eligible for the tax exemption measures described in (1) ((2)(i) and (ii)) above.

(9) Procedures for Abolition of a Tax-exempt Account

(i) Submission of a notice of abolition of a tax-exempt account

When a resident, etc. who has opened a tax-exempt account intends to stop enjoying the tax exemption schemes described in (2)(i) and (ii) above with respect to his/her tax-exempt account, he/she must submit a notice of abolition of a tax-exempt account describing his/her name, date of birth, address and other certain matters to the head of the business office of the financial instruments business operator, etc. at which the tax-exempt account is opened (instead of submitting the notice, such resident, etc. may provide by electronic or magnetic means the information that is required to be contained in the notice).

(ii) Provision of abolition information contained in the notice of abolition of a tax-exempt account to the district tax office director.

A head of the business office of a financial instruments business operator, etc. who received the submission of a notice of abolition of a tax-exempt account shall, promptly after receiving such submission, provide the information contained in that notice of abolition of a tax-exempt account (hereinafter referred to as "abolition information") to the competent district tax office director who has jurisdiction over the location of the business office of the financial instruments business operator, etc. by a specific electronic data processing system (e-Tax).

In the case where a resident, etc., who has opened a tax-exempt account before January 1, 2016 and who has not notified his/her personal ID number to the head of the business office of the financial instruments business operator, etc. at which such tax-exempt account is opened, submits a notice of abolition of tax-exempt account or provides by electronic or magnetic means the information that is required to be contained in the notice, his/her personal ID number is to be excluded from the abolition information prescribed in a. to c. above which is provided to the competent district tax office director from the head of the business office of the financial instruments business operator, etc.

(10) Procedures for Transfer of Listed Shares, Etc. in a Tax-Exempt Account

(i) Transfer of listed shares, etc. related to a tax-exempt management account

Listed shares, etc. related to a tax-exempt management account shall be transferred in the following ways on the day on which five years have passed from January 1 of the year in which the tax-exempt management account was established in the tax-exempt account opened by the resident, etc., except for those transferred to a tax-exempt management account for another year.

a. In the case where the resident, etc. has opened a specified account at the business office of a financial instruments business operator, etc. at which the tax-exempt account in which the tax-exempt management account is established is opened, the listed shares, etc. in the tax-exempt account related to the tax-exempt management account shall be transferred to the specified account from the tax-exempt account.

(Note) The listed shares, etc. in the tax-exempt account related to the tax-exempt management account of the same issue as those of the listed shares, etc. in a tax-exempt account that are to be transferred to the specified account described in a. above must be, in whole, transferred to the specified account from the tax-exempt account.

b. When the resident, etc. submits a "written request for transferring the listed shares, etc. in a tax-exempt account to another custody account which is other than the specified account" which describes the following matters (including the provision of electronic or magnetic record in which matters that should be described in the written request are recorded using electronic or magnetic means in lieu of submission of the written request), notwithstanding what is provided for in a. above, the listed shares, etc. in the tax-exempt account related to the tax-exempt management account which have been entered or recorded in the written request (including the electronic or magnetic record in which the matters which should be described in the written request are recorded, that have been provided by electronic or magnetic means; the same applies in b. below) shall be transferred from the tax-exempt account to another custody account which is other than the specified account, that has been entered or recorded in the written request.

(a) Name, date of birth and address of the person who submits the written request;

(b) Name and location of the business office of the financial instruments business operator, etc. to which the written request is to be submitted;

(c) A statement requesting transfer of the listed shares, etc. in a tax-exempt account related to the tax-exempt management account established in the tax-exempt account to a custody account other than the specified account;

(d) Class, issue and number or equity or value of the listed shares, etc. in a tax-exempt account which the resident, etc. intends to transfer;

(e) Other matters of reference;

(Note) Listed shares, etc. in a tax-exempt account may be transferred to another custody account which is other than a specified account that is opened at a business office of a financial instruments business operator, etc. which is different from the business of the financial instruments business operator, etc. at which the relevant tax-exempt account is opened.

c. When the resident, etc. has not opened a specified account at the business office of the financial instruments business operator, etc., the listed shares, etc. in a tax-exempt account related to a tax-exempt management account that are not entered or recorded in the written request described in b. above shall be transferred to another custody account which is other than the specified account opened at the business office of the financial instruments business operator, etc. from the tax-exempt account.

(ii) Transfer of cumulative investment listed shares, etc. related to a cumulative investment account

Cumulative investment listed shares, etc. related to a cumulative investment account shall be transferred by the same procedures as those for transferring listed shares, etc. related to a tax-exempt management account described in (i)a. to c. above, on the day twenty years have passed from January 1 of the year in which a cumulative investment account was established in the tax-exempt account opened by the resident, etc.

(Note) Through the tax reform in 2023, the NISA program has been reorganized into a new program consisting of the specified cumulative investment account (installment investment quota) and the specified tax-exempt management account (growth investment quota). Listed shares, etc. held in specified accounts or general accounts or under the previous general-type NISA, Dollar-Cost Averaging NISA or Junior NISA may not be received in the installment investment quota or the growth investment quota. In the past, the listed shares, etc. held in the account under the general-type NISA or Junior NISA were eligible to be rolled over to the tax-exempt management account for the next year upon the expiration of the period of tax-exempt holding or when the user under Junior NISA reached the adulthood. However, from 2024 and onwards, rollover from the general-type NISA and Junior NISA will not be allowed under the new NISA program.

(11) Automatic Opening of a Tax-Exempt Account When the Person Who Opened a Minor's Account Becomes 18 Years Old

(i) A resident, etc. who has opened a minor's account in each year between 2017 and 2023 (limited to the year in which the resident, etc. is 18 years old as of January 1; in 2023, residents, etc. who are 20 years old and 19 years old are deemed to be residents who are 18 years old) will have a tax-exempt account be opened at the business office of the financial instruments business operator, etc. at which the minor's account is opened, without performing special procedures (such resident, etc. is deemed to have submitted a notification of opening of a tax-exempt account and concluded a tax-exempt listed shares management agreement and becomes eligible for the tax exemption measures under the general-type NISA).

(ii) A resident, etc. who has opened a minor's account in each year from 2024 and onwards (limited to the year in which the resident, etc. is 18 years old as of January 1 of the year) will have a tax-exempt account be opened at the business office of the financial instruments business operator, etc. at which the minor's account is opened, without performing special procedures (such resident, etc. is deemed to have submitted a notification of opening of a tax-exempt account and concluded a specified tax-exempt cumulative investment agreement.

(12) Treatment of a Resident, Etc. Who Held a NISA Account at the End of 2023

If a resident, etc. holds a tax-exempt management account or cumulative investment account for 2023 in a tax-exempt account opened at the business office of a financial instruments business operator, etc. as of December 31, 2023, such a resident, etc. (excluding those set forth in the following) will be deemed to have concluded a specified tax-exempt cumulative investment agreement with the financial instruments business operator, etc. as of January 1, 2024, and will become eligible for the tax exemption measures described in (2)(i) and (ii) above.

(i) A resident, etc. who has submitted, by December 31, 2023, a notice of abolition of a tax-exempt account to the head of the business office of the financial instruments business operator, etc. at which the tax-exempt account is opened with a tax-exempt management account or cumulative investment account being established therein; or

(ii) A resident, etc. who has submitted, during the period between October 1 and December 31, 2023, a notice of change of financial instruments business operator, etc. to the head of the business office of the financial instruments business operator, etc. at which the tax-exempt account is opened with a tax-exempt management account or cumulative investment being established therein.

(13) Special Measures for the Case Where a Resident, Etc. Who Has Opened a Tax-Exempt Account Ceases to Fall Within the Category of Resident, Etc. upon Temporary Departure

When a resident, etc.[Note 1] who has opened a tax-exempt account ceases to fall within the category of resident, etc. upon temporary departure[Note 2] due to unavoidable circumstances such as an order of transfer of position issued by a person who pays him/her a salary, if the resident, etc. submits a written notification of continued application[Note 3] (including the case of providing by electronic or magnetic means the information that is required to be contained in that notification in lieu of submitting the notification), by the day preceding the date of departure, to the head of the business office of a financial instruments business operator, etc. with which the tax-exempt account has been opened, the resident, etc. shall be deemed to continue to fall within the category of resident, etc. during the period[Note 5] from the time of departure until the day on which the resident, etc. submits a written notification of return[Note 4] to the head of the business office of the financial instruments business operator, etc., or December 31 of the year including the day on which five years have passed since the day of the submission of the written notification of continued application, whichever comes earlier, and this tax exemption system shall continue to apply to the resident, etc.

In this case, listed shares, etc. acquired by the resident, etc. who has submitted a written notification of continued application, during the period from the day of departure until the day on which the resident, etc. submits a written notification of return may not be accepted in the tax-exempt account.

(Notes)
1. “Resident, etc.” means a resident or a non-resident with a permanent establishment.
2. “Departure” means that a resident ceases to have a domicile or residence in Japan, or that a non-resident with a permanent establishment ceases to have the permanent establishment in Japan.
3. “Written notification of continued application” means a written notification stating certain matters including the fact that a resident, etc. departs from Japan due to unavoidable circumstances such as an order of transfer of position issued by a person who pays a salary to the resident, etc.

   A resident, etc. who is eligible for the special measures for taxation on capital gains, etc. upon moving out from Japan may not file a written notification of continued application with regard to income tax for the year including the date of departure.
4. “Written notification of return” means a written notification stating certain matters including the date of return to Japan (including the case of providing by electronic or magnetic means the information that is required to be contained in that notification in lieu of submitting the notification).
5. If a resident, etc. who has submitted a written notification of continued application fails to submit a written notification of return to the head of the business office of the financial instruments business operator, etc. with which the tax-exempt account has been opened, by December 31 of the year including the day on which five years have passed since the day on which the resident, etc. submitted the written notification of continued application, the resident, etc. shall be deemed to have submitted a notice of abolition of tax-exempt account to the head of the business office of the financial instruments business operator, etc. as of the said day.

(14) Submission of Tax-Exempt Account Annual Transaction Report

When a tax-exempt management account, cumulative investment account or specified cumulative investment account is established in a tax-exempt account opened at the business office of a financial instruments business operator, etc. in a given year, the financial instruments business operator, etc. must prepare for each resident, etc. who opened such tax-exempt account and for each such tax-exempt account, a tax-exempt account annual trading report describing the name and address of the resident, etc. who opened the tax-exempt account, amount of consideration for transfer of the listed shares, etc. dealt with in the tax-exempt account during that year, the amount of dividends, etc. paid for such listed shares, etc. in the tax-exempt account related to the tax-exempt account as well as other prescribed matters and submit them to the competent district tax office director who has jurisdiction over the location of the business office of the financial instruments business operator, etc. at which the tax-exempt account was opened, by January 31 of the year immediately following the relevant year.

(15) Treatment in the Case of Withdrawal of Listed Shares, Etc. in a Tax-Exempt Account from the Tax-Exempt Account

(i) Deemed transfer

When the listed shares, etc. in a tax-exempt account have been withdrawn in whole or in part from a tax-exempt management account, cumulative investment account or specified tax-exempt management account due to the events set forth in a. to c. below (including withdrawals made by book-entry transfer), the provisions concerning this tax exemption scheme and submission of a tax-exempt account annual trading report and other provisions of laws and regulations concerning income tax shall be applied to the listed shares, etc. in a tax-exempt account that have been withdrawn by deeming that transfer has been made based on a tax-exempt listed shares management agreement, tax-exempt cumulative investment agreement or specified tax-exempt cumulative investment agreement in the amount (value) as of the withdrawal, at the time when the events for such withdrawal occurred.

a. (a) Transfer from a tax-exempt account to an account related to entry or record in another book-entry transfer account registry of the listed shares, etc. or entrustment of custody thereof (referred to as the "other custody account"); (b) transfer from a tax-exempt management account to a tax-exempt management account for another year related to a tax-exempt account in which the tax-exempt account management account is established; or (c) return of securities related to the listed shares, etc. in a tax-exempt account to the resident, etc. or abolition of the tax-exempt account;

b. Gift, inheritance or legacy;

c. Transfer other than the transfer conducted in accordance with the methods described in the tax-exempt listed shares management agreement, tax-exempt cumulative investment agreement or specified tax-exempt cumulative investment agreement.

(Note) As a result of the system of "deemed transfer," transfer shall be deemed to have been made based on a tax-exempt listed shares management agreement, tax-exempt cumulative investment agreement or specified tax-exempt cumulative investment agreement in the amount (value) as of the withdrawal, and thus, profits and losses corresponding to the amounts until withdrawal has been made (the amount of difference in the amount of acquisition) shall be exempt from taxation or shall be deemed not to exist.

(ii) Acquisition value of the shares withdrawn

A resident, etc. who has opened (or had opened) a tax-exempt account from which the listed shares, etc. in the tax-exempt account have been withdrawn as a result of (a) a transfer to another custody account, (b) transfer from a tax-exempt account to a tax-exempt account for another year, or (c) return of securities or abolition of the tax-exempt account as described in (i)a. above shall be deemed to have acquired listed shares, etc. of the same issue as those of the listed shares, etc. in the tax-exempt account in a number equivalent to the number of listed shares, etc. in the tax-exempt account which have been withdrawn due to (a) a transfer to another custody account, (b) transfer from a tax-exempt account to a tax-exempt account for another year, or (c) return of securities or abolition of the tax-exempt account, in the amount of withdrawal, at the time when withdrawal has been made due to such transfer, return or abolition, while a person who acquired the listed shares, etc. in a tax-exempt account that have been withdrawn as a result of gift, inheritance or legacy described in (i)b. above shall be deemed to have acquired the shares, etc. of the same issue as those of the listed shares, etc. in the tax-exempt account in an amount as of the withdrawal, at the time when such gift, succession or legacy was conducted.

In addition, the listed shares, etc. in a tax-exempt account which have been withdrawn from a tax-exempt management account, cumulative investment account, specified cumulative investment account or specified tax-exempt management account due to the events described in (i)c. above, shall be deemed to have been transferred in the amount as of the withdrawal, and thus, the acquisition value of the listed shares, etc. which have been withdrawn from a tax-exempt management account, cumulative investment account, specified cumulative investment account or specified tax-exempt management account due to the events described in (i) a. to c. above after such withdrawal shall be based on the amount as of the withdrawal.

16 Tax Exemption of Dividend Income and Capital Gains, Etc. from Small-Amount Listed Shares, Etc. in Minors' Accounts (So-called Junior NISA)

(1) Outline of the Tax Exemption

This is a system where, in the case that a resident, etc. has opened a minor's account in a business office of a financial instruments business operator, etc., income tax is not imposed on dividends, etc. on listed shares, etc. in the minor's account (Note 1) which the resident, etc. is to receive within the periods specified below for the respective categories of listed shares, etc. in a minor's account set forth therein (limited to the case where the financial instruments business operator, etc. is a certain person in charge of handling payment in Japan) and on capital gains, etc. from listed shares, etc. in the minor's account that have been transferred based on a minor's account management agreement during the period according to the respective category:

(i) Listed shares, etc. in a minor's account relating to a tax-exempt management account:
the period from the day on which the tax-exempt management account was established in the minor's account to the day on which five years have elapsed from January 1 of the year containing the said day; or

(ii) Listed shares, etc. in a minor's account relating to a continuous management account:
the period from the day on which the continuous management account was established in the minor's account to December 31 of the year preceding the year in which the person who has opened the minor's account is 18 years old as of January 1

Meanwhile, when the amount of proceeds from the transfer of the listed shares, etc. in a minor's account based on a minor's account management agreement is less than the total amount of the costs for acquiring the listed shares, etc. in a minor's account and the amount of costs required for such transfer or the necessary expenses for such transfer, the amount of shortage (loss) shall be deemed not to exist.

A "tax-exempt management account" may be established in each year from 2016 to 2023 (limited to the years in which the person who has opened the minor's account is under 18 years old as of January 1 and the year in which the person was born). The account may accept newly acquired listed shares, etc. and listed shares, etc. transferred from a tax-exempt management account established for a different year in the same minor's account, up to a value of JPY800,000 (Note 2) every year.

A "continuous management account" may be established in each year from 2024 to 2028 (limited to the years in which the person who has opened the minor's account is under 18 years old as of January 1). The account may accept listed shares, etc. transferred from a tax-exempt management account established for a different year in the same minor's account, up to a value of JPY800,000 (Note 2) every year.

(Notes) 1. The "listed shares, etc. in a minor's account" mentioned above refers to listed shares, etc. which are entered or recorded in the book-entry transfer account register related to the minor's account or the custody to which the minor's account is entrusted, pursuant to a minor's account management agreement.

2. The upper limit of JPY800,000 above are determined based on the amount of consideration for acquisition in the case of newly acquired listed shares, etc., and based on the value at the time of transfer (market value) in the case of listed shares, etc. transferred from a tax-exempt management account.

However, with regard to the following listed shares, etc., all of them may be transferred to a tax-exempt management account or continuous management account established for each year, regardless of the value thereof at the time of the transfer:

(i) Listed shares, etc. to be transferred from a tax-exempt management account for another year that is related to a minor's account in which the relevant tax-exempt management account has been established, to the relevant tax-exempt management account established on the day following the day on which five years have passed since January 1 of the year including the day on which the tax-exempt management account for another year was established, if these listed shares, etc. are transferred on the day on which the relevant tax-exempt management account is established; or

(ii) Listed shares, etc. to be transferred from a tax-exempt management account for another year that is related to a minor's account in which the relevant continuous management account has been established, to the relevant continuous management account established on the day following the day on which five years have passed since January 1 of the year including the day on which the tax-exempt management account for another year was established, if these listed shares, etc. are transferred on the day on which the relevant continuous management account is established.

The maximum amount of listed shares, etc. that may be accepted in the tax-exempt management account or continuous management account to which listed shares, etc. have been thus transferred is calculated by deducting the amount (market value) of listed shares, etc. withdrawn due to the transfer from the annual maximum investment amount (JPY800,000). Therefore, if the amount of listed shares, etc. withdrawn and transferred exceeds JPY800,000, no additional listed shares, etc. may be accepted in the tax-exempt management account for the year of the transfer.

<table>
<tr><th colspan="2">Category</th><th>Year in which the account may be established</th><th>Tax exemption period</th></tr>
<tr><td rowspan="2">Minor’s account</td><td>Tax-exempt management account</td><td>Each year from 2016 to 2023</td><td>Period from the day on which the tax-exempt management account was established to the day on which five years have elapsed from January 1 of the year containing the said day</td></tr>
<tr><td>Continuous management account</td><td>Each year from 2024 to 2028</td><td>Period from the day on which the continuous management account was established to December 31 of the year preceding the year in which the person who has opened the minor’s account is 18 years old as of January 1</td></tr>
</table>

(Reference) Reform of the Junior NISA Program (FY2020 Tax Reform)

The available period for opening accounts under the Junior NISA will expire on December 31, 2023 without extension. Along with this reform, the restriction on withdrawal under the Junior NISA will be eased for users who have made investments under the Junior NISA until that day. Specifically, upon the expiration of the available period for opening a minor’s account, if listed shares, etc. or deposits and savings in a minor’s account or taxable minor’s account are withdrawn from these accounts on or after January 1, 2024, this tax exemption scheme will be applied by deeming that the listed shares, etc. in the minor’s account are transferred at the time of the abolition of the minor’s account as a result of the withdrawal, and the resident, etc. holding the minor’s account will be deemed to have acquired the same issue of the shares, etc. as that of the withdrawn listed shares, etc. in the amount at the time of the withdrawal. Also, tax will not be withheld with regard to the transfer, etc. of the listed shares, etc. in the minor’s account to be made up until the abolition of the minor’s account or the dividends on the listed shares, etc. in the minor’s account to be received until that time.

Through the tax reform in 2023, the NISA program has been fundamentally expanded and made into a permanent program. Under the new NISA program that will start in 2024, listed shares, etc. held in Junior NISA accounts may not be accepted in the installment investment quota or growth investment quota.

(2) Minor’s Account

A minor’s account means an account to make book-entry settlement, etc. of listed shares, etc. that has been established by a resident, etc. (limited to a person who is under 18 years old as of January 1 of the relevant year or who was born during the relevant year) between the period of April 1, 2016 to December 31, 2023, based on a minor’s account management agreement entered into between a financial instruments business operator, etc., by submitting to the director of a business office of the financial instruments business operator, etc. a written notification for opening a minor’s account to receive application of the special measures (*i.e.*, tax exemption), pursuant to certain procedures, by attaching a written confirmation for application of a minor’s tax exemption or a written notice of abolition of a minor’s account (limited to accounts in which matters related to transactions other than the transactions based on a minor’s account management agreement are not dealt with).

Dividends, etc. to be received for listed shares, etc. managed in a minor’s account and money or other assets received as consideration for transfer of the said listed shares, etc. must be managed in a taxable minor’s account, except for certain types.

A resident, etc. who has opened a minor’s account may not transfer listed shares, etc. in the minor’s account to an account other than a taxable minor’s account from the day on which the resident, etc. opened the minor’s account to December 31 of the year preceding the year in which the resident, etc. is 18 years old as of March 31 of the year (hereinafter referred to as the "reference year"). As a result of the FY2020 Tax Reform, the available period for opening new accounts under the Junior NISA will expire in 2023, and accordingly, the restriction on withdrawal will be eased on January 1, 2024, after the expiration of that period. This does not apply when the resident, etc. withdraws all of the listed shares, etc. and deposits and savings, etc. in the minor's account and taxable minor's account due to a disaster, illness, or any other unavoidable reason (hereinafter referred to as a "reason such as a disaster").

(3) Minor's Account Management Agreement

A minor's account management agreement refers to an agreement entered into between a resident, etc. and a financial instruments business operator, etc. to enjoy the abovementioned tax exemption scheme, in relation to book-entry settlement of listed shares, which stipulates the following matters:

(i) Book-entry settlement, etc. of listed shares, etc. shall be conducted in a tax-exempt management account or continuous management account established in the account for book-entry settlement, etc.;

(ii) Only the following listed shares, etc. of the resident, etc. will be received in the tax-exempt management account:

a. The following listed shares, etc., wherein the total amount of consideration for acquiring the listed shares, etc. received during the period from the day on which the tax-exempt management account was established in the account until December 31 of the year to which the first-mentioned day belongs (meaning the consideration for purchase, amount of payment or amount of withdrawal from the account for transfer (market value)) is less than JPY800,000 (when there are listed shares, etc. set forth in b. below, the amount obtained by deducting the market value of the listed shares, etc. at the time of withdrawal made for transfer);

(a) Listed shares, etc. acquired through entrustment of purchase to a financial instruments business operator, etc. within such period (including intermediation, brokerage or agent for purchase), listed shares, etc. acquired from the financial instruments business operator, etc. or listed shares, etc. acquired through offering (limited to public offering) of listed shares, etc. conducted by the financial instruments business operator, etc., which are received in the account immediately after their acquisition;

(b) Listed shares, etc. transferred from a tax-exempt management account for another year related to an account in which the tax-exempt management account is established (excluding those set forth in b. below);

b. Listed shares, etc. which will be transferred from a tax-exempt management account for another year for the account in which the tax-exempt management account was established on the day on which five years have passed from January 1 of the year in which a tax-exempt management account for another year was established;

c. In addition to those set forth in a. and b. above, listed shares, etc. acquired due to certain grounds such as listed shares, etc. acquired through spilt or consolidation of shares or beneficial interests conducted with respect to the listed shares in a minor's account or shares of a merging corporation or merging parent corporation acquired through merger of a corporation which issued the listed shares, etc. in a minor's account.

(iii) Only the following listed shares, etc. of the resident, etc. will be received in the continuous management account:

a. Listed shares, etc. transferred from a tax-exempt management account related to an account in which the continuous management account was established (excluding those listed in b. below) during the period from the day on which the continuous management account was established in the account to December 31 of the year to which the first-mentioned day belongs, wherein the total amount as of withdrawal made for transfer is less than JPY800,000 (in the case where there are listed shares, etc. set forth in b. below, the amount obtained by deducting the amount of the listed shares, etc. at the time of withdrawal made for transfer);

b. Listed shares, etc. transferred from a tax-exempt management account for another year related to an account in which the continuous management account is established, on the day immediately following the day on which five years have passed from January 1 of the year in the tax-exempt management account for another year was established;

c. The listed shares, etc. set forth in (ii)c.;

(iv) The following listed shares, etc. shall be transferred in the following ways, respectively:

a. Listed shares, etc. related to the tax-exempt management account that are held on the day on which five years have passed from January 1 of the year in which the tax-exempt management account was established in the account (hereinafter referred to as the “five years expiry date”) (excluding those which will be transferred as described in (ii)a.(b) or b. or (iii)a. or b.): transfer in the following ways according to the respective categories:

(a) Case where the resident, etc. is younger than 18 years old on March 31 of the year immediately following the year which includes the five years expiry date: transfer to a taxable minor’s account which has been established simultaneously with the account, that is to be conducted on the day immediately following the five years expiry date;

(b) Cases other than the case set forth in (a) above: transfer to another custody account to be conducted on the day immediately following the five years expiry date.

b. Listed shares, etc. related to a continuous management account that are held by the resident, etc. as of December 31 of the year immediately before the year in which he/she is 18 years old as of January 1: transfer to another custody account to be conducted on the day immediately after December 31 mentioned above.

(v) Other certain matters

(Notes) 1. The “tax-exempt management account” refers to an account which is established to make records on the book-entry settlement, etc. of the listed shares, etc. for which book-entry settlement will be made based on a minor’s account management agreement, separately from records on other transactions, on January 1 of each year between 2016 to 2023 (limited to the years in which the resident, etc. is younger than 18 years old on January 1 of that year and the year in which he/she was born).

2. The “continuous management account” refers to an account which is established to make records, etc. on the book-entry settlement, etc. of listed shares, etc. for which book-entry settlement, etc. will be made based on a minor’s account management agreement, on January 1 of each year between 2024 to 2028 (limited to the years in which the resident, etc. is younger than 18 years old.

(4) Taxable Minor's Account

A taxable minor's account means an account which a resident, etc. who opened a minor's account opens at the business office of a financial instruments business operator, etc. or at a business office of a corporation which has a certain relationship with the said financial instruments business operator, etc. and which consists of a specified account, deposit account, or an account for managing money and other assets deposited from customers (limited to any of the above accounts in which transactions, other than those under a taxable minor's account management agreement, are not conducted; more than one specified account must not be contained), where such account is opened concurrently upon opening the minor's account.

Listed shares, etc. and deposits and savings, etc. in a taxable minor's account cannot be withdrawn from the account, in principle, until December 31 of the year preceding the reference year of the resident, etc. who has opened the taxable minor's account. However, this does not apply when withdrawing deposits or savings, etc. for acquiring listed shares, etc. in a minor's account or taxable minor's account or withdrawing all of the listed shares, etc. and deposits and savings, etc. in the minor's account and taxable minor's account due to a reason such as a disaster that arises for the resident, etc. The restriction on withdrawal will be eased on January 1, 2024.

(Notes) 1. This measure is applicable to listed shares, etc. to be received from April 1, 2016 onward in a minor's account for which a notification of opening is filed on or after January 1, 2016.

2. If a person who has opened a minor's account and taxable minor's account withdraws listed shares, etc. and deposits and savings, etc. from these accounts by December 31 of the year preceding the reference year or December 31, 2023, whichever comes earlier, it is deemed that the listed shares, etc. have been transferred or dividends, etc. thereon have been paid on the day of the withdrawal, and the following amounts will be subject to withholding at source at a tax rate of 15.315% (plus an inhabitant tax of 5%):

(i) The amount obtained by deducting the total sum of the amounts of consideration for acquisition of listed shares, etc. acquired in the minor's account during the period from the day of opening the minor's account to the day of the withdrawal from the total sum of the following amounts:

a. The total sum of the amount of consideration for any transfer of listed shares, etc. made in the minor's account and the value at the time of the transfer (market value) of any listed shares, etc. transferred from the minor's account to a taxable minor's account, during the period from the day of opening the minor's account to the day of the withdrawal; or

b. The total sum of the value of the listed shares, etc. held in the minor's account as of the day of the withdrawal (market value).

(ii) The total sum of the amount of dividends, etc. on listed shares, etc. received in the minor's account during the period from the day of opening the minor's account to the day of the withdrawal.

(5) Submission of a Minor's Account Annual Trading Report

A financial instruments business operator, etc. must prepare a report on matters including the amounts of dividend income and capital gains, etc. that arose from listed shares, etc. in a minor's account during the year, and submit it to the district director of the tax office by January 31 of the following year.

(6) Procedure for Transfer of Listed Shares, Etc. in Relation to a Tax-Exempt Management Account

(i) Transfer of listed shares, etc. in a minor's account related to a tax-exempt management account established in the minor's account in the case where the resident, etc. who opens a minor's account on March 31 of the year immediately following the year which includes the five years expiry date is younger than 18 years old shall be conducted in the following ways on the day immediately following the five years expiry date, except for those transferred to a tax-exempt management account or continuous management account for another year.

a. When a specified account which constitutes a taxable minor's account that has been established simultaneously with the minor's account is established, the listed shares, etc. in a minor's account related to the tax-exempt management account shall be transferred to the specified account from the minor's account.

(Note) Listed shares, etc. in a minor's account related to the tax-exempt management account of the same issue as those of the listed shares, etc. in a minor's account that are to be transferred to the specified account as described in a. above must be transferred in whole to the specified account from the minor's account.

b. When the resident, etc. submits to the head of the business office of a financial instruments business operator, etc. at which his/her minor's account is opened a "written request for transfer of listed shares, etc. in a minor's account to a custody account other than the specified account" which describes the following matters (including provision of electronic or magnetic records containing the records on matters which should be described in the written request by electronic or magnetic means, in lieu of the submission of the written request), notwithstanding what is provided for in a. above, the listed shares, etc. in a minor's account related to the tax-exempt management account that are entered or recorded in the written request (including electronic or magnetic records containing the records on matters which should be described in the written request that have been provided by electronic or magnetic means) shall be transferred to a custody account other than the specified account which constitutes the taxable minor's account from the minor's account.

(a) Name, date of birth and address of the person who submits a written request;
(b) Name and location of the business office of a financial instruments business operator to which the written request is to be submitted;
(c) A statement requesting transfer of the listed shares, etc. in a minor's account related to a tax-exempt management account which was established in the minor's account to a custody account other than the specified account;
(d) Class, issue and number or equity or value of the listed shares, etc. in a minor's account which the resident, etc. intends to transfer;
(e) Other matters of reference

(Note) The listed shares, etc. in a minor's account related to a tax-exempt management account in the case where a specified account which constitutes the taxable minor's account is not established shall also be transferred to a custody account other than the specified account which constitutes the taxable minor's account from the minor's account. In this case, it is not necessary to submit a written request.

(ii) The listed shares, etc. in a minor's account related to a tax-exempt management account which is established in a minor's account in the cases other than those described in (i) above shall be transferred in the following ways on the day immediately following the five years expiry date, except for those to be transferred to a tax-exempt management account or continuous management account for another year.

a. In the case where a resident, etc. who has opened the minor's account at the business office of a financial instruments business operator at which the minor's account is opened has opened a specified account, the listed shares, etc. in a minor's account related to the tax-exempt management account shall be transferred to the specified account form the minor's account.

(Note) Listed shares, etc. in a minor's account related to a tax-exempt management account of the same issue as those of the listed shares, etc. in a minor's account which are to be transferred to the specified account as described in (a) above must be, in whole, transferred to the specified account from the minor's account.

b. When the resident, etc. submits to the head of the business office of a financial instruments business operator, etc. described in a. above, a written request for transfer of listed shares, etc. in a minor's account to a custody account other than a specified account (including provision of electronic or magnetic records containing the records on matters which should be described in the written request by electronic or magnetic means, in lieu of the submission of the written request), notwithstanding what is provided for in a. above, the listed shares, etc. in a minor's account related to a tax-exempt management account that are entered or recorded in the written request (including electronic or magnetic records containing the records on matters which should be described in the written request that have been provided by electronic or magnetic means) shall be transferred to a custody account other than the specified account which has been entered or recorded in a written request.

(Note) The abovementioned listed shares, etc. may be transferred to a custody account other than the specified account opened at the business office of a financial instruments business operator that is different from the business office of the financial instruments business operator at which the minor's account is opened.

c. In the case where the resident, etc. has not opened a specified account at the business office of the financial instruments operator, etc. described in a. above, the listed shares, etc. in a minor account related to the tax-exempt management account that are not entered or recorded in the written request shall be transferred to a custody account other than the specified account which is opened at the business office of the financial instruments business operator, etc. from the minor's account.

(iii) If a continuous management account is established in a minor's account on the day following the day on which five years have passed since January 1 of the year including the day on which a tax-exempt management account was established in the minor's account, the head of the business office of the financial instruments business operator, etc. at which the minor's account was opened is to transfer the listed shares, etc. in the minor's account related to the tax-exempt management account from the tax-exempt management account to the continuous management account as of that day.

If the resident, etc. who has opened the minor's account submits a document stating the following matters (or provided information of the matters to be stated in that document by electronic or magnetic means instead of submitting the document) to the head of the business office of the financial instruments business operator, etc. at which the minor's account is opened, the head of the business office of the financial instruments business operator, etc. is not to transfer the listed shares, etc. in the minor's account related to the tax-exempt management account for which the relevant matters are entered or recorded in that document (including electronic or magnetic records in which the matters to be stated in that document that have been provided by electronic or magnetic means are recorded) to the continuous management account:

a. Name, date of birth and address of the person who submits the document;
b. Name and location of the business office of the financial instruments business operator, etc. to which the document is to be submitted;
c. A statement requesting that the listed shares, etc. in a minor's account related to a tax-exempt management account which was established in the minor's account should not be transferred to a continuous management account;
d. Class, issue and number or equity or value of the listed shares, etc. in a minor's account which the resident, etc. does not intend to transfer; and
e. Other matters of reference.

The head of the business office of the financial instruments business operator, etc. that has received the document must preserve the document for five years from the year following the year including the day on which the minor's account was abolished.

(7) Procedures for Transfer of Listed Shares, Etc. Related to a Continuous Management Account

Listed shares, etc. related to a continuous management account that are held by the resident, etc. as of December 31 of the year immediately preceding the year in which he/she is aged 18 years as of January 1 of that year shall be transferred in the same procedures as those for transferring the listed shares, etc. related to a tax-exempt management account as described in (6)(ii)a. to c. above, on the day immediately following December 31 mentioned above.

17 Exemption of Income Arising from Transfer of Bonds, Etc.

Income tax is not imposed on income arising from transfer of the discount bonds that is withheld at source at the time of issuance with regard to profit from redemption, the Long-Term Credit Bank bonds, etc. prescribed in Article 2, Paragraph 2, Item 5 of the Deposit Insurance Act, beneficial interests of loan trusts, and the Norinchukin Bank bonds prescribed in Article 2, Paragraph 2, Item 4 of the Agricultural and Fishery Cooperation Savings Insurance Act (hereinafter referred to as "beneficial interests of loan trusts, etc.").

(Note) The Long-Term Credit Bank bonds, etc. prescribed in Article 2, Paragraph 2, Item 5 of the Deposit Insurance Act specifically refer to Riccho Wide (Shinsei Bank), Risshin Wide (Aozora Bank), Rissho

Wide (Shoko Chukin Bank) which are covered by deposit insurance. Meanwhile, the Norinchukin Bank bonds prescribed in Article 2, Paragraph 2, Item 4 of the Agricultural and Fishery Cooperation Savings Insurance Act specifically refer to bonds issued by Norinchukin Bank under the Norinchukin Bank Act (Warino and Ritsuno), and those in safe custody are covered by agricultural and fishery cooperation savings insurance.

Since income arising from transfer of beneficial interests of loan trusts, etc. are exempted from tax, when the revenue from transfer of beneficial interests of loan trusts, etc. falls short of the total sum of the acquisition cost and transfer cost of the beneficial interests of loan trusts, etc. or the necessary expenses relating to the transfer, such amount in short is deemed not to have existed with regard to application of the provisions of the Income Tax Act.

18 Special Tax Treatment for Stock Option System

Stock companies can grant a right to their directors, executive officers and employees (including directors and employees of other corporations of which the corporation holds more than 50% of the total members of the issued and outstanding shares or equity contributions) to acquire a certain number of shares of the companies for no charge or at a certain price (exercise price) during a certain period (exercise period) (a share option, a right to demand the transfer of shares or a preemptive right to new shares) in accordance with the provisions set forth in the Companies Act. In this system (stock option system), the directors, executive officers and employees who are granted such a right (stock option) can exercise the right and buy shares in their own company at a predetermined exercise price and receive a capital gain upon the sale of such shares if the share price rises after that.

This is a compensation system granted to directors, executive officers and employees that is linked to performance of the company or to the company's share price, and special treatment is established to facilitate the smooth introduction of this system in the area of taxation because it is expected that this system will benefit the company in recruiting and retaining superior personnel.

In June 2019, the Small and Medium-sized Enterprises Business Enhancement Act was amended. In order to support venture businesses in achieving growth by making use of external highly skilled professionals, the amendment introduces the system for approving plans of SMEs that meet certain requirements to develop new business fields by making use of external highly skilled professionals (computer programmers, engineers, lawyers, patent attorneys, certified public tax accountants, certified public accountants, etc.). Under this system, SMEs that have obtained approval are provided with financial assistance and are also covered by this special tax treatment in terms of stock options to be granted by them to external highly skilled professionals that meet certain requirements.

Specifically, (i) directors, executive officers or employees (including their successors except for certain persons such as large shareholders) or (ii) external highly skilled professionals who engage in new business field development projects with the use of external highly skilled professionals which is carried out by approved new SMEs prescribed in Article 13 of the Small and Medium-sized Enterprises Business Enhancement Act in accordance with approved plans for new business field development with the use of external highly skilled professionals as prescribed in that Act, except for directors and employees, etc. of the SMEs (limited to such external highly skilled professionals who meet requirements such as holding the status of resident continuously from the first day of the implementation period of the approved plan for new business field development with the use of external highly skilled professionals until the day of exercise of share options; hereinafter referred to as “specified employees”) receive an economic gain (the difference between the share price and the exercise price) when they exercise the right to purchase their company’s share (demand for share transfer), exercise the right to make a claim for subscription to new shares (preemptive subscription right) or exercise the right to a bonus issue of share options in an “advantageous issuance.” These rights are granted through a contract concluded with the company based on a resolution of the ordinary general meeting of the company. In this case, income taxes and the special income taxes for reconstruction will not be assessed against this economic gain under certain conditions.

(Notes) 1. “Certain conditions” refers to the following, and those fulfilling all of these requirements are referred to as “tax qualified stock options”:

(i) That the share options, etc. must be exercised not less than two years, and not more than ten years following the date of the granting resolution (or 15 years following the date of the granting resolution if the following requirements are satisfied):

a. The period since the date of establishment of the stock company is less than five years as of the date of the granting resolution; and

b. The stock company is a company other than a company issuing shares listed on a financial instruments exchange or registered as OTC traded issues as of the date of the granting resolution;

(ii) That the total exercise price in any one year must not exceed JPY12 million;

(iii) That the strike price per share must not be less than the price of shares of the granting company at the time of the conclusion of the contract;

(iv) That the share options must not be transferred;

(v) That the sale or transfer of shares or the issuing of new shares in connection with the exercise of the rights does not contravene the terms set forth in the Companies Act that are prescribed by the granting resolution (excluding the names of the directors) for the purpose of the sale, transfer, or issue; and

(vi) That the designated shares are kept in the custody of a financial instruments business operator, etc., at one of its business offices, etc., in a specified manner, in accordance with the arrangements pertaining to the trust agreed in advance between the granting company and the financial instruments business operator, etc., such as delegation of custody or administration of the shares.

2. Statutory auditors of stock companies are excluded from eligible persons for tax qualified stock options.

3. Individuals who have, through inheritance, etc., acquired the shares that specified employees acquired under the coverage of this special treatment do not fall within the category of succeeding individuals eligible for special treatment.

4. A certain scope of specified shares held by specified employees at the time of moving out of Japan shall be deemed to have been transferred at the time of moving out from Japan at the value as of the time of exercise of such rights.

If a resident has received rights to acquire shares for free or at an advantageous cost, such as via share options, from the issuing company and the resident or his/her heir, etc. then transferred them back to the issuing company, the amount calculated by deducting the acquisition cost of the share options from the amount of consideration for the transfer is deemed to be a revenue related to business income, revenue from salaries, etc., revenue from a retirement allowance, etc., revenue related to occasional income, or revenue related to miscellaneous income which is to be paid by the issuing company and is subject to taxation.

19 Income Tax for Profit from Redemption of Discount Bonds

(1) Outline

The amount equivalent to the difference between the issue price and the redemption value of discount bonds (profit from redemption) is taxed as revenue arising from transfer of bonds, and for discount bonds issued on or after January 1, 2016, the withholding at source at the time of issuance and the separated withholding taxation at source are not applicable. Therefore, income from redemption and transfer of discount bonds carried out on or after January 1, 2016 is subject to self-assessed separated taxation at a rate of 15.315% (and an additional inhabitant tax of 5%) as capital gains, etc. on bonds.

Meanwhile, profit from redemption of discount bonds issued by a family company to be received on or after January 1, 2016 by a shareholder, etc., who served as the basis for judging whether the corporation is a family company is subject to aggregate taxation as miscellaneous income.(Note 2)

(Notes) 1. With regard to discount bonds issued on or before December 31, 2015 for which profit from redemption was subject to the withholding at source at the time of issuance, the separated withholding taxation at source at a rate of 18% is maintained for the profit from redemption, and income from transfer is exempt from tax.

However, the so-called financial bonds which are not covered by deposit insurance and Norinchukin Bank bonds are excluded from application of capital gain taxation and profit from their redemption is subject to the withholding at source at the time of issuance and separated withholding taxation at source, because their transfer is restricted, in principle, and they are financial instruments that are similar in nature to fixed-term deposits, etc.

2. If a shareholder who served as the basis for judging whether the corporation in question is a family company is a corporation and the individual who has a special relationship with the corporation that is the shareholder (i.e. the individual holds more than 50 percent of its shares) receives a profit from redemption of discount bonds, such profit is also subject to aggregate taxation. This applies to the profit to be received on or after April 1, 2021.

(2) Withholding at Source, Etc. for the Amount of Profit from Redemption of Discount Bonds

Since income from the transfer of bonds including discount bonds became taxable, the withholding at source regarding discount bonds is to be carried out at the time of redemption, similar to the case of interest on coupon bonds (bonds for which interest is paid), instead of at the time of issuance.

(i) Withholding at Source for the Amount of Profit from Redemption of Discount Bonds

In this special treatment, three systems relating to withholding at source are in place depending on the type and payment method, etc. of the discount bonds.

a. Principle

A person who pays redemption money of discount bonds in Japan to an individual, domestic corporation or foreign corporation on or after January 1, 2016 must, at the time of the payment, withhold income tax at a rate of 15.315% (and an additional inhabitant tax of 5%) for the amount of profit from redemption relating to the redemption money of the said discount bonds, and pay it to the State no later than the tenth day of the month following the month that includes the date of withholding.

b. Redemption Money of Specified Discount Bonds Delivered Through a Person Handling Specified Discount Bonds

A person in charge of handling payment in Japan with regard to redemption money of specified discount bonds to be paid in Japan to an individual, domestic corporation or foreign corporation on or after January 1, 2016 (hereinafter referred to as a "person handling specified discount bonds") must, at the time of delivering the redemption money to the individual, domestic corporation or foreign corporation, withhold income tax at a rate of 15.315% (and an additional inhabitant tax of 5%) for the amount of profit from redemption relating to the redemption money of specified discount bonds to be delivered, and pay it to the State no later than the tenth day of the month following the month that includes the date of withholding.

(a) Specified discount bonds

Specified discount bonds means discount bonds that fall under the category of listed shares, etc. that are subject to special treatment of taxation on capital gains, etc. from listed shares, etc. In the case of specified discount bonds that are not received through a person handling specified discount bonds, the payer of the redemption money will be the person having the withholding obligation pursuant to a. above.

(b) Person handling specified discount bonds

A person handling specified discount bonds who will be the person assuming the withholding obligation for the redemption money of specified discount bonds under this special treatment is a person who conducts an intermediary, brokerage or agency service for the receipt of the redemption money of specified discount bonds by the person who receives the redemption money of specified discount bonds (limited to such service conducted in Japan as a business or in relation to a business) and who is an account management institution as prescribed in the Act on Book-Entry Transfer of Corporate Bonds and Shares.

c. Redemption Money of Foreign Discount Bonds Delivered Through a Person Handling Foreign Discount Bonds

A person handling foreign discount bonds in Japan with regard to redemption money of foreign discount bonds to be paid to a resident or certain domestic corporation on or after January 1, 2016 must, at the time of delivering the redemption money of the foreign discount bonds to the resident or certain domestic corporation, withhold income tax in an amount calculated by multiplying the amount of profit from redemption relating to the redemption money of the foreign discount bonds to be delivered by 15.315% (and an additional inhabitant tax of 5% if the taxpayer is a resident), and pay it to the State no later than the tenth day of the month following the month that includes the date of withholding.

When withholding income tax at source for the redemption money of foreign discount bonds, if there is any foreign income tax to be collected at the time of payment of the redemption money of the foreign discount bonds, the tax to be withheld at source relating to the amount of profit from redemption subject to withholding at source is to be calculated by deducting the amount equivalent to the foreign income tax from the amount of profit from redemption, and then multiplying that amount by the tax rate above.

(ii) Scope of Target Discount Bonds

The target discount bonds are the following bonds that are subject to capital gain taxation:

a. Those issued at a discount;

b. Bonds of the separated principal component (bonds which constituted the principal component of bonds whose principal component and interest component are separated and traded independently (the so-called STRIPS bonds));

c. Bonds of the separated interest component (bonds which constituted the interest component of bonds whose principal component and interest component are separated and traded independently (the so-called STRIPS bonds)); and

d. Bonds for which interest is paid and whose issue price is 90% or less of the face value.

However, bonds referred to in a. to d. above which are managed in a specified account at the time of their redemption are excluded from the scope of the above discount bonds and do not require the withholding at source, because they are subject to the withholding at source or the filing of a final tax return under the specified account and because, with regard to the foreign currency denominated bonds prescribed in the Act on Issue of Government Bonds in Foreign Currency, no income tax is to be withheld at source.

(iii) Significance of the Amount of Profit from Redemption

The amount of profit from redemption that is subject to withholding at source is the following amount for the respective categories of discount bonds set forth therein:

a. Discount bonds (excluding bonds of the separated interest component) for which the period from the day of issuance to the day of redemption is one year or less: the amount calculated by multiplying the amount of redemption money of the discount bonds by 0.2%;

b. Discount bonds (excluding bonds of the separated interest component) for which the period from the day of issuance to the day of redemption exceeds one year, and bonds of the separated interest component: the amount calculated by multiplying the amount of redemption money of the discount bonds by 25%; and

c. Discount bonds for which the money required for their acquisition is managed based on a contract on management of the amount required for acquisition of discount bonds (hereinafter referred to as a "discount bond management contract") concluded with a financial instruments business operator, etc. with whom a certain domestic corporation receiving the redemption money of the discount bonds has entrusted entry or recording of the discount bonds in the book-entry transfer account register or the custody of the discount bonds and who is a person handling specified discount bonds or person handling foreign discount bonds in Japan with regard to the redemption money: where the amount of the redemption money of the discount bonds exceeds the amount required for acquiring the said discount bonds which are managed based on the discount bond management contract, the amount of such profit (only applicable to a certain domestic corporation).

1 10 Special Tax Treatment Regarding Miscellaneous Income, Etc. from Futures Trading

If a resident, etc., engages in a transaction as listed below, and has settled the transaction according to the relevant method set forth below in accordance with the category of the trade acquisition (hereinafter referred to as "net cash settlement") the business income, capital gains or miscellaneous income (hereinafter referred to as "miscellaneous income, etc.") from the futures trade involved in the net cash settlement shall be covered by self-assessed separated taxation at a rate of 15% (plus an inhabitant tax of 5% if the taxpayer is a resident) on the miscellaneous income, etc. in connection with futures trading within that year, separate from other income.

Even in the case of separate self-assessment taxation, the amount obtained by multiplying 2.1% by the amount of base income tax for each year from 2013 to 2037 shall be imposed as a special income tax for reconstruction, together with withholding tax:

(1) Commodity futures transactions, etc.: settlement of the relevant commodity futures transactions (excluding those in which delivery is to be made of the commodities);

(Note) Commodity futures transactions, etc. mean transactions as prescribed in Article 2, Paragraph 3, Item 1 through Item 4 of the Commodity Futures Trading Act which fall under futures transactions (including transactions as set forth in Article 2, Paragraph 10, Item 1, e. thereof that are conducted on a commodity market), or transactions as set forth in Article 2, Paragraph 14, Item 1 through Item 5 of the said Act which constitute over-the-counter commodity derivative transactions (limited to those conducted with commodity derivatives business operators as the counterparty).

(2) Financial instruments futures transactions, etc. (excluding crypto-and other asset derivatives transactions): settlement of the relevant financial instruments futures transactions (excluding those in which delivery is to be made of the financial instruments); or

(Notes) 1. Financial instruments futures transactions, etc. mean [a] certain transactions as set forth in Article 2, Paragraph 21, Item 1 through Item 3 of the Financial Instruments and Exchange Act (in the case of the transaction set forth in Item 3, excluding such a transaction relating to the option of effecting any of the transactions set forth in Item 4 through Item 6) which fall within the category of market derivatives transactions (excluding those relating to crypto-and other assets set forth in Paragraph 24, Item 3-2 of the same Article and those involving financial indicators prescribed in Article 29-2, Paragraph 1, Item 9 of the same Act), or [b] transactions as set forth in Article 2, Paragraph 22, Item 1 through Item 4 of the said Act (in the case of the transaction set forth in Item 3, excluding such a transaction relating to the option of effecting any of the transactions set forth in Item 5 through Item 7) which fall within the category of over-the-counter derivatives transactions (excluding those relating to crypto-and other assets set forth in Paragraph 24, Item 3-2 of the same Article and those involving financial indicators prescribed in Article 29-2, Paragraph 1, Item 9 of the same Act) (limited to those conducted with financial instruments business operators or registered financial institutions as the counterparty).

2. For the purpose of addressing the diversification of financial transactions in recent years, as well as enhancing the trust in the financial function and protecting users, the “Act for the Partial Amendment of the Payment Services Act, etc., to Address the Diversification of Financial Transactions based on Advances in Information Technology” (Act No. 28 of 2020) was enacted. This Amendment Act provides for regulations on crypto-asset exchange service providers and rules for derivatives transactions involving crypto-assets. Accordingly, the Financial Instruments and Exchange Act has been amended to include “crypto-assets (virtual currency)” in the scope of financial instruments covered by the same Act (art. 2, para. 24, item 3-2 of the Financial Instruments and Exchange Act). Under the amended Act, derivatives transactions that use “crypto-assets” (hereinafter referred to as “crypto-asset derivatives transactions”) are subject to regulations (on sales and solicitation) under the Financial Instruments and Exchange Act as in the case of foreign exchange margin transactions (FX transaction). While crypto-asset derivatives transactions are added to the types of derivatives transactions regulated under the Financial Instruments and Exchange Act, along with market derivatives transactions, over-the-counter derivatives transactions, and foreign market derivatives transactions, crypto-asset derivatives transactions are subject to aggregate taxation as they have been and therefore they are not eligible for this special tax treatment (this applies to net cash settlement of futures transactions to be conducted on or after May 1, 2020; FY2020 Tax Reform). As a result of the amendment to the Financial Instruments and Exchange Act under the Act to Partially Amend the Payment Services Act and Other Related Acts to Establish a Stable and Efficient Payment Services System (Act No. 61 of 2022), the term “crypto-assets” was changed to “crypto-and other assets” (effective as of June 1, 2023).

(3) Acquisition of securities set forth in Article 2, Paragraph 1, Item 19 of the Financial Instruments and Exchange Act: exercise (excluding those by which delivery of the financial instruments shall be made) or waiver of rights represented in the relevant securities or transfer of the relevant securities (limited to certain transfers such as those to be made to a financial instruments business operator) that is to be conducted on or after January 1, 2010.

If a loss is incurred as a result of calculating the amount of miscellaneous income, etc., in connection with the futures trading, the loss is treated as “not having occurred,” but if the taxpayer files a final tax return, and if certain criteria are satisfied, the taxpayer will be permitted to carry forward this loss and deduct it from the taxpayer’s miscellaneous income, etc. resulting from futures transactions, during each year within a three year period from the year following the year in which the losses were incurred.

(Note) “Certain criteria” above means the case where a final tax return, with the attachment of a detailed statement in connection with a calculation of the amount of loss, has been filed for income tax for a year in which a loss has arisen in net cash settlement of futures trading, and where a final tax return is filed for the succeeding year in which a profit has arisen in net cash settlement and carry forward deduction is sought, and a detailed statement in connection with calculation of the amount of the carry forward deduction sought is attached to that final tax return.

1 11 System of Reporting by Recipients of Interest, Dividends, Etc. and Submitting Payment Records, Etc.

The tax code requires that the following documents must be submitted to the tax authorities so that they can identify accurate tax information in order to properly assess taxes.

(1) Notification by Recipients of Interest, Dividends, Etc.

(i) Duty to Report by Recipients of Interest, Dividends, Etc.

An individual receiving interest, dividends and the like domestically must report his/her name (in the case of a company, the company name), address, and Individual Number or Corporate Number to the person handling the payment not later than the time of settlement of the payment.

(Notes) 1. The Individual Number or Corporate Number will have to be reported, in principle, from January 1, 2016 onward.

However, if the financial institution, etc. which receives a notification keeps a book in which the Individual Number and other information of the person submitting the notification is recorded, the person does not need to notify the financial institution, etc. of his/her Individual Number (the same applies to the obligation to submit a notification or notice referred to in (ii) to (v) below).

2. Interest subject to separated withholding taxation at source is not required to be reported, nor is any income for which tax exemption is applicable, because customer identification should have already been completed for such income when the notification for tax-exempt deposits and other such documentation was filed (including the provision by electronic or magnetic means). Therefore, those individuals or corporations who receive payments of interest, dividends, etc., for which aggregate taxation is applicable are required to report such information.

Meanwhile, if the person who receives interest or dividends, etc. has already reported the name and other necessary matters at the time of making a deposit, etc., it is not necessary to receive confirmation upon each payment (deemed reporting).

3. With regard to interest on bonds or distributions of earnings from bond investment trusts, etc. to be received by an individual, the reporting system will be applicable to such interest or dividends which are to be received on or after January 1, 2016 and which are subject to self-assessed separated taxation.

4. Corporations which are established in accordance with certain special laws such as public corporations or international organizations are also not required to report such information.

In this case, the person receiving the payment must present identification documentation and receive verification thereof.

The identification documentation is as follows:

a. An individual who has an address in Japan:

(a) The Individual Number Card; or (b) a copy of the residence certificate or a certificate of items entered in the certificate of residence which contains the Individual Number (limited to one prepared within six months prior to the day of presentation) and a document for confirming the address, etc. (documents other than those referred to in Note 1.(a) and (b) below).

(Note) The "Individual Number notification card" was abolished on May 25, 2020, but it can be used as a document for confirming the Individual Number only if the personal information including the name and address indicated on the Individual Number notification card matches the information recorded in the residence certificate.

b. An individual who does not have an address in Japan:

(a) A document for confirming the address, etc. (documents other than those referred to in (a) and (b) in Note 1. Below) (or the Individual Number of an Individual Number notification card if the individual has his/her Individual Number)

(Notes) 1. The scope of "document for confirming the address, etc." includes the following:
(a) Individual Number Card; (b) a copy of the residence certificate or a certificate of items entered in the certificate of residence (limited to one prepared within six months prior to the day of presentation); (c) a copy of a supplementary card of a family register or a seal registration certificate; (d) various kinds of health insurance certificate; (e) a physical disability certificate, etc.; (f) a driver's license; (g) a receipt of national tax or local tax, a certificate of tax payment, or a receipt of a social insurance premium (limited to one containing the stamped date indicating the day of receipt or containing the date of issuance where such date is within six months prior to the day of presentation).

2. From January 1, 2016 onward, an electronic certificate for the bearer's signature, etc. may be sent in lieu of presentation of identification documentation.

3. There is an exception to the scope of identification documents that must be presented by a person whose Individual Number, etc. is recorded in the book mentioned above (the same applies to the obligation to submit a notification or notice referred to in (ii) to (v) below).

c. A corporation which has a Corporate Number:

(a) The notification of the Corporate Number (one prepared within six months prior to the day of presentation); (b) the notification of the Corporate Number (one prepared before six months prior to the day of presentation) and a certificate of registered information, etc.; (c) a printout of the published corporation's name, location, and Corporate Number and a certificate of registered information, etc.

(Note) Starting from April 1, 2020, when a corporation that receives payment, etc. of interest, etc. or dividends, etc. makes a report, etc. as mentioned above, and if the person who receives the report, etc. confirms that the corporation's name, address and Corporate Number indicated in the report, etc. are identical with the corporation's name, address and Corporate Number made public under the provisions of the Act on the Use of Numbers to Identify a Specific Individual in Administrative Procedures, the corporation is not required to present its identification documentation to the person who receives the report, etc.

d. A corporation which does not have a Corporate Number:
A document for confirming the corporation's name

(Note) From January 1, 2016 onward, reporting of the Individual Number or Corporate Number and identity verification will be necessary by the time of the first payment. However, for a contract, etc. concluded before January 1, 2016 for which reporting and identity verification are not required upon each payment of interest, etc., a transitional measure is in place allowing the reporting of the Individual Number or Corporate Number and identity verification to be made by the first date of payment made on or after January 1, 2022.

Upon verification of the above information, the entity handling payment processing, etc. shall record the title of the documentation used as customer identification documentation in the records related to the issue of securities such as documentation related to the receipt of deposits or collective management trusts, the ledger concerning book-entry transfers of securities, and the shareholders registry, and shall include a clear statement of the fact that the name (or company name as the case may be), address, and Individual Number or Corporate Number have been verified. In addition, any such records must be kept for a specified period of time.

(ii) Submission of Notice of Interest, Etc. on Bearer Bonds

Individuals receiving payment of interest on bearer bonds, or dividends on surplus of bearer shares, or distributions of gains from bearer loan trusts or securities investment trusts in Japan must submit a "notice" stating information including the personal name (firm name), address, Individual Number or Corporate Number, and other requested information, to the person handling such payment at the time of payment.

In this case also, verification of identity is required.

Information to be indicated in a notice of interest, etc. on bearer bonds may be provided by electromagnetic means.

(Note) If separated withholding taxation at source is applicable on the interest, or if the tax exemption policy is applicable on the interest, submission of the above-mentioned notice is not required.

The customer identification procedures, the record-keeping policy for convenience purposes, the verification method, and the custody of records and documents shall follow the same procedures as the case of non-bearer bonds.

(iii) Duty to Report Information Concerning Interest, Etc. of Bonds, Etc. and Dividends, Etc. of Shares Issued Outside Japan

When payments of interest, etc. of bonds, etc. and dividends, etc. of Shares, issued outside Japan are received from a domestic agent, generally the same notification standards as (i) above apply.

(iv) Reporting of Recipients of Sales Proceeds of Shares, Etc.

On each occasion that a person who transfers shares, etc. (excluding public corporations, etc.) receives sales proceeds in Japan from a corporation to which the transfer of shares, etc., was made or from the financial instruments business operator, etc. which has been assigned to sell the shares, etc. (including cases of receipt of money or other property by reason of merger, etc.), such transferor must report matters in the same manner as (i) above to the payer before the date that the payment is to be made.

In this case, the person receiving such payment must also present a customer identification document and receive verification of the reported items.

(Notes) 1. Notice is also required of the portion of cash, etc. for which payment is to be received as a result of termination or partial cancellation of an investment trust, etc., as well as certain cash, etc. that is to be deemed and taxed as income such as capital gains, etc. involving shares, etc. The same applies to the payment record as well.

2. Upon the 2013 tax reform, income from transfer of bonds and bond investment trusts, etc. became taxable. As a result of this, the amount to be received due to redemption of bonds or termination or cancellation of bond investment trusts, etc. on or after January 1, 2016 is regarded as the amount of revenue arising from capital gains on shares, etc., in principle, and the reporting is required upon receiving payment of the redemption money or consideration for transfer.

The identification document presented upon making the notification, verification procedures concerning the payer of sales proceeds, and record keeping pertaining to such transfer shall comply with the procedures set forth in (i) above.

(v) Other Notice

The reporting of name (firm name), address, and Individual Number or Corporate Number and verification of personal identity also applies in the same manner as (i) above to the following persons:

a. a person who settles the balance, etc. of futures transactions;
b. a person who has transferred the beneficial interest in a trust and who will receive payment of consideration therefor in Japan; and
c. a person who has transferred gold bullions, etc. and who will receive payment of consideration therefor in Japan.

(2) Submission of Payment Records, Etc.

(i) Payment Records of Interest, Dividends, Etc.

The person making a payment or the agent handling payments of interest on deposits and savings, distributions of earnings from bond investment trusts, etc., interest on public and corporate bonds, distributions from surplus, dividends from profit, distribution of gains from beneficial interests of securities investment trusts, or gains from financial products, etc. shall prepare a payment record detailing annual totals of such interest, etc. (*nayose* (aggregation of names) method) and, as a rule, must submit such record to the competent district director of the tax office by January 31 of the year following the year that such payments were made or the date the obligation to make payment was fixed (in the case of dividends, within one month from the date the obligation to make payment was fixed). Meanwhile, the special treatment for no submission below has been established:

a. Payment to individuals:

With respect to interest on deposits and savings, no submission is required for those which are subject to separated withholding taxation at source and the tax exemption system.

With respect to interest, etc. on public and corporate bonds, no submission is required for those which were paid before January 1, 2016 and which are subject to separated withholding taxation at source and the tax exemption system. However, interest on World Bank bonds, etc. on which aggregate taxation is imposed, a payment record made using the "*Nayose* (aggregation of names)" method must be submitted (not necessary for amounts of JPY30,000 or less per year).

In addition, a payment record must be submitted with respect to dividends, etc. on listed shares, etc. (excluding dividends, etc. to large shareholders, etc.) among distributions of profit, etc., but a submission may be omitted with respect to distributions, etc. other than dividends, etc. on listed shares, etc. where the amount to be received for a single payment is less than the amount obtained by multiplying JPY100,000 by the number of months in the dividend calculation period divided by 12.

b. Payment to corporations:

Special treatment to allow the submission of payment records by the end of the following month for each payment with respect to payments to corporations, and the submission of a payment record may be omitted in the following respective cases:

(a) For payments of interest, etc. on public and corporate bonds, where the amount of single payment is less than JPY10,000 (if the calculation period is less than 1 year, JPY5,000, and if less than six months, JPY2,500); and

(b) For payments of dividends, etc. from profit, where the amount of single payment is less than JPY15,000 (if the calculation period is less than one year, JPY30,000).

(ii) Payment Records for Transfer Amount of Shares, Etc.

When payment for a transfer of shares, etc. (including payments of money on account of mergers) is made in Japan to a resident, etc., the financial instruments business operator, etc. that receives notification from the recipient of such payment must submit a payment record for all payments made in one year to the competent district director of the tax office no later than January 31 of the year following the year in which such payment was settled (*nayose* (aggregation of names) method). However, before January 1, 2016, if the sum of payments for sales proceeds for shares, made to the same person in one year was JPY1 million or less, a payment record need not be submitted.

The payment record can also be prepared on the occasion of each payment and be submitted to the competent district director of the tax office by no later than the last day of the month following the month in which the date the payment obligation became fixed (special method). In such case, before January 1, 2016, if the amount of one payment was JPY300,000 or less, such payment record need not be submitted. Financial instruments business operators, etc. employ this special method in practice.

(Note) If share transfers are made by means of a margin transaction, whether the submission of these payment records are required or not shall be determined on a case-by-case basis and on a per transaction basis as new short or long commitments are made, or as the unit for settlement changes.

Since the amount to be received due to the redemption of bonds or termination or cancellation of bond investment trusts, etc. on or after January 1, 2016 is regarded as the amount of revenue arising from capital gains on shares, etc., in principle, submission of payment records is not required with regard to payment of the redemption money or consideration for transfer.

(iii) Payment Records for Futures Transactions

Like the above, "records concerning futures transactions" must be submitted by January 31 of the following year with respect to a net settlement in futures transactions (excluding a net settlement in crypto-assets derivatives transactions conducted during the period from May 1 to December 31, 2020), but if the special method to prepare the record for a net settlement of a futures transaction to the same person (excluding a net settlement in crypto-assets derivatives transactions) is adopted, the record must be submitted by the last day of the month following the month in which the net settlement was made.

Records must be submitted with respect to net settlement because unlike other payment records, there are no standards for the omission of submission.

(iv) Payment Records, Etc. for Consideration for Transfer of Beneficial Interests in a Trust

Any person who makes payment of consideration for the transfer of beneficial interests in a trust and any person who makes payment of consideration for the transfer of gold bullion, etc. (excluding cases where the amount of such consideration is JPY2 million or less) is required to submit the payment records as in the case mentioned above.

However, before January 1, 2016, if the annual amount of consideration for the transfer of beneficial interests in a trust was JPY1 million or less, the payment records need not be submitted.

(v) Records Concerning Interest, Dividends or Consideration on Transfer of Shares, Etc. Received by Nominee

When a person or entity receives a payment of interest, dividends, or consideration on transfer of shares, etc., on behalf of another in connection with a business, in other words, when a financial instruments business operator, etc. acts as a nominee on behalf of a customer and receives a payment of interest or dividends, consideration on transfer of shares, etc. (excluding cases where a payment record is submitted), payment records received by the nominee for the year must be submitted to the competent district director of the tax office by the last day of January in the year following the receipt.

However, if the total amount received as nominee falls under the following cases, payment records do not need to be submitted:

a. In the case of interests, etc., JPY30,000 or less; or
b. In the case of distributions, etc. other than dividends, etc. in listed shares, etc., JPY50,000 or less.

Nevertheless, if the annual amount of consideration for the transfer of shares, etc. was JPY1 million (for preparation per payment, JPY300,000) or less before January 1, 2016, the payment records need not be submitted.

(Note) These records must be submitted for all dividends, etc. on listed shares, etc.

(vi) Records, Etc. of the Exercise of Stock Options

A stock company which has issued or allotted stock options shall submit the records of the person who exercised the stock options so issued or allotted to the head of the tax office for the period until January 31 of the year following the year during which such exercise was made. Records concerning allotment of shares without contribution and records concerning the economic benefits granted to the domestic officers, etc. from the foreign parent company, etc. are also required to be submitted in the same manner.

(Note) Since the transitional measure for the time of entering the Individual Number is not applicable to the statutory records above, the Individual Number of the person who exercises the stock options on or after January 1, 2016 must be entered.

(vii) Special Treatment for Submission of Payment Records, Etc.

With respect to the records set forth in (i) to (vi) above, which are to be submitted on or after January 1, 2021, if the number of pages of each record which should have been submitted during the second preceding year of the relevant year is 100 or more, the matters to be stated in such records are required to be submitted by using e-Tax, using cloud services, or submitting optical disks, etc. (optical disks or magnetic disks).

<Reference>

(Note) With the FY2013 tax reform, it became necessary to enter the Individual Number or Corporate Number of the payer and recipient in the payment records for payments, etc. made on or after January 1, 2016.

However, a transitional measure is in place for payments, etc. made under contracts concluded before January 1, 2016 to which "deemed reporting" is applied, allowing the reporting of the Individual Number or Corporate Number and identity verification to be made by the first payment made after January 1, 2022 and allowing omission of entry of the Individual Number or Corporate Number in the payment records until then.

There are provisions on the grace period for the entry of the Individual Number and Corporate Number for the following statutory records:

No	Type of record
1	Payment record of interest, etc.
2	Payment record of interest, etc. on foreign bonds, etc.
3	Payment record of dividends, distribution of surplus, and interest on funds
4	Payment record of dividends, etc. on foreign investment trusts, etc. or foreign shares, etc.
5	Payment record of distributions of earnings from investment trusts or specified trusts issuing beneficiary certificates
6	Payment record of distributions of earnings from open-end type securities investment trusts
7	Payment record concerning the amount deemed to be dividends, etc.
8	Payment record of consideration, etc. for transfer of shares, etc.
9	Payment record of delivered money, etc.
10	Payment record of consideration for transfer of beneficial interests of trusts
11	Payment record concerning futures transactions
12	Payment record of consideration for transfer of gold bullion, etc.
13	Record of interest income received by a registered person
14	Record of dividend income received by a registered person
15	Record of consideration for transfer of shares, etc. received by a registered person
16	Payment record of redemption money of listed securities investment trusts, etc.
17	Annual trading report of a specified account
18	Annual trading report of a tax-exempt account
19	Record of remittance to locations outside Japan, etc.
20	Record of transfer of securities to locations outside Japan, etc.

2 Corporation Tax

Whereas income tax is imposed on the income of an individual who is a natural person, corporation tax is a national tax imposed on the income of a corporation (tax base).

2-1 Outline

A corporation is either a domestic corporation (a corporation with its principal office or main business office in Japan) or a foreign corporation. The following presents a summary of the corporation taxes that are assessed on a domestic corporation.

The taxpayers are corporations (excluding public corporations) or associations without juridical personality, etc. (limited, however, to those entities for which there exists a specified representative or manager and public corporations or associations without juridical personality, etc. that are operating profit making businesses).

The tax base is the amount of the corporation's income for each fiscal year. The income for each fiscal year shall be calculated by deducting the total deductible expenses from total gross profits, which is calculated in accordance with fair and reasonable accounting standards, unless otherwise specified

The fiscal year refers to the unit period for calculating a corporation's property and its profits and losses, as specified in its articles of incorporation, etc.

Amounts which should be included in the amount of gross profits are, as a rule, profits gained from the following transactions:

(1) Sales of assets;
(2) Transfers of assets, with or without charge, or the rendering of services; and
(3) Gratuitous acquisitions of assets by transfer; and
(4) Other transactions, other than capital transactions, etc.

Amounts to be included in deductible expenses are, as a rule, the following:

(1) Amount of cost of goods sold, costs of completed work and other analogous costs;
(2) Amount of sales, general and administrative expenses, and other expense; and
(3) Losses related to transactions other than capital transactions, etc.

The following are the rates of corporate income tax levied on corporations each fiscal year, in the case of ordinary corporations:

Category		Fiscal year starting on or after April 1, 2015	Fiscal year starting on or after April 1, 2016	Fiscal year starting on or after April 1, 2018
Small and medium-sized corporation capitalized at not more than JPY100 million	Portion of annual income up to JPY8 million	15%	15%	19% (15%)
	Portion of annual income exceeding JPY8 million	23.9%	23.4%	23.2%
Ordinary corporation		23.9%	23.4%	23.2%

* The tax rate in the parenthesis in this table applies to the fiscal year starting before March 31, 2025.

(Notes) 1. For public interest corporations, etc. and special corporations, such as cooperative partnerships, a tax rate different from that stated above shall be applied. With regard to a corporation whose issued shares are held in whole by another large corporation (meaning a corporation, etc. whose amount of stated capital, etc. is JPY500 million or more) which has a relationship of full control, the reduced tax rate applicable to small and medium-sized corporations shall not apply.

2. The retained income of specified family companies and secret purpose expenditures of corporations are subject to additional taxes. There are also corporate taxes that are levied on the income from the trust property of a trust subject to corporation taxation, on the global minimum taxable amount for each subject accounting period, and on retirement pension funds.

3. From April 1, 2022, the group aggregation system has applied to corporations within a corporate group that are in a relationship of full control. Under this system, corporations within a corporate group are taxed individually and each of these corporations independently calculates and files a return of the amount of corporation tax, while certain adjustments such as aggregation of profits and losses of these corporations are carried out within the group. For a business year that commenced before April 1, 2022, the consolidated return system was applied to a parent company and its subsidiaries that were under full control.

In order to use part of the corporate inhabitant tax on a corporate tax basis as a source of local allocation tax so as to correct the unevenness in tax sources and narrow the gaps in financial strengths between regions, local corporation tax is imposed as national tax, separately from corporation tax, for any taxable fiscal year starting on or after October 1, 2014. In the case of an ordinary domestic corporation, the tax base is the tax base corporation tax for each taxable fiscal year (tax base corporation tax means the amount of corporation tax to be paid for the income gained in each taxable fiscal year and which has been calculated without application of any special treatments such as an income tax credit or foreign tax credit, and by excluding any additional penalty tax), and the amount calculated by multiplying this amount by a tax rate of 10.3% (or 4.4% for the fiscal year starting before October 1, 2019) shall be imposed as local corporation tax, together with the amount of corporation tax imposed on the income gained in each fiscal year. In the case of a corporation subject to corporation tax on the global minimum taxable amount (effective from the subject accounting period that commences on or after April 1, 2024), the tax base is the specified base amount of corporation tax for each taxable subject accounting period (meaning the amount of corporation tax on the global minimum taxable amount serving as the tax base for each subject accounting period; the amount of penalty tax is excluded). The amount of local corporation tax is calculated by multiplying the tax base amount by the tax rate of 93/907 and levied together with the amount of corporation tax on income for each business year and the amount of corporation tax on the global minimum taxable amount for each subject accounting period.

2 2 Securities

In principle, all interest on savings, interest on bonds, dividends with respect to shares and profit distributions from investment trusts, as well as capital gains, etc. on securities are included in the amount of taxable income for corporation tax purposes.

Dividends, however, are subject to special treatment designed to adjust (eliminate) the double taxation of dividends paid between corporations, under the system described below:

(1) Non-Inclusion of Received Dividends, Etc. into Gross Profits

When a corporation receives an amount of dividends, etc. from a domestic corporation within a given fiscal year, the corporation can exclude from the amount of gross profits of a certain amount according to the category of dividends, etc. on shares, etc. as set forth in a. through d. of (i) below (the "non-inclusion of received dividends, etc. into gross profits").

The amounts of dividends, etc. subject to this treatment include the following: [a] dividend on surplus or dividend on profit, the amount of distribution of surplus, or the amount of distribution of earnings from specified share investment trusts (excluding foreign stock price index-linked specified share investment trusts; the same applies hereinafter); or [b] the amount of distribution of money by investment corporations; or [c] the amount of distribution of money prescribed in Article 115, Paragraph 1 of the Act on the Securitization of Assets.

Meanwhile, the portion of the amount of distribution of earnings from securities investment trusts (excluding specified share investment trusts) other than bond investment trusts which is regarded as the amount of dividends, etc. is entirely included into the amount of gross profits.

(i) Amount of Dividends, Etc. Eligible for Non-Inclusion into Gross Profits

The amount of dividends, etc. eligible for non-inclusion into the amount of gross profits is the amount specified below for the respective categories of shares, etc. set forth therein:

a. Wholly-owned subsidiary shares, etc.(Note 1):	the entire amount of dividends, etc.
b. Affiliated corporation shares, etc.(Note 2):	the amount remaining after deducting the portion of the amount of interest on liabilities relating to affiliated corporation shares, etc. from the amount of dividends, etc.
c. Other shares, etc.(Note 3):	the amount equivalent to 50% of the amount of dividends, etc.
d. Non-control-purpose shares, etc.(Note 4):	the amount equivalent to 20% of the amount of dividends, etc.

(Notes) 1. "Wholly-owned subsidiary shares, etc." means, in the case where there is a complete controlling relationship (holding 100% of the shares, etc.) between a domestic corporation and another domestic corporation throughout the calculation period for the amount of dividends, etc., the shares, etc. of the said other domestic corporation.

2. "Affiliated corporation shares, etc." means, in the case where a domestic corporation holds more than one-third of the entire issued and outstanding shares, etc. of another corporation throughout the calculation period for the amount of dividends, etc., the shares, etc. of the said other domestic corporation (excluding wholly-owned subsidiary shares, etc.).

3. "Other shares, etc." means shares, etc. that do not fall under any of the categories of wholly-owned subsidiary shares, etc., affiliated corporation shares, etc. or non-control-purpose shares, etc.

4. "Non-control-purpose shares, etc." means, in the case where a domestic corporation holds not more than 5% of the entire issued and outstanding shares, etc. of another corporation as

of the record date for the obligation to pay dividends, etc., the shares, etc. of the said other domestic corporation (excluding wholly-owned subsidiary shares, etc.) and beneficial interests of specified share investment trusts.

5. For a business year that commences on or after April 1, 2022, the percentage of shares, etc. held referred to in 2. and 4. above is calculated by including the number of shares, etc. held by a consolidated corporation that has consolidated full controlling interest in the domestic corporation that receives dividends, etc., and the above classification of the listed shares, etc. is determined based on such percentage.

(ii) Limitation Based on Period of Ownership of Principal

If a corporation acquired shares, etc. which are the principal of the amount of dividends, etc. received (excluding deemed dividends) within one month prior to the record date for payment of such amount of dividends, and the corporation transfers the said shares, etc. or shares, etc. of the same issue as the said shares, etc., within two months from the said record date, the amount of dividends, etc. on such shares, etc. transferred (shares, etc. for short-term holding) cannot be excluded. In other words, the entire amount of the dividends, etc. will be included in gross profits.

(iii) Deduction of Interest on Liabilities

When a corporation pays interest on liabilities during the year (including the discount on notes or bond premiums, etc.), the shares, etc. subject to the calculation of deduction are limited to the affiliated corporation shares, etc. set forth in (i) b. above, and the amount of dividends, etc. on the affiliated corporation shares, etc. that is not included into the amount of gross profits is the amount obtained by deducting the amount of interest on liabilities that has been calculated as the portion relating to the affiliated corporation shares, etc. from the sum of the amounts of dividends, etc. to be received during the year with regard to the affiliated corporation shares, etc.

(2) Credit for Income Tax

The amount of any income taxes withheld when the corporation receives payments of interest, dividends, etc. (including interest on mortgage securities and gains from other financial instruments, etc.), redemption money of discount bonds, etc., is credited against the amount of corporation tax the corporation owes and any amount not creditable shall be refunded.

Also, the tax credit for the amount of income taxes withheld for any of the following is prorated depending on the holding period for the investment principal: dividends on surplus (excluding those relating to beneficial interests of specified bond management investment trusts and corporate bond-type beneficial interests, those associated with a decrease in capital surplus, and those arising from a split-off-type company split, and a share distribution), dividends on profit (excluding those relating to a split-off-type company split, and a share distribution), distribution of surplus (excluding deemed dividends), distribution of money (excluding deemed dividends), and distribution of earnings from group investment trusts (excluding jointly managed money trusts, bond investment trusts, and bond management investment trusts (excluding specified bond management investment trusts)).

The amount of income taxes withheld for other interest and dividends, etc., such as interest on deposits and savings, interest on bonds, distribution of earnings from bond management trusts, and deemed dividends, is entirely subject to tax credits.

In addition, the amount of income taxes credited against the corporation's corporation tax cannot be included into the deductible expenses under the corporate tax computation.

At the same time, the special income tax for reconstruction withheld when a corporation receives payments of interests and dividends, etc. shall be credited against the amount of special corporate tax for reconstruction to be paid by the corporation and any amount not creditable shall be refunded.

3 Inheritance Tax and Gift Tax

Individuals who acquire property through inheritance or legacy (including testamentary gifts) are subject to an "inheritance tax," and individuals who acquire property through gift (other than testamentary gifts) are subject to a "gift tax." The provisions governing inheritance taxes and gift taxes are both contained in Japan's "Inheritance Tax Act."

3 1 Inheritance Tax

The inheritance tax is a tax (national tax) imposed when an individual acquires property through inheritance or legacy upon the death of another (including testamentary gifts) based on the value of the property acquired. There is no inheritance tax for corporations (excluding corporations with no provisions on shares) or a local tax corresponding to the inheritance tax.

Taxpayers are, in principle, individuals who have acquired assets through inheritance or legacy. The taxable value of such person's inheritance tax is computed by valuing all taxable property received by such person from the decedent (assets and other rights—insurance proceeds, retirement benefits, time deposits, etc. and excluding tax-exempt property) (Note 1), then deducting from this sum the amount of the liabilities assumed by the decedent which will be borne by the first-mentioned person (limited to those which can be ascertained), funeral expenses and other miscellaneous costs.

(Note) 1. This includes the value of properties to which the taxation system for settlement at the time of inheritance applies (regarding the value of properties acquired by way of a gift made on or after January 1, 2024, the amount of basic deduction for gift tax related to taxation on the gift for settlement at the time of inheritance (JPY 1.1 million) is deducted) and the value of properties received as gifts from the decedent within seven years prior to the commencement of inheritance (regarding the value of properties received as a gift made on or after January 1, 2024, and within the four-year period between seven years prior to the commencement of inheritance until three years prior to the commencement of inheritance, JPY 1 million is deducted from the total value).

2. The special rule for addition to the value of properties received as a gift made "within seven years prior to the commencement of inheritance" applies to gift tax on properties acquired by way of a gift made on or after January 1, 2024. This period is "three years prior to the commencement of inheritance" when it applies to gift tax on properties acquired by way of a gift made before that day.

3. If the estate includes residential land, etc. that had been used for the business or residence of the decedent or a relative who depends on the decedent for his/her livelihood, the "special treatment on small-scale residential land, etc." whereby an amount of a certain percentage (80% for an area of up to 330 m^2 in the case of land used for residence) is reduced when calculating the value to be included into the taxable value is applied under certain conditions.

The inheritance tax amount is computed by first totaling the taxable values of all the relevant persons who acquired property through inheritance or legacy, then deducting the basic deduction shown below. This post-deduction amount (total value of taxable estate) is next hypothetically partitioned among the statutory successors according to their statutory shares. The amount of inheritance tax is computed by applying the inheritance tax rate to these partitioned amounts (value of taxable estate). The sum of the inheritance taxes on these amounts (total inheritance taxes) is then apportioned based on the ratio of taxable values of each person who acquired property through inheritance or legacy and the amount of tax deduction is deducted from the amount so obtained, and each successor or legatee will independently calculate the amount of inheritance tax he or she owes.

The "basic deduction" that is subtracted from the total amount of taxable property is computed according to the following formula:

Basic deduction = JPY30 million + JPY6 million × Number of statutory successors

(Reference) The "statutory share" with respect to statutory successors and the estate is prescribed as follows:

1. Statutory successors and statutory shares under the Civil Code
   - (i) First: Children and spouse …………… one half each
   - (ii) Second: Spouse and direct ascendants … spouse: two-thirds; direct lineal ascendants: one third
   - (iii) Third: Spouse and siblings …………… spouse: three fourths; siblings: fourth
2. Number of statutory successors for inheritance tax purposes

   Even where a successor renounces his/her inheritance, the number of statutory successors for inheritance tax purposes is determined as if such renunciation had not occurred. If there are adopted children, the number of adopted children to be included into the number of statutory successors will be limited to one person if there is any natural child (or to two persons if there is no natural child).

Next, the inheritance tax employs a progressive rate schedule that increases with the value of the taxable estate of each person.

Chart 5-10 Inheritance Tax Rates (Quick Calculation Table)

Taxable Estate Value	Tax Rate	Amount of Deduction	Taxable Estate Value	Tax Rate	Amount of Deduction
JPY 10 million or less	10%	—	JPY200 million or less	40%	JPY17,000,000
JPY 30 million or less	15%	JPY 500,000	JPY300 million or less	45%	JPY27,000,000
JPY 50 million or less	20%	JPY2,000,000	JPY600 million or less	50%	JPY42,000,000
JPY100 million or less	30%	JPY7,000,000	Over JPY600 million	55%	JPY72,000,000

(Note) This tax rate schedule applies to an inheritance or legacy that occurs on or after January 1, 2015.

The inheritance tax amount of a spouse is the amount remaining after subtracting formula (2) from formula (1) depicted below, and if there is no amount remaining, the amount of inheritance tax is zero. In other words, if the value of the taxable property of the deceased's spouse is no more than JPY160 million or no more than the amount equivalent to the spouse's statutory share of the inheritance, no inheritance tax will be imposed on the spouse.

$$\text{(1) Total Inheritance tax} \times \frac{\text{Taxable values of the spouse}}{\text{Total value of taxable property}}$$

$$\text{(2) Total of Inheritance tax} \times \frac{\text{Total taxable values} \times \frac{1}{2}\left(\begin{array}{c}\text{JPY160 million, if less}\\ \text{than JPY160 million}\end{array}\right)}{\text{Total taxable values}}$$

(Note) In the above formula, the statutory share "1/2" (which corresponds to the case where successors are spouse and children) will be substituted either by "2/3" (which corresponds to the case where successors are spouse and direct lineal ascendants) or "3/4" (which corresponds to the case where successors are spouse and siblings).

If, with regard to taxable estate, there are disguises or concealments, such disguised or concealed assets will not be eligible to preferred tax treatment.

Furthermore, if any of the statutory successors are minors or disabled, the following additional deduction for minors or deduction for disabled persons may be taken from the amount of that person's inheritance tax (if the individual meets both criteria, he may claim both deductions):

(1) Deduction for minors: JPY100,000 × No. of years until individual reaches age 18 (fractions of less than one year are treated as one year)

(2) Deduction for disabled persons: JPY100,000 (JPY200,000 for special disabled persons) × No. of years until the individual reaches age 85 (fractions of less than one year are treated as one year)

There are also special provisions regarding an additional surtax of 20% to the amount of tax in the event that an individual who is not the decedent's spouse or relative within the first degree of consanguinity and a deduction in cases of successive recurring inheritances.

Filing of inheritance tax and self-assessment must be completed within a period of ten months counting from the date following the date of becoming aware of the commencement of probate (there are both payment-in-kind and deferred-payment programs).

3 2 Gift Tax

The gift tax is, in general, the tax (national tax) imposed in cases where an individual has acquired assets from another individual by gift (other than testamentary gift).

The amount of tax is computed by summing all gifts received during the year (calendar year) and subtracting the basic deduction ("gift" can also include the assumption of assets at an extreme bargain, cancellation of indebtedness or other enjoyment of economic benefit without the payment of consideration, etc.).

(Note) Gift from a corporation is subject to income tax and inhabitant tax as occasional income.

The basic deduction is JPY1,100,000.

In cases where a couple has been married for twenty years or more and a real estate for the purpose of residence or money for acquiring real estate for the purpose of residence has been given by a spouse to the other, a maximum amount of JPY20 million may be deducted (the “spousal deduction”) (this deduction can be used only once during the life of the taxpayer).

In addition, the following tax exemption systems are in place for gift of funds from a lineal ascendant.

(1) Tax Exemption in the Case of Receiving a Gift of Funds for Acquiring a Residence, Etc. from a Lineal Ascendant

If, during the period from January 1, 2015 through December 31, 2023, an individual aged 18 or older as of January 1 of the relevant year acquires money as a gift from his/her lineal ascendant, such as a parent or grandparent, for the purpose of using such money to pay for constructing, acquiring, or remodeling, etc. a building to be used as the individual’s own residence (hereinafter referred to as “construction, etc. of residential building”), and certain requirements are satisfied, such monetary gift is exempt from gift tax up to the amount specified in the following, according to the respective categories. To receive application of this system, the recipient of the gift must submit a gift tax return. However, this shall not apply if the total amount of income of the person who received the gift in that year is JPY20 million or less:

(Note) For gifts effected before April 1, 2022, the minimum age mentioned above (18) was 20.

(i) In the case where the tax rate of the consumption tax, etc. included in the amount of consideration for construction, etc. of a residential building is 10% (applicable for a limited period)

Date of conclusion of the contract for construction, etc. of a residential building	Energy-efficient and other high quality residence	Any other residence
April 2019—March 2020	JPY30 million	JPY25 million
April 2020—December 2021	JPY15 million	JPY10 million

(ii) In cases other than (i) above

Period for conclusion of the contract for construction, etc. of a residential building	Energy-efficient and other high quality residence	Any other residence
January 2015—December 2015	JPY15 million	JPY10 million
January 2016—March 2020	JPY12 million	JPY 7 million
April 2020—December 2023	JPY10 million	JPY 5 million

(Notes) 1. “Construction, etc. of residential building” includes acquisition, etc. of land, etc. used as the ground for the residential building which is carried out concurrently with the construction etc. of the residential building, and acquisition of the land to be used as the ground for the residential building to be constructed which is carried out prior to the construction of the residential building.

2. “Energy-efficient and other high quality residence” refers to a residential building that is highly conducive to the rational use of energy, a residential building assured of safety against a large-scale earthquake, or a residential building that complies with the standards for structure and equipment that are particularly necessary to enable elderly people, etc. to live independent lives.

(2) Tax Exemption in the Case of Receiving a Lump-Sum Gift of Educational Funds from a Lineal Ascendant

If a person under 30 years old (donee) receives beneficial interests of trusts from a lineal ascendant, such as a grandparent, based on a contract with a financial institution, etc., or deposits with a bank, etc. money or money, etc. acquired from a lineal ascendant through a gift in writing or purchases securities at a securities company, etc. by using such money (the case of opening an account for educational funds), as educational funds during the period from April 1, 2013 to March 31, 2026, the amount of the portion of the value of the said beneficial interests of trusts or money or money, etc. up to JPY15 million (JPY5 million for the money to be paid to parties other than schools, etc.) will be exempt from gift tax by submitting a written application for tax exemption on educational funds via the business office, etc. of the financial institution in charge or providing the business office, etc. of the financial institution in charge with the information to be contained in a written application for tax exemption on educational funds. However, beneficial interests of trusts, money, or money, etc. acquired through a gift on or after April 1, 2019, will not be exempted from tax if the total amount of income earned by the donee in the year preceding the year of acquisition exceeds 10 million yen.

When the contract terminates due to the donee reaching the age of 30 or the like, if any amount remains in the account for educational funds, a gift tax is levied on that amount by deeming that the amount has been received as a gift at the time of termination of the contract.

(Note) In cases such as where the donee reaches the age of 30, and a gift tax is levied on the amount that remains after deducting the amount spent for educational funds from the amount of tax-exempt contribution, the remaining amount is deemed to be excluded from the scope of applicability of the special tax rate for a gift from a lineal ascendant, and the general tax rate applies. This rule applies only to the portion of the beneficial interests in trusts, etc. acquired on or after April 1, 2023, which corresponds to the value of the portion to which this tax exemption system applies.

If the donor of a lump-sum gift of educational funds that has been made on or after April 1, 2019, dies before the date of termination of the contract mentioned above; with regard to gifts made before the commencement of inheritance (in the case of gifts made on or before March 31, 2021, limited to those made within three years before the commencement of inheritance), a fixed amount out of the balance of the account for educational funds as of the time of commencement of inheritance is added to the donor's estate and subject to inheritance tax, except in cases such as where the donee is under the age of 23. In this case, if the donee of a lump-sum gift made on or after April 1, 2021, is the donor's grandchild, etc. (other than the spouse and relatives by blood of the first degree of kinship), the 20%-increase will apply to the amount of inheritance tax corresponding to that balance of the account to which the fixed amount is added.

(Note)
1. Even in cases such as where the donee is under the age of 23, if the total taxable value for inheritance tax regarding the donor exceeds JPY 500 million, the remaining amount under management is deemed to have been acquired by inheritance or legacy and is subject to inheritance tax upon the death of the donor. This rule applies only to the portion of the beneficial interests in trusts, etc. acquired on or after April 1, 2023, which corresponds to the value of the portion to which this tax exemption system applies.
2. The abovementioned "remaining amount under management" is the amount corresponding to the

value of the portion of the beneficial interests in trusts, etc. acquired from the denor to which this special rule applies, out of the amount that remains after deducting the amount spent for educational funds (if a correction is made, the amount corrected; educational funds paid for purposes other than schools, etc. are limited to JPY 5 million) from the amount of tax-exempt contribution as of the day of the death of the donor.

(3) Tax Exemption in the Case of Receiving a Lump-Sum Gift of Marriage/Child-Raising Funds from a Lineal Ascendant

If a person who is 18 years old or older and under 50 years old (donee) receives beneficial interests of trusts from a lineal ascendant, such as a parent or grandparent, based on a contract with a financial institution, etc., or deposits with a bank, etc. money or money, etc. acquired from a lineal ascendant through a gift in writing or purchases securities at a securities company, etc. by using such money (the case of opening a marriage/child-raising account) as marriage/child-raising funds during the period from April 1, 2015 to March 31, 2025, the amount of the portion of the value of the said beneficial interests of trusts, money or money, etc. up to JPY10 million (JPY3 million for the money to be paid upon marriage) will be exempt from gift tax by submitting a written application for tax exemption on marriage/child-raising funds via the business office, etc. of the financial institution in charge, etc. or providing the business office, etc. of the financial institution in charge with the information to be contained in a written application for tax exemption on marriage/child-raising funds. However, beneficial interests of trusts, money, or money, etc. acquired through a gift on or after April 1, 2019, will not be exempted from tax if the total amount of income earned by the donee in the year preceding the year of acquisition exceeds 10 million yen.

(Note) Before April 1, 2019, the age requirement for the donee mentioned above (currently, the age requirement being 18 or over but below 50) was the age of 20 or over but below 50.

If the donor dies during the contract period, the amount remaining in the marriage/child-raising account as of the date of death is deemed to have been acquired from the donor through inheritance, etc. and is subject to inheritance tax. In this case, if the donee of a lump-sum gift made on or after April 1, 2021, is the donor's grandchild, etc. (other than the spouse and relatives by blood of the first degree of kinship), the 20%-increase will apply to the amount of inheritance tax corresponding to the remaining amount to which the fixed amount is added. When the contract terminates due to the donee reaching the age of 50 or other circumstances, if any amount remains in the marriage/child-raising account, a gift tax is levied on that amount by deeming that the amount has been received as a gift at the time of the termination of the contract.

(Note) When the contract terminates due to the donee reaching the age of 50, and a gift tax is levied on the amount that remains after deducting the amount spent for marriage or child-raising funds from the amount of tax-exempt contribution, the remaining amount is deemed to be excluded from the scope of applicability of the special tax rate for a gift from a liner ascendant, and the general tax rate applies. This rule applies only to the portion of the beneficial interests in trusts, etc. acquired on or after April 1, 2023, which corresponds to the value of the portion to which this tax exemption system applies.

The gift tax rate schedule is progressive, increasing with the value of the gift.

Chart 5-11 **Gift Tax Rate Table (Quick Calculation Table)**

(Applicable for the gift made after January 1, 2015)

Taxable Value After Basic Deduction	Tax Rate	Amount of Deduction	Taxable Value After Basic Deduction	Tax Rate	Amount of Deduction
JPY 2,000,000 or less	10%	—	JPY10,000,000 or less	40%	JPY1,250,000
JPY 3,000,000 or less	15%	JPY 100,000	JPY15,000,000 or less	45%	JPY1,750,000
JPY 4,000,000 or less	20%	JPY 250,000	JPY30,000,000 or less	50%	JPY2,500,000
JPY 6,000,000 or less	30%	JPY 650,000	Over JPY30,000,000	55%	JPY4,000,000

The gift tax rates for property that persons aged 18 or older have received as a gift from their lineal ascendants on or after January 1, 2015, are reduced as follows.

Taxable Value After Basic Deduction	Tax Rate	Amount of Deduction	Taxable Value After Basic Deduction	Tax Rate	Amount of Deduction
JPY 2,000,000 or less	10%	—	JPY15,000,000 or less	40%	JPY1,900,000
JPY 4,000,000 or less	15%	JPY 100,000	JPY30,000,000 or less	45%	JPY2,650,000
JPY 6,000,000 or less	20%	JPY 300,000	JPY45,000,000 or less	50%	JPY4,150,000
JPY10,000,000 or less	30%	JPY 900,000	Over JPY45,000,000	55%	JPY6,400,000

Filing and payment of gift tax self-assessment must be carried out between February 1 and March 15 of the year following the receipt of the gift. A request for deferral of payment for up to five years can be made.

(Note) If the registered ownership of shares, etc. has been transferred to that of the family, or new shares, etc. have been acquired under the new owner’s name, in principle, this will be considered a gift unless it can be proven that the recipient purchased the shares, etc. with his or her own assets.

3 3 Unitary System for Inheritance and Gift Taxes

Gift taxes are, as a general rule, imposed each calendar year on each recipient of a taxable gift. However, taxpayers can elect to have a new Unitary System for Inheritance and Gift Taxes apply in lieu of the gift tax imposed each calendar year.

If the recipient elects to have this Unitary System for Inheritance and Gift Taxes apply, the taxpayer initially pays the gift tax (the tax amount shall be calculated by multiplying a uniform tax rate of 20% on the value of the property acquired by a gift (regarding the value of the property acquired by way of a gift made on or after January 1, 2024, the amount of basic deduction for gift tax related to taxation on the gift for settlement at the time of inheritance (JPY 1.1 million) is deducted; hereinafter the same applies) after a special deduction of JPY25 million (if this special deduction has been applied, the remaining amount shall be the maximum amount of special deduction) due on the property acquired by gift at the time of the gift. Thereafter when the taxpayer inherits, the taxpayer will aggregate the value of the gift with the total value of the property he receives through inheritance (including legacies) and compute his/her inheritance tax under the normal formula (see Section 3.1 above for details), using this combined total as the taxable value of inheritance tax. The taxpayer is then allowed to credit the amount of Unitary System for Inheritance and Gift Taxes gift taxes he already paid against his/her inheritance tax liability, thus “integrating” the gift tax and the inheritance tax.

This Unitary System for Inheritance and Gift Taxes is applicable to donors age 60 or older (parents) and individuals age 18 or older who are the donor’s children and/or grandchildren (presumed successors) as of January 1 of that year. Application of this system can be selected for each donor, and there are no limits on the type of property, amount, and frequency of gifts. However, all gifts made thereafter by the selected donor will be subject to the Unitary System for Inheritance and Gift Taxes.

In order for this system to apply, it is necessary to submit a gift tax return and written notification of selection of the Unitary System for Inheritance and Gift Taxes.

In the case where certain requirements are satisfied, such as where a donee receives money for acquiring, etc. or remodeling, etc. a building for residence to be used by the donee as a gift from parents during the period from January 1, 2003 to December 31, 2023, the Unitary System for Inheritance and Gift Taxes may be selected even if the donors are under 60 years old as of January 1 of that year.

3 4 Grace Period on and Exemption from Payment of Gift Tax and Inheritance Taxes Regarding Unlisted Shares, Etc.

(1) Grace Period on and Exemption from Payment of Gift Tax and Inheritance Taxes Regarding Unlisted Shares, Etc. (General Measures)

Special treatment such as a grace period on and exemption from payment of inheritance taxes for protecting employment and maintaining regional economic vitality through unimpeded continuing operation in business of small and medium sized enterprises, and a grace period on and an exemption from the payment of gift taxes for ensuring unimpeded continuing operation in business through gifts prior to death of unlisted shares have been established as the business succession tax system.

In this section, the conventional system of grace period on and exemption from payment of gift tax and inheritance taxes regarding unlisted shares, etc. (general measures) will be explained.

In order to enjoy the benefits of such system, taxpayers need to carry out such procedures as provision of prescribed security or filing of necessary statements and documents.

(i) Grace Period on and Exemption from Payment of Gift Taxes Regarding Unlisted Shares, Etc. (General Measures)

If a donee, etc. who is a successor of a company approved by the prefectural governor as prescribed in the “Act on Facilitation of Succession of Management of Small and Medium Sized Enterprises” (hereinafter referred to as the “Facilitation Act”) (such company is hereinafter referred to as the “approved succeeding company in gift”) related to this system (such donee shall be one per company; hereinafter referred to as the “management succeeding donee”) acquires the whole or more than a certain number (value) of unlisted shares, etc. of the approved succeeding company in gift that are held by the donor (predecessor manager; multiple persons may serve as such donor in one company) from such donor as a gift (see the [Table] shown in the (Note) below) and will manage the approved succeeding company in gift, the donee may receive a grace period in connection with all of the gift taxes which the management succeeding donee should pay corresponding to the taxable value of the unlisted shares, etc. (limited to those that reach a certain limit (see the [Calculation formula] shown in the (Note) below); hereinafter referred to as the “subject donated unlisted shares, etc.”) and be exempted from payment of gift taxes for which the grace period is applied in the event of the death, etc. of the donor, under certain conditions (such that the unlisted shares, etc. will not be transferred for five years after such succession or the average employment does not fall below 80% of that as of gift).

(Note) The maximum number (value) of unlisted shares which should be donated to receive application of this general measure and the number (value) of subject donated unlisted shares, etc. shall be calculated as described in the following table and the calculation formula based on the numbers (values) described in (a) to (c) below.

(a): Total number (value) of issued shares, etc. of the approved succeeding company in gift immediately prior to gift;

(b): Number (value) of unlisted shares, etc. of the approved succeeding company in gift that were held by the management succeeding donee (successor) immediately prior to gift;

(c): Number (value) of unlisted shares, etc. of the approved succeeding company in gift that were held by the donor (predecessor manager) immediately prior to gift.

* The issued shares, etc. and unlisted shares, etc. referred to in (a) to (c) above are limited to those with no restrictions on voting rights.

[Table] Number (value) of unlisted shares, etc. which must be donated

Category		Number (value) of unlisted shares, etc. which must be donated
I	In the case of (c)≧(a)×2/3-(b)	Number (value) not less than (a) ×2/3-(b)
II	In the case of (c)<(a)×2/3-(b)	All of (c)

[Calculation formula] Maximum number (value) of unlisted shares, etc. which will be treated as subject donated unlisted shares, etc.

Maximum number (value) = Number (value) remaining after calculation using the formula (a)×2/3-(b) * When the management succeeding donee has no (b), the number (value) obtained by the formula (a) ×2/3 shall be the upper limit.

(ii) Grace Period on and Exemption from Payment of Inheritance Taxes Regarding Unlisted Shares, Etc. (General Measures)

If a heir, etc. who is a successor of a company approved by the prefectural governor as prescribed in the Facilitation Act (such company is hereinafter referred to as the “approved succeeding company”) related to this system (such heir shall be one per company; hereinafter referred to as the “management succeeding heir, etc.”) acquires the unlisted shares of the approved succeeding company that are held by the decedent (predecessor manager; multiple persons may serve as such decedent in one company) from such decedent as an inheritance or legacy and will manage the approved succeeding company, the heir may receive a grace period in connection with the inheritance taxes which the management succeeding heir, etc. should pay corresponding to 80% of the taxable value of the unlisted shares, etc. (limited to those that reach a certain limit (see the [Calculation formula] shown in the (Note) below; hereinafter referred to as "subject unlisted shares, etc."), and be exempt from payment of the inheritance tax for which the grace period is applied in the event of the death, etc. of the management succeeding heir, etc., under certain conditions (such that the unlisted shares, etc. will not be transferred for five years after succession or the average employment does not fall below 80% of that as of the time of gift).

(Note) The maximum number (value) of the subject unlisted shares, etc. that are covered by these general measures shall be calculated as shown in the following calculation formula based on the numbers (values) described in (a) and (b) below.

(a): Total number (value) of issued shares, etc. of the approved succeeding company as of commencement of succession;

(b): Number (value)of unlisted shares of the approved succeeding company that were held by the management succeeding heir, etc. (successor) immediately before commencement of succession;

* The issued shares, etc. and unlisted shares, etc. referred to in (a) and (b) above are limited to those with no restriction on voting rights.

[Calculation formula] Maximum number (value) of unlisted shares, etc. which will be treated as subject unlisted shares, etc.

Maximum number (value) = The number (value) remaining after calculation using the formula, (a)×2/3-(b).

* When the management succeeding heir, etc. has no (b), the number obtained by the calculation formula (a)×2/3 shall be the upper limit.

(iii) Grace Period on and Exemption from Payment of Inheritance Tax in the Case of Death of the Donor of the Unlisted Shares, Etc. (General Measures)

In the case of the death of the donor in connection with the management succeeding donee to whom the treatment of a grace period on and exemption from payment of gift tax (general measures) as described in (i) has been applied, the management succeeding donee (limited to those who have received confirmation from the prefectural governor under the Facilitation Act for meeting certain conditions as of commencement of inheritance) is deemed to have acquired the subject donated unlisted shares, etc. to which the system described in (i) above has been applied from the donor as an inheritance or legacy and the inheritance tax is calculated by totaling the values of these shares, etc. at the time of the gift and the value of other property inherited

The donee may receive a grace period or exemption in connection with the inheritance tax (general measures) as described in (ii) above in relation to such subject donated unlisted shares, etc. that the donee is deemed to have acquired (limited to a certain portion thereof; referred to as the "subject inherited unlisted shares, etc.") if the approved succeeding company in gift described in (i) above is an approved succeeding company (meaning those who have received confirmation from the prefectural governor under the Facilitation Act for meeting certain conditions as of commencement of inheritance).

(2) Special Treatment of Grace Period on and Exemption from Payment of Gift Tax and Inheritance Tax Regarding Unlisted Shares, Etc. (Special Measures)

In the tax reform in 2018, a temporary measure to be applied to gift and inheritance for 10 years (special measures) was established by drastically improving the conventional treatment of grace period on and exemption from payment of gift tax and inheritance tax regarding unlisted shares (general measures) “from the viewpoint of promoting smooth generational change of SMEs in a concentrated manner and contributing to improved productivity based on an understanding that business succession is an issue which should be dealt with by the Japanese economy in whole.”

The improved special treatments for grace period on and exemption from payment of gift tax and inheritance tax regarding unlisted shares, etc. (special measures) will be explained in the following sections, but since many sections are common to the general measures described above, explanation will be given by highlighting the sections which are improvements of the general measures while the describing the common sections between the two measures without any change.

In order to enjoy the benefits of such system, taxpayers need to carry out such procedures as provision of prescribed security or filing of necessary statements and documents, as in the case of general measures.

In the sentences shown in (i) and (ii) below, the underlined parts show the parts which are improvements of the general measures (parts showing special treatments).

(i) Special Treatment of Grace Period on and Exemption from Payment of Gift Tax Regarding Unlisted Shares, Etc. (Special Measures)

If a special donee, etc. who is a successor of a company specially approved by the prefectural governor as prescribed in the Facilitation Act (a specially approved succeeding company in gift) <u>by preparing a special succession plan under the Facilitation Act and receiving confirmation from the prefectural governor by March 31, 2024 (three persons may act as such special donee for each company</u>; hereinafter referred to as the “special management succeeding donee”) acquires the whole or more than a certain number (value) of unlisted shares of the specially approved succeeding company in gift that are held by the special donor (predecessor manager; multiple persons may serve as such special donor in one company) from such special donor as a gift <u>(limited to gift subject to the first application of these special treatments during the period from January 1, 2018 to December 31, 2027)</u>(see the [Table] shown in the (Note) below, if there is only one special management succeeding donee) and he/she will manage the specially approved succeeding company in gift, the donee may receive a grace period with respect to all of the gift tax which the special management succeeding donee should pay corresponding to the taxable value of the unlisted shares, etc. (<u>there are no limits as those imposed under general measures</u>; hereinafter referred to as “donated unlisted shares, etc. covered by special treatments”) and be exempted from payment of gift tax for which the grace period is applied in the event of the death, etc. of the special donor (in addition to the grounds for exemption which are allowed under general measures, <u>reduction or exemption measures in the case of transfer, etc. of unlisted shares, etc. upon occurrence of certain events that make it difficult to continue business after the passage of the special period for succession of management gift are added</u>), under certain conditions (as in the case of general measures, <u>measures for flexibility are taken for job security requirements</u>).

(Note) The number (value) of the unlisted shares, etc. which must be donated to be covered by these special measures shall be as shown in the following table based on the numbers (values) described in (a) to (c) below.

(a): Total number (value) of issued shares, etc. of the specially approved succeeding company in gift immediately prior to gift
(b): Number (value) of unlisted shares of the specially approved succeeding company in gift that were held by the special management succeeding donee, etc. (successor) immediately prior to gift
(c): Number of unlisted shares, etc. of the specially approved succeeding company in gift that were held by the special donor (predecessor manager) immediately prior to gift
* The issued shares, etc. and unlisted shares, etc. referred to in (a) to (c) above are limited to those with no restriction on voting rights.

[Table] Number (value) of unlisted shares, etc. which must be donated

Category		Number (value) of unlisted shares, etc. which must be donated
I	In the case of (c)≧(a)×2/3-(b)	Number (value) not less than (a) ×2/3-(b)
II	In the case of (c)<(a)×2/3-(b)	All of (c)

(ii) Grace Period on and Exemption from Payment of Inheritance Tax Regarding Unlisted Shares, Etc. (Special Measures)

If a heir, etc. who is a successor of a company approved by the prefectural governor as prescribed in the Facilitation Act (hereinafter referred to as a "specially approved succeeding company") by preparing a special succession plan under the Facilitation Act and receiving confirmation from the prefectural governor by March 31, 2024 (three persons may act as such special heir for each company; hereinafter referred to as the "special management succeeding heir, etc.") acquires the unlisted shares of the specially approved succeeding company that are held by the special decedent (predecessor manager; multiple persons may serve as such special decedent in one company) from such special decedent as an inheritance or legacy (limited to the inheritance or legacy subject to the first application of these special treatments during the period from January 1, 2018 to December 31, 2027) and will manage the specially approved succeeding company, the heir may receive a grace period with respect to all of the inheritance tax which the special management succeeding heir, etc. should pay corresponding to the taxable value of the unlisted shares, etc. (there are no limits such as those imposed under general measures; hereinafter referred to as "unlisted shares, etc. covered by special treatments") and be exempted from payment of inheritance tax for which the grace period is applied in the event of the death, etc. of the special management succeeding heir, etc. (in addition to the grounds for exemption which are allowed under general measures, reduction or exemption measures in the case of transfer, etc. of unlisted shares, etc. upon occurrence of certain events that make it difficult to continue business after the passage of the special period for succession of business gift are added), under certain conditions (as in the case of general measures, measures for flexibility are taken for job security requirements).

(iii) Special Treatment of Grace Period on and Exemption from Payment of Inheritance Tax in the Case of Death of the Donor of Unlisted Shares (Special Measures)

In the case of the death of the special donor in connection with a special management succeeding donee to whom the special treatment of a grace period for or exemption from gift tax set forth in (i) above (special measures) applies, the special management succeeding donee (limited to those who have received confirmation from the prefectural governor under the Facilitation Act for meeting certain condition as of commencement of inheritance) is deemed to have acquired the donated unlisted shares, etc. covered by the special treatments to which the system described in (i) above have been applied from the special donor as an inheritance or legacy, and inheritance tax to be imposed on the donee is calculated by totaling the value of these shares, etc. at the time of the gift and the value of other property inherited thereby.

The special donee may receive a grace period or exemption in connection with the inheritance tax described in (ii) above in relation to the donated unlisted shares, etc. covered by the special treatments (special measures) (there are no limits such as those imposed under general measures; hereinafter referred to as "succeeded unlisted shares, etc. covered by special treatments") that the special donee is deemed to have acquired (limited to a certain portion thereof) if the specially approved succeeding company in gift described in (i) above is a specially approved inheritance succeeding company (limited to those who have received confirmation from the prefectural governor under the Facilitation Act for meeting certain conditions as of commencement of inheritance).

(Reference) Outline of the Grace Period for and Exemption from Payment of Gift Tax and Inheritance Taxes on Individuals' Business Assets (Business Succession Tax System for Individuals)

The FY2019 tax system reform has introduced the following measures where a person who has obtained approval under the Facilitation Act, as the successor of a business operator who conducted a business covered by blue return filing under the principle of orderly bookkeeping (excluding a real estate leasing business, etc.), acquires specified business assets (meaning a certain scope of residential land, etc., buildings, depreciable assets), by way of a gift or inheritance, etc. made during the period from January 1, 2019, to December 31, 2028.

(i) Grant a grace period to the person in connection with the whole amount of the gift tax and inheritance tax on the specified business assets, under certain conditions such that the person will continue to conduct the business covered by blue return filing; and

(ii) Exempt the person from payment of gift tax and inheritance tax for which the grace period has been granted, under certain conditions such as the death of the successor.

(Note) The business succession tax system for individuals has basically the same design as the system of grace period for and exemption from payment of gift tax and inheritance taxes regarding unlisted shares, etc. discussed in (1) and (2) above. However, it should be noted that, except for the differences derived from the difference in nature between individuals and corporations, the system of grace period on inheritance tax has unique features in terms of the calculation of the amount of tax subject to the grace period; the period of business succession; the requirements for securing employment; the grounds for full exemption; the provision of collateral for the assets subject to the grace period; and the death of the donor.

3 5 Valuation of Shares for Inheritance Tax and Gift Tax Purposes

Valuation is always a problem when assets are acquired through inheritance, testamentary gift or gift *inter vivos* (gift before death).

Under the tax law, valuation of these assets should take into account only the current value at the time such assets were acquired; in other words, the market value of the assets is the sole item to be considered. However, the actual handling of assets valuation has been established by the National Tax Administration in the form of its “Evaluation Rulings.” The relevant portions of these rulings as they relate to the valuation of securities are described below:

(1) Valuation of Listed Shares

The valuation of shares is made for each share according to the method applied to each category of listed shares, quoted shares and shares for which there is no transaction market.

Valuation of listed shares is based on the closing price at the financial instruments exchange where the shares are listed at the time when taxable event takes place (in other words, the day of the inheritance or receipt of the gift). (If there is no market price available for the date of taxable event, the closing price of the date closest to that, either directly before or directly after, is used.)

However, if the said closing price is higher than the lowest average daily closing price for the month in which the date of taxable event falls and the three preceding months, valuation will be based on the lowest of these prices (hereinafter called “Monthly Average Closing Price”).

If, for example, the date of taxable event is February 20 and the final price per share on February 20 for listed shares in Company A and the average monthly values for the closing prices during the three months prior to February are as listed below, shares in Company A will be valued at the lowest price per share of the four share prices stated hereunder, which is JPY1,690:

Final price on February 20	JPY1,740
Average of the closing prices during February	JPY1,750
Average of the closing prices during January	JPY1,690
Average of the closing prices during December of the previous year	JPY1,710

(Note) Foreign listed shares will be valued at the above values in the foreign market, converted into yen at the Tokyo TTB rate at the time of taxation.

In principle, shares listed on multiple financial instruments exchanges will be valued at the closing price of the financial instruments exchange selected by the taxpayer.

(Reference) Valuation of Inheritance Tax When Margin Transactions Are in Progress

When the individual performing margin transactions of shares has died before settlement of the margin transactions, valuation of inheritance tax on assets related to the margin transactions is obtained by calculating the amount of assets and amount of liabilities separately as explained below.

In the case of a buy contract, the asset amount is the valuation amount of shares in the buy contract (together with collateral securities acting as deposited guarantee money), while the amount of liabilities is the total of the amount defined in the buy contract and the amount of interest.

In the case of a sell contract, the asset amount is the total of collateral on share loans and interest, etc. while the amount of liabilities is the total of the value of share loans and the lending shares fee.

(2) Shares with Quotations

In principle, appraisal of shares with market quotations is carried out with the following categories:

(i) Shares under Registered Issues or Over-the-Counter Managed Issues

Appraisal is based on the market price as announced by the Japan Securities Dealers Association on the date of taxable event (when both a high and a low have been reported, the average of these two is used). However, if the said trading price is higher than the lowest average daily closing price for the month in which the date of taxable event falls and the three preceding months, valuation will be based on the lowest of these prices.

(ii) Shares in the Process of Going Public

Valuation of shares, when a share is to be listed or be registered and a public offering or secondary distribution (hereinafter collectively referred to as the “public offering, etc.”) is to take place, is based on the opening price of the said share (this is the public offering price determined by either the book-building process or competitive bidding which takes place under the internal regulations of the stock exchange or the Japan Securities Dealers Association). However, the price or value of shares which do not go through this public offering process is valued taking into account the market price, etc. prior to the date of taxable event.

(Note) The “shares in the process of going public” mentioned above are shares for which a financial instruments exchange has disclosed that it has approved the listing of the shares, for the period from the date of disclosure until the day before the date of listing (excluding registered issues); and shares for which the Japan Securities Dealers Association has disclosed that it is to register the shares as registered issues, for the period from the date of disclosure until the day before the date of registration (excluding over-the-counter managed issues.)

(3) Shares Without Transaction Price

Companies issuing shares without quotations (meaning shares other than listed shares and shares with quotations) include various types of companies. Not only are there companies which are similar to those with shares listed on the stock exchange, there are also small, individually owned and run companies. There is such variety and complexity among them that valuation of their shares is carried out by categorizing them by whether the shareholders who acquired the shares as an inheritance or a gift are family shareholders who have operational control over the company that issued the shares or other shareholders, etc. and respectively using the fundamental valuation method or the exceptional valuation method based on dividend discount.

(i) Fundamental Valuation Method

The fundamental valuation method categorizes the company that has issued the shares to be valued as a large company, medium-sized company, or small company based on the number of employees, net asset value, and sales amount, and values the shares by the following method, in principle:

a. In the case of a large company, shares are by valued by the comparative similar company method, in principle. This method values shares of a company by comparing the amount of dividends, the amount of interest, and the net asset value (book value) per share with those of shares of similar companies.
b. In the case of a medium-sized company, shares are valued by using both the valuation method for a large company and that for a small company.
c. In the case of a small company, shares are valued by the net asset value method, in principle. This method

values shares of a company based on the amount remaining after converting the net assets and liabilities of a company into valuation amounts used for inheritance tax, in principle, and subtracting the amount equivalent to corporation tax, etc. on liabilities and valuation difference from the value of the net assets derived.

(ii) Exceptional Valuation Method

Shares acquired by shareholders, etc. other than family shareholders are valued by the exceptional valuation method based on dividend discount instead of the fundamental valuation method, irrespective of the size of the company issuing the shares. This method values shares by deriving the amount of the principal based on the annual dividend that is receivable by holding the shares while assuming a fixed discount rate (10%).

Meanwhile shares of a specified company subject to valuation such as a company that has only one comparative element in the comparative similar company method, a specified company holding shares, or a specified company holding land are valued by the net asset value method, in principle. However, they may also be valued by the dividend discount method if the shareholders, etc. are those other than family shareholders.

4 Local Taxes

As discussed above, income from interest and dividends, capital gains from assets, etc. is subject to national taxes (the income tax and corporation tax). In addition to these national taxes, however, such income is generally subject to prefectural and municipal taxes (since these taxes are imposed on residents, both individual and corporate residents, they are collectively referred to as "inhabitant taxes").

Since the fundamental structure of inhabitant taxes follows that of the national taxes, the following section explains their major features.

4 1 Individual Inhabitant Tax

The prefectural and municipal inhabitant taxes imposed on individuals (hereinafter referred to as "individual inhabitant tax") consist of an "income proportional" component with rates that vary depending on the individual's level of income and a "per capita tax" component.

The tax base for the prefectural and municipal income-proportional component is generally the same as the tax base used in computing the individual's national income taxes in the prior taxable year.

In this case, interest income such as deposit interest, interest on bonds or the distribution of earnings from a loan trust that is subject to withholding for income taxes (excluding interest, etc. on specified bonds, etc.) is also subject to the special withholding under the inhabitant tax "interest rate."

In addition, there is a "dividend rate" that applies to dividends, etc. received on listed shares, etc. (including interest, etc. on specified bonds, etc.) as well as a "share, etc., transfer rate" that applies to capital gains, etc. on listed shares, etc., held in a specified account for which the taxpayer elects withholding. These are taxed by special withholding at the statutory rates.

As with income tax, deductions such as the basic deduction also apply to the calculation of the amount of income-proportional tax component, but the amount of these deductions is determined separately from income tax.

For example, as indicated in the table below, the maximum amount of basic deduction is JPY480,000 for income tax in 2020 and thereafter, whereas it is JPY 430,000 for individual inhabitant tax in 2021 and thereafter.

An Individual's Income Group	Basic Deduction	
	Income Tax	Individual Inhabitant Tax
Not more than JPY24 million	JPY 480,000	JPY 430,000
More than JPY 24 million but not more than JPY 24.5 million	JPY 320,000	JPY 290,000
More than JPY 24.5 million but not more than JPY 25 million	JPY 160,000	JPY 150,000
More than JPY 25 million	JPY 0	JPY 0

(Note) The amount of basic deduction for income tax until 2019 and that for individual inhabitant tax until 2020 were uniformly set at JPY380,000 for income tax and JPY330,000 for individual inhabitant tax, respectively, regardless of the total amount of income.

The income-proportional tax and the per capita tax rates are determined separately for prefectural and municipal taxes, as shown below (the rates below are the standard tax rates).

(1) Income-proportional Tax Rates

	Prefectural Inhabitant Tax	Municipal Inhabitant Tax
Income-proportional tax rates	4%	6%

(Notes) 1. The income-proportional tax rates applicable to inhabitants of designated cities in and after FY2018 are 2% for prefectural inhabitant tax and 8% for municipal inhabitant tax.
2. Special tax rates apply for income such as capital gains on land, buildings, shares, etc.

(2) Per Capita Portion

	Prefectural Inhabitant Tax	Municipal Inhabitant Tax
Per Capita Tax Rate	JPY1,000	JPY3,000

As for local taxes, following the enactment of the "Act on Temporary Special Provisions for Local Taxes to Secure Financial Resources Necessary for Disaster Prevention Measures to be Implemented by Local Governments in Relation to the Reconstruction from the Great East Japan Earthquake" (promulgated and effective on December 2, 2011), per capita standard tax rates for individual inhabitant tax for each year shall be increased and thereby the annual amount of prefectural inhabitant tax shall be JPY1,500, and municipal inhabitant tax shall increase JPY500 to JPY3,500, during the period from FY2014 to FY2023; a JPY500 increase respectively.

(3) Inhabitant Tax Dividend Credit

A dividend credit applies to personal inhabitant tax in the same way as it does to income tax, and consequently a tax credit can be taken for dividends (the dividend credit) at the following rates:

Total Amount of Taxable Income	Up to JPY10 million	Exceeding JPY10 million	
		Portion Up to JPY10 million	Portion Exceeding JPY10 million
General dividends and distributions of earnings from specified share investment trusts	2.8%	2.8%	1.4%
Distributions of earnings from securities investment trusts, etc.	1.4%	1.4%	0.7%
Distributions of earnings from foreign currency denominated securities investment trusts	0.7%	0.7%	0.35%

(4) Special Treatment of Taxation on Income Arising from General Bonds, Etc.

Income arising from bonds other than specified bonds, beneficial interests of privately placed bond investment trusts, beneficial interests of privately placed investment trusts other than securities investment trusts, and corporate bond-type beneficial interests of specified purpose trusts which are privately placed (collectively referred to as "general bonds, etc.") is subject to the following taxation:

(i) Interest, etc. on general bonds, etc. to be received by an individual who has an address in Japan is subject to separated withholding taxation at source (taxation on interest basis) at a rate of 5%. However, interest on bonds issued by a family company to be received by a shareholder, etc., who served as the basis for judging whether the corporation is a family company is subject to aggregate taxation: and

(ii) Capital gains, etc. from transfer of general bonds, etc. of an individual who has an address in Japan (including those received due to redemption or partial cancellation of general bonds, etc. that are deemed to be revenue arising from capital gains, etc.) are subject to self-assessed separated taxation (taxation on income basis) at a rate of 5%. However, redemption money of bonds issued by a family company to be received by a shareholder, etc., who served as the basis for judging whether the corporation is a family company is subject to aggregate taxation.

(5) Special Treatment of Taxation on Income Arising from Shares, Etc. and Specified Bonds, Etc.

Income arising from shares, etc. and specified bonds, etc. (meaning specified bonds, beneficial interests of publicly offered bond investment trusts, beneficial interests of publicly offered investment trusts other than securities investment trusts, and corporate bond-type beneficial interests of specified purpose trusts that are publicly offered) is subject to the following special treatment of taxation.

(i) Self-assessed Separated Taxation on Dividends, Etc. from Listed Shares, Etc.

In principle, dividends, etc. from listed shares, etc. for which an individual who is a resident in Japan receives payment are subject to self-assessed separated taxation at a rate of 5% (taxation on income basis). However, among such dividends, etc. from listed shares, etc., with regard to dividends, etc. from specified listed shares, etc., an individual may choose self-assessed separated taxation only if the individual submits a notification of specified dividends, etc. stating their choice of self-assessed separated taxation; non-filing of a tax return or aggregate taxation applies if the individual does not choose self-assessed separated taxation.

(Note) In order to apply the same taxation method to individual inhabitant tax for 2024 and thereafter and to income tax, it will no longer be possible to select self-assessed separated taxation for income from dividends, etc. on listed shares, etc. by submitting a notification of specified dividends, etc. If a tax return is filed with a statement that the taxpayer seeks the application of either aggregate taxation or self-assessment separated taxation for income tax, the same taxation method will be applied to individual inhabitant tax.

The "dividends, etc. from listed shares, etc." subject to this special treatment include interest, etc. on specified bonds, etc. The "dividends, etc. from specified listed shares, etc." are interest, etc. or dividends, etc. with respect to listed shares, etc. (other than dividends, etc., received by a large individual shareholder, etc.), distributions of earnings from a publicly offered securities investment trust other than a bond investment trust (including foreign publicly offered securities investment trusts), and dividends, etc. on investment equity in a specified investment corporation.

(ii) Special Withholding System for Specified Dividends, Etc. (the "Dividend Tax") and the Final Tax Return Non-Filing System

Financial instruments business operators, etc. that pay (or handle payment of) a specified dividend, etc. to an individual with a residence in Japan must withhold an inhabitant tax (dividend rate) of 5% and pay the amount withheld to the taxing authority for the address of the individual receiving payment of the specified dividend, etc. on the date of payment by the 10th day of the following month (*i.e.*, the prefecture where the individual's address is located).

A special system has been put in place under which the specified dividends, etc. that are subject to this special withholding are not required to be reported on a final tax return (excluded from the tax base of the income-proportional tax component). In other words, if such special system is chosen, the tax burden for individual inhabitant tax purposes ends with the special withholding of the dividend rate.

(Note) In cases where the specified dividends, etc. are reported, they are included in the tax base of the income-proportional tax portion and subject to (aggregate) taxation; however, in computing the income-proportional tax, the dividend credit applies, and an equivalent amount is credited against the taxpayer's dividend tax amount as well.

The "specified dividends, etc." subject to these special treatment are dividends, etc. with respect to listed shares, etc. mentioned in (i) above.

(iii) Self-Assessed Separated Taxation for Income Realized upon the Transfer of Shares, Etc.

Income realized on the transfer of shares, etc., that was reported on the taxpayer's final income tax return and subject to self-assessed separated taxation is similarly separated from the taxpayer's other income under the inhabitant tax and subject to a fixed rate of tax. However, regarding the amount of capital gains on specified listed shares, etc. (meaning the adjusted income amount in the withholding account), self-assessed separated taxation may be selected only if the taxpayer submits a notification of the amount of capital gain on specified shares with a statement that the taxpayer seeks the application of self-assessed separated taxation; and the non-filing system will be applied if the taxpayer does not select self-assessed separated taxation.

(Note) In order to apply the same taxation method to individual inhabitant tax for 2024 and thereafter and to income tax, it will no longer be possible to select self-assessed separated taxation on the amount of capital gains on specified shares, etc. by submitting a notification of the amount of capital gains on specified shares, etc. If a tax return is filed with a statement that the taxpayer seeks the application of self-assessed separated taxation for income tax, the same taxation method will be applied to individual inhabitant tax.

Calculating the amount of income in this case is performed in the same manner as under income tax for capital gains on shares, etc. reported on the taxpayer's final tax return, and the personal inhabitant tax is also covered by the special exception for calculation of capital gains, etc. in connection with listed shares, etc. in a specified account.

In addition, if a loss occurs on transfer of listed shares, etc., in a fiscal year or any of the preceding three years (excluding those that have already been deducted in a previous year), the amount of these losses may be deducted off of dividend income in connection with listed shares, etc. (limited to those for which separate return reporting has been selected).

The tax rate for self-assessed separated taxation on income from transfer of shares, etc. (taxation income basis) is 5%.

The "listed shares, etc." subject to this special treatment include income, etc. on specified bonds, etc.

(iv) Special Withholding for Listed Shares, Etc., Held in a Specified Account for Which the Taxpayer has Elected Withholding (Share, Etc., Transfer Tax) and the Final Tax Return Non-Filing System

Upon the transfer (or net cash settlement) of listed shares, etc. held in a specified account for which an individual having an address in Japan has elected withholding (a specified account for which withholding is elected), income tax and the special income tax for reconstruction are withheld and the income is subject to the final tax return non-filing system.

A structure similar to this system is also implemented under the individual inhabitant tax. In other words, upon payment of the proceeds (or cash) of the income from the transfer (or net cash settlement) of listed shares, etc. held within a withholding-electing account, the financial instruments business operator, etc., making the payment will withhold an amount calculated by multiplying the amount of the increase in net income in the account since the start of the year (the amount of capital gains on specified listed shares, etc.) by the tax rate of 5% (such amount is referred to as "share, etc., transfer tax"; in the case of a decrease of net income since the start of the year, refund the amount obtained by multiplying the tax rate by the amount of the decrease), and pay over any amounts withheld to the taxing authority (the prefecture where the abovementioned individual's address is located) by January 10th of the following year.

The final tax return non-filing system (excluded from the tax base of the income-proportional tax component) applies to the income realized on the transfer (or net cash settlement) of listed shares, etc. held in a withholding-electing account that are subject to this special withholding under the income-proportional tax component. In other words, the individual inhabitant tax burden ends once the share, etc. transfer (capital gains) tax is specially withheld.

The "listed shares, etc." subject to this special treatment include income, etc. on specified bonds, etc.

(Note) With regard to dividends, etc. on listed shares, etc. received in an elective withholding account, after netting the dividends, etc. on listed shares, etc. against losses on transfer of listed shares, etc., the final tax return non-filing system can be used.

In cases where the taxpayer reports the income realized from the transfer (or net cash settlement) of listed shares, etc. held in the withholding-electing account, these are included in the tax base of the income-proportional tax component (self-assessed separated taxation); however, in computing the income-proportional tax, an amount equal to the share transfer, etc., taxes already collected (if refunded, the amount after deducting the refunded amount) is allowed as a tax credit.

(6) Special Treatment of Taxation on Discount Bonds

Profit relating to redemption money (profit from redemption) of discount bonds (excluding those received in a specified account) to be received by an individual who has an address in Japan is included in the scope of "specified dividends, etc." mentioned in (5)(ii) above and is subject to taxation on a dividend basis at a rate of 5% of the amount of such profit from redemption at the time of the redemption (special taxation). In principle, filing of a tax return is not required for a profit from redemption subject to dividend-based taxation (excluded from the tax base for income-based taxation), and the individual can complete the tax payment procedure by paying the dividend-based individual inhabitant tax by special taxation. However, the individual may choose to file a tax return and make the profit from redemption of the discount bonds subject to taxation on an income basis, thereby deducting the amount equivalent to the dividend-based tax on the profit from redemption from the income-based tax.

With regard to discount bonds held in a specified account, the profit from redemption (the amount of redemption money — purchase price) is subject to taxation based on capital gains from shares, etc. at a rate of 5% if the account is a withholding-electing account, and subject to self-assessed taxation on an income basis in other cases.

Meanwhile, with regard to discount bonds that are not held in a specified account, a certain percentage of the redemption money is deemed to be a profit from redemption, and is subject to taxation on dividend basis at a rate of 5%.

(7) Special Treatment for Taxation on Miscellaneous Income, Etc. with Respect to Futures Trading

If an individual having an address in Japan conducts a futures transaction, the miscellaneous income, etc. from the futures trading concerning the net settlement shall be separated from other income and shall be assessed a self-assessed separated taxation (taxation on income basis) at a tax rate of 5% on the amount of miscellaneous income, etc. with respect to futures trading in that year.

4 2 Corporate Inhabitant Tax

The prefectural inhabitant tax (excluding Tokyo metropolitan inhabitant tax; the same applies hereinafter) and the municipal inhabitant tax on corporations (referred to as "corporate inhabitant tax") also consists of an amount proportional to the corporation tax (corporation tax-proportional) amount and a per capita amount. The tax base for the corporation tax-proportional amount is the amount of corporation tax paid in each fiscal year (excluding the amount of corporation tax on the global minimum taxable amount for each subject accounting period).

(1) Tax Rate of Corporation Tax-Proportional Amount of Corporate Inhabitant Tax

The tax rate of the corporation tax proportional amount of corporate inhabitant tax is as specified in the table below.

Tax item	Fiscal year starting before October 1, 2019		Fiscal year starting on or after October 1, 2019	
	Standard tax rate	Upper limit for the tax rate	Standard tax rate	Upper limit for the tax rate
Prefectural inhabitant tax	3.2%	4.2%	1.0%	2.0%
Municipal inhabitant tax	9.7%	12.1%	6.0%	8.4%

Corporations that have offices, etc. in special wards of Tokyo metropolis are subject to Tokyo metropolitan corporate tax that is the aggregate of the amount equivalent to prefectural inhabitant tax and amount equivalent to municipal inhabitant tax. The tax rate is 7.0% (upper limit: 10.4%) (or 12.9% (upper limit: 16.3%) for the fiscal year starting before October 1, 2019).

(Note) Corporations that have offices, etc. in areas other than special wards of Tokyo metropolis are subject to Tokyo metropolitan corporate tax equivalent to prefectural inhabitant tax.

(2) Tax Rate of Per Capita Amount of Corporate Inhabitant Tax

The per capita prefectural inhabitant tax is divided into five tax brackets depending on the amount of stated capital, etc. and ranges from JPY20,000 to JPY800,000. The per capita municipal inhabitant tax is divided into five tax brackets for corporations with over 50 employees in an office or offices within the municipality, ranging from JPY120,000 to JPY3 million depending on the amount of stated capital, etc., and into four tax brackets ranging from JPY50,000 to JPY410,000 (all of these standard rates) for corporations with less than 50 employees in an office or offices within the municipality depending on the amount of stated capital, etc.

(Note) While there is no upper limit for the tax rate of the per capita amount of prefectural inhabitant tax, the upper limit is set as 1.2 times the standard rate regarding the per capita amount of municipal inhabitant tax.

As in the case of the corporation tax proportional amount, corporations that have offices, etc. in special wards of Tokyo metropolis are subject to Tokyo metropolitan corporate tax that is the aggregate of the amount equivalent to prefectural inhabitant tax and amount equivalent to municipal inhabitant tax with regard to the per capita amount. The tax is divided into 10 brackets, ranging from JPY70,000 to JPY3.8 million, depending on the amount of stated capital, etc. and the number of employees.

<Attachment> Types and Systems of Taxes

1. Types of Taxes

Taxes can be broadly divided into ten categories:

(1) National and local taxes (a category based on whether the Government or a local government imposes the taxes);

(2) Internal taxes and customs duty (collectively referred to as customs duties including customs taxes in a narrow sense, tonnage taxes and special tonnage taxes that are harbor dues, the latter two of which are included in customs duties in the sense of border taxes. This classification refers to customs duties in this sense and other taxes (excise taxes));

(3) Earning taxes, property taxes, consumption taxes, and transfer taxes (a category of taxes assessed on earned income, owned property, specific consumption, transfers of property and other kinds of distributions);

(4) Direct taxes and indirect taxes (a category based on whether the taxpayer and the tax bearer are the same);

(5) Personal taxes or property taxes (a category based on whether the assessment is mainly on the individual to whom the income or property is attributed, or assessed directly on the property or income without the issue of attribution);

(6) Specific taxes or ad valorem taxes (a category based on assessment by weight or by price);

(7) Independent taxes and surtaxes (a category based on whether the assessment is independent or appended to other taxes);

(8) General taxes and earmarked taxes (a category based on whether the taxes are imposed to pay general expenses or are earmarked for paying a specific expense (earmarked tax));

(9) Ordinary taxes or temporary tax (a category based on whether assessments occur each year or the assessment is limited to a specific period); and

(10) Principal taxes and additional penalty taxes (additional charges) (a category based on whether the tax is the original basic tax assessed for a specific matter or a tax to secure proper implementation of this matter).

2. Tax Systems (Actual Types of Tax Assessments)

National Taxes

Taxation of Income

- **Income tax** (a tax paid by individuals each calendar year based on earned income)
- **Corporation tax** (a tax paid by corporations each fiscal year based on income, on the global minimum taxable amount for each subject accounting period and on accumulated reserves such as a retirement pension fund)
- **Local corporation tax** (a tax paid by corporations each fiscal year based on corporation tax amount)
- **Special corporate enterprise tax** (a tax imposed on taxpayers of corporate enterprise tax using the amount of corporate enterprise tax for the business year commencing on or after October 1, 2019, as the tax base, and then transferred to prefectures)

Taxation of Assets

- **Inheritance tax** (a tax imposed on the individual receiving property through inheritance)

- **Gift tax** (a tax imposed on the individual receiving assets as a gift from another individual)
- **Land value tax** (a tax imposed on the owner of land, etc., as of January 1 of each year. Since 1998 the tax has been temporarily suspended.)

Taxation on Consumption

- **Consumption tax** (a tax imposed on persons or corporations who engage in businesses that are compensated for transferring assets, lending or providing services)
- **Liquor tax** (a tax levied on producers of liquor (or businesses that retrieve liquor from bonded areas) with the consumer being the tax bearer)
- **Gasoline tax** (a tax imposed on producers of gasoline)
- **Aviation fuel tax** (a tax imposed on owners of aircrafts based on the fuel loaded into the aircraft)
- **Liquefied petroleum gas transfer taxes** (a tax imposed on people who replenish petroleum for cars)
- **Petroleum coal tax** (a tax imposed on the extractor of crude oil and gaseous hydrocarbons)
- **Tobacco tax** (a tax imposed on producers of processed tobacco)
- **Customs duty** (a tax imposed on imported goods)

Transfer Taxes

- **Tonnage due** (a tax paid according to net tonnage when a ship with foreign goods enters a harbor)
- **Stamp duty** (a tax levied on documents such as contracts and checks, etc.)
- **Motor vehicle tonnage tax** (a tax paid according to the weight of an automobile by the person who obtains a license number or automobile inspection certificate)
- **Registration and license tax** (a tax imposed on registrations, patents and licenses, etc.)
- **International tourist tax** (a tax imposed upon departure of international tourists, etc.)

Earmarked Taxes

- **Local gasoline tax** (a tax assessed by local governments for road maintenance according to the surface area of roads and collected together with the gasoline tax)
- **Special tonnage due** (a tax transferred to the municipalities in the collection area and collected together with the tonnage tax)
- **Promotion of power resources development tax** (a tax allocated to expenses for power generation plants levied on businesses according to electricity sold)
- **Special tobacco tax** (a temporary tax levied on tobacco products to secure the financial resources necessary for assuming liabilities in the general account)
- **Special tax for reconstruction** (a tax levied to secure the financial resources for the reconstruction after the Great East Japan Earthquake; currently levied as special income tax for reconstruction)
- **Forest environment tax** (a tax imposed on individuals domiciled in Japan for an equal amount (JPY1,000 per year), collected together with individual inhabitant tax, and then transferred to municipalities and prefectures, starting in FY2024)

Additional Penalty Taxes

- **Additional tax for deficient returns** (a tax imposed at 5 to 10% of the uncollected amount for underpayment of taxes. A 10% additional tax may be imposed in case where the tax amount exceeds a certain amount. This tax may not be levied in cases where there are justifiable grounds)
- **Additional tax for not filing a tax return** (a tax imposed at 10 to 15% of the amount uncollected within a fixed period for not filing a final tax return. A 5% or 10% additional tax may be imposed in case where the tax amount exceeds a certain amount. This tax may not be levied, or a reduced rate of 5% may be applied

instead, in cases where there are justifiable grounds, etc.; a 10% additional tax may be imposed in case of the repeated failure of filing during a short period of time)

・**Additional tax on nonpayment** (a tax imposed by the tax collector at 10% of the amount unpaid within a fixed period. This tax may not be levied, or a reduced rate of 5% may be applied instead, in cases where there are justifiable grounds, etc.)

・**Heavy additional tax** (a tax imposed at 35% to 40% of the amount uncollected due to fraud or concealment; a 10% additional tax may be imposed in case of the repeated commission of fraud or concealment during a short period of time)

・**Delinquent tax** (a tax imposed at an annual rate of 7.3% or 14.6%, according to the length of the period in arrears. Adjustments are applicable for such tax rate if a certain low interest rate is applied to other transactions)

・**Interest tax** (a tax imposed at an annual rate of 7.3%, as a rule, according to the postponement period of tax payment. Adjustments are applicable for such tax rate if a certain low interest rate is applied to other transactions)

Local Taxes

◎Prefectural Taxes

(Ordinary Taxes)

・**Prefectural** (including Tokyo) inhabitant tax (a tax imposed according to income on residents (individuals and corporations) of the prefectures)

・**Enterprise tax** (a tax imposed on individuals and corporations conducting business)

・**Local consumption tax** (a tax imposed on the same person or corporation who engage in businesses as with the (national) consumption tax. For the time being this is to be reported and paid together with the (national) consumption tax.)

・**Real estate acquisition tax** (a tax paid by the individual acquiring land or a house to the prefecture in which it is located)

・**Prefectural tobacco tax** (a tax paid at the point of sale depending on the number of cigarettes sold)

・**Golf course use tax** (a tax paid by the user of the golf course)

・**Light oil delivery tax** (a tax imposed on the light oil trader according to the quantity from the special agent or original seller)

・**Automobile tax** (a tax paid at a prescribed location (of the car) by the owner of a car depending on the car type)

・**Mining lot tax** (a tax paid by the business with mining rights according to the surface area of the mine to the prefecture in which it is located)

・**Property tax** (special case) (a tax levied on assets in the special wards (*tokubetsu-ku*) of Tokyo Metropolis and on the owner of a significantly large depreciable asset according to its value)

・**Prefectural** (including Tokyo) general taxes not stipulated in Local Tax Act (a tax imposed based on each prefecture's circumstances)

(Earmarked Taxes)

・**Hunting tax** (a tax imposed on registered hunters as a source for funding for wildlife preservation and hunting management)

・**Water utility and land profit tax** (a tax imposed according to the value and surface area of the land or house benefiting from a project as a source of funding for realizing projects involving water utilization or forest roads, etc.)

・**Prefectural** (including Tokyo) earmarked taxes not stipulated in Local Tax Act (a tax imposed by prefectures for specified expenditures)

◎Municipal Taxes

(Ordinary Taxes)

・**Municipal** (special ward) inhabitant tax (a tax levied according to income on residents (individuals and corporations) of municipalities and called the special ward inhabitant tax in the Tokyo special districts)

・**Property tax** (a tax imposed according to the value on the owner of land, a house or depreciable asset)

・**Special land holding tax** (suspended) (a tax imposed on the owner or acquirer of land larger than a specific surface area according to its value)

・**Light vehicle tax** (a tax imposed on the owner of a motor scooter or motorcycle and paid to the city, town or village in which it is located)

・**Municipal tobacco tax** (the same as the prefectural tobacco tax)

・**Mineral product tax** (a tax paid according to the value of what has been mined by the mining industry to the city, town or village in which the mine is located)

・**Municipal general taxes not stipulated in Local Tax Act** (a tax imposed based on each municipality's own circumstances)

(Earmarked Taxes)

・**Business office tax** (a tax imposed on the surface area of the place of business, salaries paid, or renovations as a source of funding for city environmental maintenance)

・**Bathing tax** (a tax imposed on mineral or hot springs users as a source of funding for maintaining tourist facilities)

・**City planning tax** (a tax imposed on an owner of land or a house according to its value as a source of funding for city planning projects)

・**Water utility and land profit tax** (the same as that of prefectural)

・**Public facilities tax** (a tax imposed on individuals benefiting from public facilities such as communally used work places, storage, freight collection areas and pollutant processing facilities as a source of funding for expenses related to these facilities)

・**Land development tax** (a tax imposed according to the surface area on the developer of residential lots as a source of funding for communal facilities related to the residential land development)

・**National health insurance tax** (a tax imposed on insured persons as a source of funding for national health insurance expenses)

・**Municipal earmarked taxes not stipulated in Local Tax Act** (a tax imposed by cities, towns or villages for specified expenditures)

◎Additional Charges

・**Additional charge for deficient returns imposed by local government** (a tax imposed at 10 to 15% of the uncollected amount for underpayment of taxes. This tax may not be levied in cases where there are justifiable grounds, etc.)

・**Additional charge imposed by local government for not filing a tax return** (a tax imposed at 15 to 20% of the amount uncollected within a fixed period for not filing a final tax return within the due period. This tax may not be levied, or a reduced rate of 5% may be applied instead, in cases where there are justifiable grounds, etc.; a 10% additional tax may be imposed in case of the repeated failure of filing during a short period of time)

- **Heavy additional charge imposed by local government** (a tax imposed at 35 to 40% of the amount uncollected due to fraud or concealment; a 10% additional tax may be imposed in case of the repeated commission of fraud or concealment during a short period of time)
- **Delinquent charge** (a tax imposed at an annual rate of 7.3% or 14.6%, according to the length of the period in arrears. Adjustments are applicable for such tax rate if a certain low interest rate is applied to other transactions)

(Reference) Legal System Related to Taxes

The taxes described above are imposed according to stipulations in various tax laws. For example, taxes are imposed under their respective laws such as income taxes under the “Income Tax Act” and corporation taxes under the “Corporation Tax Act.”

However, as with the gift tax, which is imposed together with the inheritance tax under the “Inheritance Tax Act,” or like local taxes, some taxes are imposed not under specific laws for a particular tax but rather collectively under the “Local Tax Act.”

Furthermore, there are exceptions to these various laws or common rules for taxes, such as “Act on Special Measures Concerning Taxation,” “Act on General Rules for National Taxes,” “National Tax Collection Act,” and “National Tax Violations Control Act.” There are also treaties involving international relations.

Then, there are various “enforcement orders” for various tax laws that determine the details of these tax laws, “enforcement ordinance” for various tax laws that determine the procedural details, as well as “public notices,” etc., and the “circulars” issued by the National Tax Administration as implementation guidelines for instructing various tax offices.

Exercise

Class-2 Examination

The questions contained here are not identical to those used for actual examinations. They have been prepared to assist with examination preparations, in order to enable the user to understand the format of questions presented.

The term “Association Member” or “Regular Member” used in these questions refers to an association member or a regular member of the Japan Securities Dealers Association (JSDA). In addition, the term “financial instruments business operator, etc.” is also used to refer to an association member of the JSDA.

Exercise (Class-2 Examination)

Ⅰ. Read the following statements and mark each statement with "○" if it is true or with "×" if it is false.

[Financial Instruments and Exchange Act]

Q1. If a sales representative commits a malicious act in violation of the Financial Instruments and Exchange Act, but the act was outside of the scope of the authority of representation, the financial instruments business operator, etc. can avoid supervisory responsibility regarding that sales representative.

Q2. The sale of securities borrowed from another or the entrustment or acceptance of such sale is not subject to the short sale regulations.

Q3. Reports of possession of large volume or change reports are provided for public inspection for three years.

[Laws Relating to Solicitation and Sales of Financial Instruments]

Q4. When an Association Member sells investment trusts to a customer, the Consumer Contract Act does not apply because the Association Member is not the direct counterparty to the customer.

[Articles of Association and Various Rules of the Association]

Q5. A Regular Member must in advance obtain the undertaking that the customer is not a member of an antisocial force before it attempts to open an account for any sale and purchase or other transactions of securities for the customer for the first time.

Q6. A "transaction under fictitious name" is a transaction in which a customer uses a fictitious name or the name of another person to obtain the legal benefit of the transaction.

Q7. An Association Member must keep the notices and other information materials provided by the issuer of the foreign securities which the Association Member is entrusted with the custody of, and allow the customer to access these, and must deliver notices and materials, etc. delivered by the issuer at the customer's request.

[Articles of Incorporation and Various Regulations of the Exchanges]

Q8. There is only one type of trading participant on the Tokyo Stock Exchange, *i.e.* general trading participants who are qualified to conduct the sale and purchase of securities.

Q9. It is the practice for a financial instruments exchange, upon listing convertible-type bonds with share options, to decide to list the relevant convertible-type bonds with share options without conducting a listing examination, if the share certificates issued by the company which is the issuer of such bonds have been listed.

Q10. All deliveries of money between customers and trading participants with respect to the sale and purchase, etc. of securities must be made in Japanese yen.

[Equity Business]

Q11. Each time a customer makes an entrusted order for listed shares in trading sessions of the Tokyo Stock Exchange, the customer should give instructions to the financial instruments business operator regarding matters including the "effective period of an entrusted order."

Q12. The brokerage commission with respect to transactions in shares is determined in accordance with the "Brokerage Agreement Standards" established by the exchange based on the trading value.

Q13. ETFs and J-REITs are not included within the scope of transactions other than those during trading sessions.

[Bond Business]

Q14. In the case of trading interest-bearing bonds that have already been issued, the purchaser shall pay the seller the accrued interest in proportion to the number of months from the month immediately following the month that contains the last interest payment date until the month that contains the date of delivery of the bonds.

Q15. A delayed delivery transaction is one of the methods to trade bonds, where both parties to the contract, agree to the delivery of bonds subject to certain conditions, whereby the delivery of bonds is scheduled at least three months later than the contract date.

Q16. A parity value refers to a theoretical value of a convertible-type bond with share options, which is calculated by the share price and conversion price.

[Investment Trusts and Investment Corporations Business]

Q17. A fund that contains a certain percentage of both shares and bonds falls within the category of bond investment trusts.

Q18. A mother fund is an investment trust in which the beneficial interests are acquired by another investment trust to which the same investment trust settlor company gives instructions on the investment.

Q19. The base value is a value obtained by assessing shares or bonds incorporated in the portfolio of an investment trust at market value, in principle, to obtain the total assets, and deducting the total liabilities from the total assets, and dividing the remainder by the number of units of beneficial interests.

[Stock Company Law in General]

Q20. If the company fails to pay its debts, shareholders have to repay such debts to the company's creditors.

Q21. The company is entitled to exercise voting rights or to receive dividends with regard to its treasury shares.

Q22. Shareholders who dissent from a merger or assignment of business may have the company purchase their shares at a fair price following certain procedures.

[Financial Statements and Company Analysis]

Q23. The balance sheet shows the business performance of a company during a fixed interval of time.

Q24. Assets are divided into three categories, namely current assets, fixed assets and deferred assets.

Q25. Profits arise when the break-even point ratio is above 100%.

[Taxation of Securities Transactions]

Q26. Dividends, etc. held in elective withholding accounts are eligible for the final tax return non-filing system.

Q27. National government bonds and municipal bonds are included in the scope of specified bonds.

Q28. A single individual investor is allowed to open only one specified account for the transfer of listed shares, etc. and cannot open accounts with two or more financial instruments business operators.

Ⅱ. Answer the following questions in accordance with the instructions given in each question.

[Financial Instruments and Exchange Act]

Q29. Choose the two correct statements from below:

1. A financial instruments business operator must submit a notification to the Prime Minister in order to perform proprietary trading system (PTS) operations.
2. Financial instruments business operators must ensure that their capital-to-risk ratios do not fall below 120%.
3. A financial instruments business operator, etc. is not required to provide an explanation to a customer in light of the customer's suitability if it has delivered to the customer a document to be delivered prior to conclusion of a contract in advance.
4. A financial instruments business operator, etc. must prepare a document and deliver the same to all customers pursuant to the provisions of Cabinet Office Ordinance without delay upon the conclusion of a contract for financial instruments transaction.
5. The scope of the securities subject to the system for submitting reports of possession of large volume include investment securities.

[Articles of Association and Various Rules of the Association]

Q30. Choose the two false statements from below regarding the matters to be stated on the "Insider Registration Card":

1. Name or appellation
2. Address or domicile, and a mailing address
3. Company name, title, and section
4. Registered domicile
5. Members of family and relationship

[Equity Business]

Q31. Choose the one option from below which indicates the combination of the correct Price/Book-Value Ratio (PBR) and Return on Equity (ROE) for the following company (annual account closing):

(Note) Assume that there is no change in the total number of outstanding shares and the values on the balance sheets between the end of the previous term and the end of the current term. Figures appearing in the options have been rounded down to the first decimal place.

Total Number of Outstanding shares:	10 million shares
Total Assets:	JPY3.3 billion
Total Liabilities:	JPY2.5 billion
(Net) Profit for the Current Term:	JPY0.3 billion
Share Price (Market Price):	JPY320

	(PBR)	(ROE)
1.	4.0 times	9.0%
2.	4.0 times	37.5%
3.	9.0 times	9.0%
4.	9.0 times	23.7%
5.	9.0 times	37.5%

[Equity Business]

Q32. A market sell order for 4,000 shares of stock in a company was made; a contract for 3,000 shares at JPY1,000 and a contract for 1,000 shares at JPY1,020 were concluded on the same day. What would be the delivery amount in this case? Choose the one option from the options below which represents the correct amount. (The brokerage commission shall be calculated in accordance with the table below; the consumption tax rate should be 10%.)
(Note) Figures appearing in the options have been rounded down to the nearest JPY.

Contract Amount		Brokerage Commission
	≤JPY1 million	Total contract amount × 1.150%
>JPY1 million	≤JPY5 million	Total contract amount × 1.000% + JPY2,500
>JPY5 million	≤JPY10 million	Total contract amount × 0.700% + JPY12,500
>JPY10 million	≤JPY30 million	Total contract amount × 0.575% + JPY25,000
>JPY30 million	≤JPY50 million	Total contract amount × 0.375% + JPY85,000

1. JPY3,973,030
2. JPY3,976,584
3. JPY3,977,300
4. JPY4,020,000
5. JPY4,066,116

[Bond Business]

Q33. The subscriber yield of bonds can be calculated by using the following formula. Choose the one option from below which indicates the correct combination of words applicable to the relevant parentheses shown in the formula.

$$\text{Subscriber Yield} = \frac{\text{Coupon} + \dfrac{(a) - (b)}{(c)}}{(d)} \times 100$$

1. (a) Issue Price, (b) Redemption Price, (c) Issue Price, (d) Number of Years to Maturity
2. (a) Redemption Price, (b) Issue Price, (c) Number of Years to Maturity, (d) Redemption Price
3. (a) Issue Price, (b) Redemption Price, (c) Number of Years to Maturity, (d) Redemption Price
4. (a) Redemption Price, (b) Issue Price, (c) Number of Years to Maturity, (d) Issue Price
5. (a) Sales Price, (b) Purchase Price, (c) Issue Price, (d) Number of Years to Maturity

[Bond Business]

Q34. Choose the one option from below which represents the correct purchase price when purchasing a coupon bond with an annual coupon of 3.5%, 2 years remaining until maturity, so that the simple yield to maturity will be 1.00%:
(Note) Figures appearing in the options have been rounded down to the first decimal place.

1. JPY100.9
2. JPY101.9
3. JPY102.9
4. JPY103.9
5. JPY104.9

[Investment Trust and Investment Corporations Business]

Q35. Which of the following statements from A through C correctly describe the matters to be stated in the "certificate of incorporation of an investment corporation"? Choose the one option from below which indicates the combination of correct statements:

A. Matters regarding "whether an investor can have his/her investment equity in the company redeemed upon request or not"
B. Matters regarding the "minimum net assets amount which must be maintained by the investment corporation at all times"
C. Matters regarding the "policy for distribution of money"

(Options)
1. A and B
2. B and C
3. A and C
4. A, B, and C are all correct
5. A, B, and C are all false

[Incidental Businesses]

Q36. Choose the one option from below which correctly represents a business that does not fall under the scope of a business incidental to financial instruments business:

1. Borrowing and lending of securities, or intermediary or agency service therefor.
2. Money loan incidental to margin transactions.
3. Agency service for customers concerning securities.
4. Agency service for the business of any counterparty financial instruments business operators, etc.
5. Intermediary, brokerage or agency service for the sale and purchase of securities.

[Stock Company Law in General]

Q37. Choose the two correct statements from below regarding a shareholder’s rights:

1. A shareholder who holds shares of less than one unit has voting rights.
2. A minority shareholder is granted the right to seek the removal of directors.
3. The right to inspect account books is a right recognized as a sole shareholders’ right.
4. Each and every share of stock, except for class shares, has rights with the same feature, and shareholders have rights against the company that are proportional to their respective shareholdings.
5. If the company is a public company with a board of directors, the shareholder’s right to propose is granted to shareholders holding 2% or more of all voting rights or 500 voting rights or more for a continuous period of six months or longer.

[Basic Knowledge of Economics, Finance and Fiscal Policy]

Q38. Choose the two correct statements from below:

1. An overseas branch of a Japanese corporation is included in the “domestic” category for the purpose of gross domestic product (GDP) because it conducts economic activities in an overseas territory but its economic entity is located in Japan.
2. The “Short-term Economic Survey of Enterprises in Japan,” known widely by its Japanese abbreviation “BOJ Tankan,” is released every four months by Bank of Japan (BOJ).
3. The unemployment rate and regular employment index tend to lead economic fluctuations.
4. The BIS (Bank for International Settlements) was established using capital invested by the central banks of major countries around the world, and conducts settlements between central banks as well as deliberates and investigates problems related to international finance.
5. “Securitization” of assets refers to the parceling out of the assets of a company such as loans, lease receivables, and the like held by a financial institution or similar party, and remodeling the cash flow generated from the parceled assets into a financial instrument to redeem the obligee.

[Financial Statements and Company Analysis]

Q39. Choose the two options from below which correctly describe Company B, a listed company whose profit and loss statement contains the data given below (in millions of yen). In addition, assume that the amount of annual dividends of Company B is JPY700 million and the total number of outstanding shares is 10 million shares for both the previous and current term:

(Note) Figures appearing in the options have been rounded down to the first decimal place.

	Previous Term	Current Term
Sales	74,000	82,000
Sales costs	53,000	57,000
Selling expenses and general and administrative expenses	18,000	20,000
Non-operating profits and losses	1,000	-500
Extraordinary profits and losses	-500	-1,000
Corporation tax, etc.	1,500	2,000

1. The operating profit for the current term is JPY5,500 million.
2. The (net) profit margin on sales for the current term is 1.8%.
3. The ordinary profit margin on sales for the current term is 6.0%.
4. The dividend payout ratio for the current term is 20.0%.
5. The dividend payout ratio for the current term is 11.6 points higher than that for the previous term.

[Taxation of Securities Transactions]

Q40. An individual (resident) newly purchased 10,000 shares of Company A, a listed company, during the period from June of a given year to August of the same year as shown in the table below, and sold 5,000 such shares in September of the same year, for cash, via entrustment to a financial instruments business operator.

Choose the one option from below which correctly represents the amount of capital gains obtained by this sale:

(Note) Assume that the individual made no other sale or purchase of securities in that given year. No consideration is given regarding any commissions or other expenses.

Month	Sale or Purchase	Unit Price	Number of Shares
June	Purchase	JPY650	2,000 shares
July	Purchase	JPY680	4,000 shares
August	Purchase	JPY670	4,000 shares
September	Sale	JPY700	5,000 shares

1. JPY140,000
2. JPY150,000
3. JPY170,000
4. JPY200,000
5. JPY230,000

[Basic Knowledge Concerning Securities Markets]

Q41. Choose the one false statement from below:

1. With direct financing, it is the financial institution intermediary performing the financial intermediation function that bears the risk of recovering the funds, while for indirect financing, it is the final provider (investor) that bears this risk.
2. The scheme in which financial institutions invest funds (collected from fund providers) in securities traded in markets is also known as “market-type indirect financing.”
3. The secondary market is a market where the securities that have already been issued and obtained by the primary investors are then sold on (traded) to a second or third investor.
4. The protection of investors under the Financial Instruments and Exchange Act does not guarantee the payment of dividend on shares in which an investment is to be made.
5. Under the book-entry transfer system based on the Act on Book-Entry Transfer of Corporate Bonds and Shares, dividend payments for shares, etc. can be received at a single deposit account with respect to all issues, or via securities companies.

[Sales Operations]

Q42. The following text is part of the "Model Code of Ethics" provided for by the Japan Securities Dealers Association. Choose the one option from below which represents the correct combination of the words applicable to the respective parentheses.

As an important contributor to capital markets (which provide a principal place for raising and investment of funds for the national economy), we should fully understand our responsibilities concerning carrying out an intermediary function in the (a), which are entrusted to us by society and pursuant to "*The Principles in the Financial Services Industry*" published by the Financial Services Agency, we shall make every possible effort to hold the core values of (b) and (c) in order to be trusted by society and to obtain the required sophistication demanded by the profession.

1. (a) capital market, (b) sense of ethics, (c) investment decisions
2. (a) national economy, (b) sense of ethics, (c) price formation
3. (a) national economy, (b) price formation, (c) investment decisions
4. (a) capital market, (b) social common sense, (c) investment decisions
5. (a) capital market, (b) social common sense, (c) sense of ethics

Answer Sheet for Class-2 Exercise

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