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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. 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 (Gômei Kaisha), limited partnership companies (Gôshi 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)

The Companies Act was amended in June 2014 (by Act No. 90 of 2014) and the amendment came into effect in May 2015. The abovementioned related Ordinances of the Ministry of Justice were also amended accordingly and then underwent further amendments afterwards.

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 (*Gômei Kaisha*); limited partnership companies (*Gôshi Kaisha*); and limited liability companies (*Gôdô 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 (*Yûgen Kaisha*) also existed as a corporate vehicle (for details, see Column [2] below).

(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 (*Gômei 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 (Gōdô 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.).

Limited Liability Companies (Yûgen Kaisha)

Limited liability companies (Yûgen Kisha) 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 (Yûgen Kaisha) were outnumbering stock companies, and some of the limited liability companies (Yûgen 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 (Yûgen Kaisha) in the form that they previously existed. Nevertheless, former limited liability companies (Yûgen Kaisha) may continue to exist as exceptional limited liability companies (Tokurei Yûgen Kaisha). They are stock companies but must contain the words “limited liability company (Yûgen 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 (Yûgen 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 Kabushiki Kaisha (stock companies) and register to that effect (Arrangement Act, art. 45 and art. 46). Upon such changes, the treatments they received as limited liability companies (Yûgen 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 hojin"), companies are classified as an incorporated association ("shadan hojin") 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

21 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.
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.

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 Regulations, 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). 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. 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.

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).


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. If a review of that company’s articles of incorporation shows that the company can issue any shares that do not require the approval of the company to be transferred, the Act defines the company as being a public company (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).


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 listed companies should appoint at least two independent directors.

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 on June 1, 2018, a revised version was released to further clarify its purpose.

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, contribution in kind and assignment of properties after formation. (Companies Act, art. 309, para. 1 and para. 2). 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).

(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 [9]).

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, the lack of a large majority of subscriptions and payment for shares of stock, 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 latest amendments clearly stipulate 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. 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. This effect does not result from the split of the share certificates alone (such as converting one share certificate for 1,000 shares to two certificates for 500 shares).

   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.
[6] Par Value and Denomination of Shares

In Japan, many companies had been issuing par value shares in the past. In the case of a par value share, there is an amount noted on the face of the certificate, and the minimum value thereof is prescribed by the Commercial Code, which has been revised many times in accordance with changes in the value of the currency. Consequently shares of different par values such as JPY50, JPY500, JPY50,000, etc. have come to coexist in the market depending on the time of incorporation of the company. Because the articles of incorporation must be amended in order to change the par value, and because a company is prohibited from allowing its amount of net assets per share to become too small, changing share denominations was not easy.

As well as doing away with the limitations on denominations, the 2001 revision of the Commercial Code abolished the system of par value shares. Since the value of shares varies constantly along with the condition (earning capacity) of the company, assuming a constant and invariable face value of a share would be irrational (in the case of bonds there is a right to have the face value redeemed). Thus, doing away with the distinction between par value shares and non-par value shares was reasonable.

(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, these strict disclosure procedures or the rules regarding 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, the latest amendment stipulates shareholders’ appraisal right with respect to fractional shares generated as a result of the consolidation of shares (4-1(3) above).

[7] Fractional Share System

The fractional share system was established by the 1981 revision, which at the same time set a denomination of JPY50,000 per share. The reason behind this was that where the share denomination is large, even less than one share has an economic value that cannot be ignored. Certain rights are granted even to holders of fractional shares, and they are to be entered with in a fractional share register so that they can be combined with other fractional shares to form a single share. Because fractional shares are generally not for a large amount, clerical processing is troublesome. After making several amendments, including allowing a company to elect not to issue certificates for fractional shares, the 2001 revision allowed companies to have free discretion in determining the denomination of its shares, and also permitted a choice between the fractional share system and the share unit system. The Companies Act abolished the fractional share system itself.

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 a unit is too large, there will be many shareholders without important rights, so the limit is set at 1,000 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).

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 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 dividends at a certain rate 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 dividends are paid at a specific rate 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
corporation 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 an 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 opposition 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 of shares (or, rarely, not less than a certain number 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.

All 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.

[8] 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-
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
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-koukan) 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 1-2: Transfer of Shares with Restrictions on Transfer

(Shareholder A requests (i) approval of the transfer to B and (ii) designation of purchaser)

- **Approval by P**
  - Two weeks elapsed
  - No answer from P
  - Refusal by P
  - Transfer to C
- **Transfer to B**
  - Failure of statutory deposit
  - Agreement on sale price reached
  - Failure to reach a deal
  - Determination of price by the court
  - Transfer to P
  - Transfer to C
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 19 categories are listed, and 23 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 23 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 transfer will be made on the shareholders registry including the qualification as a shareholder. 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 an 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 Rules, 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 at the end of the period, 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 the subsequent result is actually a deficit, the directors, etc. will be liable for damages 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 [23]).

[9] 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 1-3, 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 1-3 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)
The management of a company 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 [13]).
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 lose 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 of Company Bonds, Shares, etc., art. 145 and art. 146; see Column [12] below).

[10] “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 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 prevents the shares from being sold 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 or share transfer (ibid., art. 797 and art. 806) 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 of Company Bonds, Shares, etc., art. 155, para. 3; see Column [12] 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, and art. 807, 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, and art. 807, 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.
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 submits 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.

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 [11]).

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).


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).
Digitization of Share Certificates

[12] 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 of Company Bonds, Shares, Etc.” 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...
(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).
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; this was the way the former limited liability company structure operated).

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 the shareholders consent, notice may also be made by email (ibid., art. 299, para. 3). 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 public company with 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 for a continuous period of six months or longer (or 300 units for a company adopting the unit share system). 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.

(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.,
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 to provide the above information or for voting (Companies Act, art. 298, para. 1, item 4, art. 302, and art. 312; Companies Ordinance, art. 65, art. 66, art. 70, art. 73 through art. 93 and art. 95), and some companies are using the Internet together with holding their shareholders meeting.

(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 the 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 (futsu 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) Following number is the number of item in 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) a 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 and shares transfer (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 [9] 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.

Although the Companies Act does not uniformly force the companies to select an outside
director, 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, it must have outside directors
(Companies Act, art. 373, para. 1, item 2) (For outside company auditors, see 8-5(4)(Note)).

In 2014, an amendment was made to the rules for outside directors 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. If a large, public company with board of company
auditors which must submit an annual securities report has no outside directors, it must explain
the “reason why it is not appropriate to have an outside director” in the shareholders meeting
(Companies Act, art. 327-2; this explanation is required to be contained in a business report and
reference documents; Companies Ordinance, art. 124, para. 2 and para. 3, and art. 74-2).

(3) Competing Business and Transactions in Conflict of Interest

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. Stipulation must be made in detail of the method of calculating remuneration when
the amount is not fixed, and specific contents if the remuneration is not monetary (Companies Act,
art. 361).


(4) 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 [13] 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 a 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 the 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).
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 [9] 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 [9] 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).

A shareholder who has ceased to be a shareholder and lost standing to sue is still entitled to file a shareholder derivative suit and a multiple derivative suit if the loss of the shareholder’s status was not due to the shareholder’s voluntary transfer of the share but was caused by the share exchange or any other measure taken by the company (Companies Act, art. 847-2).
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. 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).

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(4) above).
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). 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).

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 [9] 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).

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.
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.
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.
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 Rules, 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 Rules, 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 Rules, art.
133).

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 Rules, art. 135).
[14] 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 Rules, 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 Rules, 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 Rules, 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).


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 (kanpo) 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 Rules, 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 Rules, 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 Rules, 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 Rules, 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 or share transfer must also be put into
this reserve (Companies Act, art. 445, para. 1 through para. 3 and para. 5; Accounting Rules, art.
35 through art. 39). As with the stated capital, the capital reserve is formed from the contribution
by shareholders and its accumulation does not have any upper limit.

[16] 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 refers to surplus that 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 Rules, 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; Companies Ordinance, 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 Rules, 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 Rules, 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 Rules, 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 Rules, art. 76, para. 1, item 2, (d)).

In principle, all of the subsidiaries shall be included in the scope of consolidation (for details, see Chart 1-3, Column [9]). 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 Rules, 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 Rules, art. 2, para. 3, item 18). 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 Rules, 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 Rules, art. 2, para. 3, item 23 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 Rules, art. 2, para. 3, item 22). Among the assets, shares of associated companies shall be classified and recorded in the non-consolidated balance sheet (Accounting Rules, art. 74, para. 3, item 4 and art. 82).

There is another term “affiliated party” which refers to a more broad 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 Rules, 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 Rules, 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).

[17] 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).
[18] **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 almost no procedures have been taken for the purpose of issuing the shares, it is possible to bring a suit for confirmation of nonexistence of new issue (Companies Act, art. 829). This may be brought by anybody at any time.

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.
[19] Share Option System
Share options are similar to former preemptive rights but can be used for various purposes. When the capital increase through allotment to shareholders (see 10-2(1)(i)) is decided, each shareholder shall hold the right to receive the allotment of new shares in proportion to his/her shareholding. This right was called the preemptive right to subscribe for new shares in general (in some cases the other party to the capital increase through allotment to third party held the preemptive right). Later, a method to transfer the company’s treasury shares and a method to grant preemptive rights by granting stock options to the directors or employees as incentive compensation are introduced. When the scope of persons to which stock options can be granted was expanded to the officers and employees of the affiliates and the business partners, a different term, share options, was used to demonstrate that the system was different from the preemptive rights in the past. Nevertheless, the preemptive rights (warrants) attached to bonds with subscription right were planned to be made available separately from the bonds themselves to a broad range of person prior to such change in the term. If share options are issued in return for compensation, it may function as a fund raising vehicle.

(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 difference is that issues for no consideration may be made in case of share options (ibid., art. 238, para. 1, item 2). 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).

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**[20] 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 (sec 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).

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(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).

[21] 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-hakkou), 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 manager, such as a bank. However, a bond manager 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).

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 manager 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 manager is provided with the authority to carry out actions requisite to protecting the bondholders, as follows. For instance, the bond manager 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 manager has these significant duties, the bond manager cannot freely resign from the position (ibid., art. 711), and the dismissal of the bond manager by the issuing company is restricted (ibid., art. 713). In addition, the bond manager 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 manager 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).

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 [20]). Bonds have become paperless earlier than shares, and are managed through a digitized accounting book (see Column [12] 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 (trusor) 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 manager. 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.

**[22] 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.
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).

[23] 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 and share transfer. 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 1-8 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).
(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 1-9) 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 1-9), 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) A company split may be made between limited liability companies (ご守株会社), a limited liability company (ご守株会社) 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 (ご守株会社) or a limited partnership company (ご守株会社) (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 a 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.).

[24] Company Split 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 koukan) and Share Transfer (kabushiki iten)

(1) Share Exchange (kabushiki koukan)

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 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 5 Entity Conversion

A stock company may become a general partnership company (*gômei kaisha*) or a limited partnership company (*gôshi kaisha*) or a limited liability company (*gôdô 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.

[25] 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. The former Commercial Code provided for a reconstruction system which shall only be applied to stock companies and called corporate arrangement, but was abolished upon the enforcement of the Companies Act.

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).
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.

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; Corporation Regulations, 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.
# Chapter 2 Basic Knowledge of Economics, Finance and Fiscal Policy

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Economics Growth and the GDP

(1) History of and Challenges for Economic Growth in Japan

Most countries are consistently faced with economic problems such as inflation, unemployment, and deterioration in international balance of payments. The resolution of these problems is one of the most important tasks of policy makers and Japan is no exception.

During the high growth period of the 1960s, the Japanese economy achieved tremendous advances, recording average real economic growth of more than 10% per year. Nevertheless, consumer prices also rose sharply during this same period, with an average appreciation rate of 6% to 7% per year, giving a strong impression that the economic growth was accompanied by high inflation. Economic expansion also led to many problems, including balance of trade deficits resulting from insufficient foreign currency reserves, which in turn made it difficult to pay for imports. This was the so-called problem of “balance of payments constraint.”

The following 1970s were said to be a period of big fluctuation. After the U.S. dollar could no longer be exchanged for gold following the “Nixon Shock” in 1971, the yen rate was switched to a floating exchange rate system in 1973, and many believed the appreciation of the yen would lead to deterioration in Japan’s competitiveness in exports. It is well known that intervention by the government and the Bank of Japan (the “BOJ”) in the foreign exchange markets at the time led to an excess supply of currency and paved the way for the inflation that followed. Thus, while the spike in oil prices caused by the first oil crisis in 1973 was the immediate trigger that accelerated inflation, some believe that a further cause of the inflation was the BOJ’s inability to adequately control the money supply.

Immediately after the first oil crisis, consumer prices soared out of control, increasing as much as 21% during FY1974. That year, the real economic growth rate was minus 0.5%, the first negative growth rate since the end of World War II. In contrast to the high growth during the 1960s, the main problem in the Japanese economy during the 1970s was sustaining growth while controlling inflation.

The 1980s started with the second oil crisis, and Japan could not escape from the worldwide recession. In order to break free from stagflation, which refers to the simultaneous conditions of recession and inflation, the U.S. under the Reagan administration adopted a policy mix which combined a credit squeeze with fiscal expansion. This policy caused the value of the U.S. dollar to go up and the budget deficit to increase, which in turn led to a deficit in the current account, and the U.S. turned into a debtor country.

Japan achieved economic recovery mainly by increasing exports, but its trade surplus continued to grow and other countries urged Japan to correct its external imbalance. The G7 countries reached a common understanding that trade imbalances were to be corrected by
adjusting exchange rates and with the Plaza Accord in 1985, the devaluation of the U.S. dollar was encouraged. Thereafter, the U.S. dollar continued to drop rapidly. In Japan, the rise in the yen and the fall in the U.S. dollar caused a substantial deterioration in the revenues of exporting companies, and led to the so-called “strong-yen recession” in 1986. Nevertheless, the rising yen also enabled companies to significantly reduce their import costs for raw materials etc., such as crude oil, and as the effect of such trend, from the start of 1987 significant improvements began to be seen in corporate income. Since February of the same year, the official discount rate was reduced to 2.5% and money markets eased substantially. The low U.S. dollar (strong yen), low crude oil prices, and low interest rates, at the time were called the “triple-low phenomenon” and played an important role in promoting the 51-month long economic boom that followed.

As the pace of economic expansion accelerated, labor was in short supply, and Japan was getting close to reaching a state of full employment. With the increasing pressure of rising consumer prices and wages, the BOJ strengthened its tight monetary policy in May 1989 as a preventive measure against inflation. The official discount rate was increased to 6% in August 1990, when the Gulf crisis occurred. The economy began to slow down in 1991, and market adjustments were necessitated. Asset prices had declined substantially since early 1990, and a successive series of counter-cyclical measures taken by the government could not easily improve the overall slump in the market. For four consecutive years starting in FY1990, corporate performance continued to decline, and the real economic growth rate for FY1993 ended up being negative. At the end of 1993, it appeared that the economy had bottomed out. However, a rapid appreciation in the Japanese yen to as high as JPY80 per USD 1 for a brief period forced the Japanese economy into a phase of mini-adjustment. Although there was a growing shift towards correction of the overvalued yen and there have been signs of stable growth since then, events such as the increase in the consumption tax rate triggered a slowdown in the economy from the latter part of 1997. This slowdown continued throughout 1998 and the major shocks in the form of the Asian currency crisis, and the credit insecurity resulting from failures of financial institutions became a significant drag on the economy.

With the recovery of the Asian economies and the global economy as a whole, exports increased. Various policies such as a special credit guarantee program took effect, and public investment was aggressively injected into the economy, so that a recovery began to occur at the start of 1999. Nevertheless, the world then experienced the collapse of the IT bubble, so that the economy again began to regress from the end of 2000.

The BOJ adopted a policy of “quantitative easing” beginning in March 2001, and with the growth in the global economy, such as in the U.S. and China, as well as the completion of inventory adjustments that began after the IT bubble had burst, the economy began to recover from the start of 2002. Since then, although the pace of recovery slowed on two occasions, under the influence of deterioration of the situation in Iraq and upon an adjustment of inventory in the IT sector, the longest period of economic expansion in history was still recorded, exceeding that of the Izanagi boom.

Nevertheless, financial insecurity subsequently spread worldwide from around the summer of 2007 with the breakout of the subprime loan problem in the U.S., and with inflation backed by a
sharp rise in the price of resources, the Japanese economy started to slow down from the end of
the same year. Sparked by the subsequent collapse of Lehman Brothers in September 2008, the
financial markets throughout the world were thrown into confusion. Global demand drastically
decreased mainly as a result of a correction in excess consumption in the household sector sparked
by a decline in housing prices in the U.S., and a contraction in international trade was also
experienced with a decline in trade creditworthiness, and as a result the Japanese economy began
to worsen at an unprecedented pace.

Affected by rapid monetary/fiscal policies by different countries, the global economy
bottomed out in the beginning of 2009, and the Japanese economy went through a gradual export
led recovery. In addition, growth in individual consumption by domestic economic policies such
as subsidies for eco-friendly cars and the eco-point system also backed the recovery of the
Japanese economy.

However, the Great East Japan Earthquake, which occurred in March 2011, in combination
with the worsening debt problems in Europe and the downturn in the global economy that
followed, put a downward pressure on the Japanese economy which was on track to recovery. The
worsening debt crisis in Europe made investors more inclined to avoid risk and prompted them to
buy Japanese yen as a risk-free asset. As a result, the Japanese yen rose to a postwar record high
against the dollar (USD1=JPY75.32) as of October 31, 2011. The sharp rise in the Japanese yen
weakened the competitiveness of the Japanese export industry and slowed down exports.
Moreover, due to the suspension of operations of the nuclear power plants in Japan, imports of
fossil fuels rapidly increased and thus, in 2011, a trade deficit was seen for the first time in 31
years.

After the struggle against the Japanese yen appreciation, the Japanese economy came to a
turning point in the latter half of 2012. From around September of the same year, against the
backdrop of a recovery in the U.S. economy and the resolution of the debt crisis in Europe, the
rising trend of the yen subsided. Furthermore, a decision by the Noda Cabinet to dissolve the
House of Representatives for a new election brought a sense of anticipation for the economic
policy package proposed by the President of the Liberal Democratic Party, Mr. Abe, who
advocated bold monetary easing and accordingly, a rapid depreciation of the yen occurred.
The yen’s further weakening led to improvement of corporate performance and a sharp rise
in share prices. These trends led to improved consumer confidence and positively impacted the
asset markets, thereby boosting consumer spending. Finally, since the latter half of FY2012, the
Japanese economy has been growing, driven by consumer spending. Moreover, in 2013, the
economic growth led by domestic demand continued as a result of the considerable increase in
public investment in addition to the increase in consumer spending.

However, the consumption tax hike to 8% as of April 2014, caused a last-minute surge in
demand followed by a reactionary demand decline, resulting in a temporary significant downturn
of the Japanese economy. Thereafter, the economy continued to be slow to recover and remained
trapped in the stagnation phase. However, since the latter half of FY2016, the economy has been
recovering. Since FY2018, the Japanese economy has continued to gradually expand;
nevertheless, there are risks of economic slowdown emerging around the world such as the U.S.
China trade friction and withdrawal of the United Kingdom from the EU (Brexit).

(2) Gross Domestic Product

In “(1) History of and Challenges for Economic Growth in Japan” above, the terms “economic growth” and “economic growth rate” have been used in the discussion without being properly defined. In general, economic growth is measured by Gross Domestic Product (GDP). GDP is a widely used index that represents the country’s comprehensive economic activities in three facets, i.e., production (or added value), distribution (or income), and expenditure. The “Principle of Equivalence of Three Aspects of National Income” applies to these three facets, since all three facets are considered to have the same numeric values.

A simple explanation of the concept of GDP from the perspective of production activities is as follows: production requires the intermediate input of raw materials and energy which are the result of production by other industrial activities; the added value, then, is the total value of production less the amount of the intermediate inputs. GDP is a flow concept, which gives the total of the added value which is generated by all the various economic activities within a country.

In the real world, however, not all of the remainder of the production amount minus the amount of intermediate inputs remains as added value. Rather, it is also necessary to take into consideration the value of those resources which are depleted in the course of production, such as machinery and equipment that wear out after prolonged use. The value of the depletion in these resources is referred to as the consumption of fixed capital (depreciation), and the added value less depreciation is referred to as the net added value. Measuring the level of economic activity using the GDP, which does not deduct the depreciation of fixed capital, may lead to an overestimation of the economy. For the purposes of calculating the national economy, the value which remains after deducting the depreciation of fixed capital from GDP is referred to as the Net National Product, and the word “Gross” in GDP indicates that the value includes, and does not deduct, the depreciation of fixed capital.

The above explanation shows why the Net National Product is a more accurate expression of a country’s economic activities than GDP. Yet, accurate and short term measurement of the value of fixed capital depreciation is difficult, and therefore, GDP is most widely used to express a country’s economic activities.

There is also the concept of Gross National Income (GNI), which is used in contrast to Gross Domestic Product (Gross Domestic Income (GDI)). GNI was also referred to as Gross National Product (GNP) in the former System of National Accounts (SNA):

\[ \text{GNI} = \text{GDI} + \text{Net income received from abroad} \]

The concept of “Domestic” covers economic agents residing in the domestic territory (a country’s territory excluding the foreign diplomatic establishments and the military organizations residing in that country and adding the country’s diplomatic establishments and the military organizations residing in other countries). For example, a subsidiary of a foreign corporation in Japanese territory is included in the “Domestic” category as a producer residing in Japan since
such entity conducts economic activities in the domestic territory of Japan. On the other hand, an overseas branch of a Japanese corporation would not be included within the “Domestic” category.

Furthermore, the concept of “National” means the residents of the country, and includes corporations which satisfies the requirements of being a resident as set forth in the circular “Interpretation and Application of Foreign Exchange Acts and Regulations” of the Foreign Exchange and Foreign Trade Act (FEFTA) and its subordinating orders, governments, private non-profit institutions serving households, and individuals residing in that country (anyone residing in that country for more than six months regardless of nationality; persons who are resident abroad for a period of more than two years are excluded from the category of residents).

(Source) Cabinet Office
GNI indicates the total amount of income generated by the residents of a country, adding the net factor income received from overseas (employee income, property income such as investment income, and corporate income) to GDP, and is assessed from a flow perspective. The difference between GNI and GDP used to be very small in Japan. However, direct overseas investments and overseas securities investments increased rapidly beginning in the late 1980s, causing net factor-income receipts to increase. As a result, the difference between GNI and GDP has been widening, and many have come to believe that GDP should be taken as a more accurate measure of the country’s economic activities than the GNI. National income statistics have been released on a GDP basis since the third quarter of 1993, by the (former) Economic Planning Agency (see Chart 2-1).

(3) Gross Domestic Product from the Point of View of Distribution

Let us look at how added value generated in one year is distributed to the production factors such as labor and capital. According to the SNA, the following relationship is established:

\[
\text{GDP} = \text{Employee income} + \text{Operating surplus} + \text{Depreciation of fixed capital} + (\text{Indirect taxation} – \text{Subsidies})
\]

Chart 2-2 shows the added value for 2016 from the aspects of production and distribution. According to this chart, the production in 2016 was JPY13.3 trillion from primary industries, JPY376.3 trillion from secondary industries and JPY610.1 trillion from tertiary industries, for a total of JPY999.7 trillion. When the intermediate inputs are deducted from these amounts to obtain the added value amounts, the respective results are JPY6.2 trillion, JPY143.4 trillion and JPY384.7 trillion, for a total of JPY534.3 trillion.

The breakdown of the distribution by sector is as follows: JPY269.0 trillion for employee income such as wages, JPY105.3 trillion for operating surplus and mixed income which is the sum of the profits of the private corporations and the individual businesses such as farmers, rent, and interest income, JPY119.9 trillion for depreciation of fixed capital, and JPY40.1 trillion for indirect government revenue other than direct taxation ([indirect taxation] – [subsidies]), for a total of JPY534.3 trillion. Thus, the amount of GDP is the same whether seen from the perspective of production or that of distribution.
(4) Gross Domestic Expenditures

Of the three facets of production, distribution and expenditures, we have discussed production and distribution. Now, let us review national economic activities with respect to expenditures. Chart 2-3 shows the Gross Domestic Expenditures (GDE) and the composition of each final demand component.

There are two types of consumption: private consumption and government consumption. The major part of private sector final consumption (private consumption) is household consumption expenditures, whereas government final consumption consists of purchases of goods and services by the central government and municipal governments, and this includes large amounts for employment services such as salaries for civil servants, education expenses, and defense spending.

Gross fixed capital formation includes investments in housing and corporate plant and equipment (construction of factories, the acquisition of machinery, research and development, etc.) by the private sector and public fixed capital formation (investments in the construction of roads, ports, airports, etc. by the government and other public sectors). Public fixed capital formation is generally called public investment.

A change in inventory is generally known as inventory investment. It consists of unsold merchandise at the end of the fiscal term, and intermediate inputs from other industries that were not consumed during the fiscal term. A change in the inventory of the public sector is a change in the government’s inventory, such as a change in the government’s stockpiles of petroleum, rice, etc.

Net exports of goods and services are the exports of goods and services (overseas demand for domestic products) less imports of goods and services (domestic demand for foreign products). The above consumption and investment items include the final demand for consumption goods and investment goods, regardless of whether such demand arises domestically or overseas. Imports of goods and services are deducted from such to compute the final gross value of domestic products.

Private consumption constitutes the largest portion of final demand. In FY2017, the nominal share of private consumption was 55.4%, and a comparison with previous years shows that the
trend for this line item is comparatively stable. Nevertheless, investment in plant and equipment and exports are particularly important from the perspective of fluctuations in the economy, especially in recent years. Although investment in plant and equipment accounted for 15.8% of nominal GDP and exports accounted for 17.9% thereof in FY2017, which is relatively low when compared to private consumption, this is because the amplitude is relatively large.

The ratio of public capital formation (public investment) to nominal GDP grew substantially from the start of the 1990s and rose to the level of 9.3% in FY1995. In FY2007, as a result of the continued reduction of public works spending aimed at achieving fiscal consolidation, this ratio declined to 4.8%, the lowest level since FY1980. After the Great East Japan Earthquake, it turned upward due to the considerable increase in public works spending coupled with the large-scale supplementary budget compiled by the Abe Cabinet as a part of its economy-boosting measures. However, after peaking at 5.3% in FY2013, it started to decrease again, falling down to 5.1% in FY2017.

The following formula shows the Gross Domestic Expenditures (Gross Domestic Product) as a total of final demand categories:

\[
\text{GDP(Y)} = \text{Private consumption (C)} + \text{Private investment (I)} + \text{Government expenditures (G)} + \text{Exports (EX)} – \text{Imports (IM)}
\]

(5) Real and Nominal

As shown in Chart 2-3, the nominal GDP (= GDE) of Japan in FY2017 was JPY548.7 trillion, whereas the real GDP for the same year was JPY533.0 trillion. The difference between “real” and “nominal” GDP values is that the nominal value GDP assesses the year’s level of economic activities based on market prices, while the real value GDP assesses the same by making adjustments for the effect of price fluctuations.

An increase in nominal GDP does not mean that the level of economic activity increased by the same margin if the market price has also increased. Therefore, a change in the real GDP, which is the nominal GDP less the effect of price increases, yields a more accurate picture of the change in the level of economic activity. The deflator is the factor that accounts for the difference between the nominal and real GDP, and is obtained by dividing the nominal value by the real value.
### Chart 2-3

#### Nominal GDE and Each Demand Type, etc.

(Chart 2-3: Nominal GDE and Each Demand Type, etc.
(Unit: JPY trillion, %)

<table>
<thead>
<tr>
<th></th>
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<th></th>
<th></th>
<th></th>
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</thead>
<tbody>
<tr>
<td>Nominal GDE</td>
<td>516.4</td>
<td>528.5</td>
<td>525.7</td>
<td>499.3</td>
<td>507.2</td>
<td>518.5</td>
<td>539.9</td>
<td>539.4</td>
<td>548.7</td>
</tr>
<tr>
<td>Final consumption expenditure in private sector</td>
<td>(53.4)</td>
<td>(54.3)</td>
<td>(55.7)</td>
<td>(57.6)</td>
<td>(59.1)</td>
<td>(57.6)</td>
<td>(56.4)</td>
<td>(55.7)</td>
<td>(55.4)</td>
</tr>
<tr>
<td>Private housing</td>
<td>25.2</td>
<td>21.3</td>
<td>19.5</td>
<td>13.9</td>
<td>16.6</td>
<td>15.5</td>
<td>16.1</td>
<td>17.0</td>
<td>17.3</td>
</tr>
<tr>
<td>Private investment in plant and equipment</td>
<td>(4.9)</td>
<td>(4.0)</td>
<td>(3.7)</td>
<td>(2.8)</td>
<td>(3.3)</td>
<td>(3.0)</td>
<td>(3.0)</td>
<td>(3.2)</td>
<td>(3.2)</td>
</tr>
<tr>
<td>Change in inventory of private sector</td>
<td>1.4</td>
<td>0.4</td>
<td>0.5</td>
<td>1.0</td>
<td>-1.6</td>
<td>0.4</td>
<td>1.2</td>
<td>-0.3</td>
<td>0.1</td>
</tr>
<tr>
<td>Final consumption expenditure in government</td>
<td>(15.8)</td>
<td>(15.8)</td>
<td>(15.7)</td>
<td>(13.6)</td>
<td>(15.3)</td>
<td>(15.6)</td>
<td>(15.6)</td>
<td>(15.5)</td>
<td>(15.8)</td>
</tr>
<tr>
<td>Public fixed capital formation</td>
<td>47.8</td>
<td>40.1</td>
<td>27.9</td>
<td>24.7</td>
<td>26.9</td>
<td>27.1</td>
<td>26.8</td>
<td>27.0</td>
<td>27.8</td>
</tr>
<tr>
<td>Change in inventory of public sector</td>
<td>0.3</td>
<td>0.0</td>
<td>0.0</td>
<td>-0.1</td>
<td>0.0</td>
<td>0.1</td>
<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
</tr>
<tr>
<td>Net exports of goods and services</td>
<td>5.5</td>
<td>6.5</td>
<td>7.6</td>
<td>5.9</td>
<td>-13.8</td>
<td>-8.7</td>
<td>-0.4</td>
<td>5.4</td>
<td>4.9</td>
</tr>
<tr>
<td>Exports of goods and services</td>
<td>(1.1)</td>
<td>(1.2)</td>
<td>(1.4)</td>
<td>(1.2)</td>
<td>-2.7</td>
<td>-1.7</td>
<td>-0.1</td>
<td>(1.0)</td>
<td>(0.9)</td>
</tr>
<tr>
<td>Imports of goods and services (deducted)</td>
<td>46.9</td>
<td>56.4</td>
<td>76.6</td>
<td>75.9</td>
<td>82.8</td>
<td>92.3</td>
<td>91.8</td>
<td>88.9</td>
<td>98.2</td>
</tr>
<tr>
<td>Real GDE</td>
<td>441.4</td>
<td>464.2</td>
<td>492.6</td>
<td>492.9</td>
<td>512.5</td>
<td>511.0</td>
<td>518.3</td>
<td>524.5</td>
<td>533.0</td>
</tr>
<tr>
<td>GDP Deflator (Year 2011 = 100)</td>
<td>117.1</td>
<td>113.8</td>
<td>106.7</td>
<td>101.3</td>
<td>99.0</td>
<td>101.5</td>
<td>103.0</td>
<td>102.8</td>
<td>102.9</td>
</tr>
</tbody>
</table>

(Note) Percentage shares are shown in parentheses.
(Source) Cabinet Office

**6) Assessing GDP Statistics**

Normally economic growth is determined by making a comparison between the current GDP and that of the previous term (year or quarter), with economic growth consisting of the difference between the two figures. GDP is announced every quarter and is quite useful in judging the quarter’s economic climate (see Chart 2-4).
The quarterly GDP statistics are called the QE (Quarterly Estimates), and they yield important information for judging and evaluating economic trends. There are two methods of reading the QE: (a) comparing it with the previous year’s QE for the same quarter, and (b) comparing it with the QE for the previous quarter of the same year at annualized rates. The former uses “serial” data that has not been processed statistically, while the latter uses data that has been “seasonally adjusted,” which means it has been processed statistically.

Seasonal adjustment means statistical processing which eliminates the “regular cyclical variations during a year,” such as fluctuations as a result of the climate (the harvesting of crops, etc.), systemic factors such as Christmas and bonuses, and differences in the number of days in a month. Analysis of the economic climate requires adjustments for these seasonal variation factors, and for this reason the seasonally adjusted figures are important information for analyzing the economic climate.

Use of annualized rates, whereby the growth for one quarter is assumed to continue for a full year, facilitates comparisons with other periods.

GDP statistics were completely reformed on the basis of the “1993 System of National Accounts” (abbreviated as “93SNA”) as adopted by the United Nations in 1993 for use starting in autumn 2000. This change was made in order to take into account changes in the role of the government, and changes in the social and economic environment such as an increase in the use of computers, as well as to achieve greater consistency for purposes of international comparison, and closer harmonization with other international statistics. Major changes include defining...
expenditures for computers and software as an investment in plant and equipment rather than as an intermediate input as had been done previously, adding the depreciation of fixed capital in the form of infrastructure to final consumption costs of the government, and separating consumption into “final consumption expenditures” that are borne as a cost of consumption, and “real final consumption costs” associated with the receipt of benefits.

In addition to this, the method of calculating the deflator and its use to obtain real values in GDP statistics were changed at the end of 2004, with the method changing from the fixed-base year method to the chain-linking method. In contrast to the fixed-base year method, whereby a specific year is used as the base year, in the chain-linking method the base year is changed annually to the preceding year. The strong influence imparted by information technology goods on investment and consumption during the present economic cycle can be cited as part of the background for the change.

There have been sharp declines in prices of information technology related goods in keeping with the rapid improvement of quality and advance of technological innovation, creating a tendency for greater distortion in GDP statistics the longer the period of time has elapsed from the fixed-base year. It is believed that using the chain-linking method results in GDP statistics which better reflect actual conditions.

At the end of 2016, GDP statistics were revised on the basis of the “2008 System of National Accounts” (abbreviated as “08SNA”), a new international standard. Changes were made to a broad range of statistical items in light of the changes in the economic situation after the adoption of 93SNA. For example, research and development (R&D), which has become more important in corporate production activities, is now treated as capital formation, instead of intermediate consumption.

1 2 Economy and the Economic Climate

(1) Economic Growth and Economic Cycles

To understand economic trends, it is useful to view the fluctuations in the economy from the perspectives of “economic growth” and “economic cycles.”

When comparing the GDP of various countries, most industrialized countries show sustained growth. In other words, each country seems to show a general growth trend if the economy is viewed over the long-term, although the level of growth differs by country.

On the other hand, the economy seems to repeatedly prosper and shrink when GDP is seen over a period of three to five years, meaning that these shorter cycles appear to revolve in a cycle around the long term trend of economic growth. Thus, normal economic fluctuations are led by a growth trend which is accompanied by the smaller waves of fluctuation (see Chart 2-5).

When assessing the economy, the focus may shift from emphasizing growth to emphasizing cycles depending on the phase of economic growth. For example, in areas such as East Asia where economic growth has been very rapid, greater emphasis is placed on whether economic
growth can continue in the long term, rather than on short-term economic cycles, and analysis focuses on determining the causes of economic growth.

(2) What Is Economic Growth?

The two essential factors leading to economic growth are supply and demand. Supply factors involve matters that assist a company in obtaining the production components that are necessary to produce “goods,” such as capital (facilities), labor, and raw materials. Demand factors involve matters that facilitate the sale of the “goods” that the company produces. Let us review this by applying the concepts to the Japanese economy during the 1960s when it sustained a high level of growth. In this example, the “supply factor” was cheap labor from rural areas, particularly agricultural communities, which supported a rapid increase in manufacturing. The “demand factor” was the increase of exports in the steel and shipbuilding industries and the expanded facilities of these industries which had a ripple effect on other industries, and thereby supported economic growth.

When discussing economic growth, the main question often is, “What is the true level of Japan’s economic capacity?” The true level of Japan’s economic capacity translates to “potential growth capacity” in economic terms. Potential growth capacity is the average growth rate that can be achieved by utilizing available labor, capital, and technology, etc. Therefore, it is often
indicated that this involves the “supply capacity” of a country, which represents the level of production that a country can attain. In general, the factors that determine the supply capacity of a country are labor capacity, capital stock, and technological progress. The following discussions focus on these three factors:

(i) Labor Capacity

The term “labor capacity” often leads a reader to think of the number of laborers. However, the definition of labor capacity in the context of economic analysis means the “labor input volume,” which is the number of laborers employed multiplied by the total work hours per laborer.

The total population, or the population of laborers of working age (actual number of people in the age group that can work; generally the group comprising age 15 through age 64), and the ratio of people willing to work (labor force participation rate) are also particularly important factors in determining the labor capacity. The decline of total population of Japan, including persons from foreign countries, which started after reaching a peak in 2008, is having a negative influence on labor capacity. According to the birth median (death median) estimate from the “Estimated Future Population of Japan” (as of 2017) by the National Institute of Population and Social Security Research, the working age population is expected to continue declining and decrease by about 30 million people by 2065.

When considering the trend of the labor force, however, the acceptance of workers of foreign nationalities must be considered, and it is also possible that there will be increases in the labor force participation rate depending on trends among women, whose participation is low relative to that of men, and among the population aged 65 and older. Therefore, estimates of future economic growth based on labor capacity requires consideration of legal and systemic issues, including issues related to participation of women in the workforce, pension issues, and immigration issues related to foreign workers.

(ii) Capital and Technological Progress

“Capital” is the investment made by corporations in plant and equipment that is actually used in production capacity. After a corporation decides to acquire certain machinery or to build a factory, it takes a certain amount of time for such capital investment to become productive (gestation period). Technological progress becomes clearly visible when for example the most recent equipment causes a significant increase in the efficiency of production. In economic analysis, these effects are often called improvements in “labor productivity.” Chart 2-6 shows a simplified version of these relationships.

Labor productivity (= amount of added value produced per laborer) can be divided into a capital equipment ratio (volume of capacity per laborer) and technological progress. Improvement in labor productivity is achieved by an increase in the numerator (amount of added value produced) or a reduction in the denominator (labor volume, within a range that will not reduce production volume of the added value), or both. Improvement in the capital equipment ratio, therefore, shows the impact on the denominator, i.e., how much productivity per laborer is replaced by increasing facilities by one unit, after increasing the capital equipment ratio per laborer. In Chart 2-6, such replacement is shown by the shift of the curve.
The curve shows the combination of facility capital and labor capacity necessary to produce one unit of product. Therefore, when there is a high level of capital equipment, the labor requirement declines. When there is a low level of production facilities, more labor is needed to produce the same amount of product.

An increase in the capital equipment ratio is expressed as a shift of the curve toward the upper left. IT and information technology investment constitutes an effort to improve labor productivity by investing in information technology such as computers. The focus was on a combination of increasing the per-person capital equipment ratio and utilizing technological innovation in such forms as personal computers to improve labor productivity.

On the other hand, an increase in the rate of technological progress is expressed as a shift of the curve to the lower left. In other words, less equipment and less labor are required to produce one unit of product, because of the technological progress.

(iii) Other Factors

The two factors mentioned are not the only determinants of economic growth. There are other factors that determine economic growth including:

(Note) "Equal unit production volume curve" indicates that less labor is required as one moves to the left and up along the curve which combines production facilities \((K)\) and labor \((L)\), the two necessary factors for production \((Y)\) is the amount of added value produced. Moving down and to the right, a production organization indicates that more labor is required to produce the same volume. This curve shows that the greater the shift to the left and downwards, the more efficient productivity becomes, and the more efficient the economy becomes.
• Ease of the company’s entry into and withdrawal from the market (activating the activities of highly productive companies and having underproductive companies withdraw from the market);
• Reduction of future risks (advancing financial and capital markets and encouraging positive research and development investments);
• Openness of trade (introducing overseas knowledge and knowhow and strengthening competitiveness of domestic markets, in addition to expanding the market); and
• Enhancing infrastructure (social capital such as roads and harbors, technological progress, and legal systems to protect intellectual property rights to motivate innovative ideas).

(3) **What Is an Economic Cycle?**

An economic cycle is an evaluation method that sees the economy in cycles, alternating repetitions of prosperity and recession. In this document, an economic cycle is distinguished from economic growth, in that the economic cycle is a short-term movement that, in multiple sequences makes up a long-term trend, that is, economic growth. More technically, a long-term trend is defined as the production level (i.e., latent GDP) that can be achieved by the Japanese economy using the average labor and capital available. An economic cycle is expressed as the gap between the actual GDP and the latent GDP (GDP gap).

There is no definitive conclusion of what causes economic cycles. For example, some say the intermittent external shocks such as the fluctuations in the crude oil price are a cause of economic cycles while others emphasize the “full employment barrier” or “production capacity barrier” (a condition that occurs when production capacity cannot fulfill demand; and the price of goods increases causing a decline in demand). There are those who often point to the occurrence of overcapacity in equipment and inventory as the cause of economic cycles. Recently, some persons have said that delays in financial and economic strategies cause the “swing” (fluctuation) of the cycle to be amplified.

In reality, a complex combination of all of these factors causes the economic cycle, and no single factor can be the consistent cause of economic cycles at all times. Also, once the economy reverses itself as a result of certain causes, this will tend to have a ripple effect on other factors and the level of influence becomes cumulative. It is often the case that the force changes direction only when the wave hits some barrier.

(4) **Assessing Statistics on Economic Cycles**

Since economic fluctuations comprise various factors, an overall assessment of the economy must be made based on a comprehensive analysis of many different aspects. However, there are almost an infinite number of indicators that represent the many aspects of the economy and covering all of these can be difficult. The Cabinet Office combines several of the most important indicators to derive indicators of the type called the “Indexes of Business Conditions,” and
announces it monthly. The Indexes of Business Conditions attempt to identify trends and tipping points in economic conditions by combining several economic indicators that are believed to have a close relationship with the economy, including employment, production and consumption.

The series used for the Indexes of Business Conditions are categorized into the three types shown in Chart 2-7, *i.e.*, leading series, coincident series, and lagging series, and the indices calculated using these series are referred to as (i) leading indices, (ii) coincident indices, and (iii) lagging indices. All of these indices are used to assess the actual condition of the economy.

**Chart 2-7 Series Used in the Indexes of Business Conditions**

| Leading series | 1. | Index of Producer’s Inventory Ratio of Finished Goods (Final Demand Goods) |
|               | 2. | Index of Producer’s Inventory Ratio of Finished Goods (Producer Goods For Mining and Manufacturing) |
|               | 3. | New Job Offers (Excluding New School Graduates) |
|               | 4. | Machinery Orders at Constant Prices (Except for Volatile Orders) |
|               | 5. | Total Floor Area of New Housing Construction Started |
|               | 6. | Consumer Confidence Index |
|               | 7. | Nikkei Commodity Price Index (42 items) |
|               | 8. | Interest Rate Spread |
|               | 9. | Stock Prices (TOPIX) |
|               | 10. | Index of Investment Climate (Manufacturing) |
|               | 11. | Sales Forecast DI of Small Business |

| Coincident series | 1. | Index of Industrial Production (Mining and Manufacturing) |
|                  | 2. | Index of Producer’s Shipments (Producer Goods for Mining and Manufacturing) |
|                  | 3. | Index of Producer’s Shipment of Durable Consumer Goods |
|                  | 4. | Index of Non-Scheduled Worked Hours (Industries Covered) |
|                  | 5. | Index of Producer’s Shipment (Investment Goods Excluding Transport Equipment) |
|                  | 6. | Retail Sales Value (Change From Previous Year) |
|                  | 7. | Wholesale Sales Value (Change From Previous Year) |
|                  | 8. | Operating Profits (All Industries) |
|                  | 9. | Effective Job Offer Rate (Excluding New School Graduates) |

| Lagging series | 1. | Index of Tertiary Industry Activity (Business Services) |
|               | 2. | Index of Regular Workers Employment (Industries Covered) (Change From Previous Year) |
|               | 3. | Business Expenditures for New Plant and Equipment at Constant Prices (All Industries) |
|               | 4. | Living Expenditure (Workers’ Households) (Change From Previous Year) |
|               | 5. | Corporation Tax Revenue |
|               | 6. | Unemployment Rate |
|               | 7. | Contractual Cash Earnings (Manufacturing) |
|               | 8. | Consumer Price Index (All Items, Less Fresh Food) (Change from Previous Year) |
|               | 9. | Index of Producer’s Inventory |

(Source) Cabinet Office
The leading index is created from eleven statistical series that are believed to move ahead of the economy by three to six months, and includes series for the inventory ratio and Tokyo Stock Exchange Stock Price Index. The coincident index is created from nine statistical series that are believed to move concurrently and in the same direction as economic fluctuations, such as production statistics and the ratio of job openings to job applicants. The lagging index is created from nine series that follow the economy, including the unemployment index.

Traditionally, public announcements in Japan focused on the Diffusion Index (DI) but from April 2008 a change was made to publication of economic indicators with more focus on the Composite Index (CI). The DI is an index which expresses the ratio of expanding series from among the series chosen, so that the economy is said to be expanding at the point where more than 50% of these series are growing. With the DI the basic criteria is solely whether the 50% level is exceeded or not. The level of the figures does not have any significance, and it is only possible to determine the trend of the economy.

The CI, on the other hand, is an index prepared as a composite of the rates of change of each series used, so that the pace of change in the economy can also be detected in addition to the economic trend, making it more useful than the DI.

Since launching the system of publication focusing on the CI, the Cabinet Office which is the source of the public announcements, has released the “overall assessment using the CI,” enabling a more precise overview of fluctuation points in the economy.

It is also possible to make a judgment of the current status of the economy from the results of various survey studies of corporations and consumers, from the perspective that it may be possible to substitute the “attitude” of corporations and consumers for the state of the economy. This is referred to as survey data.
A particularly prominent survey is the “Short-Term Economic Survey of Enterprises in Japan,” known widely by its Japanese abbreviation “BOJ Tankan,” which is released every three months by the BOJ. There is much interesting data for such projections, such as various DIs on industry performance, prices, facilities and equipment, employment, and cash flow etc., as well as various plans including sales, income and equipment investment plans. This survey enables us to obtain data on how companies view the economic situation and their forecasts for the future. This survey is known outside of Japan by its short name “TANKAN,” and it attracts great attention from those abroad.

The beginning of an economic expansion (or end of an economic contraction) is called the economic trough and the beginning of an economic contraction (or end of an economic expansion) is called the economic peak. The economic benchmark dates in Chart 2-10 indicate the dates when economic turning points in Japan are believed to have occurred. One economic cycle consists of a trough, a period of expansion, a peak, and a period of contraction. The length of time for one cycle is called a cycle period.

Chart 2-10 confirms fifteen economic cycles in Japan since the end of World War II. Among these cycles, the average duration from the second to the 15th cycle, the full cycles of which can be confirmed, is 52 months, whereas the average duration of an expansion is 36 months and the average duration of a contraction is 16 months. As shown, the average duration of an expansion is twice as long as the average duration of a contraction. The expansion period of the third cycle is called the “Jimmu Economy” and the expansion period of the fourth cycle is called the “Iwato Economy.” The expansion period of the sixth cycle is called the “Izanagi Economy.” The economic expansion period which started from December 2012 is longer than the “Izanagi Economy” (the sixth cycle), and would be as long as the 14th cycle, which is the longest economic expansion period since the end of World War II, if it continues until the end of 2018.
(Notes) 1. The shaded areas indicate a phase of cyclical downturns.
2. From March 2004, changes were made to, inter alia, the companies surveyed, and consequently, the statistics are not continuous between the surveys conducted in and before December 2003, and those conducted from March 2004.
3. As a result of the recent periodic review, discontinuity occurs in the survey conducted in December 2017 and that conducted in March 2018.
(Source) BOJ, Cabinet Office
<table>
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<tr>
<th>Cycle</th>
<th>Trough</th>
<th>Peak</th>
<th>Trough</th>
<th>(Reference) Quarterly benchmark dates</th>
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<td></td>
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<td>Expansion</td>
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(Source) Cabinet Office

(5) **Inventory Cycle**

If a normal economic cycle lasts for two to five years, an inventory cycle is taking place for most of that time.

Two factors determine the inventory cycle. The first factor is the gap between the anticipated demand estimated by a corporation when it plans its production strategy and the actual demand that occurs. The second is when the corporation strategically attempts to adjust the inventory for anticipated future price fluctuations. For example, if a company expects that the price of a raw material will increase, the company may decide to make more of its products while the cost of the raw material is still cheap, in anticipation of being able to sell the products at a higher price when prices are rising and thereby earn greater profits. Typical examples of this can be seen when companies increase their inventories in order to take advantage of an anticipated upswing in prices for raw materials.

Inventory cycles can be categorized into “intentional” changes in inventory and “unintentional” changes in inventory. These changes often move in different directions in economic expansion and recession. By recognizing them as separate cycle phases, the changes can be divided into four phases.
When the economy bottoms out, demand approaches a recovery. However, corporate forecasts and projections reflect pessimism about anticipated demand. As a result, the inventory accumulated during a recession declines unexpectedly (“unintentional decline in inventory”). Subsequently, when entering the economic expansion period, corporate forecasts and projections reflect optimism about anticipated demand causing them to make large-scale purchases (“intentional increase in inventory”). During such a period tight demand for goods leads...
corporations to increase inventory as a matter of strategy. However, once the economy shifts from expansion to recession, although the corporate estimates are still bullish, demand comes to be less than had been anticipated, and corporations face “unintentional increases in inventory.” Once corporations acknowledge an economic downturn, their estimates of future demand become pessimistic, and they drawdown the accumulated excess inventory. This condition is called “intentional decline in inventory.” The inventory cycle moves through these processes.

When assessing the inventory cycle, the analyst must pay attention to the differences among inventory classes, such as raw materials inventory, work in process inventory, product inventory, and the inventory in the distribution sector, as goods progress through their process from manufacturers to distributors.

(6) Equipment Investment Cycle

The economic expansion that began in January 2002 (the 14th cycle) became the largest expansion since the end of World War II, and surpassed the expansion seen during the “Izanagi Economy (the sixth cycle).” These exceptionally long periods of economic expansion contain factors that cannot be explained just by the inventory cycle.

Many of the expansions that exceed a period of five years are said to be equipment investment cycles. There are three main factors that determine an equipment investment cycle.

The first is replacement investment. Over time, a company’s initial equipment and machinery wears out and needs to be replaced. A cycle of equipment investment corresponds to the life span of such machinery and equipment that need to be replaced.

The second factor is the stock adjustment principle. When a corporation makes an investment in equipment, it first determines the desired level of capital stock, based on assessment of current and future economic conditions. This principle holds that a corporation’s equipment investment is made to eliminate the gap between the existing level of capital stock and the above-mentioned desired level.

The third factor is autonomous investments. These investments include research and development expenses, investments in streamlining operations, and investments in automation. These investments, such as investments in product development made to maintain a corporation’s competitiveness, or investments made to lower overall costs by leveraging information technology, are based on long-term plans. They are made separately from investments made because of the corporation’s short-term anticipation of demand.

“The acceleration principle” is what further heightens the equipment investment cycle generated by the above-mentioned factors. This principle states that a corporation’s investment in plant and equipment causes a ripple effect in demand for equipment investment in numerous other companies. This principle also states that the demand for large investment in plant and equipment with the aim of earlier expansion of production equipment from an optimistic perspective leads to further demand for large investment in plant and equipment.
(Note) The shaded areas indicate a phase of cyclical downturns.
(Source) Cabinet Office

(Note) Actual performance values for FY2017
(Source) Development Bank of Japan
(1) Assessing Consumption-Related Statistics

Fundamental perspectives of statistics, mainly on the behavior of households, will be discussed in this section.

The household economy plays two roles with respect to the national economy. The first is their role as demanders through private consumption and housing investments. The second is their role in providing production inputs as labor in the labor market. The household trends discussed here focus on the first role.

(i) Determinants of Consumer Spending

Private consumption amounts to almost 60 percent of final demand in the recent Japanese economy, making it the largest component of demand. The factors that determine the amount of consumer spending are increases and decreases in income and changes in the propensity to consume.

There are many types of income such as employment compensation, including wages and salaries; income from assets, including interest from savings, dividends from securities, and rental income from real estate; mixed income which is the profit of an unincorporated business and social insurance benefits from the government such as pension payments and unemployment insurance.

Disposable income is the total of these incomes less deductions such as income tax and other items, health insurance fee, pension premium payments, and unemployment insurance fee. Disposable income is the portion of income that the household can spend freely, and is the source of funds used at the time of consuming.

Propensity to consume is the percentage of disposable income that is actually expended for consumption. There are two definitions of propensity to consume, but the one referred to in this part is what is called the average propensity to consume. The percentage of additional income that is expended for consumption is called the marginal propensity to consume.

Propensity to consume can be taken as equivalent to “tightness of purse strings.” In other words, consumption increases when disposable income increases, even if the propensity to consume remains constant. At the same time, consumption increases if the propensity to consume increases for some reason, even if disposable income stays the same.

However, disposable income and the propensity to consume are not determined independently as they are often affected by the same factors. The net of disposable income minus consumption is referred to as household savings, and the ratio of savings divided by disposable income is referred to as the household savings rate.

\[
\begin{align*}
\text{Income} & = \text{Employment compensation} + \text{Income from assets} + \text{Mixed income} + \text{Social insurance benefits, etc.} \\
\text{Disposable income} & = \text{Income} - \text{Income taxes, etc.} - (\text{Health insurance fee} + \text{Pension premium payment} + \text{Unemployment insurance fee, etc.})
\end{align*}
\]
Households generally estimate their future income based on past experience and information about the future that is currently available. They anticipate future interest rate trends and inflation in the same manner. Consumption is simply the result of decisions made on how to distribute current and future spending based on these estimates of current and future economic conditions. That portion allotted for future spending is called savings. Factors such as the employment situations of family members, the retained financial assets, as well as age, taxes and social security system are all taken into consideration when estimating future income.

With respect to private consumption and disposable income in Japan, the marginal propensity to consume declined after the first oil crisis (1973 – 1974), and as a result, the average propensity to consume declined to below 80%. With the sudden rise in oil prices, anticipated future household income declined, and job insecurity became noticeable as businesses started to review their employment practices, which caused households to become more conservative in their spending. On the other hand, a decline in the average propensity to consume was not seen following the second oil crisis (1979 – 1980). Thereafter, the average propensity to consume continued to rise and early in the 21st century, it started to exceed 95%. This is considered to have been strongly affected by the increase in the number

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(Note) 1979 and previous years are based on the year 1990, while the period from 1980 to 1993 is based on the year 2000, and 1994 and subsequent years are based on the year 2011.

(Source) Cabinet Office
of aged households that are consuming by breaking into their savings, with such increase being related to the increase in the number of aged households.

There are some circumstances where even if income falls sharply, the result is an increase in the propensity to consume (the ratchet effect), in contrast to the case of oil crisis mentioned above. This is because, even if the disposable income falls, a considerable amount is needed to be spent on food and other necessities, and this amount is difficult for consumers to reduce. It is necessary to be aware that in these circumstances, the propensity to consume will increase even if income falls and the consumer’s mindset deteriorates. The result is that the amount of consumer spending varies less than the changes in growth of GDP.

(ii) Types and Characteristics of Consumption-Related Statistics

There are several types of statistics that indicate the dynamics of consumer behavior, i.e., National Income Statistics (Cabinet Office), the Family Income and Expenditure Survey (Ministry of Internal Affairs and Communications), Survey of Household Economy (Ministry of Internal Affairs and Communications), department-store sales statistics (Association of Department Stores of Japan), chain-store sales statistics (Association of Chain Stores of Japan), large-scale retail store sales trend (Ministry of Economy, Trade and Industry), sales of new automobiles (Japan Automotive Dealers Association), and others.

The Family Income and Expenditure Survey compiles the figures for household income and expenditure that include the detailed items of expenditures for all households except those consisting of single students. These figures are published as the Family Income and Expenditure Survey Results. It has made it possible to analyze the consumption activities of households from a variety of perspectives, including age group, income strata, or occupation of the head of the household. The Family Income and Expenditure Survey also contains data concerning areas such as income, savings and debts. Nevertheless, since the Family Income and Expenditure Survey is conducted as a sample survey (of approximately 8,000 households) it contains the problem of significant distortion associated with changes to the sample, particularly in big ticket items that are purchased infrequently. In order to resolve this issue, and also to identify consumption related to information technology, the Survey of Household Economy has been conducted since 2001 with a larger sample size (approximately 30,000 households). This is also used in areas such as estimating GDP. In addition, as a means to keep up with the trends in overall consumption, consumption trend indexes (CTIs) have been released since 2018. There are two types of CTIs: namely, (i) household consumption tax index (CTI micro) to estimate the trend in consumption expenditures of households which include single-person households; and (ii) total consumption trend index (CTI macro) to estimate the monthly trends in household final consumption expenditures in GDP.

It is also important to monitor consumption from a sales perspective. Department-store sales statistics are used as an indicator that shows the consumption trend in the high-end goods. Imported art, which increased greatly in volume in FY1988 and FY1989, is included in the sundries category of department store items, and big growth was noted in this category. Supermarket sales volume is a particularly convenient tool for understanding the basics of
consumption. Spending on less essential durable goods (appliances, automobiles, etc.), on
dining-out, and discretionary (arbitrary) spending such as spending on education and leisure
activities, are more sensitive to economic conditions. Sensitivity to economic conditions is
more evident among the high-priced durables, such as automobiles. It is however necessary
to be aware that a certain portion of consumer spending is not captured by department store,
supermarket, or large-retailer sales reports, given the growing diversification of consumption
by greater use of suburban-type specialty shops, convenience stores, and online sales.

Recently, more attention has come to be paid to the “consumer mind,” meaning the
psychological aspect of households regarding their own consumption. One contributing
factor towards this attention is the growing perception that uneasiness over job security, life
at old age or both may have had an adverse impact on consumption. If this perception is
correct then this would mean that expectations for lifetime income (the amount an individual
expects to earn over his or her life) have fallen, and a determination cannot be made solely
on the basis of present income or employment trends. Methods used to make judgments
about consumption under these circumstances include studies on the trends in expenditure for
durable goods and services which are not essential for daily life, and for which it is possible
to select the timing for when to make purchases, and results of questionnaire surveys on
consumer trends (by the Cabinet Office).

(2) Assessing Housing-Related Statistics

Along with private consumption, another role of households in the economy is the
acquisition of housing. Spending on housing is included in GDP demand items as “housing
investment.” While private consumption is fairly stable relative to economic fluctuations,
spending on housing reacts sensitively to economic fluctuations. The reason for this sensitivity is
the significant difference in the amount of capital and interest payments on housing loans caused
by even the slightest change in interest rates, thereby influencing an individual’s ability to buy a
home.

The factors influencing home investment decisions include (a) income, (b) interest rates on
housing mortgages, (c) taxation, and (d) housing prices, all of which have an influence on an
individual’s ability to buy a home. Increases in income, decreases in interest rates, tax deductions
for home purchases, expansion of tax incentives for home purchases, and decreases in the prices
of homes all contribute to an increased ability for home acquisition.

Housing-related statistics include statistics on private-home investment included in GDP
statistics and the number of new construction starts of dwellings in the “Housing Starts Statistics”
compiled by the Ministry of Land, Infrastructure, Transport and Tourism. The statistics on private
home investments included in GDP statistics are “progress-based” figures, whereas the Housing
Starts Statistics are figures based on “the commencement of new construction” during the term.
Therefore, the latter tends to move ahead of economic fluctuations, and is used as a leading
economic indicator. Housing acquisitions can also have a significant effect on the economy
because it often is accompanied by the consumption of related materials and other related
consumption.
(3) Assessing Employment-Related Statistics

Some areas of the employment system are associated with economic growth, while other areas of the employment system are associated with economic cycles. This part discusses the areas that most closely reflect economic cycles.

(i) Employment Adjustment Mechanism

If economic cycles are considered in terms of their dissociation from long-term trends in economic growth, as noted earlier, the economic situation can be assessed by measuring the dissociation of the average corporate supply capacity to actual demand in the market. Therefore, in reality, the gap between supply and demand is expressed by a change in the increase and decrease in stock or the equipment operating rate.

In Japan, adjustments to labor time frequently precede adjustments to the number of persons employed. Over the short term, there is a tendency to make this adjustment by addressing overtime and otherwise adjusting the hours worked. Thus, restructuring by cutting the number of employees is only carried out when an employer determines that adjustments to working hours will not be sufficient as an adjustment, and that adjustments must be made over an extremely long term. Moreover, there is a strong tendency for these adjustments to involve contingent personnel, such as part-time workers and temporary employees, rather than full-time employees. As a last resort, a company would stop hiring, and lay off full-time employees. Adjustments in work hours are often made at the same time as inventory adjustments, whereas adjustments in the number of personnel are often made at the same time as adjustments in capital investments.

An increase in unemployment among household heads, however, strongly impacts consumption, and it is possible to track structural changes in the society through the unemployment rate for different age groups. However, the environment for employment is currently undergoing change, through the spread of temporary worker dispatching business, etc., and thus the relationships between companies and employees are becoming more diversified.

(ii) Types and Characteristics of Employment Indicators

Employment indicators include overtime, the ratio of job openings to job applicants, the unemployment rate, the regular employment index etc. These statistics are announced by the Ministry of Health, Labor and Welfare, and the Ministry of Internal Affairs and Communications.

The total work hours in a month is called the real aggregate work hours. Real aggregate work hours are the sum of predetermined work hours (regular work hours) and overtime work hours (week-end overtime and after-hours overtime, etc.). Usually, corporations first attempt to cope with adverse business conditions by reducing overtime. Therefore, fluctuations in overtime link in with economic fluctuations.

The “unemployment rate” is obtained by dividing the total number of completely unemployed persons by the labor force. The definition of an unemployed person is a person who is not an employed person and is looking for work during the survey period (the last week of the month) but is not yet working. The labor force is defined as the sum of employed
persons and unemployed persons who are 15 years of age or older and who have a desire to work. The labor force participation rate is defined as the ratio of the labor force to the number of people who are 15 years of age or older and indicates the proportion of people who are 15 years of age or older that actually enter the labor market. In addition, since 2018, the labor underutilization indicator has been released on a quarterly basis. Underutilized labor refers to persons including those who are working on a part-time basis but wish to work more or persons among the non-labor force who wish to work. It is expected that the potential labor force will be identified through the analysis of the underutilized labor indicator and utilized as new sources of labor supply in the future. The competition to find a job is fierce during an economic recession, and consequently many people who have lost
their jobs do not actively look for work. These people are not classified as unemployed persons and are treated as being outside of the labor market (representing a decline in the labor force participation rate). Thus, while the unemployment rate increases at a moderate speed, the actual market situation may be much worse than what is represented by the unemployment rate.

As mentioned above, layoffs of employees are a measure of last resort. Since Japanese corporations do not readily lay off employees, the unemployment rate and regular employment index in Japan lag behind economic fluctuations.

The ratio of job openings to job applicants is obtained by dividing the number of job openings by the number of job applicants. The number of job openings (number of positions available) increases when the economy prospers and decreases when the economy deteriorates. Therefore, the ratio of job openings to job applicants increases during economic prosperity and decreases during an economic slump. When the ratio is greater than 1, it indicates that many corporations are finding workers to fill their positions. When the ratio is less than 1, it indicates that there are more workers looking for work than the number of openings. While fluctuations in the ratio of job openings to job applicants coincide with fluctuations in the economy, the ratio includes only workers and positions registered with the Public Employment Security Offices (this is called “Hello Work”), and does not include workers who seek employment through means such as the help-wanted advertisements on newspapers and magazines.

Recently, there are situations where even though the ratio of job openings to job applicants rises, reflecting economic improvement, the unemployment rate does not fall. This appears to be a result of a mismatch in employment, in which the skills and conditions of work sought by companies do not match those of the people seeking work, or even if they do match, companies are not able to find the workers they wish to hire and workers are not able to find the companies that want them.

(iii) Labor Productivity and Unit Labor Cost

Labor productivity is the production volume per one unit of labor input. It is obtained by dividing production volume by the multiplication product of the number of employed persons and their work hours (man-hour basis). Consequently, increasing labor productivity indicates that the production volume generated by a unit of labor input (per labor unit, for example) is rising, which is a positive factor for economic growth.

Unit labor cost is the labor cost incurred for one unit of production volume. It is obtained by dividing aggregate labor costs (hourly wage × number of employed persons × total work hours) by the production volume. Unit labor costs can also be derived by dividing the hourly wage by labor productivity.

Unemployment rate = \( \frac{\text{Unemployed persons}}{\text{Labor force}} \times 100 \text{ (%) } \)

Labor force = Number of employed persons of 15 years of age or older + Number of unemployed persons of 15 years of age or older
The above concepts are useful in considering the relationship between wage increases and prices of goods. When the unit labor cost increases due to an appreciation in wages that surpasses the appreciation in labor productivity, corporate earnings are negatively influenced. Corporations in turn must cover losses by increasing the prices of their products, which may trigger inflation.

(4) Assessing Price Statistics

Price indicators include the Corporate Goods Price Index (CGPI), Consumer Price Index (CPI), Services Producer Price Index (SPPI), the GDP deflator, and others. These are weighted averages of the prices of various properties and services in terms of a base year (=100). However, if the weighting is left fixed then as time passes a significant discrepancy will occur between the base year and the actual reality. The further removed in time the year in question becomes from the base year, the further the discrepancy grows. Consequently, people started using the “Chain Linked Method” which reduces this divergence by changing the base year each year.

(i) Price-Influencing Factors and Their Effect on Wages

Prices are based on the cost of providing products or services and the profit margin applied by corporations (this is called the mark-up rate). Costs are determined by the price of raw materials, wages, and taxes. Mark-up rates, on the other hand, are determined by corporations depending on the degree of consumer demand for their particular goods or services. The markup rate can be higher if goods and services are popular among consumers.

Although wages are determined by companies, such decisions are strongly influenced by the labor market. When there is strong demand and corporations need to produce more, the corporations hire new workers and workers are forced to work overtime. At the same time, wages paid by the corporations tend to rise. A wage increase means an increase in production costs, and therefore, the corporation tends to cover such an increase by raising the prices of its goods. A need to expand production means that the services or products provided by the corporation are popular, and consequently the company is in a position in which it can fairly easily shift its costs to its prices. When the national economy overheats,
however, demand for labor increases across the board in all industries. Under such conditions, workers prefer to be employed by a corporation that pays higher wages. As a result, the more the economy overheats the larger the increases in wages, and the linear relationship between wage increases and employment no longer applies.

Price is an important indicator of economic prosperity. It is also closely related to people’s lives. For example, it is generally believed that in situations where price increases are accelerating, supply and demand are tight in the economy overall, and economic activities are showing strong performance. When the rate of increase in prices exceeds the rate of increase in wages, i.e., when real wages fall, the quality of life declines.

(ii) **Price Index #1: Corporate Goods Price Index (CGPI)**

The Corporate Goods Price Index (CGPI) is an index value which represents the level of the prices of goods traded among corporations. It is released by the BOJ and consists of the domestic corporate goods price index, the import goods price index and the export goods price index, which are the three basic indices, as well as a reference index which recombines and makes adjustments to the basic indices.

Among these indices, the domestic corporate goods price index is referred to as “Producer Price Index” (PPI). The PPI is a Laspeyres-formula index computed by fixing the weight of each component according to the benchmark year. The PPI fluctuates in accordance with the supply and demand for each product, and is sensitive to economic conditions.

The PPI is influenced by price factors overseas even when there is no influence from domestic inflation (e.g., a decline in the value of the yen or an increase in oil prices can be influential). For example, during the second oil crisis, in 1979-80, the inflationary pressure arising from domestic factors was controlled by a tightening of credit. However, the oil price increase did indeed cause a ripple effect in the domestic economy, in the form of a chain reaction in which “higher import prices led to higher prices for domestic corporate goods which in turn led to higher prices for consumers.” Moreover, there was a sharp spike in the international commodities markets that took place from the start of 2007 through the summer of 2008, beginning with crude oil, which led to upward pressure on domestic prices. In contrast, when the crude oil price fell from mid-2014, the PPI dropped substantially.

(iii) **Price Index #2: Consumer Price Index (CPI)**

The CPI is an index value which represents the level of the retail prices of various consumer goods and services that are offered for sale to households. As with the PPI, the CPI is a Laspeyres-formula index. The CPI is released by the Ministry of Internal Affairs and Communications. The CPI is located lower on the chain of consumption than the PPI (closer to the end user), and therefore, it lags behind the PPI. In contrast to the PPI, the CPI also includes the price of services, which contain a major labor cost component, and consequently the CPI does not react as sensitively to economic conditions as the PPI.

Critics have pointed out a discontinuity between fluctuations in the CPI and the actual quality of life. Possible reasons for this discontinuity include:
a) The CPI assumes averaged consumption that may differ from actual household consumption;
b) There is a wide fluctuation in prices of perishable foods, which consumers purchase more frequently, thereby misleading consumers when they form perceptions of overall price changes;
c) The CPI does not cover non-consumption expenditures such as direct taxes, social security payments etc., nor does it cover the prices of land, housing, etc.; and
d) Effect of the selection of the items and measurement of change in quality of goods.

Generally, the overall consumer price index excluding perishable foods (Core CPI), the overall consumer price index excluding food (other than liquors) and energy (Core Core CPI), or the overall consumer price index excluding perishables and energy (New Core Core CPI) is often used in determining the trend of prices. This is because the prices of perishable foods and energy, such as crude oil, widely fluctuate and thereby cause a major impact on prices.

(iv) Price Index #3: Services Producer Price Index (SPPI)

The SPPI was introduced by the BOJ in 1991 to measure the prices of services offered by corporations to other corporations. A major reason for creating this new index was that such services had become an important part of corporate operations. As with the PPI and CPI, the SPPI is computed as a Laspeyres-formula index using fixed weights of components according to a benchmark point in time. Fluctuations in the SPPI are influenced by labor costs and macroeconomic factors, such as supply and demand in the service industry, foreign exchange rates, interest rates, real-estate market prices, relaxation of regulations, and technological advancements, etc. The SPPI is considered as a leading indicator of the CPI.

(v) Price Index #4: GDP Deflator

The GDP deflator can be obtained by dividing the nominal GDP by the real GDP:

\[
\text{GDP deflator} = \frac{\text{Nominal GDP}}{\text{Real GDP}} \times 100
\]

The nominal GDP is the total volume of goods and services produced, multiplied by the market prices of such goods and services that year. The real GDP indicates the total amount of goods and services produced.

Therefore, the GDP deflator is an index representing the prices of goods and services included in GDP. Unlike the CGPI and CPI that apply the Laspeyres-formula, which fixes the distribution ratio of products and services at a benchmark point in time, the GDP deflator is calculated in accordance with the distribution ratio of products and services at the time of the comparison, making it a Paasche-formula index.

Since the end of 2004, however, as shown as (a) in the text box below, the GDP deflator has been calculated by use of a Paasche-formula index method, in which the base year is updated every year according to the chain-linking technique, in place of the previously used
fixed-base year Paasche-formula method that used a certain year as the base year.

\[
\text{Laspeyres index} = \frac{\sum P_i Q_i}{\sum P_{oi} Q_i} \times 100
\]

\[
\text{Paasche index} = \frac{\sum P_i Q_i}{\sum P_{oi} Q_{ti}} \times 100
\]

- \(P_{oi}\) Price of \(i\) goods at benchmark point in time
- \(Q_{oi}\) Volume of \(i\) goods at benchmark point in time
- \(P_{ti}\) Price of \(i\) goods at the time of comparison
- \(Q_{ti}\) Volume of \(i\) goods at the time of comparison

The GDP deflator may be a more comprehensive price index than the CPI, given that all goods and services are included in GDP. However, the GDP deflator only considers domestic goods, while the CPI includes imported goods.

An increase in the price of imported goods leads directly to an increase in the CPI, but does not do so immediately in the GDP deflator.

An increase in the GDP deflator occurs when there is inflation ignited by domestic factors (homemade inflation) or a ripple effect in domestic prices caused by inflation in the price of imported goods.

**Chart 2-18 Price Fluctuations**

(Note) The shaded areas indicate a phase of cyclical downturns.
(Source) Ministry of Internal Affairs and Communications, Cabinet Office, BOJ
International Balance of Payments

(1) Assessing Japan’s International Balance of Payments

International balance of payments statistics (IMF method) systematically record all of the external transactions of a given country during a specific time period. These transactions between residents and non-residents are classified as being transactions in goods, services or income; as transactions that change external assets and liabilities; and as transactions for transfers. International balance of payments statistics are organized as comprising three categories, which are the current account, the financial account, and the capital account.

The current balance is the sum of all receipts from transactions by residents of Japan and overseas residents for goods and services, subtracted by all payments for the transactions. The current account has a surplus when receipts exceed payments. In terms of national income, the current account is equal to the difference between the aggregate national savings and aggregate national investment, and surplus will occur when the savings exceed the investment. The current account is also equal in absolute terms to the financial account, which illustrates the inflow and outflow of capital between Japan and overseas countries. If a country has a current account surplus, this shows that increases in foreign assets are greater than increases in foreign liabilities, thus the net foreign assets of such country increases. On the contrary, a country with a current account deficit shows greater increases in foreign liabilities than in foreign assets.


(i) The Current Account

The current account represents the sum of three items: 1) goods and services, 2) primary income, 3) secondary income. It represents the country’s economic capacity in comparison with the capacities of foreign countries:

\[
\text{Current account} = \text{Goods and services} + \text{Primary income} + \text{Secondary income}
\]

In the goods and services balance, the balance of goods is goods exported less goods imported. The balance of services comprises shipping, tourism, and other services. The primary income consists of receipts and payments for compensation of employees, investment income (direct investments, portfolio investments, and other investments), and other primary income. The secondary income balance consists of receipts and payments for goods and services provided without any consideration offered in return, including grant aids of consumer-goods such as food and medical products, grants to international institutions and workers’ remittances.

(ii) The Financial Account

The financial account, which represents the flow of capital between Japan and overseas entities, is the sum of direct investment, portfolio investment, financial derivatives, other
investment, and reserve assets.

The financial account shows changes in assets and liabilities overseas. The change in external assets (inflow and outflow of Japanese capital to and from overseas entities) and the change in external liabilities (inflow and outflow of overseas capital to and from Japan) are shown separately. Examples of outflows of Japanese capital overseas would include direct overseas investments made by Japanese corporations and investments in foreign stocks and bonds, while examples of inflow of foreign capital to Japan would be direct investments made by foreign corporations, or investment in Japanese stocks or bonds by foreign entities.

In addition to the current account and financial account described above, the balance of payments includes the capital account and a section for errors and omissions. Their relation is expressed by the following formula.

\[
\text{Current account} + \text{Capital account} - \text{Financial account} + \text{Errors and omissions} = 0
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</table>

(Source) Ministry of Finance and BOJ

(2) Overview of Japan’s International Balance of Payment

Japan’s current account surplus started to expand in 1982 after the second oil crisis, and reached a peak in 1987 with a surplus of USD87 billion. In contrast, the U.S. showed an opposite trend. Starting in 1982, the U.S. started to post deficits, until 1991 when a surplus was recorded temporarily, but after that once again deficits were posted. In the meantime, Japanese foreign net assets continued to grow. The U.S., on the other hand, incurred increasingly larger debts to foreign countries. In 1986, its foreign debit balance exceeded its foreign credit balance, thereby
making it a debtor country.

As shown in Chart 2-20, the growth of the Japanese current account balance surplus started to accelerate following the Plaza Accord of 1985, which directly led to an increase in the value of the Japanese yen, through 1987. Then, from 1987 to 1990, the surplus shrank. The significant fall in oil prices is frequently stated as a contributing factor in the continued expansion of the current account balance surplus from 1985 through 1987 despite the rapid rise of the yen.

The purpose of the Plaza Accord, which was signed in September of 1985 by the G5 (a meeting of the finance ministers and heads of central banks from five countries) and had a significant impact on exchange rates, was to resolve a foreign exchange rate imbalance by collaborating and adjusting rates. At the time, the value of the dollar was increasing due to high interest rates in the U.S. The regulatory authorities in charge of the currencies intervened to correct the high dollar, and the value of the dollar fell quickly. However, there was no change in the fundamentals of the U.S. economy (i.e., the current account deficit and the budget deficit), even in 1986, and because Japan’s surplus continued to expand, the value of the dollar continued to fall.

In February of 1987, the “Louvre Accord” was enacted by the currency regulators of several countries to stabilize the foreign exchange market, as they were concerned that the value of the dollar had fallen to an excessively low level. However, the New York Stock Exchange crash on October 19, 1987 (this is called “Black Monday”) led to further declines in the value of the dollar. In early 1988, the value of the dollar fell to as low as JPY120.45 per USD1, setting a record low. Following this decline, the overall Japanese economy began to expand, led by domestic consumption. Japan’s current account surplus began to shrink, and in 1990, declined to USD35.8 billion, although this decline was aided by an increase in the price of crude oil following the
Persian Gulf Crisis.

At times, the trade imbalance has mushroomed into a political issue in the form of trade friction. The enactment of the Omnibus Trade and Competitiveness Act ("Super 301") in 1988 by the U.S. and other conditions are all demonstrations of the U.S.’s frustration stemming from Japan’s persistent trade surpluses with the U.S. even after the upward valuation of the yen.

Subsequently, the yen continued to rise, falling below JPY80 per USD1 for a brief instant in 1995, touching off a rash of overseas ventures on the part of Japanese companies, particularly in the manufacturing sector. Rapid economic development in other parts of Asia also caused a major increase in imports of quality goods at low prices, which reduced Japan’s current account balance surplus. From mid-1995, however, the value of the Japanese yen declined quickly, and exports, especially automobile exports, grew quickly, which in turn has caused a rapid increase in the current account balance surplus. In the latter half of the 1990s, however, in the U.S. there was a rapid rise in imports from China and Southeast Asian countries, which resulted in a smaller percentage of the U.S. current account deficit being attributable to Japan.

The current account balance surplus reached JPY15.0 trillion in 1998, and then fell to JPY10.5 trillion in 2001 as the trade surplus also declined. This period also saw the rapid development of the Chinese economy, and an increased level of concern about the hollowing out of industry, and the competitiveness of Japanese corporations. Since the start of 2002, however, the current account balance surplus has again been on the rise, while the economy has begun to recover, so that these pessimistic views are not heard much anymore. At the same time, we have seen a growing belief that the Chinese economy does not only represent a threatening competitor, but is in fact a major market opportunity.

A review of the current account in recent years shows that the positive balance on primary income has increased. In 2017, the primary income surplus, at JPY19.8 trillion, far exceeded the trade surplus (JPY5.0 trillion). One cause for this increase in the primary income surplus is the existence of securities investment and direct investment, which have accumulated to a very high level. This is a reflection of Japan becoming the largest holder of net foreign assets, as the country’s net foreign assets balance at the end of 2017 stood at JPY328.4 trillion. Meanwhile, in 2011, the trade balance fell into the red for the first time in 31 years, and has remained in the red since then. This is due to the increase in imports caused by the rise in the crude oil price in combination with the increase in the volume of imported fuel resulting from the shutdown of nuclear power plants, and the decrease in exports due to Japanese enterprises moving their production bases overseas. However, the low crude oil prices since mid-2014 significantly reduced the amount of the deficit, resulting in a trade surplus in 2016 for the first time in six years. In addition, due to the increase in the number of foreign nationals visiting Japan, the amount received in the international travel balance has been on an upward trend, bringing about a profit of JPY1.8 trillion in the international travel balance in 2017.

(3) Foreign Exchange

The foreign exchange rate is the rate used to exchange domestic currency with foreign currencies. For example, the exchange rate JPY100 per USD1 is a yen-denominated foreign
currency exchange rate. Foreign exchange refers to the act of exchanging one currency for another (for example exchanging Japanese yen and converting them to U.S. dollars) based on the foreign exchange rate.

The currency exchange rate, like the prices of general commodities, is determined by the supply of and demand for foreign currency. Assuming that all trade with foreign countries is conducted in U.S. dollars, the USD/JPY rate would be the exchange rate used by the two countries. Therefore, the rate would be determined by the relationship between the demand for dollars (purchases of dollars made by selling yen) and the supply of dollars (sales of dollars for buying yen).

Demand for dollars arises when Japan imports raw materials or products from overseas or purchases foreign securities. Supplies of dollars are generated when foreign countries import goods from Japan or purchase Japanese securities. Therefore, the supply of and demand for dollars can arise from either current trade or capital trade, and the relative relationship determines the foreign currency exchange rate.

However, recent changes in the foreign currency exchange rate have become largely dependent upon financial transactions rather than the actual demand for funds. It is still fresh in our memories that, when the global crisis in the financial system grew in 2011, the Japanese yen and Swiss Franc faced a sharp rise and thus, the Swiss National Bank took thorough measures to defend its Swiss Franc.

Furthermore, among financial transactions, the volume of foreign exchange margin transactions known as “FX” is showing a rapid increase and in Japan, FX is said to account for nearly 30% of the one-day trading volume. It is said that Japanese individual investors, who are called “Mrs. Watanabe” around the world, tend to take actions that are different from professional traders and thus the recent exchange market has begun to show incomprehensible movements.
(1) The Global Economy and the Flow of Trade and Capital

While there are many countries and jurisdictions in the world, the 39 countries and jurisdictions known as the industrialized countries (the U.S., Japan, the countries in Western Europe, Canada, Oceania, and Asia NIEs) comprise approximately 60% of the global economy. Namely, the seven major countries, referred to as the G7 (United States, Japan, Germany, France, Italy, United Kingdom, and Canada) account for about 50% of global GDP. Consequently, the economic conditions in these countries have a significant impact on the rest of the world. The U.S. in particular has an extremely large impact on the global economy, as the country that occupies the largest share.

The link between each country and the global economy is the trade and the flow of capital. The increase in the volume of global trade exceeds global economic growth rates at almost all times, and this indicates how the connections between each country and the rest of the world have become stronger due to trade. Trade reliance is a measure that represents to what degree a country’s economy is influenced by trends in global trade. Trade reliance is obtained by dividing a country’s trade volume (export plus import) by nominal GDP. A high level of trade reliance means that the country’s economy is readily influenced by trends in world trade.

Asia is an area of the world with one of the highest levels of trade reliance. Within Asia there are countries and jurisdictions, such as Hong Kong, Singapore, Thailand and Malaysia, with trade reliance that exceeds 100%. Next to Asia is Europe, although it does much of its trading within Europe. On the other hand, the trade reliance of countries with larger economies, such as Japan and the U.S., tends to stay relatively low.

The flow of capital moves in the opposite direction to the flow of trade. Capital flows from overseas entities into countries with current account deficits to cover the deficits (capital
shortages), thereby causing financial account deficits. On the other hand, capital flows out of
countries with current account surpluses in order to invest the surpluses (excess capital) overseas,
thereby causing financial account surpluses.

(2) Global Economy in the 1980s

The global economy of the 1980s started with the worldwide recession following the second
oil crisis (1979 – 1980). In the U.S., an abrupt financial squeeze was instituted at the end of 1979
in order to break the vicious cycle of stagflation, in which the inflation rate and unemployment
rate increased simultaneously. With the high interest rate policy of the U.S., countries in Central
and South America, which had financed almost all of their international debt with short-term
commercial loans based on Eurodollar interest rates, demanded an interest moratorium from
commercial banks. Many of the major commercial banks in the U.S. had loans to these countries
in excess of twice the bank’s shareholder’s equity. Naturally, many expressed concern about the
potential for an international financial crisis. The crisis was defused when the governments of the
industrialized countries, the central banks, the governments of the developing countries, and
private banks rescheduled payments. However, this severely restricted the inflow of private capital
to developing countries.

The financial squeeze in the U.S. was lifted following the accumulating debt crisis, and the
U.S. economy began to recover in 1983. During the initial stages of recovery, a big deflation gap
existed, relieving worries about accelerated inflation despite the rapid recovery. Also, high interest
rates induced foreign capital flows into the U.S., which raised the value of the dollar, and acted to
control import inflation. In order to increase supply capacity, the Reagan administration
implemented a large scale tax cut to strengthen savings in the hope that it would lead to an
increase in investments. However, the tax cut only stimulated consumption with no increase in the
private savings rate, and the enlarged budget deficit was financed with capital from countries with
large amount of current account balance surpluses such as Japan and former western Germany.
During the first half of the 1980s, the Japanese economy began restructuring its budget with a
tight budget policy. The vivid contrast between the two countries’ budget policies contributed to
enlarging the imbalance in international payments.

In September of 1985, against the background of the strong dollar and expansion of the
current account deficit in the U.S., the governments and central banks of five industrial countries
agreed that the value of the dollar was too high (the “Plaza Accord”). Considering the
fundamentals of the U.S. economy, many doubted that the value of the dollar would stay at the
same level in the medium to long-term. Consequently, the value of the dollar fell rapidly after this
declaration, and the exchange rate, which had been around JPY240 per USD1, fell to as low as
JPY120 per USD1. The U.S. economy, on the other hand, sustained a favorable cycle of “a weak
dollar, increases in exports and expansion of capital investments,” starting in the latter half of
1986. The European countries also saw a boom in capital investments during the last half of the
1980s. Finally, the imbalance in international payments gradually shrank as imports and domestic
demands increased in Japan and the European countries, while exports from the U.S. remained on
a growth trend.
Japanese exporters lost their competitive edge in export prices due to the increase in the value of the yen that started in the fall of 1985. Japanese companies established production sites worldwide, and reallocated their production tasks to concentrate production of low value-added products that required a high volume of labor within Asian countries that had cheap labor costs, while at the same time producing high value-added products in Japan. As a result, direct overseas investment by Japanese corporations soared during the latter half of the 1980s. The growth of trade friction with the U.S., and the movement towards European Community (EC) unification in 1992 in Europe, accelerated the shift of production overseas.

The countries of Asia seized the opportunity of the declining price competitiveness of Japanese products, and began to increase their exports, especially to the American market. Also, the increase in direct investment by foreign countries created a favorable cycle of “the expansion of production capacity, increases in exports, increases in income, and expansion of domestic consumption.”

(3) The Global Economy in the 1990s

In the latter half of 1990, the U.S. economy fell into recession when the dollar’s value stopped declining and a tight fiscal policy was implemented following an increase in the inflation rate in 1989. In the latter half of the 1980s, financial institutions made excessive real estate loans. The real estate market showed no signs of recovery and many financial institutions carried bad loans. As a result, these financial institutions became more conservative in their lending.

The Federal Reserve Board (FRB) tried to relax the financial markets by repeatedly cutting interest rates. However, banks continued to pursue a conservative lending policy leading to a credit crunch in which neither lending nor the money supply grew. The economy started to show some signs of recovery in 1992, but growth in employment and production was slower than during the initial stages of previous recoveries, as layoffs continued with ongoing corporate restructuring (“jobless recovery”).

At the same time as the recovery of the financial sector, the U.S. economy entered a period of solid prosperity powered by new industries that made great use of computer networks. With the inflation rate remaining stable at low levels, labor productivity rose starting in the latter half of the 1990s, and the economy expanded for nearly ten years. Nevertheless, the economy began to slow down from 2001, as the share market had entered a correction phase from mid-2000, and there was a falloff in IT investment, which had previously driven the economy.

In the early 1990s, capital inflow to emerging markets from industrial countries increased substantially due to the high growth rates of countries in Asia and Latin America which were referred to as “emerging markets.” However, the economic crisis in Thailand and Indonesia that ignited in late 1997, and the Russian economic crisis that emerged in August of 1998, led to a virtual stoppage of capital inflow to these countries (“the Asian currency crisis”). Although the rapid economic growth of the Asian economies did not return immediately, a gradual recovery began, propelled by increases in exports to the American market, increases in public spending by the Asian governments, and efforts to rebuild the financial systems.
(4) The Global Economy in the 2000s

From the start of the 2000s, we experienced even more extensive globalization which had been progressing throughout the 1990s, and we began to enter an age in which business prosperity would apply at the same time throughout the world. In the 1990s, the main players in the world economy were the U.S. and other developed countries, as well as newly developing economies particularly in East Asia, such as the NIEs and ASEAN, but from the start of the 2000s, the newly developing economies began to spread even more.

The countries referred to as BRICs (Brazil, Russia, India and China) are representatives of regions that were attracting attention as new high-growth regions. Common features of these regions are (i) that they are resource-rich countries, (ii) that they are countries with large populations, and (iii) that they are aggressively pursuing foreign investment through economic reform. Under these conditions, these regions achieved high growth as a result of investment entering the region from developed countries and by fulfilling a role as production centers within an international division of roles with the developed countries of Europe and North America being the final destinations of demand. In the year 2001, the share of newly developing countries within the global economy (in terms of nominal GDP and on a dollar basis) amounted to 21.1%, but in 2017 this had expanded to 39.7%.

In the U.S., following the collapse of the IT Bubble, the FRB greatly eased the credit supply from early 2001 onward, while the government deployed stimulus measures, including a tax cut, to support the economy through both monetary and fiscal policy, leading into a recovery starting in November of the same year. From roughly the end of 2000, the Asian region, as a world center for the production of IT equipment, experienced the strong effects of the bursting of the IT bubble in the U.S. and elsewhere, but with the subsequent recovery of the global economy, led by the U.S., the economy of this region also returned to see economic growth.

Japan also entered a period of economic expansion from February 2002 backed by the worldwide economic expansion and driven by external demand. This economic expansion (the 14th cycle) exceeded the Izanagi Boom (a 57 month period of economic expansion from November 1965 through July 1970).

This worldwide period of economic health and further anticipation of high growth on the part of newly developing countries led to a sharp spike in prices on commodities markets, including petroleum at the start of 2007. As a result, resource-rich countries such as Russia and the Middle East experienced an inflow of income, while countries that did not have natural resources experienced an outflow of income as a result of higher materials costs, leading to a slowdown in their economies.

In the summer of 2007, the slowdown in the global economy strengthened as a result of the subprime loan crisis that started in the U.S. Thereafter, the financial markets throughout the world fell into confusion, sparked by the collapse of Lehman Brothers in the fall of 2008, and the substantive economy also deteriorated at an unprecedented pace and severity (the global financial crisis). In order to overcome this global recession, cooperative easing of credit was conducted, while substantial economic policies employing fiscal stimuli were determined.

The global economy continued to improve after hitting the bottom in the beginning of 2009,
partly due to the effect of prompt monetary and fiscal policies in each country. Meanwhile, monetary easing triggered inflation worries, and the risk of monetary tightening in major countries such as China became a concern. In addition, the fiscal situation of each country deteriorated rapidly due to fiscal stimulus measures. In October 2009, window-dressing fiscal deficit was revealed in Greece.

(5) The Global Economy Since 2010

Following the revelation of the Greek window dressing, the reliability of the Euro declined and the debt crisis spread across Europe, giving rise to concerns of financial collapse in Portugal, Italy, Ireland, Greece, Spain, etc. At the same time, the situation made countries around the world face the choice between fiscal soundness and economic growth.

In the U.S. as well, the Republicans’ pursuit of a rapid progress in fiscal reconstruction caused the “fiscal cliff,” a situation where rapid spending cuts and tax hikes take place simultaneously. The U.S. Congress decided to make some tax reductions permanent while spending cuts were implemented compulsorily.

The debt problems in these countries have gradually subsided due to large-scale monetary easing by the FRB and the European Central Bank (ECB). However, in European countries, among others, the recovery of the growth rate has remained slow due to the ongoing relatively tight fiscal policies. Furthermore, the slowdown in the growth of Chinese economy has been putting downward pressure on the growth rates of other emerging economies, resulting in the stagnant growth of the global economy.

Despite such an environment, however, the U.S. economy continuously grew even under fiscal austerity, backed up by a recovery in the housing market and the steady increase of share prices. Beginning in September 2012, the FRB implemented the third-round of large-scale quantitative easing (QE3), but then launched a tapering of QE3 in January 2014, and ended QE3 at the end of October of the same year. Following this, due to continuing positive effects such as the improvement in the employment situation, the FRB raised the interest rate in December 2015, for the first time in nine and a half years. Interest rate hikes have continued at a slow pace, occurring in December 2016; in March, June and December 2017; and in March and June 2018.
(UNIT: %)


Worldwide and regional totals 100.0 100.0 100.0 100.0 100.0 100.0 100.0 100.0 100.0 100.0 100.0 100.0 100.0 100.0 100.0 100.0
Industrialized countries

79.7 79.6 78.5 76.2 74.0 71.6 68.9 68.6 65.5 63.4 62.0 60.8 60.5 60.6 61.3 60.3

	Group of Seven Industrial
Advanced Countries (G7)

64.7 63.6 62.1 59.8 57.6 54.8 52.3 52.6 49.9 47.8 47.2 45.9 45.8 46.5 47.1 46.0

		United States

31.6 29.5 27.9 27.5 26.9 24.9 23.1 23.9 22.7 21.2 21.7 21.8 22.2 24.3 24.7 24.3

		Japan

11.8 11.4 11.0 10.0

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		Germany

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		United Kingdom

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		Italy

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		Canada

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2.4

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Europe
Asia NIEs

20.7 22.7 23.1 22.2 21.7 22.2 22.3 21.4 19.2 18.6 17.0 17.2 17.2 15.7 15.8 15.8
3.4

3.2

3.2

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3.5

		South Korea

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		Taiwan

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		Hong Kong

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		Singapore

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Australia
EU

28.3 30.7 31.4 30.4 29.9 30.6 30.2 28.4 25.8 25.1 23.2 23.5 23.7 22.1 21.9 21.7

Developing Countries

20.3 20.4 21.5 23.8 26.0 28.4 31.1 31.4 34.5 36.6 38.0 39.2 39.5 39.4 38.7 39.7

Asian

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			Philippines

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Russia

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2.5

2.8

3.0

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2.6

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1.7

1.9

Mideast/North Africa

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2.5

2.6

3.0

3.3

3.4

3.9

3.7

3.9

4.1

4.1

4.1

4.1

3.8

3.7

3.6

South Africa

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1.3

1.4

1.5

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1.8

1.9

2.0

2.1

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2.2

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1.9

1.9

Central and South America

Central and Eastern Europe
Congress of Independent
States

5.5

5.0

5.1

5.7

6.2

6.5

6.9

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7.7

8.1

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7.6

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6.6

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		Brazil

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3.3

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3.3

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1.6

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1.7

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1.4

1.4

(Source) IMF “World Economic Outlook Database”

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Chapter 2

Calendar year

Chapter 3

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World GDP (Nominal, Percentage Shares)

Chapter 4

Chart 2-23

Chapter 1

Section 1. Economics


(1) Role of Currency

There are three basic functions of currency.

First is its function as a measurement of value. The existence of currency makes it possible to show the prices of goods and services in currency. In other words, currency acts as a unit of accounting for the value of goods and services.

Second is its function as a means of exchange (a means of payment or a means of settlement). In a barter system in which goods are exchanged without currency, it is difficult for a party to find another party who has what she/he wants. In this regard, having currency enables a person to exchange the goods that he/she holds for currency, and then exchange the currency for something that he/she wants, thereby achieving efficiency in exchange.

The third function of currency is as a means of preserving value. Owning currency means owning the value which the currency represents, and it is possible to save the value for future exchanges (payment or settlement).

As long as these functions of currency are fulfilled, theoretically it does not matter what is used as currency. Before the current form of currency was used, various things were used as currency such as furs and grains. However, considering the practicality of exchanging and saving currency, it is more desirable that currency be uniform, durable, dividable and, moreover, not too bulky. Precious metals such as gold, silver, etc., have all of these characteristics, and therefore became widely used as currency. Yet, it is still inconvenient to use precious metals in their raw forms of gold mass or silver mass, and thus minted gold and silver coins and bank notes which guarantee exchange-ability (convertibility) with these precious metals developed.

Today, major countries in the world, under the “Controlled Currency System”, issue money without regard to gold or silver, and distribute it as currency. In Japan as well, notes (bills) and supplementary money (coins) issued by the BOJ are not exchangeable for precious metals. Therefore, the BOJ can freely issue notes without being bound by the amount of gold it owns. For this reason, it is required that a monetary authority uphold responsible monetary policies in order to maintain the credibility and security of currency.

(2) Money Stock

When we think about currency, we think of it in terms of cash currency. Cash currency consists of notes and coins, but notes account for approximately 95% of circulated currency.

Demand deposits such as current deposits, ordinary deposits and notice deposits are called deposit currency, and are included in the term “currency”. Demand deposits can be changed into cash whenever the depositors need cash. Ordinary deposit accounts are used to make automatic
transfers of payments for utilities user charges, for example, and to transfer money between bank accounts. Current deposits are used for the settlement of checks or notes. Demand deposits are widely used as a means of payment and settlement and, therefore, are considered a type of currency. Generally, both cash currency and deposit currency are combined and referred to as the “narrowly defined currency.”

Fixed deposits such as time deposits and term savings are considered the equivalent of cash currency and deposit currency and are called quasi-currency. Fixed deposits, in principle, cannot be converted to cash until maturity, and therefore cannot be used as a means of payment or settlement during a deposit period. However, if interest is waived, it is possible to cancel the account and convert it to cash. Therefore, the combination of narrowly defined currency and quasi-currency is called the “broadly defined currency.”

Needless to say, understanding the movement of currency is essential to analyzing financial markets, and is equally important for understanding the economy as a whole. For this purpose, it is necessary to analyze the currency supply, i.e., the money stock.

Money stock means the amount of currency domestically owned by the private, non-financial sector. In other words, it is the amount of currency owned by general corporations (excluding banks), individuals, local governments, etc., excluding deposits, etc., held by national and financial institutions. This distinction between national and financial institutions, and corporations, individuals, and local governments comes from whether current deposit accounts are held with the BOJ. The former are subject to adjustments of their current deposits with the BOJ in organizing their receipts and disbursements of funds, whereas the latter have no direct relationship with the BOJ, and their receipts and disbursements of funds are organized through transactions with financial institutions.

There is more than one indicator of money stock, depending on such criteria as the definition of financial products and what types of financial institutions and other entities are regarded as issuers of currency. Examples include whether only cash and liquid deposits immediately payable are considered currency, or whether term deposits, etc., are included. Financial institutions and financial products are classified by terms and costs spent to transform and use money stock by means of payment. In Japan, the major money stock statistics are: \( M_1 \) (M One), which is the total of narrowly defined currency (i.e., the total of cash currency and deposit currency); \( M_3 \) (M Three), which is \( M_1 \) plus quasi-currency such as term deposits and CDs (negotiable certificates of deposits); and \( M_2 \) (M Two), which is the portion of \( M_3 \) that is limited to those deposits that are deposited with banks, etc., that are domestic.

Of these various money stock indexes, the BOJ places importance on \( M_2 \) and broadly defined liquidity as the most commonly used indexes of money stock. In general, however, \( M_2 \) is frequently used when looking at general trends in the money stock. If a large amount of funds included in \( M_2 \) (e.g., bank deposits) is shifted to other asset categories outside of \( M_2 \) (such as postal savings), the level of \( M_2 \) can fluctuate widely. Broadly-defined liquidity, however, is less sensitive to such reallocation of financial assets. The large-scale maturation of fixed-term postal savings deposits that began in 2000 resulted in a shift of a substantial amount of funds from the Post Office to bank deposits, which created a substantial increase in \( M_2 \) even though
## Chart 2-24 Composition of Various Indicators of Money-Stock Statistic

<table>
<thead>
<tr>
<th>Balance as of July 2018 (JPY trillion)</th>
<th>Weight (%)</th>
<th>Targeted Financial Products</th>
<th>Issuers of Currency</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>M₂</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>1,007.5</td>
<td>Cash + deposit currency +</td>
<td>BOJ, domestic banks</td>
</tr>
<tr>
<td></td>
<td></td>
<td>quasi-currency + CDs</td>
<td>(excluding Japan Post Bank), foreign banks in Japan, credit associations (Shinkin Banks), the Shinkin Central Bank, The Norin Chukin Bank, and the Shoko Chukin Bank</td>
</tr>
<tr>
<td><strong>M₁</strong></td>
<td></td>
<td>BOJ notes issued + currency in circulation</td>
<td>BOJ (Note)</td>
</tr>
<tr>
<td></td>
<td>760.7</td>
<td>Demand deposits (current deposits, ordinary deposits, savings, notice, special, tax payment reserves) - checks and notes held by financial institutions covered by survey</td>
<td>Financial institutions covered by M₂, Japan Post Bank, credit cooperatives (Shinya kumiai), The Shin-kumi Federation Bank, Labour banks (Rokin), the Federation of Labor banks (Rokinren), Agricultural Cooperatives, Federations of Agricultural Credit Cooperatives (Shin Noren), Fishery Cooperatives (Gyokyo), and Federations of Fishery Credit Cooperatives (Shingyoren)</td>
</tr>
<tr>
<td><strong>M₃</strong></td>
<td></td>
<td>Term deposits + savings with grace period + term savings + foreign currency deposits</td>
<td></td>
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<tr>
<td></td>
<td>1,338.6</td>
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<tr>
<td></td>
<td>75.0%</td>
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<tr>
<td></td>
<td>710.7</td>
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<tr>
<td></td>
<td>42.6%</td>
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<td></td>
</tr>
<tr>
<td></td>
<td>4.2%</td>
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</tr>
<tr>
<td><strong>M₄</strong></td>
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<tr>
<td></td>
<td>785.8</td>
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</tr>
<tr>
<td></td>
<td>100%</td>
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</tr>
<tr>
<td></td>
<td>4.2%</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

*1 The above covers holdings of ordinary corporations, individuals and local government entities among residents.

*2 The statistics that are used are those as of their publication in July 2018.

*3 The weight is the ratio to board liquidity, expressed as a percent.

(Note) Currency, strictly speaking, is issued by the central government, but for the purposes of money stock statistics it is classified as being issued by the BOJ.

(Source) BOJ
broadly-defined liquidity did not change by much. In this manner it is necessary to observe a variety of indicators, having differing scopes, in a comprehensive manner and with selectivity according to the purpose of the analysis at hand.

(3) Value of Currency

(i) Prices

It can be said that the value of domestic currency is determined by prices. For example, let us say there is an individual whose net income is JPY5 million. If his annual income does not change, but if prices increase the following year, what he can buy with his JPY5 million will be less compared to the previous year. In other words, the value of JPY5 million in currency has decreased. Therefore, inflation devalues currency.

Inflation substantially disturbs the major functions of currency listed in “(1) Role of Currency” above. First, when the value of currency becomes unstable, the price of commercial goods as expressed in currency becomes unstable, thereby undermining the function of currency as a measurement of value. Second, when inflation is progressing, the value of currency decreases the longer it is held, and therefore, it becomes better to dispose of it as soon as possible, which damages the function of currency as a stable means of exchange. In the worst case, it is possible that another party will refuse the currency in a transaction. Third, those who own currency in the form of cash or deposits cannot avoid the loss of value of the currency due to inflation, and therefore, the function of currency as a means of saving value is undermined as well. In particular, the rate of inflation proportionately increases the value of actual assets, primarily land, and therefore, in many cases, the gap between “the haves” and “the have-nots” widens. Actual assets such as land
are usually owned by the wealthy classes, and therefore, this may stir feelings of unfairness among people.

Thus, because inflation is a significant threat to the value of currency, monetary authorities are always carefully watching price trends. The representative index watched most for the trend in prices is the Consumer Price Index (CPI), which directly influences peoples’ lives. Trends in the Corporate Goods Price Index (CGPI), which sensitively reflects the supply and demand of commodities, are also important. In addition, the price of crude oil, which has a substantial influence on the trend of prices, is also closely watched as an important indicator related to price trends.

(ii) Interest Rates

For example, let us suppose Individual A has JPY100 million of funds. A has no specific use for the funds. On the other hand, Company B plans to expand its business and needs JPY100 million. In this case, B could borrow JPY100 million from A, and borrowing JPY100 million means B purchases the currency of JPY100 million from A. The interest B pays to A for the loan is the price of such funds. If there are many people other than B who want to borrow the funds owned by A, the value of funds increases. So, if B badly needs the funds, B must pay a higher interest rate to A. On the other hand, if there are less people who need the funds, borrowing at a lower interest rate is possible. In the real economy, there is a financial institution to mediate the movement of funds and there also exists various regulations so the flow of the funds is not this simple, but, nonetheless, the interest rate plays a role in the price of funds. Therefore, in general, if the demand for funds increases when the supply of funds is relatively low, the interest rate increases, and if the demand for funds decreases when the supply of funds is high, the interest rate decreases.

When working with interest rates, it is necessary to pay close attention to their relationship to prices. For example, if funds are borrowed at an annual interest rate of 10% when the annual increase rate in prices is 8%, essentially, the loan interest rate is 2%. The result is that the value of the currency will decrease by 8% after one year due to the increase in prices. The interest rate of 10% in this case is called the nominal interest rate, and the interest rate of 2%, which is obtained by subtracting the rate of the price increase from the nominal interest rate, is called the real interest rate.

When prices increase significantly and people borrow funds in anticipation of such increase in prices, the interest rate becomes the appropriate interest rate plus the anticipated rate of price increases, and so the nominal interest rate increases. Therefore, when inflation is progressing, high interest rates prevail, and when inflation subsides, interest rates are usually lower. However, although the close relationship between price increases and interest rates cannot be denied, these two elements do not necessarily move in unison.

The real interest rate is one of the determining factors for companies making decisions regarding their financial needs. In other words, even if the nominal interest rate is high, if the real interest rate is low, the demand for funds by companies increases. On the other hand, even if the nominal interest rate is low, if the real interest rate is high, the demand for funds by companies stagnates.
This is called the Fisher effect and is expressed in the following formula:
Nominal interest rate = Real interest rate + Anticipated (forecast) inflation rate

(iii) Foreign Exchange Rate

The value of currency overseas is expressed using an exchange rate which is the exchange ratio between the various currencies of each country. For example, if the rate of the yen against the dollar changes from JPY200 to JPY100, it means the value of the yen is doubled (on a local currency basis) (yen appreciation). If the rate of the yen against Euro rate changes from JPY80 to JPY160, it means the value of the yen against Euro becomes halved (yen depreciation).

The international financial market after World War II was based on a fixed exchange rate system with the standard currency being the overwhelmingly economically powerful dollar (in Japan, USD1 = JPY360). However, this system collapsed as the value of dollar declined due to the U.S. current account deficit, and the major currencies of the world were appreciated based on the Smithsonian Agreement in December 1971 (in the case of Japan, the yen was appreciated by 16.88% to USD1 = JPY308). However, this so-called Smithsonian System did not last long, and in 1973 the major currencies of the world shifted to a floating exchange rate system. Therefore, today’s currency exchange markets fluctuate daily, reflecting international trade balance movements and fluctuations in interest rates in each country. The yen rate since the floating of the yen has traced a long-term trend of appreciation against the dollar. In particular, after the Plaza Accord in September 1985, a rapid and wide-margin appreciation has been evident. In recent years, after hitting the post-war record high of USD1 = JPY75 in October 2011, the yen has tended to be weak against the dollar, i.e. USD1 has been equivalent to JPY120 or more until 2015, but since then, a trend of a slight appreciation in the value of yen against the dollar has been continuing with USD1 hovering around JPY110.

The fluctuation in exchange rates has a significant influence on exports and imports and the movement of capital, as well as on prices, interest rates and on the economy as a whole. If the yen depreciates, it causes import prices to increase which leads to an overall increase in prices, and the possibility of increases in the interest rate also increases. On the other hand, if the yen appreciates, prices decline due to the decline in import prices and a decrease in interest rates can also be anticipated.

(4) Money Stock and Prices

In the long term, it can be acknowledged that there exists a correlation between money stock and prices. The theory is that if the currency supply exceeds the amount of currency needed, an increase in prices would absorb that surplus. It is for this reason that the central banks such as the BOJ stress the importance of money stock in their monetary policy objectives.

An observation of the annual rate of increase to date in both money stock and prices shows that an increase in money stock is not necessarily reflected immediately in prices. Rather, price
increases start after some time lag. An abnormal increase in prices took place in 1973 and 1974 and this was, of course, due to the quadruple increase in crude oil prices (the first oil crisis). However, it is important to note that the money stock increased greatly several years earlier and this factor caused the abnormal increase in temporary demand.

In 1979 there was a substantial increase in crude oil prices again (the second oil crisis), but circumstances differed from the first oil crisis, in that the money stock was maintained at a relatively low level. During this period, the then Wholesale Price Index, which tends to reflect the movements in import prices in an exaggerated way, temporarily recorded a rate of increase that exceeded that of the money stock, but the Consumers Price Index remained stable.

(5) Excessive Money and Marshall’s K

“Marshall’s K” is one of the indicators used to measure whether the money stock is too large or too small relative to the level of economic activity. Marshall’s K is obtained by dividing the money stock (i.e., the amount of currency) by nominal GDP, which reflects the extent of actual economic activity. In general, it is thought that the rate of change in Marshall’s K is constant, and therefore, if it goes over the trend line, the amount of currency is in excess, and if it goes below, the amount of currency is too small.

In general, if the demand increases for transactions other than real economy transactions, such as investments in equipment or consumption, Marshall’s K goes over the trend line.

![Chart 2-26 Marshall’s K](image)

(Trend during 1980 1st Quarter to 2018 2nd Quarter)

(Note) The shaded areas indicate cyclical downturns.

(Source) BOJ, Cabinet Office
Financial Institutions

Within the economy as a whole, there exist entities such as households, which have excessive funds and are looking for a party to manage their funds, and there also exist entities such as companies which are short of funds and are looking for a party from which they can procure funds.

It is extremely difficult in reality, considering the efforts and expenses, etc., for an entity with excessive funds and an entity with a shortage of funds to try to independently seek out another party that matches its particular management/procurement criteria (the amount, the interest rate, the term, etc.). Financial institutions make the efficient distribution of funds possible by acting as an intermediary between an entity with excessive funds and an entity with a shortage of funds (this is called the “intermediation of funds by financial institutions”).

There are two types of methods, the direct financing method and the indirect financing method, by which funds can be transferred from an entity with excessive funds to an entity with a shortage of funds. Direct financing is a financing technique by which an entity with a shortage of funds issues securities, such as stocks or bonds, and an entity with excessive funds directly purchases these securities through securities markets and supplies the funds. In this situation, financial institutions (mainly securities companies) play a role in connecting the two parties, but, in principle, they do not supply the funds themselves. On the other hand, indirect financing is a financing technique by which financial institutions themselves (mainly banks) raise funds from an entity with excessive funds and lend the funds to an entity with a shortage of funds.

The difference between direct financing and indirect financing is the entity that bears the risk of a bad debt, etc. In the case of direct financing, such risks are borne by the entity with excessive funds that purchases securities, whereas in the case of indirect financing, such risks are borne by financial institutions.

The types of financial institutions and their operations vary from country to country and from period to period. In the case of Japan, major financial institutions are regulated by industry laws depending on the type of business, and business is conducted according to those laws.

(1) Banks
(i) BOJ

The BOJ is the central bank of Japan established under The Bank of Japan Act and has three basic functions: (a) the function of “issuing bank” that exclusively owns the right to issue bank notes; (b) the function of “bank of banks” that engages in transactions with private financial institutions; and (c) the function of “bank of the government” that handles receipts and disbursements for the government. The BOJ manages monetary policy through these functions.

(ii) Ordinary Banks (City and Regional Banks)

There are various types of banks, but the representative ones are ordinary banks such as city banks and regional banks. There are four city banks: Mizuho, MUFG, Sumitomo Mitsui,
Regional banks consist of the member banks of Regional Banks Association of Japan and the Second Association of Regional Banks. Both city banks and regional banks are licensed under the Banking Act and there is no legal distinction between them.

City banks have headquarters in big cities, develop branch networks throughout the country and deal with major corporate clients. City banks account for about 50% of the total deposit and loan balance of domestic banks, and they play a central role among commercial financial institutions in Japan.

Regional banks that are members of Regional Banks Association of Japan are headquartered in core cities in metropolises across the country, and those metropolises in which they are located are their major business bases. Therefore, their customers are mostly local residents and companies in the area. Regional banks that are members of the Second Association of Regional Banks are the same as regional banks, but were formerly mutual banks later converted to ordinary banks. Therefore, they are relatively smaller in size compared to regional banks that are members of Regional Banks Association of Japan.

Regional banks, which have concentrated their businesses in specific geographic regions, have played an important role in supplying funds to regional economies. However, some regional banks now operate their businesses beyond their geographical boundaries. Indeed, the distinction between the types of deposit-taking institutions is becoming less significant, as city banks have somewhat acquired the appearance of regional banks, while regional banks and shinkin banks have become larger through management integration. Nevertheless, regional banks do have a major impact on the local economies of their respective regions, and improving the financial soundness of both regional banks that are members of the national association and those that are members of the second association can be said to be indispensable to revitalizing the regions in which they are active. In addition, among the ordinary banks there are banks that have been converted from being long-term credit banks, and net banks specializing in banking by use of the Internet. Moreover, foreign banks that open branches in Japan are licensed to conduct business under the Banking Act.

(iii) Trust Banks

Based on the “Act on Concurrent Operation, etc. of Trust Business by Financial Institutions,” trust banks are approved to conduct trust businesses concurrently with their regular business and their primary business is trust business. They mostly deal with long-term financing based on funds collected through their trust businesses. In addition to those established to function exclusively as traditional trust banks, there are foreign banks, the first of which was established in October 1985, and banks related to securities companies established in October 1993 which became trust banks.

In addition, in 1994, two banks were added, one affiliated with the National Credit Union Association (currently the Shinkin Central Bank) and the other affiliated with Nippon Credit Bank (currently Aozora Bank). In 1995, a total of five banks were added, consisting of an affiliate bank of the Central Bank for Agriculture and Forestry, an affiliate of the Industrial Bank of Japan, and three banks related to city banks, and again, in 1998, four banks related
to city banks newly entered this line of business as well. In the past, the trust business was limited to the seven specialized banks and Daiwa Bank due to administrative guidance of the (then) Ministry of Finance which coordinates business areas, but as part of the financial deregulation that has since taken place, participation from other types of businesses has developed. As of August 10, 2018, 15 trust banks are covered under the system of deposit insurance.

(iv) Long-Term Credit Banks

Long-term credit banks are licensed under the Long-Term Credit Bank Act, but Shinsei Bank (formerly the Long-term Credit Bank of Japan) and Aozora Bank (formerly the Nippon Credit Bank, Ltd.) have converted to being ordinary banks in FY2004 and FY2006 respectively, and thus there are no longer any long-term credit banks.

(2) Financial Institutions for Small and Medium-Sized Businesses

There are many small and medium-sized businesses in Japan and it is said that they are the source of energy behind the Japanese economy. Since it was difficult for small and mid-sized companies to utilize the capital markets and borrow from major financial institutions, there are various types of financial institutions specializing in financing for small and mid-sized businesses. However, recently there have been an increasing number of small and mid-sized businesses with outstanding capabilities, while competition among financial institutions has become more and more severe, and both city banks and regional banks are actively seeking financing opportunities with small and mid-sized businesses. Therefore, financial institutions specializing in financing for small and mid-sized businesses have been taking various measures such as improving management efficiency by merging or forming business partnerships, diversifying business and strengthening local ties.

(i) Shinkin Banks

Shinkin banks are financial institutions for small and mid-sized businesses with a cooperative structure which are licensed under the Shinkin Bank Act. Shinkin banks principally lend only to members and have a close relationship with the local region, because their business area is relatively small. As of January 22, 2018, there were 261 shinkin banks nationwide.

The Shinkin Central Bank (hereinafter referred to as the “Shinkin Chukin”) is the central organization for shinkin banks throughout the country. This bank lends support to the management of shinkin banks by collecting and efficiently managing the surplus funds of each shinkin bank, by lending funds to shinkin banks with strong demand for funds, or by assisting shinkin banks whose businesses have deteriorated. In addition, since 1989, Shinkin Chukin was permitted to issue bank debentures to raise funds (at the time this bank was referred to as the “Zenshinren Bank”).

(ii) Credit Cooperatives

Credit cooperatives are financial institutions that are membership organizations for small and mid-sized businesses under the Small and Medium-sized Enterprise Cooperatives Act and the Act on Financial Businesses by Cooperative. As of February 19, 2018, there
were 148 credit cooperatives nationwide. Credit cooperatives have stronger characters as cooperative organizations than shinkin banks. The services of deposits and lending are, in principle, limited to their members. Compared to shinkin banks, they are smaller in size and closer with the local community. The Shinkumi Federation Bank is the central organization.

(iii) Labor Banks

Labor banks are financial institutions with cooperative organizations whose members are mainly labor unions, etc. and which engage in depositing and lending to their members. As of March 31, 2018, there were 13 labor banks throughout the country, and the Rokinren Bank is the central organization for them.

(iv) Shoko Chukin Bank

This is a special corporation (stock company pursuant to the special law) that was incorporated in accordance with the Shoko Chukin Bank Limited Act. Its main activities are to conduct the necessary business activities for facilitating lending to cooperative associations of small and medium-sized enterprises, other associations that mainly have members consisting of small and medium-sized enterprises, and their members. As one aspect of reform of monetary policy, it was converted from a government-affiliated corporation to a special corporation in October 2008, with the intention of being fully privatized in five to seven years from April 2015. However, the amended Shoko Chukin Bank Limited Act was passed in 2015, and the government decided to continue holding shares of Shoko Chukin Bank without setting a specific period for selling them.

Later, in the autumn of 2016, an illegal loan incident came to light and new discussions on full-scale privatization were made by the expert council that examined the drastic reforms of Shoko Chukin Bank. The expert council presented a draft schedule to review, verify and examine the crisis response business after thoroughly focusing on the establishment of a new business model for four years and also proposed a mode to determine the transition to full-scale privatization based on such review, verification and examination.

(3) Financial Institutions Related to Agriculture and Forestry

Financing for the agricultural, forestry and fishery sectors is handled at the top by the central organization, The Norinchukin Bank, and conducted mainly by chain financing, which consists of three financing chains for the agricultural, fishery and forestry sectors. However, the fishery chain is small in size and the forestry chain only conducts lending and does not accept deposits. Therefore, the cooperative financing of the agricultural sector is central to this chain financing.

The agricultural financing system is based on 668 (as of April 1, 2018) agricultural cooperatives (hereinafter referred to as the “Nokyo”) throughout the country that engage in financial activities. Nokyo are different from other financial institutions in that they engage in a diverse range of businesses such as purchases of materials related to agriculture, sales of agricultural products and the mutual aid business. Nokyo accept deposits from association members and lend funds required for the businesses of the members, although, in general, the loan amount is substantially below the deposit amount. Nokyo deposit surplus funds at the Federation of Agricultural Cooperative Associations (hereinafter referred to as the “Shinnoren”) of the
respective prefectures in which they reside. A Shinnoren can manage the deposited funds by itself, but they deposit most of the funds to be managed at the Norinchukin Bank. The Norinchukin Bank manages the funds collected through such systems by lending or investing in securities, and it is the largest institutional investor in the private sector.

However, there is a possibility that the government reform of Nokyo will change the structure of the Nokyo-based agricultural financing system throughout the country. On November 11, 2016, the Regulatory Reform Promotion Council published the “Opinions on the Reform of Agricultural Cooperatives.” In the opinions, the Council stated that the number of regional Nokyo which are authorized to operate credit businesses under their names should be decreased by half within three years so as to enable these Nokyo to concentrate their management resources on activities for agricultural promotion. Furthermore, in April 2017, the Norinchukin Bank required regional Nokyo to show the direction in separating and restructuring their financial business by May 2019.

(4) Insurance Companies

Insurance companies are divided into life insurance companies and non-life insurance companies and both are licensed under the “Insurance Business Act.” In the past, engaging in both the life insurance business and the non-life insurance business concurrently was not allowed. However, as a result of the financial deregulation that has taken place, the Insurance Business Act was amended so that insurance companies may engage in both the life insurance business and non-life insurance businesses concurrently through their subsidiaries, and mutual entry into the two businesses was permitted in April 1996.

There is no difference between life insurance companies and non-life insurance companies in that they both manage funds received in the form of insurance premiums by lending or investing in securities, etc. However, life insurance agreements cover long term periods and insurance benefits are paid steadily, whereas with non-life insurance agreements, the insurance payments are sporadic since they cover disasters, which are unpredictable in nature. Therefore, funds from life insurance are mostly invested for the long term, whereas in the case of non-life insurance, investments are mainly short-term and focus on liquidity.

(5) Financial Instrument Business Operators (Securities Companies, Etc.)

Financial instrument business operators (securities companies, etc.) are the major players in direct financing, and are registered and conduct business based on the Financial Instruments and Exchange Act.

(6) Other Private Financial Institutions

(i) Securities Finance Companies

Securities finance companies are licensed under the Financial Instruments and Exchange Act and conduct various securities financing businesses, mainly money and securities lending transactions where the securities finance companies lend money and securities necessary for the settlement of margin transactions.
(ii) **Call Loan Dealers**

Call loan dealers broker money transactions between financial institutions on short-term financial markets such as call markets and bond markets, etc. Call loan dealers play an extremely important role in terms of the execution of the monetary policy of the BOJ. As of August 13 2018, there were three call loan dealers: Tokyo Tanshi Co., Ltd., Ueda Yagi Tanshi Co., Ltd. and Central Tanshi Co., Ltd.

(iii) **Non-Banks**

There is no precise definition for non-banks, but in general, they are “companies which engage in the credit business without taking deposits.” Specifically, there are consumer financing companies, credit card companies, credit sales company, business financing companies, leasing companies, etc. Since these non-banks do not accept deposits, the majority of their funds are procured by external funding. Traditionally, external funding has come from loans from banks, but now non-banks are able to issue bonds to procure funding to engage in the loan business, under the Act on Issuance, etc. of Bonds for Financial Corporations’ Loan Business (the Non-Bank Corporate Bond Act) which came into effect in May 1999.

(7) **Government Financial Institutions**

The balance of postal savings accounts is JPY176.6 trillion (individual savings, etc. as of the end of March 2018) and accounts for approximately 20% of household savings. Through FY2000, money such as postal savings and postal life insurance received by the Postal Bureau was made available to government financial institutions under the government’s Fiscal Investment and Loan Program (FILP) Plan, as was also the case with employee pensions and national pension funds. From FY2001, however, the postal savings funds collected through the post offices have gradually been redirected towards autonomous management. This is because the postal business has become a service which can no longer be solely provided by the national government, and also because of calls that had come to be made to provide funds to the private sector and make effective use of such funds from the perspective of stimulating the national economy. As a result, in October 2005 the Japan Post Privatization Act passed, and progress commenced towards privatizing areas such as postal savings and postal life insurance. On October 1, 2007, a 100% government-owned holding company (Japan Post Holdings Co., Ltd.) and its four operating companies began operations. On October 1, 2012, Japan Post Service Company, Limited and Japan Post Network Co., Ltd. were integrated and today, Japan Post Holdings, Co., Ltd. has become a holding company with three subsidiaries, *i.e.* Japan Post, Co., Ltd., Japan Post Bank, Co., Ltd. and Japan Post Insurance, Co., Ltd., and has been listed on the first section of the Tokyo Stock Exchange in November 2015.

Other institutions have been reorganized or will be reorganized as follows.

The Housing Loan Corporation was abolished, and its business was taken over by the Japan Housing Finance Agency which was newly created in FY2007. From October 1, 2008, the Development Bank of Japan and the aforementioned Shoko Chukin Bank were converted into special corporations and scheduled to be completely privatized in stages. While maintaining the
complete privatization policy, the government continues to hold shares in the Development Bank of Japan in order to promote intensive investment in growth funds (i.e., funds supporting risks associated with innovations) conducive to regional revitalization, and shares in the Shoko Chukin Bank in order to ensure responsiveness to crises such as natural disasters. Also, on the same date, the National Life Finance Corporation, the Agriculture, Forestry and Fisheries Finance Corporation, the Japan Finance Corporation for Small and Medium Enterprise, and the Japan Bank for International Cooperation have been dismantled and were then combined into the Japan Finance Corporation, after their activities were limited and reduced. On April 1, 2012, Japan Bank for International Cooperation became a limited corporation after being separated from and made independent of Japan Finance Corporation.

(8) The Reorganization of Financial Institutions

Until recently, financial institutions in Japan were considered to be entirely separated into categories according to their business objectives or lines, and whether they were engaged in short-term or long-term financial activities. In the course of progress of liberalization, however, overlapping arose in terms of the financial products and targets that they handle, and members of one category became capable of engaging the business lines of another through newly established subsidiaries, so the former distinctions among financial institutions is becoming meaningless.

From the end of 1997 there has been a rush of mergers and business alliances between banks after several financial institutions failed, and after it became possible to have financial holding companies, large financial groups started being formed in which the above-mentioned classification of city banks, long-term credit banks, and trust banks are becoming less distinct. These large financial groups have a bank at the center and include life insurance and non-life insurance companies, as well as securities companies and other types of businesses. It is possible that further reorganization will take place, which may include financial institutions whose group affiliation is not evident. Additionally, progress is also being made toward the reorganization and privatization of government financial institutions. Moreover, new techniques such as the technique of securitization started being used, and rather than the industrial category of the entity, a functional aspect, meaning what type of financial activities are conducted and what type of risks are taken, has become more important.

As mentioned above, the greatest role played by financial institutions is that of making an efficient distribution of funds. A closer examination reveals their functional aspects in the “financial system,” that can be broken down into the following categories: (i) clearing, (ii) pooling and small lot distribution, (iii) transfer of economic resources, (iv) risk management, (v) dissemination of price information, and (vi) addressing information gaps.

(i) Clearing refers to the settlement and payment of economic transactions, and lies at the core of the financial system; (ii) pooling and small lot distribution refers to the amalgamation of funds to conduct large scale business operations while small-lot distribution of funds includes deposit and lending business; (iii) transfer of economic resources refers to the transfer of funds among locations, times and industries; (iv) risk management refers to the management of risks associated with uncertainties and provides the means to manage such risks; (v) dissemination of
Balance of Financial Assets and Liabilities by Sector as of end of March 2018 (in trillions of yen)

(Note 1) Charts shown for each sector reflect only the major categories and major items in order to show the cyclical flows of funds.

(Note 2) Loans (borrowings) include “BOJ lending,” “call loans and bills,” “loans by private financial institutions,” “lending by public financial institutions,” “lending by the non-financial sector,” “installment receivables,” and “gensaki and bond loan (borrowing and lending) transactions.”

(Note 3) Securities include “stocks and beneficiary certificates of investment trusts” and “debt securities” (“government bonds and FILP bonds,” “bank debentures,” “corporate bonds,” “beneficiary interests in trust,” etc.) (securities among Japan’s receivables are “overseas securities investments”).

(Note 4) “Others” refers to the difference between the total amount and amounts of other stated items.

(Source) BOJ
information regarding calculation of price refers to the provision of price information used for price calculations and decision making, including information related to interest rates and securities prices; and (vi) addressing information gaps refers to the provision of information as a means to assist in the finalization of transactions in cases where information exists that is not known to one of the parties to the transaction.

2 3 Financial Markets

Financial markets refer to the place where transactions of funds are conducted. In general, these markets can be separated into short-term financial markets (a maturity of less than one year) and long-term financial markets (a maturity of one year or more), depending on the period until maturity of the financial assets.

Among the short-term financial markets, the savings and loans markets engage in negotiated transactions and therefore differ somewhat from the general definition of a market. In this regard short-term financial markets (money market), in their narrow definition, refer to markets excluding loan/savings markets.

Short-term financial markets (money markets) in their narrow definition can be divided, depending on the participants, into the interbank market and the open market. The participants in the interbank market are limited to financial institutions, and this marketplace is used to invest and raise funds among financial institutions. On the other hand, the open market is open to non-financial institutions such as general business corporations.

Short-term financial markets in Japan have developed around the interbank market but, lately, the open market has progressively expanded and it has surpassed the interbank market in size.

(1) Interbank Market

As a result of daily business activities, financial institutions experience a difference between the amount of funds received through savings, etc., and the cost of funds paid out for loans and securities investments, etc. The interbank market serves the function of coordinating financial institutions with surplus funds as lenders and financial institutions with a shortage of funds as borrowers. The interbank market consists of the call market and the bill market.

The call market dates to before World War II and is the oldest money market in Japan. For a
long time, there was only a market for secured calls in which funds were borrowed based on collateral such as government bonds and bills, but in 1985 a market was created to enable call transactions without collateral. For both secured and unsecured call markets, call loan dealers play an important role as an intermediary of funds.

The secured call market is the marketplace for ultra short-term fund transactions and deals with next day funds (overnight transactions) and term funds. Most of the transactions on this market are next day funds (overnight transactions). Although the unsecured call market has a shorter history than the secured call market, in the early 1990s, it outgrew the secured call market in scale. However, the zero interest rate policy that appeared in 1999 and the sweeping financial deregulation that hit in 2001 was followed by a rapid decline of balances to the point where the balance of the unsecured call market dropped beneath that of the secured call market. Both the secured call market and unsecured call market deal in next-day funds and various term funds (20 types from two to six-day call, one to three-week call, one to 11-month call and up to one-year call), but next-day funds account for the largest share of transactions. Following the introduction of the negative interest rate policy by the BOJ in February 2016, the unsecured overnight call rate turned negative and the balance of the call market sharply dropped.

The biggest suppliers of call loans are the trust banks (including investment trusts, etc.). The biggest borrowers were city banks, but since the introduction of the negative interest rate policy, the amount of their loans has sharply dropped and other borrowers, namely, regional banks, securities companies, and securities finance companies, have increased their presence.

The bill market was established in 1971 by transferring longer-term funds from the conventional call market. Bills traded on the bill market are bills drawn by prime companies (original bills) and bills drawn by banks (cover bills) based on public corporation bonds such as government bonds and government guaranteed bonds and foreign currency bonds as collateral. The duration for bill transactions is, in principle, unregulated.

(2) Open Market

The short-term financial market in Japan developed around the interbank market, which was represented by the call market. The open market did not exist except for the gensaki market. However, starting with the establishment of the Certificate of Deposit market (“CD market”) in 1979, the Treasury Bill market (“TB market”), the Financing Bill market (“FB market”) and the Commercial Paper market (“CP market”) were created, and thus the open market expanded.

(i) Repo Market (Gensaki, Bond Repo)

Gensaki transactions are transactions to purchase (or sell) instruments on the condition that they will be resold (or repurchased) at a certain price after a certain period. When referred to simply as “gensaki,” it refers to bond gensakis which are repo transactions of bonds. The gensaki market is the oldest open market in Japan. It came about naturally after World War II as a means of financing the bond inventories owned by securities companies.

From April 1996, bond loan (borrowing and lending) transaction secured by cash began and the scale of the transaction has expanded. These are referred to as “cash collateralized bond loan transactions” (hereinafter referred to as “repo transactions” or “bond repos”).

Since these bond repo transactions were in the form of a borrowing and lending that differs from international standards, and the security was reverse, from 2001 transactions referred to as “new gensaki transactions” were introduced, which were consistent with international standards. The size of this market has been increasing because these transactions offer improved convenience in risk management and handling.

The Repo Market includes three types of transactions with differing contractual forms, and at the present time this market is growing into a core market that epitomizes the open market.

(ii) CD Market

CDs ([Negotiable] Certificates of Deposit) are negotiable deposit certificates and were introduced as the first deposit product with a deregulated interest rate in Japan in 1979. The terms for these CDs range from two weeks to five years, but by far most CDs are issued with one month to three-month maturities. CDs with a term of six months or more are extremely rare.

Legally, CDs are deposits and, therefore, the issuance can be only by financial institutions such as banks and other deposit-taking institutions. The majority is issued by city banks. Most of the holders of CDs are dealers in CDs on the secondary market (financial institutions and their affiliates, securities companies, call loan companies, etc.). In the secondary CD market, dealers engage in interest rate arbitrage in the interbank market and business corporations, among others, are also buyers of CD gensaki in the secondary market of CDs.

(iii) Short-Term Treasury Securities (T-Bill) Market

From February 2009, the former Treasury Bills (TBs, which are discount short-term treasury securities) and Financing Bills (FBs, which are short-term government securities) have been combined into Treasury Discount Bills (short-term treasury securities). Treasury Discount Bills are discount bills (short-term government bonds) with a maturity date of less than one year. They exist in four types: two-month, three-month, six-month and one-year maturities.

The previous TBs are short-term discount government bonds that were issued for the first time in 1986 for the purpose of facilitating the smooth redemption and refunding of large amounts of maturing government bonds. There are six-month TBs and one-year TBs. On the other hand, the previous FBs are government short-term securities normally redeemable in three months (13 weeks). They were issued to compensate for the temporary shortage of funds for various accounts in the government, or to obtain funds for intervention in the foreign exchange market. In the past, almost all of the bills issued were underwritten by the BOJ, but this has been amended so that from April 1999 they have been sold in the market through public auction whereby the auction was conducted on the basis of the issue conditions and amounts for bids.

Treasury Discount Bills are traded on the secondary market at interest rates that reflect market rates. They are also used by the BOJ for open market operations, and secondary market trading has been gradually increasing. Overseas investors use these bills as
instruments for managing yen-denominated assets.

(iv) CP Market

CP is an abbreviation for commercial paper and its legal nature is that of a promissory note. In Japan, the market was established in 1987 as part of the deregulation of short-term financial markets. CPs are issued at a discount and most are for three-month terms.

CP is issued by corporations through securities companies and banks and is sold to institutional investors, etc., through an intermediary of banks, securities companies and call loan dealers. Trading, in the majority of cases, is in the form of short-term gensaki. From June 1998 institutions such as banks have also been permitted to issue CP.

Furthermore, in January 2003 the Act on Book-Entry Transfer of Corporate Bonds, etc. (at the time) came into effect, and transactions in paperless electronic CPs began in March 2003.

(v) Short-Term Interest Rate Derivatives (OIS) Market

Since the lifting of the BOJ’s quantitative easing policy, trading has become active in what is called OIS (Overnight Index Swap) transactions as a means of responding to increases in and fluctuations of interest rates. The transaction involves a swap of the unsecured overnight call rate for a certain period of time against a fixed rate of interest. In Japan, this is the first true derivatives transaction on the overnight rate of interest, and has made it possible to observe the stance of the market towards future trends in monetary policy.

(3) Bank Loans

Largely due to the issue of corporate bonds and commercial paper by large corporations,
dependency on bank loans have declined and the outstanding balance of bank loans is showing a declining trend. Bank loans trend is determined by an interaction of the willingness of institutions to lend and the demand for their funds from non-financial sector, but this background is not immediately evident merely from change in the outstanding balance. In any event, Japanese corporations and households are dependent on a large number of bank loans, and there has been no change in the position of banks, acting as both deposit-takers and lenders of funds, as the major intermediaries in the supply of credit by their function of connecting suppliers of funds with those who require funds.

What is important is that loans create deposits. When a bank makes a loan, the borrower does not hold the loan as cash, but even when using funds to make a payment of one form or another, returns most of the borrowed funds to the banking sector as deposits.

The effect of bank loans that originate in an increase in deposits is called credit creation. Creation of credit is an essential part of increase in money stock, and in this sense it is useful to compare bank loans and GDP, which is an indicator of the level of economic activity.

In addition, changes in the level of deposits and of loans have an influence on the need for banks to procure funds and the demand for other asset types. For example, if there is robust demand for capital in the non-financial sector, this becomes a factor contributing toward higher interest rates and higher prices.

(4) Supply and Demand of Funds

Interest rates in financial markets fluctuate reflecting movements in the supply and demand of funds.
It is necessary to understand the “deposit reserve system” of banks when looking into the supply and demand of funds.

Private financial institutions are obligated by law to deposit a certain percentage of deposits, etc., to the BOJ as current deposits without interest. This deposit is called a reserve deposit, and the ratio imposed on deposits, etc., is called a deposit reserve rate (or payment reserve rate). Financial institutions reserve an amount obtained by multiplying the deposit reserve rate by the average balance of deposits per month (required reserve amount), and deposit the amount with the BOJ during the one month, from the 16th of the month, to the 15th of the next month. Building of reserves is done in current accounts of financial institutions at the BOJ; these accounts include funds for settlement of transactions and cash reserves in addition to deposit reserves. Financial institutions other than banks have current accounts at the BOJ, for use in settling government bond trades and other purposes.

Reserve deposits to the BOJ by private financial institutions are not made in equal amounts every day; the amounts increase or decrease daily depending on the following factors.

The first factor is the inflow and outflow of cash (the majority of which is BOJ notes). Financial institutions hold only a minimum amount of cash on hand, and the cash brought in is deposited with the BOJ immediately after the business day is concluded. For this reason, if the cash flows into financial institutions from companies and households, the reserve deposit increases. (From the viewpoint of the BOJ, the BOJ notes are being returned.) On the other hand, if companies and households withdraw cash from financial institutions, they are withdrawing cash from the BOJ and accordingly, the reserve deposit decreases. (From the viewpoint of the BOJ, it is an addition to the BOJ notes.)

The second factor is the outflow and inflow of fiscal funds. The payment of fiscal funds by the government to the private sector causes a decrease in government deposits with the BOJ and an increase in current deposits by private financial institutions with the BOJ, thus increasing the reserve deposit. On the other hand, the receipt of funds by the government from the private sector such as the income from tax collections results in increases in government deposits with the BOJ and decreases in deposits by private financial institutions with the BOJ, thus causing a decrease in reserve deposits.

Therefore, the return of BOJ notes and payment of fiscal funds in excess of receipts (also known as “excessive payment”) will cause an increase in reserve deposits (in other words, a surplus in funds) while the additional issue of BOJ notes and a net receipt of fiscal funds will cause a decrease in reserve deposits (in other words, a shortage of funds). When the funds are short, the demand for funds in the interbank market increases and the rate in the interbank market increases. In contrast, when funds are in surplus, the amount of funds managed on the interbank market increases and the interest rates in the market decline. Since interest arbitration (the concept of raising funds on the market where the interest rates are lower and managing funds on the market where the interest rates are higher) takes place between the interbank market and the open market, in the end, rate fluctuations in the interbank market are reflected in the rates on the open market.

It is one of the important functions of the BOJ to respond to the surplus or shortage of funds
and to adjust the supply and demand in financial markets. For this purpose, when funds are short, the BOJ supplies funds by purchasing securities from private financial institutions, and when there is a surplus the BOJ absorbs funds by selling the securities that it owns.

The BOJ responds to surpluses and shortages of funds by conducting open market operations to adjust for fluctuations in the supply and demand for funds in the market (financial adjustment). Financial adjustment is carried out in accordance with the fundamental guidelines for financial management as determined at the financial policy meeting, i.e., the guideline for market operations.

To better explain how this functions, a specific look shall be taken at the “Sources of Changes in Current Account Balances at the Bank of Japan and Market Operations” of July 2018. BOJ notes were issued in excess of JPY74.1 billion, while fiscal funds resulted in net receipt of JPY12.3993 trillion, so that the “surplus or shortage of funds” in that month amounted to a shortage of JPY12.4734 trillion. The BOJ also conducted market operations including purchasing of JGBs, providing funds of JPY12.4544 trillion. As a result the BOJ current account decreased by JPY19.0 billion, which brought the balance of this account to JPY393.6015 trillion by the end of the month. The BOJ performed this market operation in line with the guideline for market operations involving the yearly purchase of long-term JGBs for about JPY80 trillion in order to maintain the interest rate for 10-year JGBs at around zero percent. Consequently, the outstanding amount of the monetary base at the end of July 2018 reached JPY502.9788 trillion.

### Chart 2-31  Sources of Changes in Current Account Balances at the BOJ and Market Operations (July 2018)

<table>
<thead>
<tr>
<th></th>
<th>Current Year</th>
<th>Previous Year</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>BOJ Note Sources</strong></td>
<td>-741</td>
<td>-3,311</td>
</tr>
<tr>
<td><strong>Fiscal Sources</strong></td>
<td>-123,993</td>
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<td>General Fiscal</td>
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<tr>
<td>Government Bonds</td>
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<td>Government Short-Term Securities</td>
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<td>Foreign Exchange</td>
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<tr>
<td>Other</td>
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<td>14,746</td>
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<tr>
<td><strong>Surplus or Shortage of Funds</strong></td>
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</tr>
<tr>
<td><strong>Market Operations</strong></td>
<td>124,544</td>
<td>129,066</td>
</tr>
<tr>
<td>Outright Purchase of JGB</td>
<td>100,237</td>
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</tr>
<tr>
<td>Outright Purchase of Short-Term Government Notes</td>
<td>30,031</td>
<td>45,033</td>
</tr>
<tr>
<td>Purchase of Government Bonds under Repurchase Agreement</td>
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<td>0</td>
</tr>
<tr>
<td>Funds-supplying Operations Against Pooled Collateral (Head Office)</td>
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<td>0</td>
</tr>
<tr>
<td>Funds-supplying Operations Against Pooled Collateral (All Offices)</td>
<td>25</td>
<td>-309</td>
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<tr>
<td>Purchase of CP under Repurchase Agreements</td>
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<td>0</td>
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<tr>
<td>Other</td>
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<tr>
<td><strong>Current Deposits</strong></td>
<td>-190</td>
<td>-272</td>
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<tr>
<td><strong>Reference: Current Account Balance</strong></td>
<td>3,936,015</td>
<td>3,629,179</td>
</tr>
</tbody>
</table>

(Source) BOJ
Interest Rate

(1) Interest Rates in the Financial Market

The interest rates in the financial market are determined by the supply and demand of funds in the market. However, the interest rate is not necessarily determined independently in each market. Since interest rate arbitration takes place between markets, the interest rate of each market is linked with that of each other, and if the interest rate of a certain market is extremely high (low), the supply (demand) of funds in that market increases, and as a result the interest rates generally converge at a certain level.

Accordingly, the interest rates in individual markets are determined on the basis of the representative interest rate index. One such index for the short-term interest rate (with maturity of less than one year) is the Tokyo InterBank Offered Rate (TIBOR) set by the Japanese Bankers Association (JBA), which reflects the actual rates on the unsecured call market. By contrast, the 10-year JGB yield that is regarded as a risk-free rate is widely used for the long-term interest rate (with a maturity of one year or more).

(2) Deposit Interest Rate

A deregulated interest rate means that interest rates are freely determined without restriction. The representative deregulated interest rate deposits include large time deposits, foreign currency deposits and negotiable certificates of deposit (CDs), but as the deregulation of interest rates progresses, the minimum deposit unit for deregulated interest rate time deposits has been gradually reduced, and the interest rate for all time deposits other than fixed date-time deposits was deregulated in June 1993. In addition, in association with the deregulation of the interest rate on floating deposits, the interest rate on deposits has essentially been deregulated since October 17, 1994.

In principle, the interest rate for deregulated interest rate deposits is determined by individual negotiations between a financial institution and a depositor, taking into consideration interest rates, etc., on the short-term financial market.

(3) Interest Rate on Loans

The interest rates on loans from private financial institutions are divided into rates for short-term loans with less than one year to maturity and rates for long-term loans with more than one year to maturity.

The standard interest rate for short-term loans is the short-term prime rate which is the most preferential rate applied to loans to companies with the best credit. In the past, the short-term prime rate was supposed to fluctuate with the official discount rate. However, since January 1989, the method chosen by each financial institution, considering the funds procurement costs of the bank, fund supply and demand, market rate trends, etc. (new short-term prime rate) has been adopted. As a result, the new-short prime rate reflects the fluctuation of the market interest rate more precisely, and revisions of the interest rate are carried out more frequently.
The representative long-term interest rate for loans is the long-term prime rate. Formerly, the long-term prime rate functioned as the preferential interest rate for long-term loans, but recently it has played a smaller role as the standard interest rate because of, e.g., combinations of short-term and long-term loans. The long-term prime rate used to be determined as being the nominal interest rate of five-year bank debentures of long-term credit banks with the coupon plus 0.9%, and the expected dividend rate of five-year loan trusts of trust banks plus 0.88%, but at the present time is determined by adding a certain margin of profit with reference to the bank procurement cost on the market, such as the issuing rate of interest on five-year ordinary straight bonds issued by a bank. While city banks and regional banks extended long-term loans based on the long-term prime rate in the past, in April 1991 they introduced the long-term floating standard interest rate, linked to the short-term prime rate (new long-term prime rate, floating long-term prime rate), and this has led to the switch to the use of the new long-term prime rate for long-term loans.

The new long-term prime rate varies among borrowers and banks but is typically set by adding a certain interest rate to the new short-term prime rate that is used as a base.

The market is now moving in the direction of banks independently assessing the credit risk of borrowers and adding on an interest rate commensurate with the borrowers’ risk, to the interest rate at which the banks procure funds.

(4) **The Basic Discount Rate and Basic Loan Rate (Previously Indicated as “Official Discount Rate”)**

The Basic Discount Rate and Basic Loan Rate are the standard interest rates applied to loans to private financial institutions by the BOJ and are generally represented by the discount rate of commercial bills. They are the rates in the supplementary credit system (so-called Lombard-type lending) introduced in February 2001, and are the maximum rates paid for short-term loans to financial institutions.
Change in the basic discount rate and basic loan rate exerts an influence on the cost of capital to private financial institutions, but it is thought that the psychological impact of such change is greater than that.

They had been called the Official Discount Rates, but as they had lost their functionality as policy rates, the nomenclature used for statistics was changed effective August 2006.

### Monetary Policy

#### (1) Objective of Monetary Policy

The two objectives that the BOJ tries to achieve through various monetary policies are "contributing to the sound development of the national economy through the pursuit of price stability," and "achieving smooth and stable operations of the settlement system and thereby contributing to the stability of the financial system."

The BOJ uses various policy tools to conduct money market operations in order to accomplish these objectives. "Stability of prices," that is, stability of the value of the currency, is given particularly high importance as it has direct impact on the lives and livelihood of the country’s people. That is why the BOJ is called “the watchdog of the currency.” The second objective, the “stability of the financial system,” is of similar great importance because if there were to be an interruption in taking deposits or making the payouts for withdrawals by banks, it would practically cause economic activities to come to a halt. The BOJ pays close attention to the exchanges of funds between banks and to the management of the banks, and in the event that a financial institution is unable to meet its obligations, the BOJ makes emergency loans as a “lender of last resort.”

The BOJ is not necessarily capable of accomplishing both of these objectives at the same time. Therefore, it is necessary to give priority to either objective. The BOJ therefore manages its policies by giving priority to stable prices on the basis of the awareness that price stability is related to the long-term growth of the economy, while at the same time dealing with the maintenance of the financial system.

#### (2) Means of Implementing Monetary Policy

As a means for monetary policy, the BOJ implements two tools: (i) open market operations and (ii) reserve ratio control. Both of these tools are used for transactions between the BOJ and private financial institutions, and the primary tool used is open market operations.

In its open market operations (hereinafter referred to as the “operations”), the BOJ buys and sells bonds and bills or makes loans by bidding the loan rate in the market, causes the level of reserves it holds in current accounts for private financial institutions to rise or fall, and through those measures influences the level of short-term interest rates. When the BOJ buys bonds or other instruments and supplies credit, it is engaged in “buying operations,” and when it sells instruments and withdraws funds from the market, conversely, it is a matter of “selling operations.”

When the BOJ revised the level of short-term interest rates, it ordinarily causes interest rate
arbitrage so that effects of the operations spread and influence the cost of funds to private financial institutions that adjust their activities accordingly. If, for example, interest rates fall during a phase of economic downturn, the cost of funds to financial institutions declines and the rate they charge for loans also declines. As a result, the investments by businesses and demand in the household sector are stimulated due to the lower cost of funds and expectations of economic recovery arise. On the other hand, when prices are rising and market interest rates in general also rise, the interest rate at which businesses borrow from financial institutions or procure funds in the capital market rises, which in turn restrains the construction of plants and purchase of equipment. When interest rates rise, individuals experience increases in the cost of a mortgage or a consumer loan, and their investment or spending on a home and goods becomes restrained. This would promote a general slowing of the national economy and invite a decline in prices.

The reserve ratio control is a policy that affects the financial market by adjusting the statutory reserves of financial institutions. This is done by changing the reserve ratio. If the BOJ raises the reserve ratio, market rates will rise due to the tightening in funds caused by the obligation imposed on private institutions to increase their deposits at the BOJ. On the other hand, if the BOJ lowers the ratio, interest rates will go down due to the easing of funds caused by the freeing up of funds held by financial institutions. However, in reality, it is the announcement effect which reflects the attitude of the BOJ, rather than the direct effect on the required reserve amount, that has a more substantial influence.

These are the monetary policy tools of the BOJ, but the reserve ratio has not been changed since October of 1991. Therefore, daily monetary adjustments are conducted by operations carried out in accordance with the guideline for market operations that is determined by the Policy Board of the BOJ in its monetary policy meetings. By buying or selling bonds and bills in transactions with private financial institutions, the level of funds in the market is controlled, and more concretely, the level of funds the private financial institutions have in their current account at the BOJ is caused to rise or fall.

Effects of monetary policies implemented by the BOJ and the achievement of price stability or other final objectives cannot be seen for a long time. Therefore, it is difficult to determine its effect in the short term. For this reason, the BOJ checks on the status of the effects of its monetary policies by checking the money stock, increases in loans and interest rates on loans, etc., which are integrally related to the final objective, these being medium-term objectives of monetary policy.

However, although the medium-term objective is closely connected with the final objective, it is difficult for the BOJ to control. Therefore, the BOJ establishes objectives which are easier to manipulate. Interbank market interest is a representative of such objective, and the key vehicle used was the unsecured overnight call rate.

In the past, when changes in the Official Discount Rate influenced market interest rates, adjusting the Official Discount Rate played an important role in influencing economic activities. When, however, the era of regulated interest rates ended and rates came to be determined by the market, the Official Discount Rate declined in significance as a policy rate. When, from 1995 onward, the unsecured overnight call rate was brought below the Official Discount Rates, it was
the unsecured overnight call rate that became the policy rate.

From that time on, the Official Discount Rate was still recognized as an indicator of the BOJ’s basic stance on monetary policy, and its change had an announcement effect, but since its nomenclature was changed in 2006 (to become the Basic Discount Rate and Basic Loan Rate) that effect has also been experiencing a steady decline in its importance.

(3) Recent Monetary Policy

The Japanese economy experienced deterioration from the end of 2000. As a result of this, in March 2001, the operation target for adjustment of the money market that had been defined in terms of the unsecured overnight call rate was changed to the balance in current accounts at the BOJ (account deposit targeting). Because a shift from the interest rate to the amount or stock of funds was adopted, the targeting operation is called a quantitative easing. Consequently, change in short-term financial market rates including the unsecured overnight call rate came to be determined by the market, with the upper limit being the interest rate for funds supplied by the BOJ, including funds supplied through the supplementary system (at the official discount rate), and stayed close to zero.

The BOJ ended its quantitative easing policy in March 2006, and returned to using interest rates (the unsecured overnight call rate) for targeting operations. This was because the trend of consumer prices (excluding fresh foods) came to be above the levels of the previous year. Further, in July that year the target for interest rate operations was raised, marking the end of the zero-interest-rate regime.

Nevertheless, the outbreak of the subprime problem from the summer of 2007 touched off confusion in the financial markets, and mushroomed into a global financial crisis with the bankruptcy of Lehman Brothers in September 2008. In order to address this disruption in the financial markets, the BOJ cut the policy rate twice, on October 31 and December 19 of 2008, in the form of cooperation with central banks in other countries (the BOJ reductions were respectively from 0.5% to 0.3%, and then from 0.3% to 0.1%). Moreover, the BOJ has worked to stabilize the financial markets and to support lending to businesses by taking initiative in providing liquidity to the market through means such as increasing its operations of purchases of Japanese government securities (JGSs) under repurchase agreements, increasing purchases of long term JGBs, and purchasing commercial paper.

Subsequently, the BOJ has taken measures for overcoming the deflationary economy or returning to a sustainable growth path through fixed interest operations promoting a longer reduction of interest rates or the new introduction of a loan system for enhancing the growth base. Moreover, on October 5, 2010, it introduced the “Comprehensive Monetary Easing Policy.” In addition to cutting the policy rate from 0.1% to 0~0.1%, the BOJ set up a fund for fund purchases, etc. and decided to purchase a variety of financial assets including ETF and J-REIT which have slightly higher risks than national government bonds.

On January 22, 2013, the BOJ decided to introduce the “Price Stability Target” and implement powerful monetary easing so as to achieve a 2% increase in the year-on-year rate of change in the consumer price index at the earliest possible time. The BOJ’s previous goal of price
stability was shown in the form of “Price Stability Goal in the Medium to Long Term.” This time, since the policy goal became clearer, the degree of transparency of financial policy can be considered to have increased.

On April 4, 2013, the BOJ introduced a new monetary policy framework of “Quantitative and Qualitative Monetary Easing.” Specifically, it decided to change the main operating target for money market operations from unsecured overnight call rate to monetary base, and conduct money market operations so that monetary base will increase at an annual pace of about JPY60 to 70 trillion. Subsequently, on October 31, 2014, it decided to implement additional monetary easing and conduct monetary policy operations so that the monetary base will increase at an annual pace of about JPY80 trillion.

On January 29, 2016, the BOJ decided to introduce “Quantitative and Qualitative Monetary Easing (QQE) with a Negative Interest Rate” in order to achieve the price stability target of 2% at the earliest possible time, and pursue monetary easing in terms of three dimensions; quantity, quality, and interest rate. As a result of the application of a negative interest rate of minus 0.1% to part of the current accounts held by financial institutions at the BOJ, the unsecured overnight call rate and the 10-year JGB yield turned to negative.

On September 21, 2016, the BOJ decided to introduce the “Quantitative and Qualitative Monetary Easing with Yield Curve Control” as a new framework for strengthening monetary easing which consists of the yield curve control and inflation-overshooting commitment. Under the yield curve control policy, the BOJ will determine and publish the yield curve level at each Monetary Policy Meeting, using the short-term policy interest rate and the 10-year JGB yield as the control targets. Under the inflation-overshooting commitment policy, the BOJ commits itself to expanding the monetary base until the year-on-year rate of increase in the observed consumer...
price index (CPI) exceeds the price stability target of 2 percent and stays above the target in a stable manner. The BOJ has thus shown its readiness to promote monetary easing toward achieving the price stability target.

On July 31, 2018, the BOJ introduced a guidance note (“forward guidance”) for the policy interest rates whereby monetary policies that are to be implemented will be disclosed well in advance of its implementation and announced that it “intends to maintain the current extremely low levels of short- and long-term interest rates for an extended period of time, taking into account uncertainties regarding economic activity and prices including the effects of the consumption tax hike.” In addition, it made policies more flexible by announcing that it would “conduct more flexible purchase” in regard to the purchase amount of long-term national bonds while admitting that long-term interest rates might “fluctuate to a certain degree.”

2 6 Changes in Financial Markets

(1) Financial Deregulation and the History of Internationalization in Japan

Financial deregulation and internationalization developed rapidly in the 1980s, with a progressive accumulation of individual financial assets and development of a mutually dependent relationship with overseas counterparts.

First, deregulation of interest rates evolved and many deregulated interest-rate products were introduced. Originally, the deregulated interest-rate products were limited to large funds, but the size was gradually reduced to smaller items and the percentage of deregulated interest-rate products as a means of funds procurement for financial institutions increased. This has resulted in an effort on the part of financial institutions to link their interest rates on loans to the fluctuations in their funding cost.

Second, restrictions on areas in which financial institutions could do business were eased and the businesses handled by financial institutions progressively diversified. The financial system in Japan is based on divisions in the work system and the area of business of financial institutions is separated by the type of business. However, city banks, whose major business in the past was short-term loans to big companies, are increasing loans intended for smaller enterprises and long-term loans, whereas the percentage of long-term loans out of total loans of long-term credit banks is decreasing, and thus the division of roles among banks by type of business is dissolving. Also, the difference between banks and securities companies has become smaller due to the commencement of sales of public bonds and investment trusts at bank teller windows, dealing by banks, and the entry of both banks and securities companies into the CP business. The trend in recent years has been for a further easing of the restrictions of business areas of financial institutions.

Third, deregulation of capital transactions both domestically and overseas has been promoted with the amendment of the Foreign Exchange Act in 1980 and the publication of the Japan-U.S. Yen-Dollar Committee Report in 1984. As a result, Japanese companies actively began procuring
funds from overseas and investing in foreign securities to manage funds. In addition, in December 1986, the Tokyo Offshore Market(Note) was established and international financial transactions in Tokyo became active.

Fourth, in 1985, as the securities markets and financial markets in Japan began to expand and internationalize, bond futures transactions began, and after that, so-called derivative product markets such as stock index futures/options transactions and bond futures options transactions expanded. In April 1989, the Tokyo International Financial Futures Exchange was established and Euro-Yen interest futures transactions, yen and dollar currency transactions and other types of futures transactions began.

During this period, unification of the world financial markets was promoted and the influence of financial markets in Japan on overseas markets, and the influence of overseas markets on the Japanese financial markets have become greater than in the past.

(2) Development of the Euro Market

The Euro Market refers to the market on which currency is traded outside of the home country and its center is in London.

The Euro Market consists of the Euro Currency Market for short-term funds between banks, the Euro Credit Market for medium and long-term loans and the Euro Bond Market for the issuing and trading of bonds. The Euro Market is a core international financial market because it is not limited by restrictions on the domestic financial markets of each country and the procedures for transactions are simple.

The Euro Market is actively utilized as a place to procure funds by governments, governmental institutions, international institutions and private companies. Syndicated loans and Euro bonds play an important role as the means by which such funds are procured. Syndicated loans are conducted by a number of banks organizing a syndicate for a large amount of medium and long-term loans. This used to be the typical means of raising funds on the Euro Market. However, when accumulated debt became a serious issue in 1982, syndicated loans slowed down and the Euro Bond Market expanded. In addition, instead of borrowing short and medium-term funds from banks, issuance of short and medium-term paper, such as notes and CP issued under the framework of NIF (Note Issuance Facilities), MTN (Medium-Term Notes), Euro-CP, etc., as the need arises and within a certain limit is now widely used.

(3) Introduction of the BIS Regulation

Globalization of financial markets is also influencing financial regulations. One such example
is the regulations on the part of the Bank for International Settlements ("BIS").

BIS was established using capital invested by the central banks of major countries around the world, and it conducts settlements between central banks and deliberates and investigates problems related to international finance. In July 1988, BIS implemented a rule regarding the international standardization of equity capital ratio requirements for banks called the Basel Agreement, and the banks of major countries that engage in international business agreed that they had to reach an 8% capitalization ratio by the end of FY1992 ("Basel I"). Underlying the Basel Agreement was the understanding that efforts needed to be made by the regulatory authorities of each country in order to integrate financial regulations on an international basis and to maintain financial discipline across borders, in order to address the increasing risks surrounding the management of banks in association with the progress of globalization, and to maintain equal international competitive conditions among the banks of each country. In compliance with the Basel Agreement, in December of the same year in Japan, the BIS regulation was implemented by order of the director of the Banking Bureau of the Ministry of Finance.

Nevertheless, some discrepancies between the BIS system and the practical reality of bank operations, etc. appeared afterward. To address changes in the banking business and greater sophistication of risk management techniques, the Basel Committee on Banking Supervision started work on a revision of the system in 1998. In June 2004, they announced their final proposal, which has three key areas for reform, consisting of greater thoroughness in risk measurement, policies for strategic deployment of equity capital by the banks themselves, and greater disclosure ("Basel II"). Here, the authorities of the various countries have established a system of domestic controls that was implemented in stages between the end of 2006 and the end of 2007.

Furthermore, in response to the global financial turmoil caused by the Lehman shock, in September 2010, an agreement to introduce a strict definition of “capital,” liquidity regulations and the leverage ratio was reached ("Basel III"). Basel III is expected to be implemented step by step by 2019. Japanese banks adopting international standards started to apply Basel III in the fiscal term ending March 2013.

(4) The Japanese Big Bang

In Japan, in order to prepare for a society that is rapidly aging with fewer children and to maintain the economic growth of the future, it is necessary to supply funds smoothly to the growing industries that will support the next generation. There is a heightened understanding now that the financial markets of Japan should be regenerated and it should become an international financial market on equal footing with London and New York so that the financial market will be able to play the role it is supposed to play in allocating the economic resources of the country appropriately.

Based on this philosophy, on November 11, 1996, it was determined that the utmost efforts should be made to thoroughly reform the financial system. The reform was named as the “Japanese Big Bang” after the securities market reform in United Kingdom in the 1980s. The amended Foreign Exchange Act substantively started the reform with its enforcement in April
1998, and among other things, liberalized the foreign exchange business and the money changing business, and enabled the opening of accounts by Japanese nationals at foreign banks. Moreover, competition among financial institutions was increased by the liberalization of stock trading brokerage commissions and the authorization of banks to sell investment trusts and insurance products over the counter to retail customers; both of which lowered the barriers of entry into banking, securities and insurance business.

Users have acquired greater access to financial instruments through such means as the Internet, and now have a wider range of choice of instruments from various institutions. At the same time, however, as they have acquired greater convenience, wider choices and more chances, they now must also bear by themselves the risk accompanying their choices.

(5) Lifting of Restriction Against Pay-Offs

The pay-off system (deposit insurance) is a system of deposit insurance underwritten by the government-funded Deposit Insurance Corporation whereby depositors are able to receive funds held on deposit by a financial institution that has become insolvent up to a total limit per person of JPY10 million in principal plus the interest earned on that principal. The system is funded by premiums paid by financial institutions according to the amount of funds held on deposit. The system began in 1971, and the amount of deposits covered under the system was raised steadily.

A number of insolvencies among financial institutions beginning in 1994 caused a rise in concern among depositors. In June 1995, the Minister of Finance announced that the full amount of deposits was to be protected by a freeze on pay-offs. Moreover, in June 1996 the Deposit Insurance Act was amended as a special measure to maintain the freeze on pay-offs until the end of March 2001.

The freeze on pay-offs was justified on the grounds that because of the delays in the disclosure of information on financial institutions, including information concerning their financial condition, depositors were not in a position to judge which financial institutions were safe. However, even the freezing of pay-offs was not enough to provide for a solid financial system sufficient to eliminate financial unease, and at the end of 1999, the lifting of the freeze on pay-offs was postponed for a year (this is when the protection afforded to the full amounts of the special deposits (i.e., settlement deposits consisting of ordinary deposits, quick deposits and others) was also extended by a year and expanded to include amounts of interest in the relevant coverage).

Subsequently, progress was made in establishing the guidelines for handling insolvent financial institutions. In April 2002, time deposits excluding certain special deposits (checkable deposits such as ordinary deposits and current accounts) were no longer to be protected for the full amount, and the freeze on pay-offs was partially lifted. In April 2005, the freeze on pay-offs was lifted for deposits other than those used for settlement such as current account deposits and the like (i.e., deposits satisfying the three requirements of being non-interest bearing, subject to mandatory payments and able to provide settlement services). Settlement deposits, however, are still protected in full even after April 2005, from the perspective of having measures in place to assure stable and reliable settlement.

Pay-offs were not actually exercised in Japan for a long period of time, but in September
2010 the Incubator Bank of Japan, Limited became bankrupt, invoking the pay-off system against that Bank for the first time.

(6) **Securitization of Assets**

“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 assets thus parcelled out in this manner into a financial instrument used to repay investors.

The following is the basic structure:

First, a special paper company is established which is called a Special Purpose Company (SPC). Next, the banks and similar parties (the “originator”) holding assets in the form of loans and other receivables transfer these assets to the SPC. The SPC then generates funds through the issuance to investors of securities based on these assets, and these funds are used as the consideration for the assets transferred from the originator. Then, the securities pay dividends to the investors from the cash flow derived from the assets held by the SPC that are in the form of loans and other receivables. Special companies such as SPCs sometimes exist as trusts rather than in company form and given the legal separation that is in place, they serve the purpose of providing insulation against insolvency at the originator.

Any asset can be transferred so long as a cash flow can be nearly assured to be generated and housing loans, lease receivables, credit card loans, auto loans and the like are often securitized. There is even one instance of securitization created on the right to sell the CDs of an entertainer.

A feature of securitized instruments is that they are underpinned by the creditworthiness of the assets generating the cash flow rather than the creditworthiness of the company issuing the security. When raising money through the issuance of corporate bonds, etc., the price is determined by the creditworthiness of the company issuing the bonds. It is on this point where a distinction exists between such securitized instruments and traditional financial instruments. Given that the underlying asset generates a cash flow, securities products in the broad meaning of the term are referred to as asset-backed securities (“ABS”).

![Basic Structure of Securitized Instrument (Concept)](chart-2-34.png)

(Note) In the case of a transfer method.
3 Fiscal Policy

The economic activity of the government is called fiscal policy, and fiscal policy is closely related to people’s lives. The difference between fiscal policy and the private economy is that each is based on a different principle.

The private economy is operated by a voluntary exchange economy. Producers and consumers act to maximize profit or their personal utility (satisfaction) and, as a result, markets are formed which create an efficient market economy. However, fiscal policy consists of public services supplied unilaterally by public institutions, with taxes unilaterally collected by the government to cover those expenses. A major characteristic of fiscal policy is that transactions are by unilateral fiat and are not based on a voluntary exchange. Consequently, fiscal policy is a public economic activity undertaken by the government, which aims to realize maximum benefit for the society as a whole.

In recent years, the amount of public expenditures have grown, which has brought about a concurrent increase in Japan’s fiscal deficit. In addition, Japan is already a full-scale super-aging society, which is expected to rapidly progress going forward. Under such circumstances, there are many issues in connection with the economic activities of the government, including the review of the social security system.

In FY1990, Japan was able to break away from its chronic dependence on deficit bonds, which had presented concerns about Japanese fiscal policy for many years. However, in recent years, the road to financial restructuring has become increasingly severe as a result of factors such as the revenue shortfalls that have occurred in recent years. The scale of the over the counter trading in government bonds of JPY9,836 trillion in FY2017 occupies a very significant share in the securities market.

In this way, the economic activities of the government, the national economy, and financial and securities markets are closely connected, and therefore it is very important to learn the structure of fiscal policy.

3 1 The Public Sector of Japan

Since the economic activities of government are all prescribed by laws, it is important to understand the institutional and legal underpinnings in order to understand fiscal policy.

(1) Structure of the Budget

(i) Compilation of the Budget

Preparation and submission to the Diet of the budget is the work of the Cabinet (Cabinet’s prerogative for budget submission), and the actual compilation of a budget proposal is done by the Minister of Finance.
After the Democratic Party of Japan became the leading ruling party in 2009, the method of compiling the budget on and after FY2010 was changed from the previous method. For the budget for FY2010, the conventional system was changed to a politician-led budget compilation system under which the requests for the draft budget will be made in accordance with the manifesto prepared by the ruling party. From the budget for FY2011, the Cabinet decided to adopt a reorganized version of the budgetary request guidelines, and indicated guidelines for budget allocation beyond the framework of ministries and agencies for the purpose of allocating the budget predominantly to areas that contribute to economic recovery and development. However, following the Liberal Democratic Party’s return to the central position of power at the end of 2012, the budget for the fiscal year of 2014 and subsequent budgets have once again been compiled according to the budgetary request guidelines, under which each ministry and agency prepare their estimates for the budget (budget requests) for the following fiscal year to be submitted to the Finance Minister within the ceiling of the budgetary requests prescribed by each ministry and agency (budgetary request guidelines).

The requests for the draft budget submitted by each ministry and agency in accordance with the budgetary request guidelines are subject to the traditional assessment by the Ministry of Finance as well as the close examination by the Administrative Reform Promotion Council. Through the “screening,” the Administrative Reform Promotion Council reviews the contents of operations and proposes to review or abolish operations which are considered to be low-priority. Then, the “Economic Outlook and Basic Stance for Economic and Fiscal Management” is approved by the Cabinet, and the initial budget proposal (estimate) is determined by the Cabinet. The Government prepares the budget proposal to be submitted to the Diet based on this initial proposal.

The final budget proposal prepared by the Government is submitted to the Diet around the end of January every year. The Prime Minister submits the draft budget on behalf of the Cabinet to the Diet. Deliberation of the budget starts with the House of Representatives (according to “the right of first deliberation of the House of Representatives”).

In the Budget Committee, the national policy as a whole is discussed because the budget is related to all of the country’s activities. After the budget draft is approved by the House of Representatives through deliberation in the committee, it is sent to the House of Councilors, and the budget is adopted if it is also approved by the House of Councilors. If the House of Councilors does not vote within 30 days after the receipt of the draft budget from the House of Representatives, the budget is automatically adopted.

If the House of Councilors rejects the draft budget approved by the House of Representatives, deliberative committees are organized by both houses, and if an agreement is not reached in them, the resolution of the House of Representatives becomes the resolution of the Diet and the budget is adopted.
(ii) **General Account Budget**

The national budget consists of the General Account Budget and the Special Account Budget. The most basic budget is the General Account Budget and reference to the term “budget” generally means General Account Budget.

The General Account is the budget that covers basic expenses for conducting important financial activities such as public works, social security and education. The basic budget incorporated in a certain fiscal year is called the Regular Budget (initial budget). However, even if the budget is not approved before the new fiscal year starts on April 1, the government cannot stop administrative activities. For this reason, the government needs to compile the budget for necessary expenses only until the budget is approved, which is the Provisional Budget. When the Regular Budget is approved, the Provisional Budget loses its efficacy, even if the period for the Provisional Budget or the balance for expenditures still remains. The expenditures or debt based on the Provisional Budget are considered to be included in the Regular Budget.

Even if the budget is approved, there are cases where the contents need to be modified, for example, when a natural disaster occurs during the fiscal year and expenses for recovery are incurred or when there is a shortage in the amount available to meet necessary expenses. In such cases, new expenses are added to the budget or the contents are modified and this is called the Revised Budget. The Revised Budget is prepared, deliberated and resolved at the Diet separately from the Regular Budget. However, after it is approved, it is executed as if it were a part of the Regular Budget.
### Chart 2-36  Summary of General Account Budget

(Unit: JPY100 million)

<table>
<thead>
<tr>
<th>(Revenues)</th>
<th>FY2017 Budget (Initial)</th>
<th>FY2018 Budget</th>
<th>2017–2018</th>
<th>Remarks</th>
</tr>
</thead>
<tbody>
<tr>
<td>Tax revenue</td>
<td>577,120</td>
<td>590,790</td>
<td>13,670</td>
<td></td>
</tr>
<tr>
<td>Other revenue</td>
<td>53,729</td>
<td>49,416</td>
<td>-4,313</td>
<td></td>
</tr>
<tr>
<td>Government bonds</td>
<td>343,698</td>
<td>336,922</td>
<td>-6,776</td>
<td>○ Dependence on government bonds: approx. 34.5% (FY2017: initially 35.3%)</td>
</tr>
<tr>
<td>issued</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Government bonds</td>
<td>60,970</td>
<td>60,940</td>
<td>-30</td>
<td></td>
</tr>
<tr>
<td>under Article 4</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>(Construction bonds)</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Special government</td>
<td>282,728</td>
<td>275,982</td>
<td>-6,746</td>
<td></td>
</tr>
<tr>
<td>bonds (Deficit bonds)</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total</td>
<td>974,547</td>
<td>977,128</td>
<td>2,581</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>(Expenditures)</th>
<th>FY2017 Budget (Initial)</th>
<th>FY2018 Budget</th>
<th>2017–2018</th>
<th>Remarks</th>
</tr>
</thead>
<tbody>
<tr>
<td>National debt service</td>
<td>235,285</td>
<td>233,020</td>
<td>-2,265</td>
<td></td>
</tr>
<tr>
<td>Primary balance expenses</td>
<td>739,262</td>
<td>744,108</td>
<td>4,846</td>
<td></td>
</tr>
<tr>
<td>Social security related expenditures</td>
<td>324,735</td>
<td>329,732</td>
<td>4,997</td>
<td></td>
</tr>
<tr>
<td>Local allocation tax grants, etc.</td>
<td>155,671</td>
<td>155,150</td>
<td>-521</td>
<td>○ The total amount of the general revenues of local governments, including the local tax and local allocation tax, has been kept at substantially the same level as FY2017.</td>
</tr>
<tr>
<td>Total</td>
<td>974,547</td>
<td>977,128</td>
<td>2,581</td>
<td></td>
</tr>
</tbody>
</table>

(Note) Each figure has been rounded off, and thus differences may occur between the fractions of each figure and those of the total figures.

(Source) Ministry of Finance

(iii) Special Account Budget

The country is originally managed by one account, and it is best if all revenues and expenditures are accounted for uniformly (overall budget system). However, in Japan, under Article 13 of the Public Finance Act, a special account is established when (a) the country undertakes a specific project, (b) specific funds are held and managed by the country, and/or (c) it is necessary to separate the accounting for general revenue and the general expenditures and to appropriate a specific revenue to a specific expenditure.

The number and the contents of special accounts vary from year to year. The number of special accounts for FY2018 is 13, including the special account for grants of allocation tax and transferred tax, the special account for earthquake reinsurance, and the special account for the national debt consolidation fund.

(iv) Budget of Government Sponsored Entities

Government sponsored entities are, in form, special corporations that have a different
legal personality from the government, which are established and 100% maintained by capital investments from the government. The budget for government sponsored entities must also be submitted to the Diet for deliberation and approval. These institutions consist of four organizations, the Okinawa Development Finance Corporation, the Japan Finance Corporation, Japan Bank for International Cooperation (JBIC) and the ODA loans division of the Japan International Cooperation Agency (JICA). These institutions serve the purpose of supplementing private financial activities with their funds which are acquired from expenditures out of the General Account and loans from the Fiscal Loan Fund.

(2) **Scope and Magnitude of Fiscal Policy**

It is beneficial to understand the concept of the general government in order to see the position of the public sector with respect to the national economy as a whole. The general government refers to the combination of the central government (the country), local governments (prefectures, municipalities, etc.) and the social security fund (public pensions, etc.) in which the overlapping portions are adjusted. The general government plus public corporations (government corporations, government related financial institutions, etc.) constitute the public sector.

For the purposes of considering the ratio of the public sector to the national economy, fiscal expenditures in calculating the national economy can be divided into two broad categories, government expenditures and other transfer expenditures in the broad sense of the term. The

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**Chart 2-37 Classification of Transacting Entities in the SNA**

1. **Non-financial corporations**
   - 1. Private corporations
   - 2. Public corporations *(Kosha, Kodan, etc.)*

2. **Financial institutions**
   - 1. Private financial institutions *(BOJ, Government Finance Corporations, etc.)*
   - 2. Public financial institutions

3. **General government**
   - 1. Central government
   - 2. Local governments
   - 3. Social Security Fund
     - Kosei Nenkin
     - Kokumin Nenkin
     - National Health Insurance, etc.

4. **Private non-profit institutions for households** *(Note)*

5. **Households (including sole proprietorships)**

*(Note)* “Private non-profit institutions for households” include every non-profit institution that is a resident of Japan that provides non-marketable goods and services to households, except for those controlled by or supplied with funds from the government. Specifically, they include private schools, political parties, labor unions, political parties and religious organizations.

*(Source)* Prepared based on the materials published by the Cabinet Office
outlays that make up government expenditures can be further divided into government final consumption expenditures which are current expenditures including education, police, health, and defense; those that amount to total public fixed capital formation; and changes in public inventory. (The total of these is called public demand.) Transfer expenditures, in its broad definition, includes social security transfers, current subsidies, and transfers overseas by the government.

Looking at the ratio of public finance versus domestic demand, the public demand (FY2017) is 24.9% in nominal terms.

Also, it is useful to look at the scale of public finance using the national burden ratio. This is the ratio of taxes and social security to the national income. Based on the initial budget for FY2018, the ratio is 42.5% (of which taxes account for 24.9%). The national burden in Japan at present appears to be equivalent to or lower than that in the industrialized countries of the Western Hemisphere, but this does not take into account the large fiscal deficit. Since the aging of society is expected to proceed further in Japan, there is a strong possibility that the national burden ratio will outpace the rate of growth in the long term. The national burden ratio, if it also takes into consideration the fiscal deficit, is normally referred to as the potential national burden ratio, and according to forecasts provided by the Ministry of Finance, this ratio for FY2018 is expected to rise to 48.7%.
Government Expenditures

The government conducts its expenditure activities based on the budget. Only government expenditures of the central government are considered here, and local public finance is explained in a separate section. The General Account budget (initial base) for FY2018 totaled JPY 97.7128 trillion, a 0.3% increase from the initial budget of the previous year.

(1) Primary Balance Expenses

Primary balance expenses are obtained by subtracting the national debt from the general account expenditure. As the cost of servicing the national debt is difficult to modify politically, other expenditures are to be considered as being the bulk of expenses for the purpose of national policy. The primary balance expenses in the initial budget for FY2018, at JPY 74.4108 trillion, account for approximately 76.2% of the General Account expenditures.

(i) Social Security

This is the largest expense among primary balance expenses as well as among the general account (accounting for 44.3% of the primary balance expenses). Social security expenses can be divided into four categories: pension, medical treatment, nursing care and welfare, etc. The burden of social security expenses is expected to increase in keeping with the on-going trends of low reproduction rates and the swift aging of the population.

(ii) Local Allocation Tax Grants

Local allocation tax grants, etc. (which are large, in terms of amount, following those for social security) are taxes which have been collected as national taxes and which will be distributed to local governments for their general fiscal resources. These funds are distributed according to the financial power of local governments. Local public finance is operated based on revenue from local taxes, allocated tax grants, transfer taxes, expenditures from the national treasury (subsidies for a specified purpose from the country) and local government bonds, etc.

(iii) Education and Science Promotion

Expenses for the promotion of education and science account for 7.2% of the primary balance expenses. These include subsidies for the block-grant system for compulsory education, science technology promotion expenses, management expense grants for national university corporations and subsidies for private schools.

(iv) Public Works

These expenses are for managing the social capital which contributes to the stability of people’s lives and the promotion of industries. It is comprised of housing programs, sewage and environmental sanitation facilities, agricultural infrastructure maintenance, forest roads, industrial waterways, road maintenance, and forestry and water conservation and disaster recovery, etc.

(v) National Defense

National defense is typically considered a true public good, which is impossible to fund
from private sources. Opinion is divided on the level of defense expenses, but it is extremely
difficult to economically determine the appropriate amount that should be paid. In Japan,
since the 1976 fiscal year budget, the National Defense expenditure has been managed based
on the restriction that it must remain under 1% of GNP. From the budget for FY1987, the
policy to restrict it within the framework of 1% of GNP was abolished but a method to
explicitly show the total amount was adopted as a new financial brake. At present, the
purport to maintain moderate defense power is inherited, and the level of National Defense
expenditure has been changing but remains at approximately 1% of GNI.

(vi) Others

In addition to the above five areas, there are expenditures for expenses relating to stable
supplies of foodstuffs, energy programs, economic cooperation, pensions and, small and
medium sized enterprise business programs.

(2) National Debt Service

National debt service, the second largest expenditure item following social security expenses
in the General Account, is for repaying the principal and interest on outstanding government
bonds. Interest payments occur every year and it is necessary to repay them regardless of the

* "Primary balance expenses" refers to expenses obtained by deducting the national debt service from expenditures. It serves as an indicator showing the political expenses of the current year.

* General expenditure (=primary balance expenses – local allocation tax grants, etc.) = 588,958 (60.3%). Among such amount, social security expenses accounted for approximately 56.0%.
policy. At the same time, it is necessary to prepare for future repayments of principal. For this reason, 1/60 of the balance of outstanding government bonds at the beginning of the preceding fiscal year is saved and transferred to a Special Account for Government Bond Liquidation. In addition, a certain amount is listed in the budget and appropriated as the need arises.

The amount of national debt service rose sharply in the 1980s when governmental bonds were issued on a full-scale basis, and remained at a high level in the initial budget for FY2018, at 23.8% of the annual General Account budget. When debt service rises in this way it has the effect of restraining budget allocations for other purposes.

### 3 Taxes and Public Bonds

A major source of revenue for the country is the collection of taxes. Payment of taxes is prescribed as an obligation of the people in the Constitution, and taxes as provided for by various laws are imposed on the people. In FY1965, construction government bonds were issued for the first time since World War II, and in FY1975, special deficit financing government bonds (deficit bonds) were issued to cover current expenses. Issuance of the special deficit financing government bonds was conducted as an extraordinary, temporary measure to fill the shortage in tax revenue due to the first oil crisis, but thereafter special deficit financing government bonds continued to be issued every year except in FY1990-1993.

(1) **Taxes**

Desirable conditions for a tax system are fairness, efficiency, simplicity and low collection costs. Fairness means taxes should become proportionately higher for higher income (vertical fairness), and if the income is the same, the tax to be paid should also be the same (horizontal fairness). An economically efficient tax system is a system that minimizes the loss of social welfare (overall degree of satisfaction of the people in society) incurred by the imposition of the tax. A simple tax system is one which is easy for taxpayers to understand and is necessary to deter tax evasion as much as possible. Of course, the lower the tax collection cost, the better.

Taxes can be divided in various ways, such as into direct and indirect taxes, national tax and local taxes, or income, consumption and property taxes. Direct tax is paid by the taxpayers directly to the tax authority (including withholding tax), while indirect tax is where the entities to be taxed and the entities to pay the taxes are different. Government tax is paid to the government and local tax is paid to local governments. Taxes can also be divided according to the basis for taxation.

The tax system after World War II was, in principle, based on the “Shoup Recommendations” made in 1949. The Shoup Recommendations had two features: a tax filing system and a comprehensive income tax. Subsequently, various incentive measures were taken in Japan and as a result the comprehensive income tax became an income tax based on salary income. Furthermore, indirect tax, which supplements the income tax, was collected mainly as
taxes on certain specific products until the consumption tax was introduced in FY1989.

The tax and stamp revenues for FY2018 (General Account initial budget) are estimated at JPY59.790 trillion.

(2) Government Bonds

According to Article 4 of the Public Finance Act, in principle the expenditures of the country must have a revenue source other than government bonds and loans (government bond non-issuance policy). However, the proviso to Paragraph 1 of the same Article permits the procuring of revenue for expenses related to public work projects, capital investments and loans from the issuance of government bonds and loans within the limit of the required funds. This is based on the idea that because the burden of repayment of interest and principal of government bonds is to be borne by future generations, it is desirable to appropriate income from the issuance of government bonds to the expenditures from which future generations can benefit.

However, since FY1975, special government bonds (deficit bonds) have been issued under
Chapter 2

Chart 2-41


2. The issuance of government bonds excludes the following bonds: Ad-hoc Special Deficit-Financing Bonds issued in FY1990 as a source of funds to support peace and reconstruction activities in the Persian Gulf Region, Tax Reduction-related Special Deficit-Financing Bonds issued in FY1994–1996 to make up for a decline in tax revenues due to a series of income tax cuts preceding the consumption tax hike from 3% to 5%, Reconstruction Bonds issued in FY2011 as a source of funds to implement measures for the reconstruction in response to the Great East Japan Earthquake, and Pension-related Special Deficit-Financing Bonds issued in FY2012 and FY2013 as a source of funds to achieve the targeted national contribution to one-half of the basic pension.

(Source) Ministry of Finance
special legislation, enacted each year to secure a source of income for current expenses other than those mentioned above.

The increase in tax collections enabled the government to cease issuing special deficit financing government bonds from FY1990 to FY1993. However, the collapse of the bubble in the economy and substantial appreciation of the yen, among other factors, caused the economy to weaken. The government adopted certain economic policies, and starting in FY1994, it restarted issuing special deficit financing government bonds. Pursuant to the Act on Special Measures for Issuance of Government Bonds for Securing Financial Resources Necessary for Financial Management passed in March 2016, special deficit financing government bonds can be issued without undergoing Diet deliberations until FY2020.

In the future, in view of the certainty that the household savings rate will decline and the working population will decrease due to the low birth rate and aging of the population, it is expected that tax collections will decline and social security expenditures will increase. If budgetary deficits cause an annual increase in the cumulative debt of the country, the rise in interest payments will cause the national debt to snowball. If, in addition, the issuance of government bonds drains private sector funds, the decrease in availability of funds will cause interest rates to rise, depressing private fixed investment (this is called the “crowding-out effect”). If the economic growth rate declines because of shrinkage of the working population and falling off of private fixed investment, the economy will fall into a vicious circle where the national debt balloons. This means that without structural reform of the country’s finances, the Japanese economy will be plunged into dire straits in the future, and this is by no means a problem that can be immediately solved.

Because of the heightened awareness of the necessity for structural reform of Japan’s fiscal policy, in FY1997 the Financial Structural Reform Act was enacted, applying a brake to the issuance of government bonds. Nevertheless, after heightened anxiety over the soundness of the financial system arose during the latter half of the fiscal year accompanied by weakening of economic performance, this law was repealed and the government changed to a policy of stimulating the economy by increasing public spending from FY1998 onward. Refinancing of government bonds having reached a formidable scale, there has been a steady increase in the issuance of refinancing bonds in addition to new cash bonds. This too has been a factor behind the increase in the outstanding balance of government bonds.

There are some problems associated with the issuance of government bonds: (a) it puts pressure on private funds and causes a crowding-out effect as well as inflation due to an excessive supply of money, (b) it harms the fairness of income transfers between generations, (c) it makes financial policy rigid as a result of issuing a large volume of government bonds causing a huge amount of repayment of interest and principal on government bonds, and (d) in contrast to tax increases, government bonds can be easily used as a source of income (the sense of burden felt by citizens is lower) causing inflation and loosening of finance.

It is estimated that the amount of ordinary government bonds outstanding at the end of FY2018 will be approximately JPY883 trillion, based on the initial budget.
Fiscal Investment and Loan Program

The Fiscal Investment and Loan Program (FILP) Plan is submitted to the Diet for approval in the same manner as the budget. The FILP Plan is intended to control the flow of funds through the public sector and is a part of public finance. Public finance is the intermediary financing conducted by the public sector, and by the government intermediating between the final users of the funds (for example, private corporations or public entities) and the savers (for example, households), new assets (for example, loans) and debts (for example, deposits) are created, thereby helping to connect the saved funds with actual investments.

The flow of funds in the FILP is as follows. Funds that must be repaid are borrowed for the FILP Special Account and re-lent to or invested in what are called the FILP institutions, namely government-related financial institutions, public corporations and the like. Funds obtained through the activities of the FILP institutions are paid to the Fiscal Finance Special Account and the Fiscal Finance Special Account repays its obligations by using these funds. Investments by public corporations are mainly conducted based on this plan, and investments by local governments are greatly influenced by the FILP Plan. In this regard, FILP, together with the public works related budget of the General Account, is a central factor that determines the total amount and distribution of public investment and has been considered an important means for implementing economic programs and growth policies.

FILP, together with the budget of the General Account, is politically utilized for policies because FILP loans are made at rates lower than the market interest rates, and funds can be directed toward a specific area. Also, FILP has the power to influence the scale and distribution of public investments in that the investment plans of those corporations, which are included in public investments, are influenced by FILP. However, with the deregulation of interest rates, some say FILP puts pressure on the private banks beyond the framework of the supplementing of the private sector by the public sector because FILP institutions procure funds at lower rates than the rate paid by private entities. Furthermore, there is less room to lend money at an interest rate that is lower than the market interest rate without depending on subsidies.

Up until March 2001, the full amount of funds collected as postal savings, national welfare pension contributions and employees’ pension contributions was required to be entrusted to the Trust Fund Bureau Special Account (this is the former designation of the Fiscal Finance Funds Special Account). A large share of postal insurance funds was also allocated for FILP. But this system for automatic transfer of funds enabled the FILP activities to continue to expand, and funds were also being provided from the general account, leading to increased costs at the FILP institutions. It thereupon became necessary to adequately evaluate the purposes and efficiencies of FILP activities.

Because of this, from FY2001, both the mandatory transfer of postal savings and public annuity contributions to the Trust Fund Bureau and the Trust Fund Bureau itself were abolished, and were replaced with the Fiscal Finance Funds system. FILP institutions were authorized to issue bonds and raise funds independently (FILP agency bonds), or issue bonds guaranteed by the
government (government-guaranteed bonds), and the Fiscal Finance Funds raises funds by a lump sum to the extent of a shortfall in funding (FILP bonds).

Regarding the investments by these bodies, they are intended to achieve enhanced certainty of efficiency by review of investment plans by quantifying the efficiency through use of policy cost analysis tools. This would enable investment that is best done by the private sector and avoid acts that would increase the national burden.

The FILP in FY2018 (initial base) was JPY14.4631 trillion (ratio of initial plan to previous year minus 4.4%).

(Source) “Fiscal Investment and Financing Report 2017”

3 5 Local Public Finance

In local areas, similar to central government finance, approximately 1,700 local governments represented by 47 prefectures engage in fiscal activities. The structure of local public finance is comprehensively prescribed by the Local Government Act, and is basically the same as the national government. Local governments, in each local area, provide public services closely related to people’s lives such as education, environmental protection, livelihood protection, police and fire fighting, etc. The budgets for local governments are also divided into general accounts and special accounts. The special accounts are not uniform as they are divided into those for which creation is required by law or regulation, and those that each local government creates at its discretion, but they are classified into those such as publicly run corporate accounts which are operated in a manner similar to a business and the ordinary accounts that account for other administration.

Expenditures of local governments can be divided into categories including the following categories based on their purpose of use: civil administration expenses, education expenses, government bonds expenses, civil engineering works expenses, general affairs expenses,
sanitation expenses, commercial and industrial expenses, agriculture, forestry and fishery industries expenses, and expenditures that are closely related to the lives of residents account for much of such expenditures. In the FY2018 budget, while the general account expenditures of the national government were JPY97.7 trillion, the local government program expenditures were JPY86.9 trillion (or a little less than those of the national government).

Revenue of local government is roughly divided into local tax, distribution of local transfer taxes, special grants to local governments, local allocation tax grants, disbursements from the national treasury, and local government bonds, of which the total of local tax revenues, etc. (local taxes, local transfer tax, and special grants to local governments) of JPY42.2 trillion is estimated for FY2018. National tax receipts amounted to JPY59.1 trillion, so that local tax revenues, etc. are

![Chart 2-43 Summary of Major Items of the Local Public Finance Program (FY2018)](chart)

(Source) Based on the data published by the Ministry of Internal Affairs and Communications
less than national tax receipts. This is because in an attempt to equalize the available fiscal resources between local areas, payments are made from the national treasury to local areas in the form of subsidies that are normally earmarked for a particular use, in addition to transfers of a fixed percentage of national taxes to local areas in the form of local allocation tax grants as resources, the use of which is not specifically designated. Nevertheless, under the review of the allocation of tax resources, including national supplemental funds, local allocation tax grants and other transfers of taxes, as a result of the “Trinity (three different parts treated as a single one) reform,” the autonomy of local areas is being increased while at the same time the current gap of expenditures and tax revenues between local governments and the national government is gradually being ameliorated.

3.6 **Fiscal Policy and National Economy**

As described above, fiscal policy (public finance) is a part of the national economy and is closely related to people’s lives.

**(1) Public Goods**

A major role of the public sector is to provide specific goods and services called public goods. The Japanese economy essentially operates on a market mechanism whereby most of the goods and services are provided by private companies through the market. Specific goods and services such as national defense, police and justice, however, are necessary for society but are not provided through the market. These goods and services have to be provided by the government, and it is desirable for the government, rather than for private companies, to provide other goods and services such as education. Thus, in this way, the market mechanism fails to provide the efficient distribution of resources, which is referred to as the “failure of the market.”

The definition of public goods includes the characteristics of the inability of exclusion of consumption (meaning it is difficult to exclude people who do not pay a price for consumption) and non-competitiveness of consumption (consumption by a certain person does not disturb another person’s consumption). However, it is impossible to clearly classify all goods and services into purely private goods and purely public goods. Goods that are in-between are called quasi-public goods (mixed goods).

**(2) Role of Fiscal Policy**

There are three major roles of fiscal policy: the efficient distribution of resources, the redistribution of income and the stabilization of the economy.

(i) **Efficient Distribution of Resources**

As described above, if the government does not provide public goods and relies simply on the market mechanism to do so, this will result in the inefficient distribution of resources. If the private sector provides public goods, the benefit is enjoyed not only by the purchaser,
but also by those who do not pay for it (this is called the “free riders phenomenon”). Since it is impossible to avoid the free-rider phenomenon, leaving the supply of public goods to the private sector will not ensure that the needed amount of goods will be provided to society. In such a case, the government is expected to provide public goods so it results in an efficient distribution of resources.

(ii) **Redistribution of Income**

Since the economic condition of people is based on the amount of initial holdings, there is no assurance that a socially desirable distribution of income will be achieved even if the market mechanism functions perfectly and the resources are distributed efficiently. It is very difficult to judge whether income is divided equally among individuals, but if the actual distribution of income is skewed, the government can intervene to improve society’s standard of welfare (degree of satisfaction) as a whole. Fiscal policy usually imposes taxes progressively on the income of some individuals and transfers the income to other individuals, thereby adjusting the distribution of income.

(iii) **Stabilization of the Economy**

The economy goes through good and bad cycles, and the role of fiscal policy is to minimize the waves caused by these cycles and to maintain full employment without inflation. These economic stabilization functions of fiscal policy can be divided into built-in stabilizers (automatic stabilizing effect) and fiscal policy (discretionary business adjustment policy).

When the economy is performing well, tax revenues from income taxes and corporate taxes naturally increase. This restrains individual and corporate demand, thereby resulting in a restraining effect on the economy. On the other hand, when the economy is performing poorly, the tax revenue decreases and financial expenditures, such as social security benefits, including unemployment benefits increase, and therefore stimulate the economy. Thus, fiscal policy has an automatic stabilizing effect on the economy. However, the real economy cannot be controlled by the built-in stabilizer alone, and therefore the government implements discretionary fiscal policies to expand or restrain the scale of public finance based on economic trends.

### Budget Deficit

Budget deficit means that expenditures exceed the revenue of the government. However, the size of the deficit varies depending on how the government is defined and how revenue and expenditures of the government are presented. In general, the accounting deficit, in other words, the government bond revenue, in the General Account budget is used. However, in some cases, the deficit from the perspective of net expenditure and net borrowing (formerly the difference between savings and investment) of the public sector based on the system of national accounts (SNA) is used.
The economic effects of a budget deficit include pressures on the private economy, intergenerational inequality, rigidity of public finance, and big government. Some say that a budget deficit is justified when trying to overcome a recession. Others say that the issuance of government bonds is the same thing as a future tax increase and that this has no material influence on the economy if people expect future tax increases and act accordingly.

In addition, it is also possible to disaggregate the actual budget deficit into an economic cycle portion and a structural portion. When the economy is growing, tax revenue is positive, but it is reversed when the economy is poor. In other words, assuming there is no change in taxation or the scale of expenditure, the budget deficit shrinks when the economy is growing and expands when the economy is in a downward phase of the cycle as tax revenue then declines. Therefore, it cannot be said that fiscal restructuring is taking place smoothly just because the deficit shrinks during a good economy. In order to determine the actual situation, it is necessary to strip out the portion that is affected by changes in the economy. The portion obtained in this way is the structural deficit that remains a budget deficit even when full employment GDP is achieved. The more the structural deficit shrinks, the more strained the finance stance.

One of the indices that is closely watched by government as an indicator of the fiscal situation is the Primary Balance (PB = fundamental fiscal cash flow). The Primary Balance is the balance between revenues other than revenues generated from public borrowing (debt) and expenditures excluding the costs of interest and redemptions on government debt. If this is in balance, fiscal expenditures necessary for the life of the citizenry in any given year should be exactly matched to the tax burden on the citizenry for that year. However, the Primary Balance in Japan continues to be in a very large deficit. If the Primary Balance achieves equilibrium, and if the nominal interest rate and nominal rate of economic growth are the same, the balance of debt relative to GDP is maintained at a fixed level.

With the progress of the declining birthrate and aging of society, revenues from insurance premiums will stagnate, while social insurance benefits will continue to increase substantially and revenues from the operation of pension funds will decrease as the funds are reversed. Therefore, there are concerns that the balance of the social security fund will also deteriorate in the future.

### Chart 2-44 Meaning of the Primary Balance (PB)

<table>
<thead>
<tr>
<th>PB in Deficit</th>
<th>PB in Equilibrium</th>
<th>PB in Surplus</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Annual Revenue</strong></td>
<td><strong>Annual Expenditure</strong></td>
<td><strong>Annual Revenue</strong></td>
</tr>
<tr>
<td>Income from national borrowing</td>
<td>Cost of interest and redemptions on government debt</td>
<td>Income from national borrowing</td>
</tr>
<tr>
<td>Taxes, etc.</td>
<td>Primary balance expenses</td>
<td>Taxes, etc.</td>
</tr>
</tbody>
</table>

(Source) Made in reference to the materials produced by the Ministry of Finance
Lastly, let us talk about how financial management should occur in the future. Pensions are directly related to issue of transfers of income between generations, and therefore it is necessary to reconsider the benefit levels and equalize the burden. Lately, there are discussions regarding reviewing the ratio of direct and indirect taxes. The taxation system and social security system in Japan is expected to be under greater pressure in the future due to the aging society, and therefore it is necessary to find a solution acceptable to the people of the country (the current generation) as soon as possible.

Although Japan has one of the highest levels of per capital GDP in the world, people do not feel that they are enjoying the wealth. One of the reasons is that industry-related social capital such as roads in urban areas and social capital related to daily life, such as sewage treatment facilities and parks, are insufficient. This is because public capital was not adequately accumulated during the 1980s due to the excessive focus on financial restructuring. Moreover, recently the social capital constructed during the years of steep economic growth is becoming dated and thus investments to renovate such must also be made at the same time.

Nevertheless, there is anxiety over the massive scale of the budget deficit. The national burden in Japan is low relative to the ratios in other industrialized countries, but with the declining birthrate and aging of the population that lies ahead, it is expected that the national burden will rise.
Unless there is broad-based structural or institutional reform in regard to social security related expenditures, the system for the transfer of funds collected by the central government to local governments and other public systems, the payment of expenditures will continue to increase, causing the budget deficit to continue to increase. The absence of a framework for preventing the perpetual expansion of public works spending also causes an increase in the budget deficit. It is also necessary to make a start in the direction of sound management of national finances, and to simplify the budgeting system and move away from single-year budgets, in addition to giving more consideration to establishing order in national finance and achieving efficient management of finance.
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<th>264</th>
</tr>
</thead>
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<tr>
<td>9.1</td>
<td>Significance and Mechanism of Capital Efficiency Analysis</td>
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<tr>
<td>9.2</td>
<td>Analysis of Break-Even Points Between Profit and Loss</td>
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<td>Cash Flow Analysis</td>
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</tr>
</tbody>
</table>
1 Significance and Role of 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 3-1 is a summary of the relationships referred to above.

[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 3-1, 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 3-2.

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.
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 3-3 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).

[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 3-4, 3-5, 3-6, 3-7, and 3-8).
### Chart 3-4 Consolidated Balance Sheet

(Unit: million yen)

<table>
<thead>
<tr>
<th></th>
<th>Previous Consolidated Fiscal Year (As of March 31, 2016)</th>
<th>Current Consolidated Fiscal Year (As of March 31, 2017)</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Assets</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Current Assets</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Cash and Deposits</td>
<td>2,308</td>
<td>2,857</td>
</tr>
<tr>
<td>Deposits Paid</td>
<td>40,824</td>
<td>43,103</td>
</tr>
<tr>
<td>Notes and Accounts Receivable</td>
<td>42,722</td>
<td>51,187</td>
</tr>
<tr>
<td>Work in Process</td>
<td>20,616</td>
<td>21,423</td>
</tr>
<tr>
<td>Raw Materials and Supplies</td>
<td>97</td>
<td>49</td>
</tr>
<tr>
<td>Short-term Loans Receivable</td>
<td>12,000</td>
<td>12,000</td>
</tr>
<tr>
<td>Deferred Tax Credits*</td>
<td>3,126</td>
<td>3,903</td>
</tr>
<tr>
<td>Other Current Assets</td>
<td>1,499</td>
<td>1,990</td>
</tr>
<tr>
<td>Allowance for Bad Debt</td>
<td>−18</td>
<td>−22</td>
</tr>
<tr>
<td><strong>Total Current Assets</strong></td>
<td>123,176</td>
<td>136,493</td>
</tr>
<tr>
<td><strong>Fixed Assets</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Tangible Fixed Assets</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Buildings and Structures, net</td>
<td>11,103</td>
<td>10,463</td>
</tr>
<tr>
<td>Tools, Furniture and Fixtures, net</td>
<td>4,191</td>
<td>5,880</td>
</tr>
<tr>
<td>Land</td>
<td>2,778</td>
<td>2,778</td>
</tr>
<tr>
<td>Lease Assets</td>
<td>1,525</td>
<td>962</td>
</tr>
<tr>
<td>Construction in progress</td>
<td>1,442</td>
<td>210</td>
</tr>
<tr>
<td>Other Tangible Assets</td>
<td>3</td>
<td>2</td>
</tr>
<tr>
<td><strong>Total Tangible Fixed Assets</strong></td>
<td>21,045</td>
<td>20,298</td>
</tr>
<tr>
<td><strong>Intangible Fixed Assets</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Software</td>
<td>1,399</td>
<td>2,392</td>
</tr>
<tr>
<td>Goodwill</td>
<td>2,082</td>
<td>4,826</td>
</tr>
<tr>
<td><strong>Total Intangible Fixed Assets</strong></td>
<td>14</td>
<td>15</td>
</tr>
<tr>
<td>Investments and Other Assets</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Investment Securities</td>
<td>20,547</td>
<td>30,992</td>
</tr>
<tr>
<td>Deferred Tax Credits</td>
<td>3,203</td>
<td>1,376</td>
</tr>
<tr>
<td>Guarantee Deposits</td>
<td>3,794</td>
<td>3,914</td>
</tr>
<tr>
<td>Other Investments</td>
<td>479</td>
<td>546</td>
</tr>
<tr>
<td>Allowance for Bad Debt</td>
<td>−49</td>
<td>−44</td>
</tr>
<tr>
<td><strong>Total Investments and Other Assets</strong></td>
<td>27,977</td>
<td>36,784</td>
</tr>
<tr>
<td><strong>TOTAL ASSETS</strong></td>
<td>175,696</td>
<td>200,811</td>
</tr>
</tbody>
</table>

Note: From the consolidated fiscal year starting from April 1, 2018, deferred tax credits and deferred tax liabilities will only be indicated under the items of Investment and Other Assets and Fixed Liabilities, respectively, but the example shown above is a consolidated financial statement for FY2016.
### Liabilities

<table>
<thead>
<tr>
<th>Category</th>
<th>Previous Consolidated Fiscal Year (As of March 31, 2016)</th>
<th>Current Consolidated Fiscal Year (As of March 31, 2017)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Current Liabilities</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Promissory Notes and Accounts Payable</td>
<td>16,734</td>
<td>17,985</td>
</tr>
<tr>
<td>Lease Obligations</td>
<td>623</td>
<td>100</td>
</tr>
<tr>
<td>Accounts Payable</td>
<td>6,740</td>
<td>6,394</td>
</tr>
<tr>
<td>Accrued Corporate Taxes</td>
<td>4,012</td>
<td>4,763</td>
</tr>
<tr>
<td>Advances Received</td>
<td>14,159</td>
<td>13,782</td>
</tr>
<tr>
<td>Provision for Bonuses</td>
<td>7,633</td>
<td>7,957</td>
</tr>
<tr>
<td>Provision for Loss on Order Received</td>
<td>140</td>
<td>1,059</td>
</tr>
<tr>
<td>Reserve for Software Programs</td>
<td>208</td>
<td>235</td>
</tr>
<tr>
<td>Provision for Loss on Business Withdrawal</td>
<td>116</td>
<td>331</td>
</tr>
<tr>
<td>Other Current Liabilities</td>
<td>361</td>
<td>588</td>
</tr>
<tr>
<td>Total Current Liabilities</td>
<td>50,731</td>
<td>53,198</td>
</tr>
<tr>
<td>Fixed Liabilities</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Lease Obligations</td>
<td>837</td>
<td>760</td>
</tr>
<tr>
<td>Provisions for Directors’ Retirement Benefits</td>
<td>145</td>
<td>136</td>
</tr>
<tr>
<td>Provision for Loss on Business Withdrawal</td>
<td>–</td>
<td>238</td>
</tr>
<tr>
<td>Net Defined Benefit Liability</td>
<td>18,923</td>
<td>19,650</td>
</tr>
<tr>
<td>Deferred Tax Liabilities</td>
<td>–</td>
<td>1,013</td>
</tr>
<tr>
<td>Other Fixed Liabilities</td>
<td>46</td>
<td>89</td>
</tr>
<tr>
<td>Total Fixed Liabilities</td>
<td>19,953</td>
<td>21,887</td>
</tr>
<tr>
<td><strong>TOTAL LIABILITIES</strong></td>
<td><strong>70,684</strong></td>
<td><strong>75,086</strong></td>
</tr>
</tbody>
</table>

### Net Assets

<table>
<thead>
<tr>
<th>Category</th>
<th>Previous Consolidated Fiscal Year (As of March 31, 2016)</th>
<th>Current Consolidated Fiscal Year (As of March 31, 2017)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Shareholders’ Equity</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Stated Capital</td>
<td>12,952</td>
<td>12,952</td>
</tr>
<tr>
<td>Capital Surplus</td>
<td>9,950</td>
<td>10,899</td>
</tr>
<tr>
<td>Earned Surplus</td>
<td>90,634</td>
<td>100,530</td>
</tr>
<tr>
<td>Treasury Shares</td>
<td>–20,006</td>
<td>–17,416</td>
</tr>
<tr>
<td>Total Shareholders’ Equity</td>
<td>93,531</td>
<td>106,966</td>
</tr>
<tr>
<td>Other Aggregated Comprehensive Income</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Valuation Difference on Available-for-Sale Securities</td>
<td>8,296</td>
<td>15,286</td>
</tr>
<tr>
<td>Revaluation Reserve for Land</td>
<td>–1,276</td>
<td>–1,276</td>
</tr>
<tr>
<td>Foreign Currency Translation Adjustment</td>
<td>170</td>
<td>77</td>
</tr>
<tr>
<td>Total Other Aggregated Comprehensive Income</td>
<td>7,190</td>
<td>14,086</td>
</tr>
<tr>
<td>Non-Controlling Interest</td>
<td>4,290</td>
<td>4,671</td>
</tr>
<tr>
<td><strong>TOTAL NET ASSETS</strong></td>
<td><strong>105,012</strong></td>
<td><strong>125,724</strong></td>
</tr>
<tr>
<td><strong>TOTAL ASSETS</strong></td>
<td><strong>175,696</strong></td>
<td><strong>200,811</strong></td>
</tr>
</tbody>
</table>

(Source) EDINET website (data on Company A, an information services provider)
### Chart 3-5  Consolidated Profit and Loss Statement

(Unit: million yen)

<table>
<thead>
<tr>
<th>Item</th>
<th>Previous Consolidated Fiscal Year (April 1, 2015 through March 31, 2016)</th>
<th>Current Consolidated Fiscal Year (April 1, 2016 through March 31, 2017)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales</td>
<td>218,685</td>
<td>232,473</td>
</tr>
<tr>
<td>Sales Costs</td>
<td>174,981</td>
<td>186,013</td>
</tr>
<tr>
<td>Gross Profit on Sales</td>
<td>43,704</td>
<td>46,459</td>
</tr>
<tr>
<td>Selling Expenses and General and Administrative Expenses</td>
<td>24,435</td>
<td>24,919</td>
</tr>
<tr>
<td>Operating Profit</td>
<td>19,269</td>
<td>21,540</td>
</tr>
<tr>
<td>Non-Operating Income</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Interest Received</td>
<td>160</td>
<td>133</td>
</tr>
<tr>
<td>Dividends Received</td>
<td>326</td>
<td>276</td>
</tr>
<tr>
<td>Share of Entities’ Profit Accounted for Using Equity Method</td>
<td>57</td>
<td>36</td>
</tr>
<tr>
<td>Proceeds from Cancellation Penalties</td>
<td>0</td>
<td>143</td>
</tr>
<tr>
<td>Other Non-Operating Income</td>
<td>41</td>
<td>201</td>
</tr>
<tr>
<td>Total Non-Operating Income</td>
<td>587</td>
<td>790</td>
</tr>
<tr>
<td>Non-Operating Expenses</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Interest Paid</td>
<td>60</td>
<td>27</td>
</tr>
<tr>
<td>Loss on Retirement of Non-Current Assets</td>
<td>63</td>
<td>25</td>
</tr>
<tr>
<td>Foreign Exchange Losses</td>
<td>77</td>
<td>43</td>
</tr>
<tr>
<td>Cancellation Penalties</td>
<td>0</td>
<td>45</td>
</tr>
<tr>
<td>Impairment Loss</td>
<td>122</td>
<td>58</td>
</tr>
<tr>
<td>Provision of Allowance for Loss on Business Withdrawal</td>
<td>116</td>
<td>–</td>
</tr>
<tr>
<td>Other Non-Operating Expenses</td>
<td>47</td>
<td>13</td>
</tr>
<tr>
<td>Total Non-Operating Expenses</td>
<td>488</td>
<td>213</td>
</tr>
<tr>
<td>Ordinary Income</td>
<td>19,367</td>
<td>22,117</td>
</tr>
<tr>
<td>Extraordinary Losses</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Loss on Valuation of Investment Securities</td>
<td>498</td>
<td>–</td>
</tr>
<tr>
<td>Provision of Allowance for Loss on Business Withdrawal</td>
<td>–</td>
<td>552</td>
</tr>
<tr>
<td>Total Extraordinary Losses</td>
<td>498</td>
<td>552</td>
</tr>
<tr>
<td>Pre-tax Net Profit (or Loss) for the Term</td>
<td>18,868</td>
<td>21,564</td>
</tr>
<tr>
<td>Corporate, Inhabitants and Enterprise Taxes</td>
<td>7,391</td>
<td>7,954</td>
</tr>
<tr>
<td>Adjustment for Corporate and Other Taxes</td>
<td>-197</td>
<td>-932</td>
</tr>
<tr>
<td>Total Corporate and Other Taxes</td>
<td>7,193</td>
<td>7,022</td>
</tr>
<tr>
<td>Net Profit for the Term</td>
<td>11,674</td>
<td>14,542</td>
</tr>
<tr>
<td>Net Profit for the Term Attributable to Non-Controlling Interest</td>
<td>505</td>
<td>578</td>
</tr>
<tr>
<td>Net Profit for the Term Attributable to Owners of Parent</td>
<td>11,168</td>
<td>13,964</td>
</tr>
</tbody>
</table>

(Source) EDINET website (data on Company A, an information services provider)
### Chart 3-6  Consolidated Statement of Comprehensive Income

(Unit: million yen)

<table>
<thead>
<tr>
<th></th>
<th>Previous Consolidated Fiscal Year (April 1, 2015 through March 31, 2016)</th>
<th>Current Consolidated Fiscal Year (April 1, 2016 through March 31, 2017)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Net Profit for the Term</td>
<td>11,674</td>
<td>14,542</td>
</tr>
<tr>
<td>Other Comprehensive Income</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Valuation Difference on Available-for-sale Securities</td>
<td>−894</td>
<td>6,989</td>
</tr>
<tr>
<td>Foreign Currency Translation Adjustment</td>
<td>−84</td>
<td>−97</td>
</tr>
<tr>
<td>Total Other Comprehensive Income</td>
<td>−979</td>
<td>6,892</td>
</tr>
<tr>
<td>Comprehensive Income</td>
<td></td>
<td></td>
</tr>
<tr>
<td>(in which)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Comprehensive Income Attributable to Owners of Parent</td>
<td>10,191</td>
<td>20,860</td>
</tr>
<tr>
<td>Comprehensive Income Attributable to Non-Controlling Interests</td>
<td>503</td>
<td>574</td>
</tr>
<tr>
<td><strong>Comprehensive Income</strong></td>
<td>10,695</td>
<td>21,435</td>
</tr>
</tbody>
</table>

(Source) EDINET website (data on Company A, an information services provider)

### Chart 3-7  Consolidated Statement of Changes in Net Assets

Previous Consolidated Fiscal Year (April 1, 2015 through March 31, 2016)

(Unit: million yen)

<table>
<thead>
<tr>
<th>Shareholders' Equity</th>
<th>Stated Capital</th>
<th>Capital Surplus</th>
<th>Earned Surplus</th>
<th>Treasury Shares</th>
<th>Total Shareholders' Equity</th>
</tr>
</thead>
<tbody>
<tr>
<td>Balance at Beginning of Current Period</td>
<td>12,952</td>
<td>9,950</td>
<td>82,489</td>
<td>−20,004</td>
<td>85,387</td>
</tr>
<tr>
<td>Change of Items During the Term</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Distribution of Surplus</td>
<td>−3,022</td>
<td>−3,022</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Net Profit for the Term Attributable to Owners of Parent</td>
<td>11,168</td>
<td>11,168</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Acquisition of Company's Own Shares</td>
<td>−2</td>
<td>−2</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Disposition of Company's Own Shares</td>
<td>−</td>
<td>−</td>
<td>−</td>
<td>−</td>
<td>−</td>
</tr>
<tr>
<td>Increase by Share Exchange</td>
<td>−</td>
<td>−</td>
<td>−</td>
<td>−</td>
<td>−</td>
</tr>
<tr>
<td>Net Changes of Items Other Than Shareholders' Equity</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total Change of Items During the Term</td>
<td>−</td>
<td>−</td>
<td>8,145</td>
<td>−2</td>
<td>8,143</td>
</tr>
<tr>
<td>Balance as of the End of the Term</td>
<td>12,952</td>
<td>9,950</td>
<td>90,634</td>
<td>−20,006</td>
<td>93,531</td>
</tr>
</tbody>
</table>
### Other Aggregated Comprehensive Income

<table>
<thead>
<tr>
<th></th>
<th>Valuation Difference on Available-for-Sale Securities</th>
<th>Deferred Gains or Losses on Hedges</th>
<th>Foreign Currency Translation Adjustments</th>
<th>Total Other Aggregated Comprehensive Income</th>
<th>Non-Controlling Interests</th>
<th>Total Net Assets</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Balance at Beginning of Current Period</strong></td>
<td>9,191</td>
<td>−1,276</td>
<td>252</td>
<td>8,167</td>
<td>3,888</td>
<td>97,443</td>
</tr>
<tr>
<td><strong>Change of Items During the Term</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Distribution of Surplus</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>−3,022</td>
</tr>
<tr>
<td>Net Profit for the Term Attributable to Owners of Parent</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>11,168</td>
</tr>
<tr>
<td>Acquisition of Company's Own Shares</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>−2</td>
</tr>
<tr>
<td>Disposition of Company's Own Shares</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>−</td>
</tr>
<tr>
<td>Increase by Share Exchange</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>−</td>
</tr>
<tr>
<td>Net Changes of Items Other Than Shareholders’ Equity</td>
<td>−894</td>
<td>−</td>
<td>−82</td>
<td>−976</td>
<td>401</td>
<td>−574</td>
</tr>
<tr>
<td><strong>Total Change of Items During the Term</strong></td>
<td>−894</td>
<td>−</td>
<td>−82</td>
<td>−976</td>
<td>401</td>
<td>7,568</td>
</tr>
<tr>
<td><strong>Balance as of the End of the Term</strong></td>
<td>8,296</td>
<td>−1,276</td>
<td>170</td>
<td>7,190</td>
<td>4,290</td>
<td>105,012</td>
</tr>
</tbody>
</table>

Current Consolidated Fiscal Year (April 1, 2016 through March 31, 2017)

(Unit: million yen)

<table>
<thead>
<tr>
<th></th>
<th>Stated Capital</th>
<th>Capital Surplus</th>
<th>Earned Surplus</th>
<th>Treasury Shares</th>
<th>Total Shareholders’ Equity</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Balance at Beginning of Current Period</strong></td>
<td>12,952</td>
<td>9,950</td>
<td>90,634</td>
<td>−20,006</td>
<td>93,531</td>
</tr>
<tr>
<td><strong>Change of Items During the Term</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Distribution of Surplus</td>
<td>−4,069</td>
<td></td>
<td></td>
<td>−4,069</td>
<td></td>
</tr>
<tr>
<td>Net Profit for the Term Attributable to Owners of Parent</td>
<td></td>
<td></td>
<td>13,964</td>
<td></td>
<td>13,964</td>
</tr>
<tr>
<td>Acquisition of Company’s Own Shares</td>
<td></td>
<td></td>
<td>−2</td>
<td></td>
<td>−2</td>
</tr>
<tr>
<td>Disposition of Company’s Own Shares</td>
<td></td>
<td></td>
<td>0</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Increase by Share Exchange</td>
<td>949</td>
<td></td>
<td>2,592</td>
<td></td>
<td>3,542</td>
</tr>
<tr>
<td>Net Changes of Items Other Than Shareholders’ Equity</td>
<td></td>
<td></td>
<td>9,895</td>
<td>2,590</td>
<td>13,435</td>
</tr>
<tr>
<td><strong>Total Change of Items During the Term</strong></td>
<td></td>
<td></td>
<td>949</td>
<td>2,590</td>
<td>13,435</td>
</tr>
<tr>
<td><strong>Balance as of the End of the Term</strong></td>
<td>12,952</td>
<td>10,899</td>
<td>100,530</td>
<td>−17,416</td>
<td>106,966</td>
</tr>
<tr>
<td></td>
<td>Other Aggregated Comprehensive Income</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>-----------------------------------------------------------------</td>
<td>--------------------------------------------------------------------------------------------------------</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Valuation Difference on Available-for-sale Securities</td>
<td>Deferred Gains or Losses on Hedges</td>
<td>Foreign Currency Translation Adjustments</td>
<td>Total Other Aggregated Comprehensive Income</td>
<td>Non-Controlling Interests</td>
</tr>
<tr>
<td>Balance at Beginning of Current Period</td>
<td>8,296</td>
<td>−1,276</td>
<td>170</td>
<td>7,190</td>
<td>4,290</td>
</tr>
<tr>
<td>Change of Items During the Term</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Distribution of Surplus</td>
<td></td>
<td></td>
<td>−4,069</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Net Profit for the Term Attributable to Owners of Parent</td>
<td></td>
<td></td>
<td></td>
<td>13,964</td>
<td></td>
</tr>
<tr>
<td>Acquisition of Company’s Own Shares</td>
<td></td>
<td></td>
<td>−2</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Disposition of Company’s Own Shares</td>
<td></td>
<td></td>
<td>0</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Increase by Share Exchange</td>
<td></td>
<td></td>
<td></td>
<td>3,542</td>
<td></td>
</tr>
<tr>
<td>Net Changes of Items Other Than Shareholders’ Equity</td>
<td>6,986</td>
<td>−</td>
<td>−93</td>
<td>6,895</td>
<td>380</td>
</tr>
<tr>
<td>Total Change of Items During the Term</td>
<td>6,986</td>
<td>−</td>
<td>−93</td>
<td>6,895</td>
<td>380</td>
</tr>
<tr>
<td>Balance as of the End of the Term</td>
<td>15,286</td>
<td>−1,276</td>
<td>77</td>
<td>14,086</td>
<td>4,671</td>
</tr>
</tbody>
</table>

(Source) EDINET website (data on Company A, an information services provider)
### Chart 3-8 Consolidated Cash Flow Statement

(Unit: million yen)

<table>
<thead>
<tr>
<th>Cash Flow from Operating Activity</th>
<th>Previous Consolidated Fiscal Year (April 1, 2015 through March 31, 2016)</th>
<th>Current Consolidated Fiscal Year (April 1, 2016 through March 31, 2017)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Pre-tax Net Profit for the Term</td>
<td>18,868</td>
<td>21,564</td>
</tr>
<tr>
<td>Depreciation Expenses</td>
<td>3,916</td>
<td>4,147</td>
</tr>
<tr>
<td>Impairment Loss</td>
<td>122</td>
<td>58</td>
</tr>
<tr>
<td>Amortization of Goodwill</td>
<td>218</td>
<td>260</td>
</tr>
<tr>
<td>Increase (Decrease (‒)) in Allowance for Doubtful Accounts</td>
<td>−16</td>
<td>−0</td>
</tr>
<tr>
<td>Increase (Decrease (‒)) in Provision for Bonuses</td>
<td>858</td>
<td>323</td>
</tr>
<tr>
<td>Increase (Decrease (‒)) in Provision for Employee Retirement Benefits</td>
<td>2,265</td>
<td>727</td>
</tr>
<tr>
<td>Increase (Decrease (‒)) in Provision for Directors’ Retirement Benefits</td>
<td>−13</td>
<td>−9</td>
</tr>
<tr>
<td>Increase (Decrease (‒)) in Provision for Loss on Orders Received</td>
<td>−432</td>
<td>919</td>
</tr>
<tr>
<td>Increase (Decrease (‒)) in Provision of Allowance for Loss on Business Withdrawal</td>
<td>116</td>
<td>452</td>
</tr>
<tr>
<td>Increase (Decrease (‒)) in Other Provision</td>
<td>27</td>
<td>26</td>
</tr>
<tr>
<td>Interest and Dividends Income</td>
<td>−487</td>
<td>−409</td>
</tr>
<tr>
<td>Interest Paid</td>
<td>60</td>
<td>27</td>
</tr>
<tr>
<td>Gain (Loss (-)) on Valuation of Investment Securities</td>
<td>498</td>
<td>−</td>
</tr>
<tr>
<td>Share of Profit (Loss (-)) of Entities Accounted for Using Equity Method</td>
<td>−57</td>
<td>−36</td>
</tr>
<tr>
<td>Loss on Retirement of Fixed Assets</td>
<td>63</td>
<td>25</td>
</tr>
<tr>
<td>Decrease (Increase (‒)) on Receivables</td>
<td>2,449</td>
<td>−8,010</td>
</tr>
<tr>
<td>Decrease (Increase (‒)) on Inventory Assets</td>
<td>−2,264</td>
<td>−534</td>
</tr>
<tr>
<td>Decrease (Increase (‒)) on Other Current Assets</td>
<td>−345</td>
<td>−401</td>
</tr>
<tr>
<td>Increase (Decrease (‒)) on Inventory Obligations</td>
<td>775</td>
<td>1,148</td>
</tr>
<tr>
<td>Increase (Decrease (‒)) in Other Current Assets</td>
<td>−843</td>
<td>−580</td>
</tr>
<tr>
<td>Other Cash Flow from Operating Activity</td>
<td>96</td>
<td>−127</td>
</tr>
<tr>
<td>Subtotal</td>
<td>25,878</td>
<td>19,572</td>
</tr>
<tr>
<td>Interest and Dividends Received</td>
<td>490</td>
<td>409</td>
</tr>
<tr>
<td>Interest Paid</td>
<td>−60</td>
<td>−27</td>
</tr>
<tr>
<td>Corporate and Other Taxes Paid</td>
<td>−8,060</td>
<td>−7,505</td>
</tr>
<tr>
<td><strong>CASH FLOW FROM OPERATING ACTIVITY</strong></td>
<td>18,247</td>
<td>12,449</td>
</tr>
<tr>
<td>Cash Flow from Investment Activity</td>
<td>Previous Consolidated Fiscal Year (April 1, 2015 through March 31, 2016)</td>
<td>Current Consolidated Fiscal Year (April 1, 2016 through March 31, 2017)</td>
</tr>
<tr>
<td>------------------------------------------------------------------------</td>
<td>-------------------------------------------------------------------------</td>
<td>-------------------------------------------------------------------------</td>
</tr>
<tr>
<td>Payments into Time Deposits</td>
<td>–</td>
<td>–194</td>
</tr>
<tr>
<td>Proceeds from Withdrawal of Time Deposits</td>
<td>167</td>
<td>–</td>
</tr>
<tr>
<td>Proceeds from Redemption of Investment Securities</td>
<td>2,000</td>
<td>–</td>
</tr>
<tr>
<td>Purchase of Property, Plant and Equipment and Intangible Assets</td>
<td>–3,935</td>
<td>–4,739</td>
</tr>
<tr>
<td>Purchase of Investment Securities</td>
<td>–3,006</td>
<td>–2,140</td>
</tr>
<tr>
<td>Proceeds from Redemption of Investment Securities</td>
<td>–</td>
<td>2,000</td>
</tr>
<tr>
<td>Purchase of Shares of Subsidiaries Resulting in Change in Scope of Consolidation</td>
<td>–14</td>
<td>–</td>
</tr>
<tr>
<td>Purchase of Shares of Non-consolidated Subsidiaries</td>
<td>–</td>
<td>–291</td>
</tr>
<tr>
<td>Payments for Guarantee Deposits</td>
<td>–81</td>
<td>–170</td>
</tr>
<tr>
<td>Proceeds from Collection of Guarantee Deposits</td>
<td>13</td>
<td>76</td>
</tr>
<tr>
<td>Other Cash Flow from Investment Activity</td>
<td>16</td>
<td>100</td>
</tr>
<tr>
<td><strong>CASH FLOW FROM INVESTMENT ACTIVITY</strong></td>
<td><strong>–4,839</strong></td>
<td><strong>–5,359</strong></td>
</tr>
</tbody>
</table>

| Cash Flow from Financial Activity                                      |                                                                       |                                                                         |
| Purchase of Treasury Shares                                           | –2                                                                     | –2                                                                     |
| Cash Dividends Paid                                                   | –3,022                                                                 | –4,069                                                                  |
| Cash Dividends Paid to Non-Controlling Shareholders                   | –123                                                                   | –193                                                                   |
| Repayments of Lease Obligations                                       | –864                                                                  | –629                                                                   |
| Others                                                                 | –                                                                       | –18                                                                    |
| **CASH FLOW FROM FINANCIAL ACTIVITY**                                 | **–4,013**                                                             | **–4,912**                                                             |

| Translations Gains and Losses on Cash and Cash Equivalents            | –23                                                                    | –59                                                                    |
| Increase (Decrease (−)) on Cash and Cash Equivalents                  | 9,370                                                                  | 2,117                                                                  |
| **Balance of Cash and Cash Equivalents at Beginning of Term**         | 33,762                                                                 | 43,133                                                                  |
| Increase on Cash and Cash Equivalents by Share Exchange               | –                                                                       | 332                                                                    |
| **Balance of Cash and Cash Equivalents at End of Term**               | 43,133                                                                 | 45,582                                                                  |

(Source) EDINET website (data on Company A, an information services provider)
Structure and Interpretation of Balance Sheet

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 3-9 shows the basic structure of the balance sheet in this respect.

[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 3-10 shows the balance sheet for all industries in Japan for the fiscal year 2016.
### Chart 3-10  Balance Sheet for All Industries (FY 2016, Consolidated Basis)

<table>
<thead>
<tr>
<th></th>
<th>(%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Current Assets</td>
<td>42.8</td>
</tr>
<tr>
<td>Current Liabilities</td>
<td>29.5</td>
</tr>
<tr>
<td>Fixed Liabilities</td>
<td>28.2</td>
</tr>
<tr>
<td>Fixed Assets</td>
<td>57.2</td>
</tr>
<tr>
<td>Net Assets</td>
<td>42.3</td>
</tr>
</tbody>
</table>

(Source) Calculated in part based on “Handbook of Industrial Financial Data 2017” (Development Bank of Japan) (hereinafter referred to as “Handbook of Industrial Financial Data 2017”)

**[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 3-11 and 3-12 below as a comparison between the gas and pharmaceuticals industries for fiscal year 2016.

### Chart 3-11  Balance Sheet for Gas Industry (FY 2016, Consolidated Basis)

<table>
<thead>
<tr>
<th></th>
<th>(%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Current Assets</td>
<td>22.1</td>
</tr>
<tr>
<td>Current Liabilities</td>
<td>14.9</td>
</tr>
<tr>
<td>Fixed Liabilities</td>
<td>34.9</td>
</tr>
<tr>
<td>Fixed Assets</td>
<td>77.9</td>
</tr>
<tr>
<td>Net Assets</td>
<td>50.2</td>
</tr>
</tbody>
</table>

(Source) Calculated in part based on Handbook of Industrial Financial Data 2017

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1 The percentage is rounded to one decimal place. As a result, there are cases in which the gross amount will not be 100.
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 77.9% of total assets and pharmaceuticals at only 52.6% of total assets.
2. There is a difference in the ratio of net assets, with pharmaceuticals at 64.6% and gas at only 50.2%.
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 (14.9%), is about forty percent of the ratio of fixed liabilities (34.9%) in the same industry whereas in the pharmaceuticals industry, the ratio of current liabilities (21.1%) is about 1.5 times the ratio of fixed liabilities (14.3%).

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.

### 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 3-13.
<table>
<thead>
<tr>
<th>Assets</th>
<th>Current Assets</th>
<th>Quick Assets</th>
<th>Cash, deposits, notes receivable, accounts receivable, temporarily owned securities, etc.</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Inventory Assets</td>
<td>Products and manufactured goods, semi-finished goods, work in process, stored supplies, etc.</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Other Current Assets</td>
<td>Advance payments, short-term prepaid expenses, etc.</td>
<td></td>
</tr>
<tr>
<td>Fixed Assets</td>
<td>Tangible Fixed Assets</td>
<td>Buildings, structures, machinery and equipment, vessels, vehicles, transportation equipment, tools, instruments, fixtures, land, construction in progress, etc.</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Intangible Fixed Assets</td>
<td>Goodwill, patents, land rights, trademarks, design rights, mining rights, fishing rights, etc.</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Investments and Other Assets</td>
<td>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(^{\text{Note}}), tax-deferred assets, etc.</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Deferred Assets</td>
<td>Expenses incurred to establish business, start-up costs, bond issuance costs, development expenses, etc.</td>
<td></td>
</tr>
</tbody>
</table>

(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 are shown in Chart 3-14:

<table>
<thead>
<tr>
<th>Liabilities</th>
<th>Current Liabilities</th>
<th>Fixed Liabilities</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Short-term Monetary Obligations</td>
<td>Long-term Monetary Obligations</td>
</tr>
<tr>
<td></td>
<td>Notes payable, accounts payable, short-term loans, corporation tax due, etc.</td>
<td>Corporate bonds, long-term loans, long-term loans from affiliated companies, etc.</td>
</tr>
<tr>
<td></td>
<td>Provisions for adjustments for returned goods, etc.</td>
<td>Net defined benefit liability(Note)</td>
</tr>
<tr>
<td></td>
<td>Other Current Liabilities</td>
<td>Other Fixed Liabilities</td>
</tr>
<tr>
<td></td>
<td>Advances received, deposits received, unearned revenue, accrued expenses, etc.</td>
<td>Tax deferred liabilities, etc.</td>
</tr>
</tbody>
</table>

(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 3-15.

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 3-15 Classification of Net Assets

<table>
<thead>
<tr>
<th>(Non-Consolidated Balance Sheet)</th>
<th>(Consolidated Balance Sheet)</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>I. Shareholders’ Equity</strong></td>
<td><strong>I. Shareholders’ Equity</strong></td>
</tr>
<tr>
<td>1. Stated Capital</td>
<td>1. Stated Capital</td>
</tr>
<tr>
<td>2. Deposit for Subscriptions to Shares</td>
<td>2. Deposit for Subscriptions to Shares</td>
</tr>
<tr>
<td>3. Capital Surplus</td>
<td>3. Capital Surplus</td>
</tr>
<tr>
<td>(1) Capital Reserve</td>
<td></td>
</tr>
<tr>
<td>(2) Other Capital Surplus</td>
<td></td>
</tr>
<tr>
<td><strong>Total Capital Surplus</strong></td>
<td><strong>4. Earned Surplus</strong></td>
</tr>
<tr>
<td><strong>II. Earned Surplus</strong></td>
<td></td>
</tr>
<tr>
<td>(1) Profit Reserve</td>
<td>5. Treasury Shares</td>
</tr>
<tr>
<td>(2) Other Earned Surplus</td>
<td>6. Deposit for Subscriptions to Treasury Shares</td>
</tr>
<tr>
<td>Reserves for XXX</td>
<td></td>
</tr>
<tr>
<td>Earned Surplus Brought / Carried Forward</td>
<td></td>
</tr>
<tr>
<td><strong>Total Earned Surplus</strong></td>
<td><strong>Total Shareholders’ Equity</strong></td>
</tr>
<tr>
<td><strong>III. Treasury Shares</strong></td>
<td><strong>Total Shareholders’ Equity</strong></td>
</tr>
<tr>
<td><strong>6. Deposit for Subscriptions to Treasury Shares</strong></td>
<td></td>
</tr>
<tr>
<td><strong>Total Shareholders’ Equity</strong></td>
<td><strong>Total Shareholders’ Equity</strong></td>
</tr>
<tr>
<td><strong>II. Valuation and Translation Adjustments</strong></td>
<td><strong>II. Accumulated Other Comprehensive Income</strong></td>
</tr>
<tr>
<td>2. Deferred Gains or Losses on Hedges</td>
<td>2. Deferred Gains or Losses on Hedges</td>
</tr>
<tr>
<td>3. Revaluation Difference on Land</td>
<td></td>
</tr>
<tr>
<td><strong>Total Valuation and Translation Adjustments</strong></td>
<td><strong>Total Accumulated Other Comprehensive Income</strong></td>
</tr>
<tr>
<td><strong>III. Share Options</strong></td>
<td><strong>III. Share Options</strong></td>
</tr>
<tr>
<td><strong>IV. Non-controlling Interests</strong></td>
<td></td>
</tr>
<tr>
<td><strong>TOTAL NET ASSETS</strong></td>
<td><strong>TOTAL NET ASSETS</strong></td>
</tr>
</tbody>
</table>

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.

## 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:

<table>
<thead>
<tr>
<th>Category</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>(1) Gross Profit on Sales</td>
<td>This shows the gross profit after deducting expenses that are the “Sales Cost” from “Sales.”</td>
</tr>
<tr>
<td>(2) Operating Profit</td>
<td>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.</td>
</tr>
<tr>
<td>(3) Ordinary Profit</td>
<td>This shows the profit after adding “Non-Operating Income” to operating profit and deducting “Non-Operating Expenses.”</td>
</tr>
<tr>
<td>(4) Net Profit for the Term</td>
<td>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.</td>
</tr>
</tbody>
</table>

Chart 3-16 shows the step-by-step structure for calculation of these profits.
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 3-17 shows the average rates of the four different forms of profit for all industries in Japan generated over a 10-year period.

As indicated in Chart 3-6 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 3-18 shows the cost and other ratios for all industries, the gas industry and the pharmaceuticals industry in the profit and loss statement for the 2016 fiscal year when sales are given as 100%.

<table>
<thead>
<tr>
<th>Chart 3-18</th>
<th>Cost and Other Ratios by Industry Type (FY 2016, Consolidated Basis)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>All Industries</td>
</tr>
<tr>
<td>Sales Costs</td>
<td>74.8</td>
</tr>
<tr>
<td>Gross Profit on Sales</td>
<td>25.2</td>
</tr>
<tr>
<td>Selling Expenses and General and Administrative Expenses</td>
<td>18.4</td>
</tr>
<tr>
<td>Net Profit for the Term</td>
<td>4.4</td>
</tr>
</tbody>
</table>

(Source) Calculation in part based on Handbook of Industrial Financial Data 2017

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 3-19 provides an example.
In FY2016, the sales profit margin for the gas industry reached 4.1% while that of the pharmaceuticals industry was 2.58 times this percentage at 10.6%, a much higher figure. Nevertheless, the respective return on equity for these two industries is quite close, with gas at 5.7% and pharmaceuticals at 8.4%. The explanation for this is thought to be the fact that the equity turnover ratio for the gas industry (1.37 times) is about 1.73 times that of the pharmaceuticals industry (0.79 times), something that is a reflection of differing rates of capital efficiency.

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:

\[
\text{Consolidated Net Profit & Loss} = \text{Net Profit of Parent Company Alone} + \text{Cumulative Net Profit for Consolidated Subsidiaries} \pm \text{Consolidated Adjustment}
\]

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.
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 3-20 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 3-21 shows an example for Company A (refer to Charts 3-4, 3-5 and 3-7) 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 2016.

![Chart 3-21 Mutual Relationships Among Consolidated Financial Statements]

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
depts, 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 3-22.

### Chart 3-22 Summary Financial Reports from Transactions in the Example

#### Profit and Loss Statement

<table>
<thead>
<tr>
<th>Lease rent</th>
<th>Service Commissions Received</th>
<th>Net Profit for the Term</th>
</tr>
</thead>
<tbody>
<tr>
<td>15</td>
<td>70</td>
<td>20</td>
</tr>
<tr>
<td>35</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Operating Expenses</td>
<td></td>
<td></td>
</tr>
<tr>
<td>20</td>
<td></td>
<td>70</td>
</tr>
<tr>
<td>Net Profit for the Term</td>
<td></td>
<td></td>
</tr>
<tr>
<td>70</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

#### Balance Sheet

<table>
<thead>
<tr>
<th>Cash</th>
<th>Stated Capital</th>
<th>Net Profit for the Term</th>
</tr>
</thead>
<tbody>
<tr>
<td>120</td>
<td>100</td>
<td>20</td>
</tr>
</tbody>
</table>

#### Cash Flow Statement (Direct Method)

<table>
<thead>
<tr>
<th>Operating Income</th>
<th>Operating Expenses</th>
<th>Cash Flow from Sales Activity</th>
</tr>
</thead>
<tbody>
<tr>
<td>70</td>
<td>50</td>
<td>20</td>
</tr>
<tr>
<td>Cash from Sales Activity</td>
<td></td>
<td>20</td>
</tr>
<tr>
<td>70</td>
<td></td>
<td>Std Capital 100</td>
</tr>
</tbody>
</table>

#### Cash Flow Statement (Indirect Method)

<table>
<thead>
<tr>
<th>I. Cash Flow from Sales Activity</th>
<th>Net Pre-tax Profit for the Term</th>
</tr>
</thead>
<tbody>
<tr>
<td>20</td>
<td>20</td>
</tr>
</tbody>
</table>

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 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.
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**.

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

**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.
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 3-23 shows the basic elements of company analysis.
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 3-24 provides some representative examples of ratio of profit to capital and profit margin on sales.
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 3-25 shows these types of capital and the relationship amongst them.

Ordinary income and profit for the term are most often used in the numerator as profit. Therefore, as shown in Chart 3-24 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:

\[
\text{Total Capital} = \text{Total Assets} = \text{Equity + Third Party Capital (Liabilities) + Non-Controlling Interests, Etc.}
\]

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 3-4 and Chart 3-5 above:

\[
\text{FY2015: Ratio of Profit to Total Capital (Consolidated Basis)} = \frac{(\text{Net) Profit for the Term}}{\text{Total Capital (Average Between Beginning and End of the Term)}} \times 100
\]

\[
= \frac{11,168}{(166,283 + 175,696) \div 2} \times 100
\]

\[
= \frac{11,168}{170,990} \times 100 = 6.53\%
\]

\[
\text{FY2016: Ratio of Profit to Total Capital (Consolidated Basis)} = \frac{(\text{Net) Profit for the Term}}{\text{Total Capital (Average Between Beginning and End of the Term)}} \times 100
\]

\[
= \frac{13,964}{(175,696 + 200,811) \div 2} \times 100
\]

\[
= \frac{13,964}{188,254} \times 100 = 7.42\%
\]

* Total capital as of the end of FY2014= JPY166,283 million

[Determining Whether Ratios Are Good or Bad]
Determining whether the end results for a ratio of profit to total capitals of 6.53% (FY2015) and 7.42% (FY2016) 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 FY2016 (year ended on March 31, 2017) are as follows (calculated based on the Handbook of Industrial Financial Data 2017):

<table>
<thead>
<tr>
<th>Category</th>
<th>Ratio</th>
</tr>
</thead>
<tbody>
<tr>
<td>All Industries</td>
<td>3.37%</td>
</tr>
<tr>
<td>Non-manufacturing industries</td>
<td>3.30%</td>
</tr>
</tbody>
</table>

The figure of 7.42% for the FY2016 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

\[
\text{Ratio of Enterprise Profit to (Usage) Total Capital (\%)} = \frac{\text{Operating Profit + Interest & Dividends Received}}{\text{(Usage) Total Capital (Average Between Beginning and End of the Term)}} \times 100
\]

[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 3-4 and Chart 3-5 above:

\[
\begin{align*}
\text{FY2015: Ratio of Enterprise Profit to (Usage) Total Capital (Consolidated Basis)} &= \frac{\text{Operating Profit + Interest & Dividends Received}}{(166,283* + 175,696) ÷ 2} \times 100 \\
&= \frac{19,269 + 486}{170,990} \times 100 = 11.55% \\
\text{FY2016: Ratio of Enterprise Profit to (Usage) Total Capital (Consolidated Basis)} &= \frac{\text{Operating Profit + Interest & Dividends Received}}{(175,696 + 200,811) ÷ 2} \times 100 \\
&= \frac{19,755}{188,254} \times 100 = 10.55% 
\end{align*}
\]
Chart 3-26 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 FY2016 is above the average for all industries (5.54%) and the average of the information services (6.86%), on a consolidated basis for FY2016.

<table>
<thead>
<tr>
<th></th>
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<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>All Industries</td>
<td>6.7</td>
<td>3.9</td>
<td>3.7</td>
<td>5.4</td>
<td>4.6</td>
<td>4.5</td>
<td>5.4</td>
<td>5.4</td>
<td>5.6</td>
<td>5.6</td>
<td></td>
</tr>
<tr>
<td>Information Services Industry</td>
<td>9.3</td>
<td>8.1</td>
<td>8.6</td>
<td>8.7</td>
<td>9.1</td>
<td>9.4</td>
<td>8.3</td>
<td>7.5</td>
<td>7.0</td>
<td>6.9</td>
<td></td>
</tr>
</tbody>
</table>

(Source) Handbook of Industrial Financial Data 2017

(3) Ratio of Profit to Equity

\[
\text{Ratio of Profit to Equity} \times 100 = \frac{\text{Net Profit for the Term}}{\text{Equity (Average Between Beginning and End of the Term)}}
\]

[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 on 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 3-27 shows the changes in ROE for the past 10 years for all industries, the manufacturing industry and non-manufacturing industries in Japan.

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>All Industries</td>
<td>9.3</td>
<td>0.9</td>
<td>3.6</td>
<td>6.3</td>
<td>4.5</td>
<td>5.2</td>
<td>8.5</td>
<td>8.1</td>
<td>7.6</td>
<td>8.6</td>
</tr>
<tr>
<td>Manufacturing Industry</td>
<td>9.8</td>
<td>−1.7</td>
<td>2.4</td>
<td>6.6</td>
<td>4.0</td>
<td>4.8</td>
<td>8.5</td>
<td>8.3</td>
<td>7.5</td>
<td>8.0</td>
</tr>
<tr>
<td>Non-manufacturing Industry</td>
<td>8.4</td>
<td>5.0</td>
<td>5.4</td>
<td>5.8</td>
<td>5.3</td>
<td>5.8</td>
<td>8.4</td>
<td>8.0</td>
<td>7.6</td>
<td>9.5</td>
</tr>
<tr>
<td>Information Services Industry</td>
<td>9.8</td>
<td>1.8</td>
<td>8.9</td>
<td>10.2</td>
<td>9.6</td>
<td>11.6</td>
<td>11.3</td>
<td>11.2</td>
<td>11.7</td>
<td>11.1</td>
</tr>
</tbody>
</table>

(Source) Handbook of Industrial Financial Data 2017

[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 3-28 contains statistical data (consolidated basis) compiled for the wholesale industry and pharmaceuticals industry for FY2016.
Chart 3-28  Analysis of Ratio of Profit to Equity (Consolidated Basis)

<table>
<thead>
<tr>
<th></th>
<th>ROE</th>
<th>ROA</th>
<th>Financial Leverage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Wholesale Industry</td>
<td>8.80%</td>
<td>2.82%</td>
<td>3.12</td>
</tr>
<tr>
<td>Pharmaceuticals Industry</td>
<td>8.46%</td>
<td>5.53%</td>
<td>1.53</td>
</tr>
</tbody>
</table>

(Source) Calculated based on Handbook of Industrial Financial Data 2017

In the statistics for FY2016, ROA for the pharmaceuticals industry is about 1.96 times the wholesale industry whereas the ROE for the pharmaceuticals industry is 0.96 times the wholesale industry. Thus, the gap between the two industries has diminished. 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 3-4 and Chart 3-5 above:

\[
\text{FY2015: Ratio of Profit to Equity (Consolidated Basis)} = \frac{(\text{Net} \text{ Profit for the Term})}{\text{Equity (Average Between Beginning and End of the Term)}} \\
= \frac{11,168}{(93,555 + 100,722) \div 2} \times 100 \\
= \frac{11,168}{97,139} \times 100 = 11.50\%
\]

\[
\text{FY2016: Ratio of Profit to Equity (Consolidated Basis)} = \frac{(\text{Net} \text{ Profit for the Term})}{\text{Equity (Average Between Beginning and End of the Term)}} \\
= \frac{13,964}{(100,722 + 121,053) \div 2} \times 100 \\
= \frac{13,964}{110,888} \times 100 = 12.59\%
\]

* Equity as of the end of FY2014 = JPY93,555 million

When the ratio of profit to equity for FY2016 is compared with the statistical data for FY2016 given in Chart 3-27 above, it is higher than the average for all industries (8.6%) and the average for the information services industry (11.1%). Therefore, it can be concluded that the subject company has higher profitability relative to all industries and the average information services industry company.
(4) **Ratio of (Net) Profit to Stated Capital**

\[
\text{Ratio of (Net) Profit to Stated Capital (\%) = \frac{(Net) Profit for the Term}{Stated Capital (Average Between Beginning and End of the Term)} \times 100}
\]

[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. In that sense, 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 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 3-4 and Chart 3-5 above:
Chart 3-29 shows the ratios of (net) profit to stated capital for FY2016 for all industries, manufacturing industries and non-manufacturing industries in Japan.

\[
\text{FY2015: Ratio of (Net) Profit to Stated Capital (Consolidated Basis)} = \frac{(\text{Net) Profit for the Term}}{\text{Stated Capital (Average Between Beginning and End of the Term)}} \times 100
\]

\[
= \frac{11,168}{(12,952* + 12,952) \div 2} \times 100
\]

\[
= \frac{11,168}{12,952} \times 100 = 86.23\%
\]

\[
\text{FY2016: Ratio of (Net) Profit to Stated Capital (Consolidated Basis)} = \frac{(\text{Net) Profit for the Term}}{\text{Stated Capital (Average Between Beginning and End of the Term)}} \times 100
\]

\[
= \frac{13,964}{(12,952 + 12,952) \div 2} \times 100
\]

\[
= 107.81\%
\]

* Amount of Stated Capital as of the end of FY2014 = JPY12,952 million

[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:

<table>
<thead>
<tr>
<th>Formula</th>
<th>Description</th>
<th>FY2015</th>
<th>FY2016</th>
</tr>
</thead>
<tbody>
<tr>
<td>Ratio of Ordinary Profit to Total Capital (%)</td>
<td>Ordinary Profit / Total Capital (Average Between Beginning and End of the Term) \times 100</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Ratio of Ordinary Profit to Equity (%)</td>
<td>Ordinary Profit / Equity (Average Between Beginning and End of the Term) \times 100</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Ratio of Ordinary Profit to Stated Capital (%)</td>
<td>Ordinary Profit / Stated Capital (Average Between Beginning and End of the Term) \times 100</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

[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 3-4 and Chart 3-5:

- **Ratio of Ordinary Profit to Total Capital (Consolidated Basis)**
  
  \[
  \text{Ratio} = \frac{\text{Ordinary Profit}}{(166,283* + 175,696) / 2} \times 100 = 11.33\%
  \]

- **Ratio of Ordinary Profit to Equity (Consolidated Basis)**
  
  \[
  \text{Ratio} = \frac{19,367}{(93,555* + 100,722) / 2} \times 100 = 19.94\%
  \]

*Total capital as of the end of FY2014 = JPY166,283 million.
*2 Equity as of the end of FY2014 = JPY93,555 million.
*3 Stated capital as of the end of FY2014 = JPY12,952 million.
The above ratios must be compared with the average for all industries and the non-
manufacturing industries as shown in Chart 3-30 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 FY2016
exceeds the averages for all industries and the non-manufacturing industries.

<table>
<thead>
<tr>
<th>Ratio of Profit to Capital</th>
<th>Fiscal year</th>
<th>2016</th>
</tr>
</thead>
<tbody>
<tr>
<td>All Industries</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Non-Manufacturing</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total Capital</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Equity</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Stated Capital</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

*1 Total capital as of the end of FY2014 = JPY166,283 million.
*2 Equity as of the end of FY2014 = JPY93,555 million.
*3 Stated capital as of the end of FY2014 = JPY12,952 million.

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 3-16 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 3-31 shows the effects on profit margins of differing levels of sales for three railway transport companies.

The corporations are listed according to the order of total sales, and it can be seen that there is a correlation in the ordering based on scale.

<table>
<thead>
<tr>
<th>Railway transport companies</th>
<th>Sales (JPY millions)</th>
<th>Gross Profit Margin</th>
<th>Operating Profit Margin</th>
<th>Ordinary Profit Margin</th>
<th>Net Profit Margin for the Term</th>
</tr>
</thead>
<tbody>
<tr>
<td>JC Co.</td>
<td>1,756,980</td>
<td>45.67</td>
<td>35.26</td>
<td>32.10</td>
<td>22.36</td>
</tr>
<tr>
<td>JW Co.</td>
<td>1,441,411</td>
<td>25.58</td>
<td>12.24</td>
<td>11.15</td>
<td>6.33</td>
</tr>
<tr>
<td>KT Co.</td>
<td>1,204,867</td>
<td>18.15</td>
<td>5.38</td>
<td>4.71</td>
<td>2.18</td>
</tr>
</tbody>
</table>

(Source) Calculated based on securities reports of the companies

Chart 3-32 shows similar data for three food processing companies.

NH, which is by far the strongest in terms of total sales, ranks third for gross profit margin, and MS, which ranks third in terms of total sales, ranks first for gross profit margin. This demonstrates that the relationship between total sales and profit margin on sales has a tendency to be irregular.
[Analysis of Factors Underlying Irregular Cases]

This raises the question of why such irregular cases exist, and Chart 3-33 has been prepared in an attempt to clarify the reasons for this. From this chart, three factors are apparent:

(1) For the ratio of cost of goods sold to sales, NH is the highest, followed by PH, and MS is the lowest, which results in a situation in which MS has the highest gross profit margin and NH and PH have low margins.

(2) The ratio of selling expenses and general and administrative expenses to sales for MS relative to the other two companies is significantly high. This is a fact explainable by the company’s extremely low operating profit margin.

(3) NH has a higher ratio of interest expense to sales than MS and PH, indicating financing of NH is much more heavily dependent on borrowing.

Chart 3-34 shows the model employed in the analysis of (net) profit margin on sales at each level.
The following shows the results when the (net) profit margin on sales is obtained for the subject company based on Chart 3-5 above:

\[
\text{FY2015: (Net) Profit Margin on Sales} = \frac{11,168}{218,685} \times 100 = 5.11\%
\]

\[
\text{FY2016: (Net) Profit Margin on Sales} = \frac{13,964}{232,473} \times 100 = 6.01\%
\]

For the subject company, its (net) profit margin on sales for FY2016 is higher than the averages for all industries shown in Chart 3-35.

<table>
<thead>
<tr>
<th>Classification</th>
<th>Fiscal year</th>
<th>2016</th>
</tr>
</thead>
<tbody>
<tr>
<td>All Industries</td>
<td></td>
<td>4.37</td>
</tr>
<tr>
<td>Non-Manufacturing</td>
<td></td>
<td>4.50</td>
</tr>
</tbody>
</table>

(Source) Calculated based on Handbook of Industrial Financial Data 2017

(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):
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 3-5 above:

\[
\text{Gross Profit Margin on Sales (\%)} = \left( 1 - \frac{\text{Sales Cost}}{\text{(Net) Sales}} \right) \times 100
\]

FY2015: Gross Profit Margin on Sales (Consolidated Basis) = \( \frac{218,685 - 174,981}{218,685} \times 100 = 19.98\% \)

FY2016: Gross Profit Margin on Sales (Consolidated Basis) = \( \frac{232,473 - 186,013}{232,473} \times 100 = 19.99\% \)

Comparing the ratio for FY2016 against the average ratios for Japanese industries (see Chart 3-36), 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.

<table>
<thead>
<tr>
<th>Classification</th>
<th>Fiscal year</th>
<th>2016</th>
</tr>
</thead>
<tbody>
<tr>
<td>All Industries</td>
<td></td>
<td>25.22</td>
</tr>
<tr>
<td>Non-Manufacturing Industries</td>
<td></td>
<td>23.82</td>
</tr>
</tbody>
</table>

(Source) Calculated based on Handbook of Industrial Financial Data 2017
(3) Operating Profit Margin on Sales

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 3-5 above:

\[
\text{Operating Profit Margin on Sales (\%)} = \frac{\text{Operating Profit}}{\text{(Net) Sales}} \times 100
\]

<table>
<thead>
<tr>
<th>Year</th>
<th>Operating Profit Margin on Sales (Consolidated Basis)</th>
</tr>
</thead>
<tbody>
<tr>
<td>FY2015</td>
<td>[\frac{19,269}{218,685} \times 100 = 8.81%]</td>
</tr>
<tr>
<td>FY2016</td>
<td>[\frac{21,540}{232,473} \times 100 = 9.27%]</td>
</tr>
</tbody>
</table>

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

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 3-5 above:

\[
\text{FY2015: Operating Profit Margin on Sales (Consolidated Basis)} = \frac{19,367}{218,685} \times 100 = 8.86\%
\]

\[
\text{FY2016: Operating Profit Margin on Sales (Consolidated Basis)} = \frac{22,117}{232,473} \times 100 = 9.51\%
\]

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 3-37).

<table>
<thead>
<tr>
<th>Classification</th>
<th>Fiscal year</th>
<th>2016</th>
</tr>
</thead>
<tbody>
<tr>
<td>All Industries</td>
<td></td>
<td>7.00</td>
</tr>
<tr>
<td>Non-Manufacturing Industries</td>
<td></td>
<td>6.95</td>
</tr>
</tbody>
</table>

(Source) Calculated based on Handbook of Industrial Financial Data 2017

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 3-38, 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 3-39 shows a breakdown of the mechanism used for stability analysis with each of the specific financial ratios for each component of 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 3-4 above:

\[
\begin{align*}
\text{FY2015: Current Ratio (Consolidated Basis)} & = \frac{123,176}{50,731} \times 100 = 242.80\% \\
\text{FY2016: Current Ratio (Consolidated Basis)} & = \frac{136,493}{53,198} \times 100 = 256.58\%
\end{align*}
\]

To determine whether this ratio is good or bad, Chart 3-40 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 3-40 Changes in Current Ratio of Japanese Industries (Consolidated Basis)**

<table>
<thead>
<tr>
<th></th>
<th></th>
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<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>All Industries</td>
<td>127.1</td>
<td>128.5</td>
<td>135.9</td>
<td>138.1</td>
<td>136.9</td>
<td>138.3</td>
<td>141.8</td>
<td>144.6</td>
<td>144.7</td>
<td>145.4</td>
</tr>
<tr>
<td>Information Services Industry</td>
<td>150.0</td>
<td>152.5</td>
<td>149.4</td>
<td>147.5</td>
<td>161.5</td>
<td>151.2</td>
<td>139.7</td>
<td>140.0</td>
<td>138.3</td>
<td>129.1</td>
</tr>
</tbody>
</table>

(Source) Handbook of Industrial Financial Data 2017

**[Evaluating the Current Ratio]**

The current ratio for the subject company in FY2016 is significantly above the average of 145.4% (FY2016) for all industries as well as the average of 129.1% (FY2016) 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 around 100%. Chart 3-41 clearly shows these differences in current ratios among different industries.

**Chart 3-41 Comparison of Current Ratios Among Japanese Industries (Consolidated Basis)**

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Pharmaceuticals Industry</td>
<td>319.2</td>
<td>271.7</td>
<td>294.2</td>
<td>308.1</td>
<td>257.4</td>
<td>277.8</td>
<td>270.2</td>
<td>247.9</td>
<td>265.3</td>
<td>224.5</td>
</tr>
<tr>
<td>Electronics Parts Industry</td>
<td>266.8</td>
<td>275.5</td>
<td>270.7</td>
<td>233.0</td>
<td>237.0</td>
<td>258.6</td>
<td>289.6</td>
<td>294.6</td>
<td>295.9</td>
<td>296.6</td>
</tr>
<tr>
<td>Retail Industry</td>
<td>106.4</td>
<td>101.4</td>
<td>104.3</td>
<td>104.5</td>
<td>105.2</td>
<td>107.0</td>
<td>110.4</td>
<td>112.2</td>
<td>116.0</td>
<td>118.7</td>
</tr>
<tr>
<td>Gas Industry</td>
<td>93.1</td>
<td>109.4</td>
<td>114.2</td>
<td>124.4</td>
<td>135.6</td>
<td>132.6</td>
<td>139.3</td>
<td>149.2</td>
<td>143.2</td>
<td>147.9</td>
</tr>
</tbody>
</table>

(Source) Handbook of Industrial Financial Data 2017

**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 3-42 shows the average quick ratios that have existed in Japan.

<table>
<thead>
<tr>
<th>Fiscal year</th>
<th>2016</th>
</tr>
</thead>
<tbody>
<tr>
<td>All Industries</td>
<td>97.13</td>
</tr>
<tr>
<td>Manufacturing Industry</td>
<td>103.57</td>
</tr>
<tr>
<td>Non-Manufacturing Industries</td>
<td>88.89</td>
</tr>
</tbody>
</table>

(Source) Calculated based on Handbook of Industrial Financial Data 2017

**[Application of Formula]**

Below is the calculation of the quick ratio for the subject company based on Chart 3-4 above.

First, it is necessary to calculate the amount of the subject company’s quick assets for two years as follows:

**FY2015:** Cash and Deposits $2,308 + deposits paid 40,824 + Notes Receivable & Accounts Receivable 42,722 + Securities 0 - Allowance for Bad Debt 18 = Quick Assets 85,836

**FY2016:** Cash and Deposits $2,857 + deposits paid 43,103 + Notes Receivable & Accounts Receivable 51,187 + Securities 0 - Allowance for Bad Debt 22 = Quick Assets 97,125

Using these values yields the following for the quick ratio:

**FY2015:** Quick Ratio (Consolidated Basis) = \( \frac{85,836}{50,731} \times 100 = 169.20\% \)
At 182.57%, the subject company’s quick ratio in FY2016 is well above the averages in all industries in 2016, including the manufacturing industry and non-manufacturing industries. Therefore, the short-term solvency of the subject company can be regarded as extremely favorable.

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 3-43 shows, the average fixed ratio for Japanese corporations exceeds 100% by a large margin. In most instances, the fixed ratios for FY2016 were unusually high in those industries characterized by significant levels of fixed assets such as railways (260.7%), general trading companies (190.1%) and air transportation (179.2%). In contrast, this ratio is low in other industries such as metering instruments (57.7%) and electronics parts (61.7%), showing the wide disparity among different industries.

Chart 3-43 Changes in Fixed Ratios (Consolidated Basis)

<table>
<thead>
<tr>
<th></th>
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<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>All Industries</td>
<td>152.8</td>
<td>164.7</td>
<td>159.8</td>
<td>155.9</td>
<td>156.8</td>
<td>154.7</td>
<td>151.5</td>
<td>147.4</td>
<td>147.0</td>
<td>144.6</td>
</tr>
<tr>
<td>Information Services Industry</td>
<td>89.2</td>
<td>97.6</td>
<td>90.0</td>
<td>91.0</td>
<td>80.4</td>
<td>78.8</td>
<td>88.2</td>
<td>93.3</td>
<td>95.4</td>
<td>102.3</td>
</tr>
</tbody>
</table>

(Source) Handbook of Industrial Financial Data 2017
[Application of Formula]

The following is a calculation of the fixed ratios of the subject company based on Chart 3-4 above:

<table>
<thead>
<tr>
<th>Fiscal Year</th>
<th>Fixed Ratio (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>FY2015</td>
<td>52.14%</td>
</tr>
<tr>
<td>(Consolidated Basis)</td>
<td>52,519 / 100,722 × 100</td>
</tr>
<tr>
<td>FY2016</td>
<td>53.13%</td>
</tr>
<tr>
<td>(Consolidated Basis)</td>
<td>64,317 / 121,053 × 100</td>
</tr>
</tbody>
</table>

The fixed ratio for the subject company was 53.13% in FY2016, which is significantly below the averages for all industries (FY2016) and the average for the information services industry (FY2016). Therefore, the subject company can be regarded as financially stable.

(2) Fixed Assets to Long-Term Capital Ratio

Fixed Assets to Long-term Capital Ratio (%) = \( \frac{\text{Fixed Assets}}{\text{Equity} + \text{Minority Interests} + \text{Fixed Liabilities}} \times 100 \)

[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:

\[ \text{Fixed Assets} = \text{Equity} + \text{Non-Controlling Interests} + \text{Fixed Liabilities} \]

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 3-44 shows the average fixed assets to long-term capital ratios in Japan industries for the purpose of comparative analysis.

### Chart 3-44

<table>
<thead>
<tr>
<th>Classification</th>
<th>Fiscal year</th>
<th>2016</th>
</tr>
</thead>
<tbody>
<tr>
<td>All Industries</td>
<td></td>
<td>81.08</td>
</tr>
<tr>
<td>Manufacturing Industry</td>
<td></td>
<td>75.39</td>
</tr>
<tr>
<td>Non-Manufacturing Industries</td>
<td></td>
<td>87.42</td>
</tr>
</tbody>
</table>

(Source) Calculated based on Handbook of Industrial Financial Data 2017

[Application of Formula]

Below, the fixed assets to long-term capital ratios of the subject company have been calculated based on Chart 3-4 above:

\[
\text{FY2015: Fixed Assets to Long-term Capital Ratio (Consolidated Basis)} = \frac{52,519}{100,722 + 4,290 + 19,953} \times 100 = 42.03\%
\]

\[
\text{FY2016: Fixed Assets to Long-term Capital Ratio (Consolidated Basis)} = \frac{64,317}{121,053 + 4,671 + 21,887} \times 100 = 43.57\%
\]
The fixed assets to long-term capital ratio for the subject company was 43.57% in FY2016, 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

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 3-45 shows the averages for Japanese industries. As shown in Chart 3-46, 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.

<table>
<thead>
<tr>
<th></th>
<th></th>
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<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>All Industries</td>
<td></td>
<td>162.2</td>
<td>176.7</td>
<td>167.8</td>
<td>165.7</td>
<td>170.4</td>
<td>164.8</td>
<td>158.6</td>
<td>150.2</td>
<td>150.0</td>
<td>145.8</td>
</tr>
<tr>
<td>Information Services Industry</td>
<td></td>
<td>118.7</td>
<td>122.3</td>
<td>128.5</td>
<td>132.2</td>
<td>125.4</td>
<td>126.8</td>
<td>148.3</td>
<td>144.4</td>
<td>143.7</td>
<td>148.0</td>
</tr>
</tbody>
</table>

(Source) Handbook of Industrial Financial Data 2017

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>General Trading Companies</td>
<td></td>
<td>248.7</td>
<td>223.9</td>
<td>Pharmaceuticals</td>
<td></td>
<td>48.0</td>
<td>55.4</td>
</tr>
<tr>
<td>Air Transportation</td>
<td></td>
<td>181.5</td>
<td>151.3</td>
<td>Electronics Parts</td>
<td></td>
<td>47.1</td>
<td>46.7</td>
</tr>
<tr>
<td>General Construction</td>
<td></td>
<td>260.8</td>
<td>223.9</td>
<td>Publishing &amp; Printing</td>
<td></td>
<td>74.7</td>
<td>73.0</td>
</tr>
</tbody>
</table>

(Source) Handbook of Industrial Financial Data 2017

[Application of Formula]

Obtaining the liability ratios based on previously shown Chart 3-4 for the subject company
yields the following:

<table>
<thead>
<tr>
<th></th>
<th>FY2015: Liability Ratio</th>
<th>FY2016: Liability Ratio</th>
</tr>
</thead>
<tbody>
<tr>
<td>(Consolidated Basis)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>100%</td>
<td></td>
<td></td>
</tr>
<tr>
<td>50,731 + 19,953</td>
<td>100,722</td>
<td>53,198 + 21,887</td>
</tr>
<tr>
<td>× 100</td>
<td>70.18%</td>
<td>× 100</td>
</tr>
</tbody>
</table>

Using a benchmark of 100%, the figure of 62.03% (FY2016) for the subject company’s liability ratio is not only less than ideal, but also healthy relative to the average of 148.0% for the information services industry (FY2016).

8 4 Equity Ratio

Equity Ratio (%): \[
\text{Equity Ratio} \times 100 = \frac{\text{Equity}}{\text{Total Capital}} \times 100 = \frac{\text{Equity}}{\text{Equity + Share Options + Non-Controlling Interests + Liabilities}} \times 100
\]

[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 3-47 shows the average liquidity ratios for Japan’s domestic industries for the past 10 years.
Chart 3-47  Comparison of Equity Ratios Among Japanese Industries (Consolidated Basis)

<table>
<thead>
<tr>
<th>Classification</th>
<th>Fiscal year</th>
</tr>
</thead>
<tbody>
<tr>
<td>All Industries</td>
<td>36.1</td>
</tr>
<tr>
<td>Manufacturing Industry</td>
<td>40.6</td>
</tr>
<tr>
<td>Non-Manufacturing Industries</td>
<td>30.6</td>
</tr>
<tr>
<td>Information Services Industry</td>
<td>45.0</td>
</tr>
</tbody>
</table>

(Source) Handbook of Industrial Financial Data 2017

[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 3-48 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 3-48 Composition of Equity for Three Warehousing Companies (Consolidated Basis, FY2016) (%)

<table>
<thead>
<tr>
<th></th>
<th>ST Co.</th>
<th>MB Co.</th>
<th>YD Co.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Stated Capital &amp; Capital Reserve</td>
<td>13.47</td>
<td>9.64</td>
<td>5.87</td>
</tr>
<tr>
<td>Consolidated Surplus</td>
<td>30.71</td>
<td>41.52</td>
<td>27.14</td>
</tr>
<tr>
<td>Other</td>
<td>11.76</td>
<td>11.83</td>
<td>22.83</td>
</tr>
<tr>
<td>Total (Equity Ratio)</td>
<td>55.95</td>
<td>62.99</td>
<td>55.84</td>
</tr>
</tbody>
</table>

(Source) Calculated based on securities reports of the companies

[Application of Formula]

Obtaining the equity ratios based on Chart 3-4 above for the subject company yields the following:

\[
\begin{align*}
\text{FY2015: Equity Ratio} & = \frac{100,722}{175,696} \times 100 = 57.33\% \\
\text{FY2016: Equity Ratio} & = \frac{121,053}{200,811} \times 100 = 60.28\%
\end{align*}
\]

The equity ratio for the subject company was 60.28% (FY2016). This was higher than the averages for all industries, the non-manufacturing industry and the information services industry (FY2016). 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 3-49 shows several examples of the principal turnover ratios used in the system 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 3-4 and Chart 3-5 above for the subject company yields is the following:

FY2015: Total Capital Turnover Ratio
(Consolidated Basis) = \frac{218,615}{(166,283* + 175,696) ÷ 2} = 1.28 \text{ Times/Year}

FY2016: Total Capital Turnover Ratio
(Consolidated Basis) = \frac{232,473}{(175,696 + 200,811) ÷ 2} = 1.23 \text{ Times/Year}

* Total capital as of the end of FY2014 was JPY166,283 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 3-50 shows industry averages for total capital turnover ratios in Japan.

<table>
<thead>
<tr>
<th>Classification</th>
<th>Fiscal Year</th>
</tr>
</thead>
<tbody>
<tr>
<td>All Industries</td>
<td>0.95</td>
</tr>
<tr>
<td>Information Services</td>
<td>0.91</td>
</tr>
</tbody>
</table>

(Source) Handbook of Industrial Financial Data 2017

From this it can be seen that the total capital turnover ratio of 1.23 times a year for the subject company (FY2016) was higher than the averages for all industries and the information services industry (FY2016).

[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:

\[
\text{Total Capital Turnover Period} = \frac{1}{\text{Total Capital Turnover Ratio}}
\]
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 FY2016 of the subject company is calculated according to the two formulae referred to above based on Chart 3-4 and Chart 3-5 above:

As shown above, the total capital turnover period for the subject company is 9.72 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):

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 3-4 and Chart 3-5 above:
From this, it can be surmised that the increase in the ratio of (net) profit to total capital for the company from 6.53% to 7.42% in FY2016 was caused by the change in the (net) profit margin on sales rather than the total capital turnover ratio. 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

From this, it can be surmised that the increase in the ratio of (net) profit to total capital for the company from 6.53% to 7.42% in FY2016 was caused by the change in the (net) profit margin on sales rather than the total capital turnover ratio. 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.

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(2) Operating Capital Turnover Ratio

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[Application of Formula]

The following is the calculation of operating capital of the subject company based on Chart 3-4 above:

FY2015: Operating Capital = \[\text{Total Capital} \times 166,283*1 - (\text{Construction in Progress} \times 275*2 + \\
\text{Investments and Other Assets} \times 26,010*3 + \text{Deferred Assets} \times 0*4) + \text{Total Capital} 175,696 - (\text{Construction in Progress} 1,442 + \\
\text{Investments and Other Assets} 27,977 + \text{Deferred Assets} 0) \] ÷ 2
= 143,138

FY2016: Operating Capital = \[\left(\text{175,696} - 29,419\right) + \left(200,811 - 36,994\right) \] ÷ 2
= 155,047

*1 Total capital as of the end of FY2014 = JPY166,283 million
*2 Construction in progress as of the end of FY2014 = JPY275 million
*3 Investments and other assets as of the end of FY2014 = JPY26,010 million
*4 Deferred assets as of the end of FY2014 = JPY0 million

From this, the operating capital turnover ratio can be calculated as follows:

\[
\begin{align*}
\text{FY2015: Operating Capital Turnover Ratio} & = \frac{218,685}{143,138} = 1.53 \text{ Times} \\
\text{FY2016: Operating Capital Turnover Ratio} & = \frac{232,473}{155,047} = 1.50 \text{ Times}
\end{align*}
\]

For reference purposes, Chart 3-51 shows the average operating capital turnover ratios for all industries and the information services industry.

<table>
<thead>
<tr>
<th>Chart 3-51</th>
<th>Changes in Operating Capital Turnover Ratios of Japanese Industries (Consolidated Basis)</th>
<th>(Times/Year)</th>
</tr>
</thead>
<tbody>
<tr>
<td>All Industries</td>
<td>1.20</td>
<td>1.14</td>
</tr>
<tr>
<td>Information Services Industry</td>
<td>1.10</td>
<td>1.14</td>
</tr>
</tbody>
</table>

(Source) Handbook of Industrial Financial Data 2017
(3) Equity Turnover Ratio

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 3-52, 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.

<table>
<thead>
<tr>
<th></th>
<th>Tire Manufacturers</th>
<th>Pharmaceutical Companies</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>TG Co.</td>
<td>YG Co.</td>
</tr>
<tr>
<td>Equity Capital Ratio (%)</td>
<td>28.83</td>
<td>38.62</td>
</tr>
<tr>
<td>Total Capital Turnover Ratio (Times/Year)</td>
<td>0.75</td>
<td>0.74</td>
</tr>
<tr>
<td>Equity Turnover Ratio (Times/Year)</td>
<td>2.44</td>
<td>1.70</td>
</tr>
</tbody>
</table>

(Source) Calculated based on securities reports of the companies

[Application of Formula]

Below, the equity turnover ratio of the subject company has been calculated based on Chart 3-4 and Chart 3-5 above:

\[
\begin{align*}
\text{FY2015: Equity Turnover Ratio (Consolidated Basis)} &= \frac{218,685}{(93,555* + 100,722) \div 2} = 2.25 \text{ (Times)} \\
\text{FY2016: Equity Turnover Ratio (Consolidated Basis)} &= \frac{232,473}{(100,722 + 121,053) \div 2} = 2.10 \text{ (Times)} \\
* \text{Equity as of the end of FY2014 was JPY93,555 million.}
\end{align*}
\]

Chart 3-53 shows the averages of Japanese industries.
(4) **Inventory Turnover Ratio**

<table>
<thead>
<tr>
<th>Classification</th>
<th>Fiscal year</th>
<th>2016</th>
</tr>
</thead>
<tbody>
<tr>
<td>All Industries</td>
<td></td>
<td>1.97</td>
</tr>
<tr>
<td>Non-Manufacturing Industries</td>
<td></td>
<td>2.11</td>
</tr>
</tbody>
</table>

(Source) Calculated based on Handbook of Industrial Financial Data 2017

### [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 3-4 and Chart 3-5 above:

**FY2015:**

\[
\text{Inventory Turnover Ratio (Consolidated Basis)} = \frac{218,685}{(18,474* + 20,713) \div 2} = 11.16 \text{ (Times)}
\]

\[
\text{Inventory Turnover Period} = \frac{12}{11.16 \text{ Times}} = 1.08 \text{ Months}
\]
Chart 3-54 shows the average inventory turnover periods for Japan.

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>All Industries</td>
<td>1.31</td>
<td>1.40</td>
<td>1.44</td>
<td>1.29</td>
<td>1.35</td>
<td>1.40</td>
<td>1.34</td>
<td>1.36</td>
<td>1.37</td>
<td>1.41</td>
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<tr>
<td>Information Services</td>
<td>0.43</td>
<td>0.41</td>
<td>0.37</td>
<td>0.31</td>
<td>0.33</td>
<td>0.34</td>
<td>0.33</td>
<td>0.31</td>
<td>0.30</td>
<td></td>
</tr>
</tbody>
</table>

(Source) Handbook of Industrial Financial Data 2017

Analysis of 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.

FY2016: Inventory Turnover Ratio (Consolidated Basis) = \( \frac{232,473}{(20,713 + 21,472) \div 2} \) = 11.02 (Times)

Inventory Turnover Period = \( \frac{12}{11.02} \) Times = 1.09 Months

* Inventory assets as of the end of FY2014 were JPY18,474 million.
[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:

\[
\text{Sales} = \text{Variable Costs} + \text{Fixed Costs}
\]

\[
\text{Sales} - \text{Variable Costs} = \text{Fixed Costs}
\]

\[
\text{Sales} \times \left(1 - \frac{\text{Variable Costs}}{\text{Sales}}\right) = \text{Fixed Costs}
\]

\[
\text{Sales} = \frac{\text{Fixed Costs}}{1 - \frac{\text{Variable Costs}}{\text{Sales}}}
\]

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 3-55 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.
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 … profit 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 3-56 is a diagram that shows the parameters involved in 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 3-57 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 3-57** Ratio of Cash Flow from Operations to Sales by Industry Type

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Industries Where Ratio Is High</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Communications</td>
<td>21.8</td>
<td>19.9</td>
<td>18.5</td>
<td>18.0</td>
<td>22.2</td>
</tr>
<tr>
<td>Railroad</td>
<td>18.2</td>
<td>18.1</td>
<td>18.4</td>
<td>18.5</td>
<td>17.9</td>
</tr>
<tr>
<td>Pharmaceuticals</td>
<td>15.5</td>
<td>13.0</td>
<td>12.3</td>
<td>13.7</td>
<td>15.0</td>
</tr>
<tr>
<td>Industries Where Ratio Is Low</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>General Structure</td>
<td>3.6</td>
<td>3.7</td>
<td>3.2</td>
<td>4.4</td>
<td>10.5</td>
</tr>
<tr>
<td>Bakery and Confectionery Goods</td>
<td>5.3</td>
<td>5.3</td>
<td>6.5</td>
<td>6.0</td>
<td>6.9</td>
</tr>
<tr>
<td>Manufacturing</td>
<td>3.9</td>
<td>3.0</td>
<td>4.0</td>
<td>5.0</td>
<td>4.1</td>
</tr>
<tr>
<td>Wholesaling</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>All Industries</td>
<td>7.2</td>
<td>8.0</td>
<td>8.2</td>
<td>9.0</td>
<td>9.1</td>
</tr>
</tbody>
</table>

(Source) Handbook of Industrial Financial Data 2017
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]**

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.

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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.

<table>
<thead>
<tr>
<th>Fiscal Year</th>
<th>Classification</th>
<th>2012</th>
<th>2013</th>
<th>2014</th>
<th>2015</th>
<th>2016</th>
</tr>
</thead>
<tbody>
<tr>
<td>Industries Where Ratio Is High</td>
<td></td>
<td>21.8</td>
<td>19.9</td>
<td>18.5</td>
<td>18.0</td>
<td>22.2</td>
</tr>
<tr>
<td>Communications</td>
<td></td>
<td>18.2</td>
<td>18.1</td>
<td>18.4</td>
<td>18.5</td>
<td>17.9</td>
</tr>
<tr>
<td>Railroad</td>
<td></td>
<td>15.5</td>
<td>13.0</td>
<td>12.3</td>
<td>13.7</td>
<td>15.0</td>
</tr>
<tr>
<td>Pharmaceuticals</td>
<td></td>
<td>3.6</td>
<td>3.7</td>
<td>3.2</td>
<td>4.4</td>
<td>10.5</td>
</tr>
<tr>
<td>Industries Where Ratio Is Low</td>
<td></td>
<td>5.3</td>
<td>5.3</td>
<td>6.5</td>
<td>6.0</td>
<td>6.9</td>
</tr>
<tr>
<td>General Structure</td>
<td></td>
<td>3.9</td>
<td>3.0</td>
<td>4.0</td>
<td>5.0</td>
<td>4.1</td>
</tr>
<tr>
<td>Bakery and Confectionery Goods Manufacturing</td>
<td></td>
<td>7.2</td>
<td>8.0</td>
<td>8.2</td>
<td>9.0</td>
<td>9.1</td>
</tr>
<tr>
<td>All Industries</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

(Source) Handbook of Industrial Financial Data 2017

\[ \text{Ratio of Cash Flow from Operations to Sales (\%)} = \frac{\text{Cash Flow from Operations}}{\text{Sales}} \times 100 \]

[Application of Formula]

Below, the ratios of cash flow from operations to sales are calculated for the subject company based on Chart 3-5 and Chart 3-8 above:

\[
\begin{align*}
\text{FY2015: Ratio of Cash Flow from Operations to Sales (Consolidated Basis)} &= \frac{18,247}{218,685} \times 100 = 8.34\% \\
\text{FY2016: Ratio of Cash Flow from Operations to Sales (Consolidated Basis)} &= \frac{12,449}{232,473} \times 100 = 5.36\%
\end{align*}
\]

The rule of thumb is that the higher the ratio of cash flow from operations to sales, the better. For the subject company, in FY2016, the ratio of cash flow from operations to sales was slightly below the average for all industries of 9.1% (FY2016).

**[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 3-4 and Chart 3-8 above yields the following for the subject company:

\[
\begin{align*}
\text{FY2015: Ratio of Cash Flow from Operations to Interest Bearing Debt (Consolidated Basis)} &= \frac{18,247}{1,460} \times 100 = 1249.79\% \\
\text{FY2016: Ratio of Cash Flow from Operations to Interest Bearing Debt (Consolidated Basis)} &= \frac{12,449}{860} \times 100 = 1447.56\%
\end{align*}
\]

Chart 3-58 shows the average ratios of cash flow from operations to interest-bearing liabilities for all industries and the information services industry.
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 3-59 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.
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:

<table>
<thead>
<tr>
<th>Measurement</th>
<th>Formula</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales Growth Rate (%)</td>
<td>$\frac{\text{Total Sales for the Current Term}}{\text{Total Sales for the Previous Term}} \times 100$</td>
</tr>
<tr>
<td>Fixed Assets Growth Rate (%)</td>
<td>$\frac{\text{Fixed Assets for the Current Term}}{\text{Fixed Assets for the Previous Term}} \times 100$</td>
</tr>
<tr>
<td>Total Capital Growth Rate (%)</td>
<td>$\frac{\text{Total Capital for the Current Term}}{\text{Total Capital for the Previous Term}} \times 100$</td>
</tr>
<tr>
<td>Equity Growth Rate (%)</td>
<td>$\frac{\text{Equity for the Current Term}}{\text{Equity for the Previous Term}} \times 100$</td>
</tr>
<tr>
<td>Stated Capital Growth Rate (%)</td>
<td>$\frac{\text{Stated Capital for the Current Term}}{\text{Stated Capital for the Previous Term}} \times 100$</td>
</tr>
<tr>
<td>Profit Growth Rate (%)</td>
<td>$\frac{\text{Profit for the Current Term}}{\text{Profit for the Previous Term}} \times 100$</td>
</tr>
</tbody>
</table>

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:

Rate of Increase in Revenue (%) = \left( \frac{\text{Sales for the Current Term}}{\text{Sales for the Previous Term}} - 1 \right) \times 100

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 FY2016 (ended March 31, 2017) based on Chart 3-4 and Chart 3-5 above yields the following:

<table>
<thead>
<tr>
<th>Measure</th>
<th>Formula</th>
<th>Calculation</th>
<th>Growth Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>(1) Sales Growth Rate (%)</td>
<td>( \frac{232,473}{218,685} \times 100 )</td>
<td>(106.30%)</td>
<td></td>
</tr>
<tr>
<td>(2) Fixed Assets Growth Rate (%)</td>
<td>( \frac{64,317}{52,519} \times 100 )</td>
<td>(122.46%)</td>
<td></td>
</tr>
<tr>
<td>(3) Total Capital Growth Rate (%)</td>
<td>( \frac{200,811}{175,696} \times 100 )</td>
<td>(114.29%)</td>
<td></td>
</tr>
<tr>
<td>(4) Equity Growth Rate (%)</td>
<td>( \frac{121,053}{100,722} \times 100 )</td>
<td>(120.19%)</td>
<td></td>
</tr>
<tr>
<td>(5) Stated Capital Growth Rate (%)</td>
<td>( \frac{12,952}{12,952} \times 100 )</td>
<td>(100.00%)</td>
<td></td>
</tr>
<tr>
<td>(6) Ordinary Profit Growth Rate (%)</td>
<td>( \frac{22,117}{19,367} \times 100 )</td>
<td>(114.20%)</td>
<td></td>
</tr>
<tr>
<td>(7) Net Profit Growth Rate (%)</td>
<td>( \frac{13,964}{11,168} \times 100 )</td>
<td>(125.04%)</td>
<td></td>
</tr>
</tbody>
</table>

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 3-60 shows the averages growth rates in Japan for sales, net profit after-tax, total capital and equity from FY2006 with this year set as the benchmark of 100 with the growth rates for successive years shown relative to this chart.
### Chart 3-60 Changes in Growth Rates (Consolidated Basis)

<table>
<thead>
<tr>
<th>Type of Industry</th>
<th>Fiscal year</th>
<th>Sales</th>
<th>Net Profit (After Tax)</th>
<th>Total Capital</th>
<th>Equity</th>
</tr>
</thead>
<tbody>
<tr>
<td>All Industries</td>
<td>2006</td>
<td>100.0</td>
<td>100.0</td>
<td>100.0</td>
<td>100.0</td>
</tr>
<tr>
<td></td>
<td>2007</td>
<td>106.8</td>
<td>102.2</td>
<td>101.1</td>
<td>101.1</td>
</tr>
<tr>
<td></td>
<td>2008</td>
<td>99.8</td>
<td>9.1</td>
<td>95.1</td>
<td>90.1</td>
</tr>
<tr>
<td></td>
<td>2009</td>
<td>88.7</td>
<td>36.3</td>
<td>96.4</td>
<td>94.3</td>
</tr>
<tr>
<td></td>
<td>2010</td>
<td>93.7</td>
<td>65.3</td>
<td>97.2</td>
<td>96.0</td>
</tr>
<tr>
<td></td>
<td>2011</td>
<td>94.6</td>
<td>48.2</td>
<td>100.1</td>
<td>97.1</td>
</tr>
<tr>
<td></td>
<td>2012</td>
<td>97.2</td>
<td>58.4</td>
<td>107.1</td>
<td>106.0</td>
</tr>
<tr>
<td></td>
<td>2013</td>
<td>108.5</td>
<td>104.8</td>
<td>117.7</td>
<td>119.1</td>
</tr>
<tr>
<td></td>
<td>2014</td>
<td>113.1</td>
<td>112.7</td>
<td>127.0</td>
<td>132.7</td>
</tr>
<tr>
<td></td>
<td>2015</td>
<td>113.4</td>
<td>109.5</td>
<td>125.2</td>
<td>131.0</td>
</tr>
<tr>
<td></td>
<td>2016</td>
<td>109.5</td>
<td>127.0</td>
<td>129.7</td>
<td>138.0</td>
</tr>
<tr>
<td>Information Services Industry</td>
<td>2006</td>
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<td>100.0</td>
<td>100.0</td>
<td>100.0</td>
</tr>
<tr>
<td></td>
<td>2007</td>
<td>106.1</td>
<td>110.0</td>
<td>99.9</td>
<td>102.9</td>
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<td></td>
<td>2008</td>
<td>106.9</td>
<td>20.1</td>
<td>95.3</td>
<td>96.6</td>
</tr>
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<td></td>
<td>2009</td>
<td>101.6</td>
<td>99.7</td>
<td>106.1</td>
<td>104.6</td>
</tr>
<tr>
<td></td>
<td>2010</td>
<td>104.3</td>
<td>122.4</td>
<td>114.7</td>
<td>111.6</td>
</tr>
<tr>
<td></td>
<td>2011</td>
<td>107.6</td>
<td>121.8</td>
<td>117.6</td>
<td>117.9</td>
</tr>
<tr>
<td></td>
<td>2012</td>
<td>116.0</td>
<td>158.5</td>
<td>128.3</td>
<td>127.9</td>
</tr>
<tr>
<td></td>
<td>2013</td>
<td>123.8</td>
<td>168.7</td>
<td>154.7</td>
<td>141.1</td>
</tr>
<tr>
<td></td>
<td>2014</td>
<td>132.9</td>
<td>186.8</td>
<td>172.8</td>
<td>160.0</td>
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<tr>
<td></td>
<td>2015</td>
<td>144.9</td>
<td>218.4</td>
<td>190.8</td>
<td>176.6</td>
</tr>
<tr>
<td></td>
<td>2016</td>
<td>155.1</td>
<td>226.2</td>
<td>208.8</td>
<td>190.2</td>
</tr>
</tbody>
</table>

(Source) Handbook of Industrial Financial Data 2017

# 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:
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 3-61 illustrates the differences between dividend ratio and dividend payout ratio.

<table>
<thead>
<tr>
<th>Fiscal year</th>
<th>2013</th>
<th>2014</th>
<th>2015</th>
<th>2016</th>
</tr>
</thead>
<tbody>
<tr>
<td>Stated Capital</td>
<td>18,346</td>
<td>18,558</td>
<td>17,291</td>
<td>17,224</td>
</tr>
<tr>
<td>Net Profit for the Term</td>
<td>7,560</td>
<td>8,071</td>
<td>7,467</td>
<td>7,968</td>
</tr>
<tr>
<td>Dividend Amount</td>
<td>2,705</td>
<td>3,206</td>
<td>3,602</td>
<td>3,740</td>
</tr>
<tr>
<td>Dividend Ratio (%)</td>
<td>14.7</td>
<td>17.3</td>
<td>20.8</td>
<td>21.7</td>
</tr>
<tr>
<td>Dividend Payout Ratio (%)</td>
<td>35.8</td>
<td>39.7</td>
<td>48.2</td>
<td>46.9</td>
</tr>
</tbody>
</table>

(Source) Calculated in part based on Handbook of Industrial Financial Data 2015, 2016 and 2017

From this Chart, it is clear that, for the period from 2013 through 2016, the dividend ratio showed a mild change while the dividend payout ratio showed dramatic swings in response to profit during each year.

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 3-62 for the dividend situation for the subject company.
Obtaining the figures for the dividend ratio and dividend payout ratio for the subject company based on the abovementioned chart 3-62 yields the following:

\[
\text{FY2015:} \\
\text{Dividend Ratio} = \frac{3,952}{12,952^*1} \times 100 = 30.51\% \\
\text{Dividend Payout Ratio} = \frac{3,952}{9,569^*2} \times 100 = 41.30\% \\
\text{FY2016:} \\
\text{Dividend Ratio} = \frac{4,223}{12,952^*1} \times 100 = 32.61\% \\
\text{Dividend Payout Ratio} = \frac{4,223}{12,188^*2} \times 100 = 34.65\%
\]

*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 FY2015 and JPY12,952 million in FY2016.

*2 The amount of net profit for the parent company of the subject company on a non-consolidated basis was JPY9,569 million in FY2015 and JPY12,188 million in FY2016.

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 3-63 shows how these six indicators are arranged into a hexagonal shape.
Chart 3-63 Arrangement Showing Combinations of Indicators

Profitability (Ratio of Profit to Total Equity)
Liquidity (Current Ratio)
Efficiency of Asset Utilization (Inventory Turnover Ratio)
Growth Capacity (Sales Growth Rate)
Stability (Fixed Ratio)
Corporation Size (Equity)

[Application of Graphic Representation]

Chart 3-64 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 3-65 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.

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 approximately 40% that of the average for all industries, the efficiency of asset utilization (inventory turnover ratio) is higher, and further, profitability exceeds the average for all industries. On the other hand, the stability (fixed ratio) is below the average for all industries, which is approximately 70% of the average for all industries. The growth capacity and liquidity 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, stability and profitability.

Similarly, based on Chart 3-64, Chart 3-66 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, stability 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.

<table>
<thead>
<tr>
<th>Characteristics of Indicator</th>
<th>Selected Indicators</th>
<th>Subject Company</th>
<th>Information Services Industry</th>
<th>All Industries</th>
</tr>
</thead>
<tbody>
<tr>
<td>Profitability</td>
<td>Ratio of Profit to Equity (%)</td>
<td>12.6</td>
<td>11.1</td>
<td>8.6</td>
</tr>
<tr>
<td>Corporation Size</td>
<td>Equity (JPY million)</td>
<td>121,053</td>
<td>69,613</td>
<td>174,456</td>
</tr>
<tr>
<td>Efficiency of Asset Utilization</td>
<td>Inventory Turnover Rate (Times/Year)</td>
<td>11.02</td>
<td>39.94</td>
<td>8.51</td>
</tr>
<tr>
<td>Growth Capacity</td>
<td>Sales Growth Rate (%)</td>
<td>106.3</td>
<td>107.1</td>
<td>96.6</td>
</tr>
<tr>
<td>Liquidity</td>
<td>Current Ratio (%)</td>
<td>256.6</td>
<td>129.1</td>
<td>145.4</td>
</tr>
<tr>
<td>Stability</td>
<td>Fixed Ratio (%)※</td>
<td>53.1</td>
<td>102.3</td>
<td>144.6</td>
</tr>
</tbody>
</table>

(Source) Calculated in part based on Handbook of Industrial Financial Data 2017  ※For fixed ratio, the smaller value is desirable
Chart 3-66 Characteristics of the Subject Company Relative to Information Services Industry

Diagram showing:
- Profitability
- Liquidity
- Efficiency of Asset Utilization
- Growth Capacity
- Stability
- Corporation Size

Legend:
- Dotted line: Information services industry
- Solid line: The Subject Company
Chapter 4  Taxation of Securities Transactions

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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 inhabitants 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, 2018, with the exception that it incorporates the taxation measures accompanying the change at the time of raising the consumption tax rate.
- 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.
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 less the expenses (necessary expenses) directly necessary to generate such income. However, cost of living expenses are not considered necessary expenses.

Outline

1. Taxpayers
   (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” must pay 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 nonresident 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 income arising from their business activities within Japan, the expression “residents, or non-residents having 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).

Even 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 (“kokyo hoin”), 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 inhabitants 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”);
   b. Tax exemption for interest income on small-sum public bonds held by disabled persons, etc. (so-called “Tokubetsu Maru Yu”);
   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.

(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.
<table>
<thead>
<tr>
<th>Type of Income</th>
<th>Outline of Income</th>
</tr>
</thead>
<tbody>
<tr>
<td>Interest Income</td>
<td>• 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.</td>
</tr>
<tr>
<td>Dividend Income</td>
<td>• 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 bonds, etc. management investment trusts), and distributions of gains from specified trusts issuing beneficial interests, etc.</td>
</tr>
<tr>
<td>Real Estate Income</td>
<td>• Income from leasing a house, office, apartment, garage, land, neon sign location, etc.</td>
</tr>
<tr>
<td>Business Income</td>
<td>• Income from the business activities of retail sales, manufacturing, wholesale, service, etc.</td>
</tr>
<tr>
<td></td>
<td>• Income from agricultural and livestock activities.</td>
</tr>
<tr>
<td></td>
<td>• Income from the business activities of a lawyer, physician, dentist, judicial scrivener, registered representative, etc.</td>
</tr>
<tr>
<td></td>
<td>• Income from continuous transactions in securities such as shares, futures and options transactions that rise to the level of a business.</td>
</tr>
<tr>
<td>Salary Income</td>
<td>• Income from salaries, wages, allowances, bonuses, etc. (excluding retirement allowances).</td>
</tr>
<tr>
<td>Retirement Income</td>
<td>• Income from the retirement allowances and lump-sum pension and lump-sum retirement payments paid by social insurance systems, etc.</td>
</tr>
<tr>
<td>Timber Income</td>
<td>• Income from the transfer of standing or felled timber.</td>
</tr>
<tr>
<td></td>
<td>• However, income from the transfer of timber made within five years from the date of acquisition is excluded (such income will be considered business income or miscellaneous income).</td>
</tr>
<tr>
<td>Capital Gains</td>
<td>• 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).</td>
</tr>
<tr>
<td></td>
<td>• 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).</td>
</tr>
<tr>
<td></td>
<td>• 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).</td>
</tr>
<tr>
<td>Occasional Income</td>
<td>• 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.</td>
</tr>
<tr>
<td>Miscellaneous Income</td>
<td>• 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).</td>
</tr>
<tr>
<td></td>
<td>• 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.</td>
</tr>
</tbody>
</table>

(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: \( (\text{Amount of income} - \text{Amount of the deduction for retirement income}) \times 1/2 \)

g. Timber income: \( [\text{Amount of income} - (\text{Planting & management expenses}) + (\text{Cutting fee/transfer expenses})] - \text{JPY500,000} \) (special deduction)

h. Capital gains: \( [\text{Amount of income} - (\text{Acquisition cost, etc.} + \text{Transfer expenses})] - \text{JPY500,000} \) (special deduction)

i. Occasional income: \( [\text{Amount of income} - \text{Amount spent to earn income}] - \text{JPY500,000} \) (special deduction)

j. Miscellaneous income: Amount of income − Necessary expenses

The multiplication by 1/2 described in the retirement income item at f. above will not be applicable to the retirement income of certain directors.

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) Losses arising from transfer through a financial instruments business operator, etc. of listed shares, etc. during or after 2009 may under certain circumstances be netted against dividend income in connection with listed shares, etc., and may further be carried forward and deducted from the amount of income from transfer of shares, etc., as well as dividend income in connection with listed shares, etc., in each of the following three years.

In addition, with regard to the amount of losses on transfer of specified bonds, etc. arising on or after January 1, 2016, it became possible to deduct such losses in the category of interest income from profits in the category of dividend income, and vice versa, and to carry forward and deduct such losses for the next three years.

Further, it also became possible to carry out aggregation of profits and losses between the category of income relating to specified bonds, etc. and the categories of losses on transfer and dividend income relating to listed shares, etc. which had already been subject to special treatment of aggregation of profits and losses and deduction of net losses carried forward (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 (4) and 1-4 (6) (vii) below for details):

a. Beneficial interests of publicly offered bond investment trusts, etc., publicly-offered-bond-type beneficial interests of specified purpose trusts and interests, etc. on specified bonds for which payment is to be received from a domestic corporation, etc. on or after January 1, 2016;

b. 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.

c. Dividends, etc. on listed shares, etc., for which payment is received from a domestic corporation (excluding payments received by large shareholders);

d. Dividend, etc. on publicly offered securities investment trusts for which payment is received from a domestic corporation;

e. Dividend, etc. from investment accounts for which payment is received from a specified
investment corporation;
f. Dividend, etc. in elective withholding accounts; and
g. 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 f. above, or income from the transfer of listed shares, etc., described in g. 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 public 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 Inhabitants Tax System

Under the inhabitants tax (Prefectural Inhabitants Tax and Municipal Inhabitants 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 inhabitants 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. With regard to income subject to special withholding (interest income, dividend income, income from the transfer of listed shares, etc. held in a specified account for which the taxpayer elects for withholding taxation at source) that is subject to a separated withholding taxation at source or is not included in the final tax return (final tax return non-filing system), under the inhabitants tax such income will be treated in the same way in computing the income-proportional amount, i.e., in principle, it will be subject to separated taxation, and no return will be required (omission of filing of a tax return regarding the small-amount dividend income discussed later may not be chosen for inhabitants tax).

(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 14 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 (widowers), 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 or dependent in the case of spouse and dependent deductions must not exceed JPY380,000. 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:

<table>
<thead>
<tr>
<th>Total Taxable Income</th>
<th>Tax Rate</th>
<th>Amount of Deduction</th>
</tr>
</thead>
<tbody>
<tr>
<td>JPY1.95 million or less</td>
<td>5%</td>
<td>—</td>
</tr>
<tr>
<td>More than JPY 1.95 million, but not more than JPY 3.30 million</td>
<td>10%</td>
<td>JPY 97,500</td>
</tr>
<tr>
<td>More than JPY 3.30 million, but not more than JPY 6.95 million</td>
<td>20%</td>
<td>JPY 427,500</td>
</tr>
<tr>
<td>More than JPY 6.95 million, but not more than JPY 9.00 million</td>
<td>23%</td>
<td>JPY 636,000</td>
</tr>
<tr>
<td>More than JPY 9.00 million, but not more than JPY 18.00 million</td>
<td>33%</td>
<td>JPY1,536,000</td>
</tr>
<tr>
<td>More than JPY18.00 million, but not more than JPY40.00 million</td>
<td>40%</td>
<td>JPY2,796,000</td>
</tr>
<tr>
<td>More than JPY40.00 million</td>
<td>45%</td>
<td>JPY4,796,000</td>
</tr>
</tbody>
</table>

(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 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.

(iii) Tax Credits [“zeigakukoujo”]

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. Foreign tax credits;
c. Special credits for borrowings for acquisition of a home (housing loan credit); or
d. 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 and other payment for employees and capital investment; 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, withholding applies to interest received in Japan from bonds and other instruments issued outside of Japan as well as profits on redemptions of discount bonds, etc., which are subject to separated withholding taxation at source, in addition to ordinary interest. 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 with specified accounts for which the election of withholding taxation at source of specified accounts has been submitted).

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 inhabitants 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 inhabitants 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]**

\[
\text{Payment amount, etc.} \times \text{total tax rate (\%)} (*) = \text{Amount of Income Tax and Special Income Tax to be Withheld}^{(Note)}
\]

(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

\[
\text{Total tax rate (\%) } = \text{Income tax rate (\%) } \times 102.1\%
\]

*2 Example of the total tax rate according to the income tax rate

<table>
<thead>
<tr>
<th>Income tax rate (%)</th>
<th>5</th>
<th>7</th>
<th>10</th>
<th>15</th>
<th>16</th>
<th>18</th>
<th>20</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total tax rate (%)</td>
<td>5.105</td>
<td>7.147</td>
<td>10.21</td>
<td>15.315</td>
<td>16.336</td>
<td>18.378</td>
<td>20.42</td>
</tr>
</tbody>
</table>

(Income tax rate (%)×102.1%)

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.”
Chapter 4. Taxation of Securities Transactions

 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, the Income Tax Act provides that income tax and the special income tax for reconstruction on interest income be withheld at the time of payment by withholding 20.42% at source, and that 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) subject to the various kinds of special treatment discussed in (2) through (9) below (separated withholding taxation at source, self-assessed separated taxation, special treatment of not requiring the filing of a final tax return, and tax exempt 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 subject to a 15.315% “separated withholding taxation at source” (plus an inhabitants 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.

With regard to interest on public and corporate bonds set forth in (c) above, other than interest on specified bonds, if a corporation that pays interest on bonds falls under the

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category of a family company prescribed in Article 2, Item 10 of the Corporation Tax Act due to the appointment of a person who receives the interest on the day on which the payment is determined (for interests on bearer bonds, the day of the payment) as a shareholder, and thus becomes the basis for judging whether the corporation is a family company, the interest on bonds received by the said shareholder is not suitable for separated withholding taxation at source—the system that allows the taxpayer to complete the income taxation procedure only by paying the amount of withholding tax—and, therefore it is subject to comprehensive 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 above case. 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 inhabitants 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.

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.

c. Interest on specified bonds:

(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 4 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 11 of the said Article to which the provisions of Paragraph 2 of the said Article apply.

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;
Chapter 4. Taxation of Securities Transactions

(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 the 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 (2) 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;

(ii) Interest on bonds other than specified bonds that are received by a shareholder, etc., who served as the basis for judging whether a corporation is a family company, from the said 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 (4) 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 nonresident or foreign corporation: interest, etc. which is domestic source income (the interest, etc. set forth in Article 161, Item 4 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 (6) 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 corporation which falls under the category of a family company and which is received by its shareholders, etc.;
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 inhabitants 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 (and an additional inhabitants tax of 5% if the taxpayer is a resident) upon delivery of the said interest, etc., and 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 contain certain
matters (hereinafter referred to as a “notification of commencement of receiving dividends, etc.”)
to the director 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. must accept, into the specified account for dividends on listed shares, etc. in connection with the elective withholding account of the resident, etc. who submitted the notification, 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 (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 Over 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. (interest income) for the year, up to the amount of the dividend income, etc. from listed shares, etc. (interest income) (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 over and deducted from the amount of capital gains, etc. from listed shares, etc. and the amount of dividend income, etc. from listed shares, etc. (interest income) (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 dividend income, etc. from listed shares, etc. (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)*

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 management 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. 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 4-3  Summary of the *Maru Yu* and *Tokubetsu Maru Yu* Systems

<table>
<thead>
<tr>
<th>Category</th>
<th>Tax-Exempt Interest Income, Etc. from Small-Sum Savings (<em>Maru Yu</em>)</th>
<th>Tax-Exempt Interest on Small-Sum Government Bonds (<em>Tokubetsu Maru Yu</em>)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Applicable Savings</td>
<td>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.</td>
<td>Government bonds, publicly-offered municipal bonds</td>
</tr>
<tr>
<td>Applicable Users</td>
<td>Must qualify as “disabled person”</td>
<td>Same as on the left</td>
</tr>
<tr>
<td>Procedures</td>
<td>(i) The tax-exempt line must be established through a “Notification of Tax Exempt Savings.”</td>
<td>(i) The tax-exempt line must be established through a “Notification of Special Tax Exempt Savings.”</td>
</tr>
<tr>
<td></td>
<td>(ii) Submission of an “Application for Tax-Exempt Savings” upon making the deposit, etc.</td>
<td>(ii) Submission of an “Application for Special Tax-Exempt Savings” at the time of purchase.</td>
</tr>
<tr>
<td></td>
<td>(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 Law on the Book-Entry Transfers of Bonds and Shares, Etc.</td>
<td>(iii) Same as on the left.</td>
</tr>
<tr>
<td></td>
<td>(iv) Verification of qualification as disabled person, etc. and identification.</td>
<td>(iv) Same as on the left.</td>
</tr>
<tr>
<td>Maximum Allowable Amount</td>
<td>Principal of JPY3.5 million</td>
<td>Same as on the left</td>
</tr>
</tbody>
</table>

(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.

<table>
<thead>
<tr>
<th>Category</th>
<th>Tax Exemption on Interest Income for Asset Formation Housing Savings</th>
<th>Tax Exemption on Interest Income for Asset Formation Pension Savings</th>
</tr>
</thead>
<tbody>
<tr>
<td>Applicable Savings</td>
<td>(i) Deposits, collective management trusts, securities.</td>
<td>(i) Same as on the left.</td>
</tr>
<tr>
<td></td>
<td>(ii) Life insurance, fire and casualty insurance, etc.</td>
<td>(ii) Same as on the left as well as endowment insurance.</td>
</tr>
<tr>
<td>Applicable Users</td>
<td>Employees under 55 years of age.</td>
<td>Same as on the left.</td>
</tr>
<tr>
<td>Procedures</td>
<td>(i) One branch of one type of financial institution may be used.</td>
<td>(i) Same as on the left.</td>
</tr>
<tr>
<td></td>
<td>(ii) Establishment of an exemption limit by the “Notification for Asset Formation Tax Exempt Housing Savings.”</td>
<td>(ii) Establishment of an exemption limit by the “Notification for Asset Formation Tax Exempt Pension Savings.”</td>
</tr>
<tr>
<td></td>
<td>(iii) Submission of an “Application for Asset Formation Tax Exempt Housing Savings” upon making the deposit, etc.”</td>
<td>(iii) Submission of an “Application for Asset Formation Tax Exempt Pension Savings” upon making the deposit, etc.”</td>
</tr>
<tr>
<td></td>
<td>(iv) Submission of a “Notification on Confirmation of Application of Exemption on Asset Formation Tax Exempt Pension Savings” at the maturity of the deposits.</td>
<td></td>
</tr>
<tr>
<td>Maximum Allowable Amount</td>
<td>JPY5.5 million including Asset Formation Pension Savings.</td>
<td>JPY5.5 million in combination with the Asset Formation Housing Savings (JPY3.85 million for life and fire and casualty insurance, etc.)</td>
</tr>
<tr>
<td>Other</td>
<td>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.</td>
<td>Same as on the left</td>
</tr>
</tbody>
</table>
(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 inhabitants 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 (debtor) based on real estate collateral, and the companies create mortgages on the real estate of the debtor 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) Proceeds of Gold Savings Accounts, Etc.

The proceeds of 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.
(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.
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, inhabitants 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, interest on funds and distributions of proceeds from investment trusts (excluding proceeds of bond investment trusts and publicly offered bond management 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;
   - 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 capital, etc. of such corporation (the total of capital and capital reserve) 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 (bunkatsugatabunkatsu) (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 4-6 Image of Deemed Dividends](image)

(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 \( \text{(deduction of interest on borrowed funds)} \) 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 inhabitants 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 inhabitants 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 (2) (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 inhabitants tax); and
b. Dividend income from securities investment trusts (other than a specified share investment trust) --- 5% (plus 1.4% for inhabitants tax; however, for ordinary foreign currency-denominated securities investment trusts this is 2.5% (plus 0.7% for inhabitants 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 inhabitants tax of 1.4%); and
b. Dividend income from securities investment trusts (other than specified share investment trusts) --- 2.5% (plus 0.7% for inhabitants tax; however, for ordinary foreign currency-denominated securities investment trusts this is 1.25% (plus 0.35% for inhabitants 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 4-7  Dividends Tax Credit Rates Concerning Shares, Etc.

<table>
<thead>
<tr>
<th>Total Taxable Income, Etc.</th>
<th>JPY10 million</th>
<th>Dividend Deduction Rate</th>
</tr>
</thead>
</table>
| (i) Less than JPY10 million | Income other than dividend income | (i) Income tax: 10%  
(ii) Inhabitants tax: 2.8% |
|                            | Dividend income |                         |
| (ii) Over JPY10 million when dividend income is added | Income other than dividend income | (i) Income tax  
Portion (a): 10%  
Portion (b): 5%  
Inhabitants tax  
Portion (a): 2.8%  
Portion (b): 1.4% |
|                            | Dividend income |                         |
| (iii) Income other than dividend income is over JPY10 million | Income other than dividend income | (i) Income tax: 5%  
(ii) Inhabitants tax: 1.4% |
|                            | Dividend income |                         |

(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 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% inhabitants 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 place etc. bond investment trusts as well as dividends, etc., on investment trusts, etc., in foreign private placement bonds, etc. for which separated withholding taxation at source is to be collected) 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 (or investment units in the event of an investment corporation) or equity contributions of at least 3% of the total number of shares.

b. Dividends, etc. in connection with distributions of earnings of beneficial interests in 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).

The following dividends, etc. are excluded from this “dividends, etc. on listed shares, etc.”:

a. Dividends, etc. which are domestic source income (the dividends, etc. set forth in Article 161, Item 5 of the Income Tax Act) and to which the provisions of Article 212, Paragraph 2 of the said Act apply; and

b. The distributions of profits from foreign specified purpose trusts prescribed in Article 9-6, Paragraph 7, Item 1 of the Act on Special Measures Concerning Taxation or the distributions of earnings from foreign specified investment trusts prescribed in Item 2 of the said Paragraph to which the provisions of Paragraph 5 of the said Article apply.

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.

If the exceptional treatment is to be used, a final tax return is to be filed with certain documents such as payment notifications attached, 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. However, the dividend credit does not apply.

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) Medical expenses, dependents or other deductions that could not be fully deducted from the amount of other income in that year such as regular employment income or business income 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.

(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.”

(3) **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.”), these dividends, etc. are taxed separately from other income, at a 15.315% separated withholding taxation at source (plus an inhabitants tax of 5%, if the taxpayer is a resident) and the taxpayer is not required to file a final tax return:

(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 inhabitants tax of 5%, if the taxpayer is a resident), with the resident receiving the payment being subject to a separated withholding taxation at source.

(4) **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 (5) 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) Dividends, etc. that are received from a domestic corporation with respect to listed shares, etc. (excluding those received by a large shareholder, etc.);
(ii) Distributions of earnings from publicly offered securities investment trusts (securities investment trusts that do not fall within specified shares investment trusts, and for which the beneficial interests thereof were publicly offered at inception,) among securities investment trusts (so-called contractual type share investment trusts) other than bond investment trusts;

(iii) 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.

(iv) Small-sum dividends of unlisted shares, etc. (dividends, etc. that do not fall within (i) through (iii) above, 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);

(v) Distributions of earnings from beneficial interests of investment trusts, other than securities investment trusts, which do not fall under the category of bond investment management trusts and for which the offering of beneficial interests upon establishment has been conducted through a certain type of public offering to be received from the Government, local government, or any other domestic corporation; 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.

(5) 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 inhabitants 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.”).

(ii) Dividends, etc. on distributions of earnings from publicly offered securities investment trusts (excluding bond investment trusts);

(iii) Dividends, etc. on investment units of a specified investment corporation;

(iv) Dividends, etc. which are distributions of earnings from beneficial interests of
investment trusts, other than securities investment trusts, which do not fall under the category of bond investment management trusts and for which the offering of beneficial interests upon establishment 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).

(6) 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. 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 hôjin) 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 nonresidents 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 of beneficial interests on publicly offered securities investment trusts (excluding specified share investment trusts);
c. Dividends, etc. on investment units of specified investment corporations;
d. Dividends, etc. which are distributions of earnings from beneficial interests of investment trusts, other than securities investment trusts, which do not fall under the category of bond investment management trusts and for which the offering of beneficial interests upon establishment 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 inhabitants 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.

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% inhabitants 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.

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) 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.
(7) 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 (5) 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.

1 4 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% inhabitants 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% inhabitants 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. 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% inhabitants 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

General shares, etc. subject to this self-assessed separated taxation are those listed below which are not listed shares, etc. “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 (kyodokumiai), 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 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.

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).

(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:

\[
\begin{align*}
\text{Amount of business income or miscellaneous income} &= \left( \text{Total income from transfer} \right) - \left( \text{Basis of transferred assets and other necessary expenses} \right) \\
\text{Capital gains} &= \left( \text{Total income from transfer} \right) - \left( \text{Acquisition expense of the transferred assets and transfer expenses} \right)
\end{align*}
\]

(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 merger, split-off-type company split, 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
(excepting 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 received by the following individuals due to redemption of bonds other than specified bonds are subject to aggregate taxation as miscellaneous income:
[a] A certain shareholder who serves as the basis for judging whether a corporation is the family company prescribed in Article 2, Item 10 of the Corporation Tax Act, where the corporation that delivers the money or assets other than money due to redemption of bonds other than specified bonds will fall under the category of the family company if such judgment is made under the Corporation Tax Act on the day of the redemption (specifically, a shareholder who will satisfy the requirements set forth in Article 71, Paragraph 1, Item 5, a. of the Order for Enforcement of the Corporation Tax Act if the said person were the officer referred to in the said Paragraph (hereinafter referred to as a “specified individual”));
[b] A relative of a specified individual;
[c] A person in a relationship with a specified individual where the marital relationship is de facto, though a marriage has not been registered;
[d] An employee of a specified individual;
[e] A person other than those set forth in [b] through [d] above who maintains his/her living by receiving money or any other assets from a specified individual; and
[f] A relative of any of the persons set forth in [c] through [e] above who depends on such person for his/her livelihood.

(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 transfer restriction or shares with restriction on transfer
by succession --- Value of such shares on the date on which the restriction on
transfer is lifted;
[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.

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)

<table>
<thead>
<tr>
<th>Trading of Share Issue A</th>
<th>(No. of Shares)</th>
<th>(Unit Cost)</th>
<th>(Total Amount)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Acquired May last year</td>
<td>3,000 shares</td>
<td>JPY400</td>
<td>JPY1.2 million</td>
</tr>
<tr>
<td>Acquired April this year</td>
<td>5,000 shares</td>
<td>JPY1,000</td>
<td>JPY5.0 million</td>
</tr>
<tr>
<td>Sold June this year</td>
<td>4,000 shares</td>
<td>JPY1,300</td>
<td>JPY5.2 million</td>
</tr>
<tr>
<td>Acquired November this year</td>
<td>1,000 shares</td>
<td>JPY1,200</td>
<td>JPY1.2 million</td>
</tr>
</tbody>
</table>

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:

\[
\text{Cost per share sold} = \frac{\text{JPY1.2 million} + \text{JPY5 million}}{3,000 \text{ shares} + 5,000 \text{ shares}} = \text{JPY775 (Cost per share sold)}
\]

Therefore, the capital gain for these shares sold in June this year is as follows:

\[
\begin{align*}
\text{(No. of sold shares)} & \quad (\text{Basis}) \\
4,000 \text{ shares} & \quad \times \quad \text{JPY775} \\
\text{(Transfer earnings)} & \quad = \quad \text{JPY3.1 million} \\
\text{JPY5.2 million} & \quad - \quad \text{JPY3.1 million} \\
\end{align*}
\]

\[
\begin{align*}
\text{(No. of sold shares)} & \quad (\text{Capital gain}) \\
(\text{Transfer earnings}) & \quad = \quad \text{JPY2.1 million}
\end{align*}
\]

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 inhabitants tax of 5% if the taxpayer is a
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;

(Note) 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 45 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 1. 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 1. 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 the case where no assets other than shares or capital contributions of either of the following are delivered to a shareholder, etc. of the corporation: shares of or capital contributions to the merging corporation; or shares of or capital contributions to a corporation that has a relationship with the merging corporation whereby the said corporation 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 have been delivered to a shareholder, etc. of the said corporation as assets as consideration for a split prescribed in the Corporation Tax Act, except for either the shares of or capital contributions to the corporation succeeding in the split or the shares of, or capital contributions to a corporation that has a relationship with the corporation succeeding in the split whereby the said corporation 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

(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.

There are also provisions stipulating that 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. are to deemed to be revenue, 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 not 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 based on 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, 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,
e 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 the day of promulgation of the Act for
Partial Amendment of the Income Tax Act, etc. (Act No. 23 of 2008) (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., specified custody shares, 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., specified custody shares, 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., specified custody shares, 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., specified custody shares, or bonds held in a specified account.

Through this special treatment, the loss arising from specified management shares, etc., specified custody shares, 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. held 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 account registry (meaning the book-entry account registry prescribed in the Act on Book-Entry of Company Bonds, Shares, etc.; 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. held in a specified account above are the following listed shares, etc.:

a. Listed shares, etc. in a tax-exempt 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 in which the 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 which are transferred, based on rules established by an authorized financial instruments business association (Japan Securities Dealers Association), from the tax-exempt account to a specified account within a period during which the shares, etc. are designated as shares of over-the-counter managed issues.

(ii) Specified Custody Shares

The “specified custody shares” are shares which were specified management shares as of January 4, 2009 and which were withdrawn from the specified management account on January 5 of the same year and for which certain certification has been provided to the effect that no shares of the same issue have been acquired or transferred on or after that day.
“Certain certification has been provided” means that certification has been provided by attaching prescribed documents to the tax return for the year in which application of this special treatment is sought.

(Note) If shares of the same issue as those withdrawn from the specified management account are acquired or transferred on or after January 5, 2009, all of the shares of that issue will be excluded from the category of specified custody shares.

(iii) 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 account registry 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.

Notwithstanding (2) (iv) above, a special treatment has been enacted allowing a resident, etc. filing a tax return to deduct its losses on transfer of listed shares, etc. that occur in any year from 2016, and which still exist even after netting as set forth in (2) (iv) above, from dividend income, etc. in connection with listed shares, etc. for which self-assessed separated taxation has been selected.

(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) An 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 of odd lot shares or other listed shares, etc. similar to the same, pursuant to a buyback request, etc. 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, in the event of income deduction amounts such as the medical cost deduction or dependents deduction, which could not be fully deducted from other amounts of income such as general salary income or business income during that year, these can be deducted from the amount of capital gains on transfer, etc. of listed shares, etc. after the aggregation discussed above. 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.
(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 in Custody with 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 with a specified account”):

a. Calculation of income tax on transfers of listed shares, etc. in custody with 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 with a specified account may be elected by submitting the form “Notification of election of withholding taxation at source of specified account” to a financial instruments business operator; and

c. Income from the transfer of listed shares, etc. in custody with 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 minor’s taxable account; or
b. The Specified Account Application, etc. has been submitted in order to open a minor’s taxable 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.

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 a “specified margin transaction, etc. account.”
### (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. Specifically, this is as follows:

a. Shares, etc. listed on a financial instruments exchange;

b. Shares registered as “issues registered for over-the-counter trading” (including capital contributions and investment units of investment corporations), shares designated by an authorized financial instruments business association as over-the-counter managed issues (including capital contributions and investment units of investment corporations), and Bank of Japan contribution certificates registered in a register kept at an authorized financial instruments business association as registered issues;

c. Over-the-counter convertible type bonds with share options (meaning bonds with share options (including the convertible specified bonds and the specified bonds with preferred equity subscription rights under the Act on the Securitization of Assets) 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);

**Chart 4-9 Specified Accounts from January 1, 2016 Onward**

<table>
<thead>
<tr>
<th>Specified account (withholding account)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Interest income</td>
</tr>
<tr>
<td>- Interest on specified bonds</td>
</tr>
<tr>
<td>- Distribution of profits from publicly offered bond investment trusts</td>
</tr>
<tr>
<td>Capital gains, etc. from listed shares, etc.</td>
</tr>
<tr>
<td>- Capital gains or losses from specified bonds (redemption)</td>
</tr>
<tr>
<td>- Capital gains or losses from publicly offered bond investment trusts (cancellation/redemption)</td>
</tr>
<tr>
<td>- Capital gains or losses from listed shares</td>
</tr>
<tr>
<td>- Capital gains or losses from publicly offered share investment trusts (cancellation/redemption)</td>
</tr>
<tr>
<td>Dividend income</td>
</tr>
<tr>
<td>- Dividends from listed shares</td>
</tr>
<tr>
<td>- Distribution of profits from publicly offered share investment trusts</td>
</tr>
</tbody>
</table>

A financial instruments business operator, etc. calculates the capital gains or losses, interest, and dividend income for the year (aggregates these amounts with capital losses), and withholds tax at source (income tax of 15%, inhabitants tax of 5%).

<table>
<thead>
<tr>
<th>Specified account (account for simplified tax return)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Capital gains, etc. from listed shares, etc.</td>
</tr>
<tr>
<td>- Capital gains or losses from specified bonds (redemption)</td>
</tr>
<tr>
<td>- Capital gains or losses from publicly offered bond investment trusts (cancellation/redemption)</td>
</tr>
<tr>
<td>- Capital gains or losses from listed shares</td>
</tr>
<tr>
<td>- Capital gains or losses from publicly offered share investment trusts (cancellation/redemption)</td>
</tr>
</tbody>
</table>

(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.
d. Shares, etc. traded on a foreign financial instruments market;

e. 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) Investment trusts for which the offering of beneficial interests has been “conducted through a certain type of public offering” mean investment trusts for which the offering of beneficial interests have been conducted through the following solicitation of offers to acquire in the respective cases set forth therein:

(a) In the case where the offering of beneficial interests 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 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 issued 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 basic terms and conditions of an investment trust managed under instructions from the settlor or the basic terms and conditions of an investment trust managed without instructions from the settlor

(b) In the case where the offering of beneficial interests is made outside Japan:

Where the solicitation of offers to acquire relating to the 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

f. Investment units of specified investment corporations;

(Note) A “specified investment corporation” means an investment corporation under the Act on Investment Trusts and Investment Corporations which satisfies the following requirements (publicly offered type/open-ended type):

(a) The certificate of incorporation provides that investment units will be refunded in response to a request by an investor; and

(b) The solicitation for subscription for the investment units 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 falls under the cases set forth in the said Item is stated in the investment unit
application certificate.

g. 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);

h. 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);

i. National government bonds and municipal bonds;

j. Bonds issued or guaranteed by a foreign state or local public entity thereof;

k. 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);

l. Bonds for which public offering of securities at the time of their issuance was conducted through a certain type of public offering;

(Note) “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 issued only to qualified institutional investors; the same applies in (b)) 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; or

(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.

m. 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;

n. 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;

o. The following bonds issued in 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

(Note) “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.

(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).

p. 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 its 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.

q. Corporate bonds issued by a person engaged in a banking business or a type I financial instruments business (excluding type I small amount electronic offering handling business operator) 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 any affiliated company of the bank, etc. (excluding certain bonds where in substance the acquirers are not numerous); and

r. 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).

Listed shares, etc. to be in custody with Specified Account, after submitting Specified Account Opening Application, include:
   a. Those listed shares, etc. that have been acquired through a request for purchase to the financial instruments business operator (including intermediation, brokering or acting as agent for such consignment of purchase) or have been purchased from the financial instruments business operator;
   b. Those listed shares, etc. that have been held and transferred from the taxpayer’s specified account with another financial instruments business operator, etc.;
   c. Certain listed shares, etc. that have been acquired through a gift or an inheritance, etc., which are transferred to the specified account of the heir, etc. from an inheritance account that was opened by the ancestor, etc. at a financial instruments business operator, etc.;
   d. Those listed shares acquired through a share split or consolidation, share distribution, or allocation of shares without consideration with respect to listed shares, etc. held in specified custody accounts which are accepted in a specified account by entering, etc. the same in the book-entry transfer registry;
   e. Certain listed shares, etc. that have been allotted to the members of a life insurance company upon its conversion from a mutual company to a stock company; or
   f. Certain shares with restrictions on transfer, which are transferred by a certain method, to a specified account opened at the business office of a financial instruments business operator, etc. at which an account under which the shares with restriction on transfer are managed is opened, at the time when such restriction on transfer is removed.
The types of transfer of shares in custody with 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 with 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 with 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 in custody with 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 shares in custody with 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, 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.)

The specified account annual trading report takes the place of the detailed statement of account of capital gains, etc. from shares, etc. that is filed along with the final tax return. Accordingly, if the report is filed together with the tax return, the taxpayer will also be eligible for the special provisions regarding loss carry forwards, 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 Shares, Etc. in Custody with 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 “election of withholding taxation at source of specified accounts” to the business office of the financial instruments business operator, etc. with whom the account is opened.

The election form must be submitted not 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 form is submitted, 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 custody account for which the tax-payer filed a withholding election 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-electing custody 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. If the result is positive (adjusted income amount in the withholding-electing custody account), the financial instruments business operator withholds (or, in the case of inhabitants tax, special withholding applies) 15.315% in income tax and the special income tax for reconstruction, and 5% in inhabitants tax;

b. If the result of deducting the net income amount in the withholding-elected account immediately prior to the transaction from the net income amount in the withholding-elected account after the transaction is a negative number, the financial instruments business operator refunds the negative amount to the accountholder upon payment of the sales proceeds or cash used to settle the transaction. The amount of the refund is calculated by multiplying the negative amount by the above-mentioned tax rate and is limited to a maximum of amounts already withheld; and

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

The amount of income, etc. or loss realized upon the transfer of the listed shares, etc. held in a specified account for which the taxpayer has made the withholding election 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 specified account but cannot be made for only a part of the capital gain or loss for a particular 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 inhabitants tax, with the taxpayer similarly not being required to file a final tax return.

(7) Special Treatment for Calculation and Withholding, Etc. Regarding Dividends, Etc. within an Account for Which Withholding Has Been Elected

For specified accounts for which elective withholding has been selected (an “elective withholding account”), a special rule on calculating dividend income, etc. and the withholding
amount has enabled netting 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 (2) 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 to the financial instruments business operator, etc., at which the elective withholding account is opened, a notification of commencement of receiving dividends, etc. in an elective withholding account.

The financial instruments business operator, etc. which has received 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 submission of this notification of commencement has been received.

(Note) Except for cases in which a notice of closing specified account is filed, cancellation of the treatment under the special treatment is made by filing a notification of termination of receipt of dividends into an elective withholding account.

(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% inhabitants tax, if the taxpayer is a resident).

The special treatment for non-filing of a final tax return 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.

Nevertheless, 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)

The special treatment described below shall apply to cases where residents, etc. acquire by payment of cash (haraikomi) certain shares (“Specified Shares” or “Specified New Shares”) issued by specified small or medium companies or specified new small or medium companies.

(Note) The “Specified Shares or Specified New Shares” that are eligible for these special treatment shall be shares issued upon the establishment of a specified small or medium company or a specified new small or medium company or thereafter and acquired for cash (excluding those subject to 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

If a resident, etc. has acquired Specified Shares for cash, they may deduct the amount necessary to acquire the Specified Shares 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.

(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 an event specified below occurs between the date of incorporation 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, then that certain amount that is deemed to be the amount of such loss shall be deemed to be the amount of loss arising from the transfer of such Shares (capital loss) in the calculation of the amount of income derived from the transfer of shares, etc. in that year.

(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 Over of Amount of Capital Loss Relating to Specified Shares

Where a Resident, etc. who has acquired Specified Shares by payment of cash is unable to deduct all of the loss resulting from transferring the Specified Shares between the date of acquisition thereof and the date preceding the date of the listing, etc. of the said Shares, in calculating the amount of capital gains, etc. in connection with shares, etc. in the year containing the date on which the transfer was made, the amount 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 Enterprise (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 JPY10 million).

The amount of the gift deduction shall be calculated as follows:

\[
\text{Amount of Gift Deduction} = \left( \frac{\text{The amount of the gift deduction that is spent within the year}}{\text{Maximum of 40% of gross income, etc.}} \right) + \left( \frac{\text{The amount required to acquire the Deductible Specified New Shares that were acquired in that year (to a maximum of JPY10 million)}}{\text{Maximum of 40% of gross income, etc.}} \right) - \text{JPY2,000}
\]

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 Enterprise, and the transfer or gift becomes known to the Small or Medium Enterprise by way of, *inter alia*, notice pursuant to an agreement in connection with investment, the Specified Small or Medium Enterprise must by January 31 of the year following the year the date to which the Specified Small or Medium Enterprise became aware of the same belongs, notify the competent district director of the tax office having jurisdiction over the Small or Medium Enterprise, 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 specified new small or medium-sized stock company 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 small or medium-sized enterprise that has been established for less than ten years: shares issued by such corporation that have been acquired under an agreement relating to certain investment relating to a limited liability partnership for investment;

(c) A domestic corporation, being a stock company issuing shares of which the business has been designated under the rules of a certified financial instruments firms association as likely to grow and develop that is also a certain small or medium-sized enterprise that has been established for less than ten years: shares issued by such corporation following conclusion of an agreement with a certain financial instruments business operator, etc. relating to certain investment(s); or

(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, 2019: shares issued by such designated company.

b. Specified New Small or Medium Enterprise, and Specified New Shares

A “Specified New Small or Medium Enterprise” 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 specified new small or medium-sized stock company 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 whose number of years since incorporation is less than one year): shares issued by such stock company;

(b) 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, 2019: shares issued by such designated company;

(c) 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, 2020;

(d) 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, 2020; and

(e) A stock company engaged in certain businesses involving the solving of local problems faced in the special zone for reconstruction, and which has been designated by March 31, 2021 (limited to those that satisfy requirements such as that not more than five years have elapsed since the company was designated as such by the local government authorized under the provisions of the Act on Special Zone for Reconstruction from the Great East Japan Earthquake): shares issued by such stock company.

c. 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 or Specified New Shares by payment of cash.

However, the persons listed below shall not be eligible for the special treatment:

(a) A shareholder of a stock 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 Corporation Tax Act Enforcement Order, would fulfill the conditions listed in Item 5 a. of the said Paragraph;

(b) An individual who upon the incorporation of the company that issues shares transferred to the said company the whole of the business that the individual (“Former Business Proprietor”) was managing;

(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) A person (excluding persons described at (a) through (c) above) who has entered into an agreement providing conditions relating to investment in shares with a company that does not fall within the scope of an agreement relating to investment as provided in Article 5, Paragraph 2, Item 3 d. of the Enforcement Regulations for the Law Promoting New Business Activities by Small and Medium-sized Enterprises.

(9) Special Treatment for Taxation on Capital Gains from Transfer of Shares in Exchange for Shares of a Corporation Implementing Special Corporate Restructuring

When an individual transfers shares, etc. of a corporation through a special corporate restructuring under a special corporate restructuring plan approved by an approved business implementing special corporate restructuring under the Act on Strengthening Industrial Competitiveness (limited to corporations that have obtained approval of the special corporate restructuring plan during the period from the day of enforcement of the Act for Partial Amendment of the Act on Strengthening Industrial Competitiveness and Other Acts until March 31, 2021) and receives delivery of the shares of the approved business implementing special corporate restructuring, 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.

(10) Special Treatment for Capital Gains from Exchange of Shares

(i) Exchange of Shares

If a resident assigns the shares owned by the resident (hereinafter referred to as the “Old Shares”), through an exchange of shares, etc. (in principle, limited to exchange of shares where no assets other than shares are delivered) carried out by the issuer of the Old Shares, to a parent corporation that wholly owns the exchanging corporation and receives shares of the parent corporation in exchange or ceases to hold the Old Shares due to a qualified exchange of shares (limited to exchange of shares where no assets other than shares, etc. are delivered) carried out by the corporation issuing the Old Shares, the transfer or donation of the Old Shares shall be treated as having not occurred.

(Note) “Parent company that wholly owns the exchanging corporation” 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 exchange of shares.

(ii) Share Transfer

If a resident assigns the shares owned by the resident through a share transfer (in principle, limited to exchange of shares where no assets other than shares 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 seikyukentsuki 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 jokotsuki 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 JPY 100 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 continuation 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.

(v) Revocation of Taxation on Deemed Transfer, etc. under the System of Taxation at Various 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
(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.

1 5 Tax Exemption of Dividend Income and Capital Gains, Etc. from Small-Amount Listed Shares, Etc. in Tax-Exempt Accounts

(1) Outline of the Tax Exemption Scheme

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. aged 20 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 tax-exempt management account or cumulative investment account established in the tax-exempt accounts opened at business offices of financial instruments business operators, etc. Listed shares, etc. may be acquired via tax-exempt accounts in the following amounts: [i] up to JPY1.2 million per year for the period from the day on which a tax-exempt management account was established in the tax-exempt account until December 31 of the year in which the first-mentioned day belongs (JPY1 million per year for a tax-exempt management account established before January 1, 2016); and
[ii] up to JPY400,000 per year for the period from the day on which an cumulative investment account was established in the tax-exempt account until December 31 of the year in which the aforementioned day belongs. Tax exemption is available for the following periods: [i] a maximum of five years for each tax-exempt management account established in the tax-exempt account (a tax-exempt management account may be established every year during the ten years between 2014 and 2023); and [ii] a maximum of 20 years for each cumulative investment account established in the tax-exempt account (a cumulative investment account may be established every year during the 20 years between 2018 to 2037).

Investors may choose either of the two tax-exemption schemes: [a] those related to the tax-exempt management account described in [i] above (hereinafter referred to as the “general-type NISA”); and [b] those related to the cumulative investment account described in [ii] above (hereinafter referred to as the “Dollar-Cost Averaging NISA”).

Dividends, etc. eligible for tax exemption under the general-type NISA or Dollar-Cost Averaging NISA are limited to those delivered via the financial instruments business operators, etc. with which investors hold their tax-exempt accounts (e.g., the parties in charge of handling payment of dividends, etc.) Therefore, dividends, etc. delivered directly to investors from the companies that issued the listed shares, etc. are not covered by this scheme. (For details, refer to “(Reference) Method of Receiving Dividends, Etc. From Listed Shares and Taxation on Such Dividends, Etc. via Tax-Exempt Accounts” described below.)

(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.

(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.

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 or 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(2) 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, 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” mentioned above refers to the following listed shares, etc.

(a) Certain listed shares, etc. which are entered or recorded in the book-entry account registry 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; and

(b) Certain listed shares, etc. which are entered or recorded in the book-entry account registry 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.
## Outlines of the General-type NISA and Dollar-Cost Averaging NISA

<table>
<thead>
<tr>
<th>Eligible account holder (eligible persons)</th>
<th>General-type NISA (tax exempt management account)</th>
<th>Dollar-Cost Averaging NISA (cumulative investment account)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Eligible income</td>
<td>Dividends, etc. and capital gains on small-amount listed shares, etc. in tax-exempt accounts (dividends and capital gains obtained from investments in shares and investment trusts, etc.)</td>
<td>Dividends, etc. and capital gains on small-amount listed shares, etc. in tax-exempt accounts (dividends and capitals gains obtained from investments in certain investment trusts)</td>
</tr>
<tr>
<td>Eligible investments</td>
<td>Listed shares or publicly offered stock investment trusts</td>
<td>Publicly offered stock investment trusts and listed shares investment trusts, etc. suitable for long-term accumulated investment or diversified investment</td>
</tr>
<tr>
<td>Account opening period</td>
<td>Ten years from 2014 to 2023</td>
<td>20 years from 2018 to 2037</td>
</tr>
<tr>
<td>Tax exemption period</td>
<td>Maximum five years</td>
<td>Maximum 20 years</td>
</tr>
<tr>
<td>Tax-exempt investment amount</td>
<td>Up to JPY1.2 million (JPY1 million until 2015) as a new investment amount per year The maximum tax-exempt investment amount is JPY6 million * The unused portion may not be rolled over to subsequent years</td>
<td>Up to JPY400,000 as a new investment amount per year The maximum tax-exempt investment amount is JPY8 million * The unused portion may not be rolled over to subsequent years</td>
</tr>
<tr>
<td>Number of tax-exempt accounts</td>
<td>One account per person</td>
<td></td>
</tr>
<tr>
<td>Change of the financial instruments business operator, etc.</td>
<td>May be changed year by year. However, when shares or investment trusts, etc. are purchased using the NISA account which has already been opened, no change is allowed during that year.</td>
<td></td>
</tr>
<tr>
<td>Change between general-type NISA and Dollar-Cost Averaging NISA</td>
<td>Choose either general-type NISA or Dollar-Cost Averaging NISA. May be changed year by year. However, when shares or investment trusts, etc. are purchased using the NISA account which has already been opened, no change is allowed during that year.</td>
<td></td>
</tr>
<tr>
<td>Investment methods</td>
<td>No limitation</td>
<td>Periodical and continuous investment methods under agreement</td>
</tr>
<tr>
<td>--------------------</td>
<td>--------------</td>
<td>------------------------------------------------------------</td>
</tr>
<tr>
<td>Treatments after termination of the tax exemption period</td>
<td>(i) Shares and investment trusts, etc. shall be transferred to taxable accounts such as a specified account and general account and tax shall be levied on subsequent dividends and capital gains, etc. (ii) In addition to (i) above, after the termination of the tax exemption period, the relevant shares and investment trusts may be held without being subject to tax by using the tax exemption portion for the following year (i.e. roll over) * Transfer is allowed even if the total amount of market value exceeds JPY1.2 million</td>
<td>(i) Investment trusts, etc. shall be transferred to taxable accounts such as a specified account and general account and tax shall be levied on subsequent dividends and capital gains, etc. * Roll over is not allowed</td>
</tr>
<tr>
<td>Others</td>
<td>—</td>
<td>The financial instruments business operator, etc. must confirm the address and other information of the account holder as of the day on which ten years have passed since the day on which the first cumulative investment account was established in the tax-exempt account, and as of the day on which five years have passed since the day following the said day and each day that comes every five years thereafter</td>
</tr>
</tbody>
</table>
Conceptual Diagram of the General-Type NISA

Tax-exempt period: up to 5 years

<table>
<thead>
<tr>
<th>Year</th>
<th>1st year</th>
<th>2nd year</th>
<th>3rd year</th>
<th>4th year</th>
<th>5th year</th>
</tr>
</thead>
<tbody>
<tr>
<td>2014</td>
<td>JPY 1 million</td>
<td>JPY 1 million</td>
<td>JPY 1 million</td>
<td>JPY 1 million</td>
<td>JPY 1 million</td>
</tr>
<tr>
<td>2015</td>
<td>JPY 1.2 million</td>
<td>JPY 1.2 million</td>
<td>JPY 1.2 million</td>
<td>JPY 1.2 million</td>
<td>JPY 1.2 million</td>
</tr>
<tr>
<td>2016</td>
<td>JPY 1.2 million</td>
<td>JPY 1.2 million</td>
<td>JPY 1.2 million</td>
<td>JPY 1.2 million</td>
<td>JPY 1.2 million</td>
</tr>
<tr>
<td>2017</td>
<td>JPY 1.2 million</td>
<td>JPY 1.2 million</td>
<td>JPY 1.2 million</td>
<td>JPY 1.2 million</td>
<td>JPY 1.2 million</td>
</tr>
<tr>
<td>2018</td>
<td>JPY 1.2 million</td>
<td>JPY 1.2 million</td>
<td>JPY 1.2 million</td>
<td>JPY 1.2 million</td>
<td>JPY 1.2 million</td>
</tr>
<tr>
<td>2019</td>
<td>JPY 1.2 million</td>
<td>JPY 1.2 million</td>
<td>JPY 1.2 million</td>
<td>JPY 1.2 million</td>
<td>JPY 1.2 million</td>
</tr>
<tr>
<td>2020</td>
<td>JPY 1.2 million</td>
<td>JPY 1.2 million</td>
<td>JPY 1.2 million</td>
<td>JPY 1.2 million</td>
<td>JPY 1.2 million</td>
</tr>
<tr>
<td>2021</td>
<td>JPY 1.2 million</td>
<td>JPY 1.2 million</td>
<td>JPY 1.2 million</td>
<td>JPY 1.2 million</td>
<td>JPY 1.2 million</td>
</tr>
<tr>
<td>2022</td>
<td>JPY 1.2 million</td>
<td>JPY 1.2 million</td>
<td>JPY 1.2 million</td>
<td>JPY 1.2 million</td>
<td>JPY 1.2 million</td>
</tr>
<tr>
<td>2023</td>
<td>JPY 1.2 million</td>
<td>JPY 1.2 million</td>
<td>JPY 1.2 million</td>
<td>JPY 1.2 million</td>
<td>JPY 1.2 million</td>
</tr>
</tbody>
</table>

- An account is established for one account every year.
- The tax exemption is continuously available up to 1.2 million yen with regard to the listed shares, etc. transferred to another tax-exempt management account (limited to such account opened with the same financial instruments business operator, etc.).
- Up to five tax-exempt management accounts may be established within five years (for up to 6 million yen of tax-exempt investment in total).
- Only one tax-exempt management account may be established for each year (for up to 1.2 million yen of tax-exempt investment per tax-exempt management account).

Conceptual Diagram of the Dollar-Cost Averaging NISA

<table>
<thead>
<tr>
<th>Year of account establishment</th>
<th>1st year</th>
<th>2nd year</th>
<th>3rd year</th>
<th>4th year</th>
<th>5th year</th>
</tr>
</thead>
<tbody>
<tr>
<td>2018</td>
<td>JPY 400,000</td>
<td>JPY 400,000</td>
<td>JPY 400,000</td>
<td>JPY 400,000</td>
<td>JPY 400,000</td>
</tr>
<tr>
<td>2019</td>
<td>JPY 400,000</td>
<td>JPY 400,000</td>
<td>JPY 400,000</td>
<td>JPY 400,000</td>
<td>JPY 400,000</td>
</tr>
<tr>
<td>2020</td>
<td>JPY 400,000</td>
<td>JPY 400,000</td>
<td>JPY 400,000</td>
<td>JPY 400,000</td>
<td>JPY 400,000</td>
</tr>
<tr>
<td>2021</td>
<td>JPY 400,000</td>
<td>JPY 400,000</td>
<td>JPY 400,000</td>
<td>JPY 400,000</td>
<td>JPY 400,000</td>
</tr>
<tr>
<td>2022</td>
<td>JPY 400,000</td>
<td>JPY 400,000</td>
<td>JPY 400,000</td>
<td>JPY 400,000</td>
<td>JPY 400,000</td>
</tr>
<tr>
<td>2023</td>
<td>JPY 400,000</td>
<td>JPY 400,000</td>
<td>JPY 400,000</td>
<td>JPY 400,000</td>
<td>JPY 400,000</td>
</tr>
<tr>
<td>2024</td>
<td>JPY 400,000</td>
<td>JPY 400,000</td>
<td>JPY 400,000</td>
<td>JPY 400,000</td>
<td>JPY 400,000</td>
</tr>
<tr>
<td>2025</td>
<td>JPY 400,000</td>
<td>JPY 400,000</td>
<td>JPY 400,000</td>
<td>JPY 400,000</td>
<td>JPY 400,000</td>
</tr>
<tr>
<td>2026</td>
<td>JPY 400,000</td>
<td>JPY 400,000</td>
<td>JPY 400,000</td>
<td>JPY 400,000</td>
<td>JPY 400,000</td>
</tr>
<tr>
<td>2027</td>
<td>JPY 400,000</td>
<td>JPY 400,000</td>
<td>JPY 400,000</td>
<td>JPY 400,000</td>
<td>JPY 400,000</td>
</tr>
</tbody>
</table>

- Tax-exempt account
- Cumulative investment account (Account establishment period: 20 years)
- Tax exemption period: 20 years

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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\(^\text{Note 1}\))
(iv) via transactions accounts held at securities companies (allocated in proportion to the number of shares\(^\text{Note 2}\))

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\% (\text{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.

<table>
<thead>
<tr>
<th>Method of receiving dividends, etc.</th>
<th>Where to receive</th>
<th>Dividends, etc. received via tax-exempt accounts</th>
<th>Sales proceeds received via tax-exempt accounts</th>
</tr>
</thead>
<tbody>
<tr>
<td>(i) Using a receipt of dividends</td>
<td>At Japan Post Bank or post offices, etc.</td>
<td>20% tax(^\text{Note 3}) (Incl. local tax)</td>
<td>Tax-exempt</td>
</tr>
<tr>
<td>(ii) Using a registered dividend receiving account</td>
<td>Designated bank accounts</td>
<td>20% tax(^\text{Note 3}) (Incl. local tax)</td>
<td>Tax-exempt</td>
</tr>
<tr>
<td>(iii) Using an account designated for each issue</td>
<td></td>
<td>20% tax(^\text{Note 3}) (Incl. local tax)</td>
<td>Tax-exempt</td>
</tr>
<tr>
<td>(iv) Receiving dividends by allocation in proportion to the number of shares</td>
<td>Transaction accounts at securities companies</td>
<td>Tax exempt</td>
<td>Tax-exempt</td>
</tr>
</tbody>
</table>

\(\text{Notes}\)
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.
(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 and tax-exempt accumulated investment agreement are not dealt with) to be used to enter or record listed shares, etc. in the book-entry account registry or entrust custody of listed shares, etc., which is opened by a resident, etc. (limited to persons who are aged 20 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 (1) above, by submitting an application for opening of a tax-exempt account with documents including a letter of confirmation of eligibility for tax exemption, notice of abolition of an account or notice of abolition of tax-exempt account (hereinafter collectively referred to as the “letter of confirmation of eligibility for tax exemption, etc.”) or an application for easy opening of a tax-exempt account which does not require the attachment of a letter of confirmation of eligibility for tax exemption (such application shall be allowed to be submitted from January 1, 2019) for the account establishment period to which the year in which the account is to be opened belongs (hereinafter referred to as the “account opening year”) (the period refers to the period in which a tax exempt management account or cumulative investment account may be newly established in the account; the same applies hereinafter) to the director 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; or
(ii) Tax-exempt cumulative investment agreement: from January 1, 2018, to December 31, 2037.

(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 (1) above, which describe the following matters:

(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

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).
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 amount of consideration for purchase, payment for purchase or withdrawal from the account for transfer (market value); the same applies in (5)) 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 in (5)), 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 in (5)) 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 in 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 on the day on which five years have passed from January 1 of the year in which the tax-exempt management account was established.

(Note) When a specified account is 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) The abovementioned “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.

(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 (1) above, which describes the following matters:

(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.)

a. Among the listed shares, etc. acquired through entrustment of purchase with the financial instruments business operator, etc., listed shares acquired from the financial instruments business operator, etc. or listed shares, etc. acquired through offering of 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 listed shares, etc. received during the receiving period does not exceed JPY400,000.

b. In addition to those set forth in (a) above, 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) Listed, shares, etc. in a tax-exempt management account will, except for those which will be transferred as described in (ii)b. above, shall be transferred from an account in which the cumulative investment account was established to another custodial account on the day on which 20 years have passed from January 1 of the year in which the cumulative investment account was established.

(iv) Other certain matters
(Notes) 1. The abovementioned “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 abovementioned “cumulative investment account” refers to an account used to make records on the book-entry settlement of listed shares, etc. for which book-entry settlement, etc. is to be made based on a tax-exempt cumulative investment agreement separately from other records on other transactions.

3. “Publicly offered or other stock investment trusts” which are covered by the cumulative investment agreement refer to the following securities investment trusts:

   (i) Securities investment trusts other than bond investment trusts, for which beneficial interests are listed on a financial instruments exchange or traded on a foreign financial instruments market; and

   (ii) Securities investment trusts other than bond investment trusts, for which the offering of beneficial interests for the creation thereof was conducted through public offering (meaning the solicitation of offers to acquire as specified in the following according to the categories of cases set forth respectively therein):

      a. If the offering of beneficial interests is conducted in Japan:

         Where the solicitation of offers to acquire beneficial interests as prescribed in Article 2, Paragraph 3 of the Financial Instruments and Exchange Act regarding the offering falls under the case set forth in Item 1 of the said paragraph (meaning the case where the solicitation is issued to a large number of persons, but excluding the case where the solicitation is issued only to qualified institutional investors; the same applies in b.), and where it is stated in the basic terms and conditions of an investment trust managed under instructions from the settlor that the solicitation of offers to acquire falls under the case set forth in the said item; or

      b. If the offering of beneficial interests is conducted outside Japan:

         Where the solicitation of offers to acquire regarding the offering is equivalent to one that falls under the case set forth in Article 2, Paragraph 3, Item 1 of the Financial Instruments and Exchange Act,
(6) **Procedures for Application for Issuance of Letter of Confirmation of Eligibility for Tax Exemption**

(i) **Submission of an application for issuance of a letter of confirmation of eligibility for tax exemption**

A resident, etc. who intends to obtain a letter of confirmation of eligibility for tax exemption must submit to the director of the business office of a financial instruments business operator, etc. an issuance application stating his/her name, date of birth, address and personal number as well as other certain matters, during the period from October 1 of the year immediately preceding the year in which the account establishment period started to September 30 of the year in which the account establishment period ends.

A resident, etc. who intends to submit an issuance application must, upon making the submission, notify his/her name, date of birth, address and personal number to the director of the business office of the financial instruments business operator, etc. by presenting a copy of his/her residence certificate or other identity verification document or by transmitting an electronic signature certificate, etc. upon making such submission and receive confirmation for the matters notified.

(ii) **Provision of application information from the director of the business office of a financial instruments business operator to the competent district tax office director**

A director of the business office of a financial instruments business operator, etc. who received submission of an issuance application must, promptly after receiving such submission, provide information described in the issuance application (hereinafter referred to as the “application 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) **Issuance, etc. of a Letter of Confirmation of Eligibility for Tax Exemption, etc.**

The competent district tax office director who received provision of application information shall confirm whether or not the application information has been provided to him/her or another tax office director prior to the receipt of provision of such application information with respect to the resident, etc. who submitted an issuance application containing such application information (i.e. whether or not application has been filed redundantly). The competent district tax office director who made such confirmation must issue to the applicant, via the director of the business office of the financial instruments
business operator, etc. who received submission of an issuance application containing such application information the following documents specified in accordance with the respective categories:

a. Cases where an application information has not been provided to the competent district tax office director or another tax office director prior to receiving provision of the relevant application information: the following documents according to the respective categories:
   (a) Cases where the issuance application containing the relevant application information has been submitted during the period from October 1 to December 31 of the year immediately preceding the year in which the account establishment period started: a letter of confirmation of eligibility for tax exemption for the account establishment period which starts from January 1 of the year following the year in which such submission was made;
   (b) Cases where the issuance application containing the application information was submitted during the period from the day of commencement of the account establishment period until September 30 of the year in which the account establishment period ends: a letter of confirmation of eligibility for tax exemption for the account establishment period during which such submission was made.

b. Cases where the application information was provided to the competent district tax office director or other tax office director prior to receiving provision of the relevant application information: a document stating to the effect that a letter of confirmation of eligibility for tax exemption will not be issued and other certain matters.

(7) Procedures Related to Opening of a Tax-Exempt Account

(i) Submission of an application for 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 20 or older as of January 1 of the year in which the account is opened) must submit to the director of the business office of the financial instruments business operator, etc. at which he/she intends to open the account an application for opening of a tax-exempt account describing his/her name, date of birth, address and personal ID number as well as other certain matters by attaching a letter of confirmation of eligibility for tax exemption for the account establishment period to which the account opening year belongs, during the period from October 1 of the year immediately preceding 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 scheme will be received in the account for the first time in the account opening year (when a notice of abolition of account or notice of abolition of tax-exempt account is to be attached, the relevant day or September 30 of the account opening year, whichever is the earlier). In submitting an application for opening of a tax-exempt account, a resident, etc. must give similar notices as in the case of submitting an issuance application described in (6)(i) above, and receive confirmation.
(ii) Submission of an application for easy opening of a tax-exempt account

In addition to the procedures for opening an account described in (i) above, from January 1, 2019, a resident, etc. who intends to newly open a tax-exempt account may submit an application for easy opening of a tax-exempt account which does not require a letter of confirmation of eligibility for tax exemption be attached thereto, to the director of the business office of the financial instruments business operator, etc. and may open a tax-exempt account on the day when such submission was made.

(Notes) 1. A resident, etc. who has already opened a tax-exempt account cannot submit an application for easy opening of a tax-exempt account to the director of the business office of a financial instruments business operator.

2. When an application for issuance of a letter of confirmation of eligibility for tax exemption has been filed for an account establishment period starting on or after 2018, a resident, etc. may not submit an application for easy opening of a tax-exempt account to the director of the business office of a financial instruments business operator.

3. A tax-exempt account which is opened by submitting an application for easy opening of a tax-exempt account in the case described in 1 or 2 above will be treated as a general account (subject to taxation) from its opening.

(iii) Prohibition of redundant submission of an application for opening of a tax-exempt account and prohibition of redundant submission of a letter of confirmation of eligibility for tax exemption for the same account establishment period

A director of the business office of a financial instruments business operator, etc. may not accept an application for 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.

A resident, etc. who has already submitted a letter of confirmation of eligibility for tax exemption to establish a tax exempt management account or cumulative investment account for the account establishment period may not submit a letter of confirmation of eligibility for tax exemption to establish a tax-exempt management account or cumulative investment account for the same account establishment period as that of the first-mentioned account establishment period or an account establishment period which, in whole or in part, overlaps with the first-mentioned period, to the director of the business office of the financial instruments business operator, etc. who received submission of the letter of confirmation of eligibility for tax exemption or a director of a business office of a financial instruments business operator, etc. other than the first-mentioned director of the business office of the financial instruments business operator, etc.

(8) 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 exempt schemes described in (1) above with respect to his/her tax-exempt account, he/she must submit a notice of abolition of a tax-exempt account describing the following matters to the director of the business office of the financial instruments business operator, etc. at which the tax-exempt account is opened.

a. Name, date of birth and address of the person who submits a notice of abolition of a tax-exempt account.

(Note) Before March 31, 2016, the submitter’s personal ID number was required to be stated.

b. A statement to the effect that the tax-exempt account will be abolished and the code or number of the tax-exempt account with respect to which the resident, etc. intends to stop enjoying the tax exemption scheme described in (1) above.

c. Other certain matters

(ii) Provision of abolition information contained in the notice of abolition of a tax-exempt account to the district tax office director.

A director of the business office of a financial instruments business operator, etc. who received submission of a notice of abolition of a tax-exempt account shall, promptly after receiving such submission, provide the following information (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):

a. Name, date of birth and personal number of the person who submitted a notice of abolition of a tax-exempt account;

b. A statement to the effect that the tax-exempt account has been abolished through submission of a notice of abolition of tax-exempt account and the date of submission;

and

c. Other certain matters.

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 director 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, 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 director of the business office of the financial instruments business operator, etc.

(9) 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” (hereinafter referred to as the “written request for transfer of listed shares, etc. in a tax-exempt 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 for transfer of listed shares, etc. in a tax-exempt account are recorded using electronic or magnetic means that is conducted together with the transmission of the resident’s specified electronic signature certificate, etc. in lieu of submission of the written request for transfer of listed shares, etc. in a tax-exempt account), 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 for transfer of listed shares, etc. in the tax-exempt account (including the electronic or magnetic record in which the matters which should be described in the written request for transfer of listed shares, etc. in the tax-exempt account 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 for transfer of listed shares, etc. in the tax-exempt account.

(a) Name, date of birth and address of the person who submits the written request for transfer of listed shares, etc. in the tax-exempt account;
(b) Name and location of the business office of the financial instruments business operator, etc. to which the written request for transfer listed shares, etc. in a tax-exempt account 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 for transfer of listed shares, etc. in a tax-exempt account 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 listed shares, etc. related to a cumulative investment account

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.

(10) Automatic Opening of a Tax-Exempt Account When the Person Who Opened a Minor’s Account Becomes 20 Years Old

When a resident, etc. who has opened a minor’s account becomes 20 years old, the resident, etc. who has opened the minor’s account 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.

(11) Submission of Tax-Exempt Account Annual Transaction Report

When a tax exempt management account or 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
(12) 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 or cumulative investment 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 or 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 (hereinafter 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; (c) return of securities related to the listed shares, etc. in a tax-exempt account to the resident, etc.; or (d) 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 or 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 or 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, (c) return of securities or (d) 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, (c) return of securities or (d) 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 or cumulative investment 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 or cumulative investment 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.

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 \(^{\text{Note 1}}\) 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 20 years old as of January 1 of the year

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 20 years old as of January 1 of the year 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 20 years old as of January 1 of the year). 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 account registry 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>
<thead>
<tr>
<th>Category</th>
<th>Year in which the account may be established</th>
<th>Tax exemption period</th>
</tr>
</thead>
<tbody>
<tr>
<td>Minor’s account</td>
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<tr>
<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 20 years old as of January 1 of the year</td>
</tr>
</tbody>
</table>
### Outline of the Junior NISA

| **Intended account holder (eligible persons)** | Residents, etc. who are under 20 years old (from 0 to 19 years old) as of January 1 of the year in which the account will be opened |
| **Investment and management** | In principle, the person who has parental authority, etc. conducts investment and management on behalf of the minor. |
| **Tax exemption coverage** | Dividends and capital gains, etc. from small amount listed shares, etc. in the minor’s account (Dividends and capital gains obtained from investments in shares and investment trusts, etc.) |
| **Investment products** | Listed shares, publicly offered share investment trust, etc. |
| **Account opening period** | Eight years from 2016 to 2023 * Opening of a new account every year is unnecessary. |
| **Tax exemption period** | Up to five years |
| **Tax exempt investment amount** | Up to JPY800,000 every year as an amount of new investment. The maximum tax exempt investment amount is JPY4 million. * The unused quota may not be used in the following year onward. |
| **Number of available tax-exempt accounts** | One account per person * Accounts may not be opened redundantly |
| **Restriction on withdrawal** | Withdrawal is restricted until December 31 of the year in which the relevant minor is 18 as of March 31. If withdrawal is made in violation of the requirements, past profits will also be subject to taxation. * In the case of withdrawal due to unavoidable reasons such as disaster, withdrawal may be made without being taxed, as an exception. Upon such withdrawal, the account will be abolished. |
| **Change of financial instruments business operator, etc.** | Change is not allowed. * The financial institution may not be changed unless the account is abolished, and in such case, past profits will also be subject to taxation. |
| **Treatment after termination of the tax exemption period** | (i) Listed shares, etc. shall be transferred to a taxable minor’s account and subsequent dividends and capital gains will be taxed. (ii) In addition to what is provided for in (i) above, the listed shares, etc. may be held without being taxed by utilizing the tax exemption quota for the following year after the termination of the tax exemption period. * Even if the total amount of market value in five years exceeds JPY800,000, all of them may be received in the tax exemption quota for the following year. However, when the total amount of market value as of transfer has exceeded JPY800,000, listed shares and share investment trusts, etc. may not be newly purchased using the tax exemption quota for the following year. |
<In the case where the person who opened a minor’s account becomes 20 years old by the time of termination of the tax exemption period>

(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 20 years old as of January 1 of the year or who was born during the 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”).

However, 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 which 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 20 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 abovementioned “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 20 years old on January 1 of that year and the year in which he/she was born).

2. The abovementioned “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 20 years old on January 1 of that year).

(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.

(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 application for 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, 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 inhabitants 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:
- 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
- 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 director 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” (hereinafter referred to as the “written request for transfer of listed shares, etc. in a minor’s 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 for transfer of listed shares, etc. in a minor’s account by electronic or magnetic means together with the transmission of a specified electronic certificate for signature of the resident, etc., in lieu of the submission of the written request for transfer of listed shares, etc. in a minor’s account), 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 for transfer of listed shares, etc. in a minor’s account (including electronic or magnetic records containing the records on matters which should be described in the written request for transfer of listed shares, etc. in a minor’s account 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 for transfer of listed shares, etc. in a minor’s account;
(b) Name and location of the business office of a financial instruments business operator to which the written request for transfer of listed shares, etc. in a minor’s account 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 for transfer of listed shares, etc. in a
minor’s account.

(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 from 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 director 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 (including provision of electronic or
magnetic records containing the records on matters which should be described in the
written request for transfer of listed shares, etc. in a minor’s account by electronic or
magnetic means together with the transmission of a specified electronic certificate for
signature of the resident, etc., in lieu of the submission of the written request for
transfer of listed shares, etc. in a minor’s account), 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 for transfer of
listed shares, etc. in a minor’s account (including electronic or magnetic records
containing the records on matters which should be described in the written request for
transfer of listed shares, etc. in a minor’s account 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 for transfer of
listed shares, etc. in a minor’s account from the minor’s account.

(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 for transfer of listed shares, etc. in a minor’s account 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.

(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 20 years or older 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.

7 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.

8 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, etc. 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 other words, directors, executive officers or employees (including their successors except for certain persons such as large shareholders) 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;
   (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.

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 inhabitants 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 corporation is subject to aggregate taxation as miscellaneous income.

(Note) 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) 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 inhabitants 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 inhabitants 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 of Company Bonds, Shares, etc.

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 inhabitants 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 account registry 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).

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 inhabitants 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.: settlement of the relevant financial instruments futures transactions (excluding those in which delivery is to be made of the financial instruments); or

(Note) 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 1 through 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, 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 (limited to those conducted with financial instruments business operators or registered financial institutions as the counterparty).

(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.

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. 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; (b) the Individual Number notification card and a document for confirming the address, etc.; or (c) 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) below).

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) in Note 1. below); or (b) a document issued by a public agency

(Notes) 1. A “document for confirming the address, etc.” means the following:

   (a) 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); (b) a copy of a supplementary card of a family register or a seal registration certificate; (c) various kinds of health insurance certificate; (d) the national pension handbook, etc.; (e) a driver’s license; (f) 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.

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 payment made after January 1, 2019.

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.
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 exempt 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 exempt 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 the settlement of balance in the futures transactions, but if the special method to prepare the record for a net settlement of a futures transaction to the same person 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, 2014, if the number of pages of each record which should have been submitted during the second preceding year of the relevant year is 1,000 or more, the matters to be stated in such records are required to be submitted by either the method for submitting optical disks, etc., or the method for sending by use of e-Tax.

<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, 2019 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:

<table>
<thead>
<tr>
<th>No</th>
<th>Type of record</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Payment record of interest, etc.</td>
</tr>
<tr>
<td>2</td>
<td>Payment record of interest, etc. on foreign bonds, etc.</td>
</tr>
<tr>
<td>3</td>
<td>Payment record of dividends, distribution of surplus, and interest on funds</td>
</tr>
<tr>
<td>4</td>
<td>Payment record of dividends, etc. on foreign investment trusts, etc. or foreign shares, etc.</td>
</tr>
<tr>
<td>5</td>
<td>Payment record of distributions of earnings from investment trusts or specified trusts issuing beneficiary certificates</td>
</tr>
<tr>
<td>6</td>
<td>Payment record of distributions of earnings from open-end type securities investment trusts</td>
</tr>
<tr>
<td>7</td>
<td>Payment record concerning the amount deemed to be dividends, etc.</td>
</tr>
<tr>
<td>8</td>
<td>Payment record of consideration, etc. for transfer of shares, etc.</td>
</tr>
<tr>
<td>9</td>
<td>Payment record of delivered money, etc.</td>
</tr>
<tr>
<td>10</td>
<td>Payment record of consideration for transfer of beneficial interests of trusts</td>
</tr>
<tr>
<td>11</td>
<td>Payment record concerning futures transactions</td>
</tr>
<tr>
<td>12</td>
<td>Payment record of consideration for transfer of gold bullion, etc.</td>
</tr>
<tr>
<td>13</td>
<td>Record of interest income received by a registered person</td>
</tr>
<tr>
<td>14</td>
<td>Record of dividend income received by a registered person</td>
</tr>
<tr>
<td>15</td>
<td>Record of consideration for transfer of shares, etc. received by a registered person</td>
</tr>
<tr>
<td>16</td>
<td>Payment record of redemption money of listed securities investment trusts, etc.</td>
</tr>
<tr>
<td>17</td>
<td>Annual trading report of a specified account</td>
</tr>
<tr>
<td>18</td>
<td>Annual trading report of a tax-exempt account</td>
</tr>
<tr>
<td>19</td>
<td>Record of remittance to locations outside Japan, etc.</td>
</tr>
<tr>
<td>20</td>
<td>Record of transfer of securities to locations outside Japan, etc.</td>
</tr>
</tbody>
</table>
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).

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:
<table>
<thead>
<tr>
<th>Category</th>
<th>Fiscal year starting on or after April 1, 2015</th>
<th>Fiscal year starting on or after April 1, 2016</th>
<th>Fiscal year starting on or after April 1, 2018</th>
</tr>
</thead>
<tbody>
<tr>
<td>Small and medium-sized corporation</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>capitalized at not more than 100</td>
<td>Portion of annual income up to 8 million yen</td>
<td>15%</td>
<td>19% (15%)</td>
</tr>
<tr>
<td>million yen</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Portion of annual income exceeding 8 million yen</td>
<td>23.9%</td>
<td>23.4%</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>23.2%</td>
</tr>
<tr>
<td>Ordinary corporation</td>
<td>23.9%</td>
<td>23.4%</td>
<td>23.2%</td>
</tr>
</tbody>
</table>

* The tax rate in the parenthesis in this table applies to the fiscal year starting before March 31, 2019.

(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, and in addition, the retained income of family corporations and secret purpose expenditures of corporations are subject to additional taxes.

2. There is a consolidated return system for a parent company and its subsidiaries that are wholly owned, either directly or indirectly. There are also corporate income taxes, etc., that are respectively assessed on the income for trust property of a trust subject to corporation taxation, and on retirement pension funds, etc.

3. With regard to corporations whose issued shares are held in whole by another large corporations (meaning a corporation, etc. whose amount of stated capital, etc. is JPY500 million or more) which has a wholly controlling interest therein, the reduced tax rate applicable to small and medium-sized corporations shall not apply.

In order to use part of the corporate inhabitants 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. 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.
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, 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.

(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 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.

### 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 the 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), then deducting from this sum (including the value of properties to which the taxation system for settlement at the time of inheritance apply and the value of properties received as gifts from the decedent within three years prior to the commencement of inheritance) 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) 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 m² 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 4-10  Inheritance Tax Rates (Quick Calculation Table)

<table>
<thead>
<tr>
<th>Taxable Estate Value</th>
<th>Tax Rate</th>
<th>Amount of Deduction</th>
<th>Taxable Estate Value</th>
<th>Tax Rate</th>
<th>Amount of Deduction</th>
</tr>
</thead>
<tbody>
<tr>
<td>JPY 10 million or less</td>
<td>10%</td>
<td>—</td>
<td>JPY200 million or less</td>
<td>40%</td>
<td>JPY17,000,000</td>
</tr>
<tr>
<td>JPY 30 million or less</td>
<td>15%</td>
<td>JPY 500,000</td>
<td>JPY300 million or less</td>
<td>45%</td>
<td>JPY27,000,000</td>
</tr>
<tr>
<td>JPY 50 million or less</td>
<td>20%</td>
<td>JPY2,000,000</td>
<td>JPY600 million or less</td>
<td>50%</td>
<td>JPY42,000,000</td>
</tr>
<tr>
<td>JPY100 million or less</td>
<td>30%</td>
<td>JPY7,000,000</td>
<td>Over JPY600 million</td>
<td>55%</td>
<td>JPY72,000,000</td>
</tr>
</tbody>
</table>

(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.

\[
\begin{align*}
(1) \text{Total Inheritance tax} & \times \frac{\text{Taxable values of the spouse}}{\text{Total value of taxable property}} \\
(2) \text{Total of Inheritance tax} & \times \frac{\text{Total taxable values} \times \frac{1}{2} \left( \text{JPY160 million, if less than JPY160 million} \right)}{\text{Total taxable values}}
\end{align*}
\]

(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 20 (fractions of less than one year are treated as one year)

(2) Deduction for disabled persons: JPY100,000 (JPY200,000 for special disabled persons) \times \text{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 that require the value of property a successor acquired by gift from the decedent within three years prior to the commencement of probate to be included in
the amount of taxable property, 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, as well as 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 inhabitants 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, 2021, an individual aged 20 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:
(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%

<table>
<thead>
<tr>
<th>Date of conclusion of the contract for construction, etc. of a residential building</th>
<th>Energy-efficient and other high quality residence</th>
<th>Any other residence</th>
</tr>
</thead>
<tbody>
<tr>
<td>April 2019—March 2020</td>
<td>JPY30 million</td>
<td>JPY25 million</td>
</tr>
<tr>
<td>April 2020—March 2021</td>
<td>JPY15 million</td>
<td>JPY10 million</td>
</tr>
<tr>
<td>April 2021—December 2021</td>
<td>JPY12 million</td>
<td>JPY 7 million</td>
</tr>
</tbody>
</table>

(ii) In cases other than (i) above

<table>
<thead>
<tr>
<th>Period for conclusion of the contract for construction, etc. of a residential building</th>
<th>Energy-efficient and other high quality residence</th>
<th>Any other residence</th>
</tr>
</thead>
<tbody>
<tr>
<td>January 2015—December 2015</td>
<td>JPY15 million</td>
<td>JPY10 million</td>
</tr>
<tr>
<td>January 2016—March 2020</td>
<td>JPY12 million</td>
<td>JPY 7 million</td>
</tr>
<tr>
<td>April 2020—March 2021</td>
<td>JPY10 million</td>
<td>JPY 5 million</td>
</tr>
<tr>
<td>April 2021—December 2021</td>
<td>JPY 8 million</td>
<td>JPY 3 million</td>
</tr>
</tbody>
</table>

(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 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, 2019, the portion of the value of the said beneficial interests of trusts 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, etc.

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.
(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 20 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 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, 2019, the portion of the value of the said beneficial interests of trusts 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, etc.

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. 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.

The gift tax rate schedule is progressive, increasing with the value of the gift.

<table>
<thead>
<tr>
<th>Taxable Value After Basic Deduction</th>
<th>Tax Rate</th>
<th>Amount of Deduction</th>
</tr>
</thead>
<tbody>
<tr>
<td>JPY 2,000,000 or less</td>
<td>10%</td>
<td>—</td>
</tr>
<tr>
<td>JPY 3,000,000 or less</td>
<td>15%</td>
<td>JPY 100,000</td>
</tr>
<tr>
<td>JPY 4,000,000 or less</td>
<td>20%</td>
<td>JPY 250,000</td>
</tr>
<tr>
<td>JPY 6,000,000 or less</td>
<td>30%</td>
<td>JPY 650,000</td>
</tr>
<tr>
<td>JPY10,000,000 or less</td>
<td>40%</td>
<td>JPY1,250,000</td>
</tr>
<tr>
<td>JPY15,000,000 or less</td>
<td>45%</td>
<td>JPY1,750,000</td>
</tr>
<tr>
<td>JPY30,000,000 or less</td>
<td>50%</td>
<td>JPY2,500,000</td>
</tr>
<tr>
<td>Over JPY30,000,000</td>
<td>55%</td>
<td>JPY4,000,000</td>
</tr>
</tbody>
</table>

The gift tax rates for property that persons aged 20 or older have received as a gift from their lineal ascendants on or after January 1, 2015, are reduced as follows.

<table>
<thead>
<tr>
<th>Taxable Value After Basic Deduction</th>
<th>Tax Rate</th>
<th>Amount of Deduction</th>
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<tbody>
<tr>
<td>JPY 2,000,000 or less</td>
<td>10%</td>
<td>—</td>
</tr>
<tr>
<td>JPY 4,000,000 or less</td>
<td>15%</td>
<td>JPY 100,000</td>
</tr>
<tr>
<td>JPY 6,000,000 or less</td>
<td>20%</td>
<td>JPY 300,000</td>
</tr>
<tr>
<td>JPY10,000,000 or less</td>
<td>30%</td>
<td>JPY 900,000</td>
</tr>
<tr>
<td>JPY15,000,000 or less</td>
<td>40%</td>
<td>JPY1,900,000</td>
</tr>
<tr>
<td>JPY30,000,000 or less</td>
<td>45%</td>
<td>JPY2,650,000</td>
</tr>
<tr>
<td>JPY45,000,000 or less</td>
<td>50%</td>
<td>JPY4,150,000</td>
</tr>
<tr>
<td>Over JPY45,000,000</td>
<td>55%</td>
<td>JPY6,400,000</td>
</tr>
</tbody>
</table>
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 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 after a special deduction of JPY25 million) 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 values 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 20 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 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, 2021, 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.
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

<table>
<thead>
<tr>
<th>Category</th>
<th>Number (value) of unlisted shares, etc. which must be donated</th>
</tr>
</thead>
<tbody>
<tr>
<td>I</td>
<td>In the case of (c)(\geq (a) \times \frac{2}{3}-(b)) Number (value) not less than ((a) \times \frac{2}{3}-(b))</td>
</tr>
<tr>
<td>II</td>
<td>In the case of (c)&lt;(a)(\times \frac{2}{3}-(b)) All of (c)</td>
</tr>
</tbody>
</table>

### 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 \((a) \times \frac{2}{3}-(b)\)

* When the management succeeding donee has no (b), the number (value) obtained by the formula \((a) \times \frac{2}{3}\) 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 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) by preparing a special succession plan under the Facilitation Act and receiving confirmation from the prefectural governor by March 31, 2023 (three persons may act as such special donee for each company; 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 (limited to gift subject to the first application of these special treatments during the period from January 1, 2018 to December 31, 2027)(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. (there are no limits as those imposed under general measures; 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, 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), under certain
conditions (as in the case of general measures, measures for flexibility are taken for job
security requirements).

(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>
<thead>
<tr>
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</tr>
<tr>
<td>II</td>
<td>In the case of (c)&lt;(a)×2/3-(b) All of (c)</td>
</tr>
</tbody>
</table>

(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, 2023 (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).

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...
(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 (Shares which are known to be in the process of application for listing by the stock exchange, for the period from the date this becomes known until the day before the date of listing; and shares which are known to be in the process of registration as a registered issue, for the period from the date this becomes known until the day the registration; excluding over-the-counter managed issues.)

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 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.

(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 “inhabitants taxes”).

Since the fundamental structure of inhabitants taxes follows that of the national taxes, the following section explains their major features.

4 1 Individual Inhabitants Tax

The prefectural and municipal inhabitants taxes imposed on individuals (hereinafter referred to as “individual inhabitants 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 inhabitants 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 income-proportional tax component, but the amount of these deductions is determined separately from income tax. For example, while the basic deduction for income tax is JPY380,000, for individual inhabitants tax this is JPY330,000.

(Note) As a result of the tax reform in 2018, the amount of basic deduction for income tax on and after 2020 and individual inhabitants tax on and after 2021 has been amended to be a maximum JPY480,000 for income tax and a maximum JPY430,000 for individual inhabitants tax, respectively.

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

<table>
<thead>
<tr>
<th></th>
<th>Prefectural Inhabitants Tax</th>
<th>Municipal Inhabitants Tax</th>
</tr>
</thead>
<tbody>
<tr>
<td>Income-proportional tax rates</td>
<td>4%</td>
<td>6%</td>
</tr>
</tbody>
</table>

(Notes) 1. The income-proportional tax rates applicable to inhabitants of designated cities in and after FY2018 are 2% for prefectural inhabitants tax and 8% for municipal inhabitants tax.
2. Special tax rates apply for income such as capital gains on land, buildings, shares, etc.

(2) Per Capita Portion

<table>
<thead>
<tr>
<th>Per Capita Tax Rate</th>
<th>Prefectural Inhabitants Tax</th>
<th>Municipal Inhabitants Tax</th>
</tr>
</thead>
<tbody>
<tr>
<td>JPY1,000</td>
<td></td>
<td>JPY3,000</td>
</tr>
</tbody>
</table>

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 inhabitants tax for each year shall be increased and thereby the annual amount of prefectural inhabitants tax shall be JPY1,500, and municipal inhabitants tax shall increase JPY500 to JPY3,500, during the period from FY2014 to FY2023; a JPY500 increase respectively.
(3) **Inhabitants Tax Dividend Credit**

A dividend credit applies to personal inhabitants 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:

<table>
<thead>
<tr>
<th>Total Amount of Taxable Income</th>
<th>Up to JPY10 million</th>
<th>Exceeding JPY10 million</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Portion Up to JPY10 million</td>
<td>Portion Exceeding JPY10 million</td>
</tr>
<tr>
<td>General dividends and distributions of earnings from specified share investment trusts</td>
<td>2.8%</td>
<td>2.8%</td>
</tr>
<tr>
<td>Distributions of earnings from securities investment trusts, etc.</td>
<td>1.4%</td>
<td>1.4%</td>
</tr>
<tr>
<td>Distributions of earnings from foreign currency denominated securities investment trusts</td>
<td>0.7%</td>
<td>0.7%</td>
</tr>
</tbody>
</table>

(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 corporation 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 corporation 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.

An individual who is a resident in Japan may as an option to aggregate taxation elect to segregate from other income the dividends, etc. from listed shares, etc. for which payment is to be received, and have this taxed at a rate of 5% under self-assessed separated taxation (taxation on income basis).

The “dividends, etc. for listed shares, etc.” subject to this special treatment include interest, etc. on specified bonds, etc.

(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 inhabitants 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 inhabitants 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. (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 interest, etc. on specified bonds, etc.

(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 inhabitants tax and subject to a fixed rate of 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 inhabitants 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 inhabitants 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 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 inhabitants 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

Redemption money of discount bonds (excluding those received in a specified account) to be received by an individual who has an address in Japan is subject to taxation on dividend basis at a rate of 5% of the amount of profit from redemption relating to the redemption money, at the time of the redemption, while the profit from redemption of the discount bonds is subject to taxation on an income basis, and the amount equivalent to the dividend-based tax on the redemption money of the discount bonds is to be deducted 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.

42 Corporate Inhabitants Tax

The prefectural inhabitants tax (excluding Tokyo metropolitan inhabitants tax; the same applies hereinafter) and the municipal inhabitants tax on corporations (referred to as “corporate inhabitants 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.
(1) **Tax Rate of Corporation Tax-Proportional Amount of Corporate Inhabitants Tax**

The tax rate of the corporation tax proportional amount of corporate inhabitants tax is as specified in the table below.

<table>
<thead>
<tr>
<th>Tax item</th>
<th>Fiscal year starting before October 1, 2019</th>
<th>Fiscal year starting on or after October 1, 2019</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Standard tax rate</td>
<td>Upper limit for the tax rate</td>
</tr>
<tr>
<td>Prefectural inhabitants tax</td>
<td>3.2%</td>
<td>4.2%</td>
</tr>
<tr>
<td>Municipal inhabitants tax</td>
<td>9.7%</td>
<td>12.1%</td>
</tr>
</tbody>
</table>

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 inhabitants tax and amount equivalent to municipal inhabitants 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 inhabitants tax.

(2) **Tax Rate of Per Capita Amount of Corporate Inhabitants Tax**

The per capita prefectural inhabitants 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 inhabitants 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 inhabitants tax, the upper limit is set as 1.2 times the standard rate regarding the per capita amount of municipal inhabitants 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 inhabitants tax and amount equivalent to municipal inhabitants tax with regard to the per capita amount. The tax is divided into 10 brackets, ranging from 70,000 yen to 3.8 million yen, depending on the amount of stated capital, etc. and the number of employees.
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)

<table>
<thead>
<tr>
<th>National Taxes</th>
</tr>
</thead>
<tbody>
<tr>
<td>Taxation of Income</td>
</tr>
<tr>
<td>• <strong>Income tax</strong> (paid by individuals each calendar year based on earned income)</td>
</tr>
<tr>
<td>• <strong>Corporation tax</strong> (paid by corporations each fiscal year based on income and on accumulated reserves such as a retirement pension fund)</td>
</tr>
<tr>
<td>• <strong>Local corporation tax</strong> (paid by corporations each fiscal year based on corporation tax amount)</td>
</tr>
</tbody>
</table>
Taxation of Assets

- **Inheritance tax** (paid by the individual receiving property through inheritance)
- **Gift tax** (paid by the individual receiving assets as a gift from another individual)
- **Land value tax** (paid by 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** (taxes 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)

Additional Penalty Taxes

- **Additional tax for deficient returns** (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)
- **Additional tax 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. This tax may not be levied, or a reduced rate of 5% may be applied instead, in cases where there are justifiable grounds)
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)

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**Local Taxes**

© Prefectural Taxes

(Ordinary Taxes)

• **Prefectural** (including Tokyo) inhabitants 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)

• **Automobile acquisition tax** (a tax imposed on the purchaser according to the purchase price of a car)

• **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) inhabitants tax (a tax levied according to income on residents (individuals and corporations) of municipalities and called the special ward inhabitants 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
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.
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. When a financial instruments business operator, etc. carries out advertising of the contents of the financial instruments business in which it engages, it must indicate its registration number.

Q3. The Financial Instruments and Exchange Act classifies investors into professional investors and general investors, and enacts differences in treatment under the conduct regulations of financial instruments business operators, etc. based on this classification.

Q4. The sale of securities borrowed from another or the entrustment or acceptance of such sale is not subject to the short sale regulations.

Q5. 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]

Q6. The Act on Sales, Etc. of Financial Instruments provides for the compensation liability for damages incurred by customers arising from the breach of explanation obligations and the presumption of the amount of damages, etc.

Q7. Under the Act on Sales, Etc. of Financial Instruments, the obligation of financial instruments providers, etc. to explain important matters applies to all customers.

Q8. Under the Act on Sales, Etc. of Financial Instruments, even if the customer manifests its intent not to require explanation of important matters, the financial instruments providers, etc. is not exempt from the obligation to explain important matters.
[Articles of Association and Various Rules of the Association]

Q9. In the case where a Regular Member accepts from a customer the deposit of securities under a simple deposit contract, the Regular Member must conclude with the said customer a contract concerning the deposit of securities under the terms and conditions of safe custody management agreement.

Q10. 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.

Q11. 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.

Q12. An Association Member may only allow persons who have a sales representative qualification or who are registered as a sales representative to conduct the business of sales representatives.

Q13. 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]

Q14. 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.

Q15. 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.

Q16. Brokerage for clearing of securities, etc. is, in substance, an act to execute a sale or purchase, etc. by using nominally the name of a clearing participant for clearing a transaction between the clearing participant, who entrusts the sale or purchase, etc., and a clearing organization.
Q17. “Brokerage Agreement Standards” stipulated by a financial instruments exchange provide the contents of the contract for transactions at exchange to be concluded between the relevant exchange and the financial instruments business operators, and while financial instruments business operators are obliged to comply with these standards, customers are not.

Q18. 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]

Q19. The Financial Instruments and Exchange Act requires exchanges to announce the contract prices of transactions executed on the financial instruments exchange markets (the highest, lowest and closing prices) every business day.

Q20. 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.”

Q21. 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.

Q22. ETF and J-REIT are not included within the scope of transactions other than those during trading sessions.

Q23. The offering price made by the book building method is determined by comprehensively taking into account matters such as: the weighted average of the winning bid prices in competitive bidding; the risks that may arise until listing; and the estimates for demand.

[Bond Business]

Q24. Specified bonds are asset-backed securities backed by a variety of assets such as receivables and real estate, and issued by a specific purpose company.

Q25. In the case of trading interest-bearing bonds that have already been issued, the purchaser shall pay the seller the accrued interest in accordance with the period from the month immediately following the last interest payment month until the month of delivery of the bonds.
Q26. Bond transactions are conducted mainly in the exchange markets and very few transactions are conducted over-the-counter.

Q27. 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.

Q28. 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]

Q29. A fund that contains a certain percentage of both shares and bonds falls within the category of bond investment trusts.

Q30. 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.

Q31. A dividend from a monthly-paid investment trust will not be paid beyond the profit obtained by the fund.

Q32. Voting rights relating to the securities incorporated in the trust property of an investment trust managed under instructions from the settlor are exercised by the trustee company based on the instructions given by the investment trust settlor company.

Q33. 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.

Q34. A closed period refers to a period which has been specified in advance in the basic terms and conditions of an investment trust during which no dividends shall be paid.

Q35. Among dividends from additional offering-type stock investment trusts, refund of principal (special dividends) is subject to taxation.
[Stock Company Law In General]

Q36. If the company fails to pay its debts, shareholders have to repay such debts to the company’s creditors.

Q37. The company is entitled to exercise voting rights or to receive dividends with regard to its treasury shares.

Q38. Shareholders who dissent from a merger or assignment of business may have the company purchase their shares at a fair price following certain procedures.

Q39. Dividends paid to shareholders without distributable amounts are invalid.

Q40. Allotment to shareholders is a method for allotting new shares to existing shareholders in proportion to the number of shares already held by them.

[Financial Statements and Company Analysis]

Q41. The balance sheet shows the business performance of a company during a fixed interval of time.

Q42. Assets are divided into three categories, namely current assets, fixed assets and deferred assets.

Q43. The “group-parent multiplier” identifies the multiplier by which the consolidated sales, profits, assets, etc. of the group exceed those of a subsidiary company on a nonconsolidated basis.

Q44. A desirable level of the fixed assets to long-term capital ratio is 100% or more.

Q45. Profits arise when the break-even point ratio is above 100%.

[Taxation of Securities Transactions]

Q46. In “domestic taxation for residents,” the amount of loss from dividend income can be deducted from other income through the aggregation of profits and losses.

Q47. Dividends, etc. held in elective withholding accounts are eligible for the final tax return non-filing system.
Q48. National government bonds and municipal bonds are included in the scope of specified bonds.

Q49. 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.

Q50. The upper limit of the tax-exempt investment amount under the tax exemption program for dividend income, capital gains, etc. from small-amount listed shares, etc. in minors’ accounts (so-called Junior NISA) is JPY800,000 annually.

II. Answer the following questions in accordance with the instructions given in each question.

[Financial Instruments and Exchange Act]

Q51. Choose the two correct statements from below which describe the “system of sales representatives”:

1. A financial instruments business operator, etc. must register any person who conducts the solicitation for sale and purchase of securities as a sales representative.
2. An employee of a financial instruments business operator, etc. whose registration as a sales representative was revoked due to a supervisory disposition prescribed in the Financial Instruments and Exchange Act may be registered as a sales representative again upon the expiration of one year from the date of revocation.
3. When the registered sales representative no longer conducts the duties of sales representative due to retirement or other reasons, a financial instruments business operator, etc. must notify the Prime Minister to that effect without delay.
4. A sales representative shall be deemed to have the authority to perform any and all judicial or extra-judicial acts in connection with the acts provided for in the Act, including the sale and purchase of securities, on behalf of the financial instruments business operator, etc. to which he/she belongs.
5. A financial instruments business operator, etc. is not directly liable to satisfy the obligations borne by its sales representatives.
Q52. 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 the customer pursuant to the provisions of Cabinet Office Ordinance without delay upon the conclusion of a contract for financial instruments transaction or when otherwise specified by Cabinet Office Ordinance.
5. The scope of the securities subject to the system for submitting reports of possession of large volume include investment securities.

Q53. 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
[Articles of Association and Various Rules of the Association]

Q54. Choose the two false statements from below regarding a corporate information management system:

1. An Association Member must establish internal rules for the management of corporate information that prescribe matters concerning the communication procedures of corporate information.
2. An Association Member must establish procedures necessary to manage the corporate information so that officers and employees who acquire the corporate information immediately report that acquisition to the management section.
3. An Association Member must manage the corporate section so that the corporate information is not communicated to other sections that do not need such information for their business, such as by physically isolating the corporate section from other sections.
4. A corporate section is a section that comprehensively manages corporate information.
5. An Association Member is not required to conduct regular inspections or monitoring to check whether or not the corporate information is managed properly pursuant to the internal rules.

[Articles of Association and Various Rules of the Association]

Q55. Which of the following examples A to C correctly describes the representation of advertising, etc. which an associated member is prohibited from placing as provided for in the “Rules Concerning Representation of Advertising, Etc. and Offer of Premiums”? Choose the one option from below which indicates the combination of the correct descriptions:

A. Representation of advertising, etc. which impairs the dignity of the association member
B. Representation of advertising, etc. which hampers fair competition among association members
C. Representation of advertising, etc. which includes a judgment or evaluation for which the basis is not clearly indicated

(Options)
1. A and B
2. A and C
3. B and C
4. A, B, and C
5. None of the above is applicable
[Equity Business]

Q56. 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

(Options)

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<thead>
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<th>PBR</th>
<th>ROE</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. 4.0 times</td>
<td>9.0%</td>
</tr>
<tr>
<td>2. 4.0 times</td>
<td>37.5%</td>
</tr>
<tr>
<td>3. 9.0 times</td>
<td>9.0%</td>
</tr>
<tr>
<td>4. 9.0 times</td>
<td>23.7%</td>
</tr>
<tr>
<td>5. 9.0 times</td>
<td>37.5%</td>
</tr>
</tbody>
</table>
[Equity Business]

Q57. A market sell order for 4,000 shares of stock in a company was made; a contract for 3,000 shares at JPY 1,000 and a contract for 1,000 shares at JPY 1,020 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 8%).

(Note) Figures appearing in the options have been rounded down to the nearest JPY.

<table>
<thead>
<tr>
<th>Contract Amount</th>
<th>Brokerage Commission</th>
</tr>
</thead>
<tbody>
<tr>
<td>≤ JPY1 million</td>
<td>Total contract amount × 1.150%</td>
</tr>
<tr>
<td>&gt; JPY1 million</td>
<td>≤ JPY5 million</td>
</tr>
<tr>
<td>&gt; JPY5 million</td>
<td>≤ JPY10 million</td>
</tr>
<tr>
<td>&gt; JPY10 million</td>
<td>≤ JPY30 million</td>
</tr>
<tr>
<td>&gt; JPY30 million</td>
<td>≤ JPY50 million</td>
</tr>
</tbody>
</table>

(Options)
1. JPY3,973,884
2. JPY3,976,584
3. JPY3,977,300
4. JPY4,020,000
5. JPY4,066,116

[Bond Business]

Q58. 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.

Subscriber Yield = \[
\frac{\text{Coupon} + \frac{(a) - (b)}{(c)}}{(d)} \times 100
\]

(Options)
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]

Q59. Choose the one option from below which represents the correct yield during the holding period on an interest-bearing government bond with an annual coupon of 2.1% and a maturity of 10 years, which was purchased at JPY99.20, and sold 3 years later at JPY101.70:
(Note) Figures appearing in the options have been rounded down to the third decimal place.

1. 1.008%
2. 2.368%
3. 2.385%
4. 2.884%
5. 2.956%

[Bond Business]

Q60. 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
Q61. Choose the two correct statements from below regarding cashing out from an investment trust:

1. Cashing out from an investment trust may only be made by requesting the distributor to buy back the fund.
2. Requests for cashing out sent to distributors of stock investment trusts shall not be accepted later than 3:00 p.m.
3. The base value applicable to the cashing out price of funds that primarily invest in domestic assets is the base value on the cashing out application date.
4. Payment of the proceeds cashed out from funds that primarily invest in domestic assets is, in principle, made on the day following the date of receipt of the cashing out application.
5. For MMFs and MRFs, cashing (meaning same day withdrawal) is not allowed.

Q62. 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]

Q63. 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]

Q64. 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 has rights with the same feature, in principle, 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.
Q65. 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.
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 parcelled assets into a financial instrument to redeem the obligee.

Q66. Choose the two correct statements from below:

1. The labor force is the number of persons who are 15 years of age or older and who have a desire to work.
2. The Corporate Goods Price Index (CGPI) is an index value which represents the level of the retail prices of various consumer goods and services that are offered for sale to households.
3. The nominal interest rate is the real interest rate minus the rate of the price increase.
4. If the yen depreciates, it causes import prices to increase which leads to an overall increase in prices, and the possibility of increases in the interest rate also increases.
5. “Marshall’s K” is an indicator used to measure whether the amount of currency domestically owned by the private financial sector is too large or too small relative to the level of economic activity.
[Financial Statements and Company Analysis]

Q67. 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.

<table>
<thead>
<tr>
<th></th>
<th>Previous Term</th>
<th>Current Term</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales</td>
<td>74,000</td>
<td>82,000</td>
</tr>
<tr>
<td>Sales costs</td>
<td>53,000</td>
<td>57,000</td>
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<tr>
<td>Selling expenses and general and administrative expenses</td>
<td>18,000</td>
<td>20,000</td>
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<tr>
<td>Non-operating profits and losses</td>
<td>1,000</td>
<td>-500</td>
</tr>
<tr>
<td>Extraordinary profits and losses</td>
<td>-500</td>
<td>-1,000</td>
</tr>
<tr>
<td>Corporation tax, etc.</td>
<td>1,500</td>
<td>2,000</td>
</tr>
</tbody>
</table>

(Options)
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.
Q68. 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.

<table>
<thead>
<tr>
<th>Month</th>
<th>Sale or Purchase</th>
<th>Unit Price</th>
<th>Number of Shares</th>
</tr>
</thead>
<tbody>
<tr>
<td>June</td>
<td>Purchase</td>
<td>JPY650</td>
<td>2,000 shares</td>
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<tr>
<td>July</td>
<td>Purchase</td>
<td>JPY680</td>
<td>4,000 shares</td>
</tr>
<tr>
<td>August</td>
<td>Purchase</td>
<td>JPY670</td>
<td>4,000 shares</td>
</tr>
<tr>
<td>September</td>
<td>Sale</td>
<td>JPY700</td>
<td>5,000 shares</td>
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</table>

(Options)
1. JPY140,000
2. JPY150,000
3. JPY170,000
4. JPY200,000
5. JPY230,000
[Basic Knowledge Concerning Securities Markets]

Q69. Choose the one false statement from below:

1. With direct financing, it is the financial intermediary that bears the risk of recovering the funds, while for indirect financing, it is the final lender (investor) of the funds that bears this risk.
2. 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.
3. The protection of investors under the Financial Instruments and Exchange Act does not guarantee the price of securities in which investment is to be made.
4. Under the book-entry transfer system, dividend payments for shares, etc. can be received at a single deposit account with respect to all issues, or via securities companies.
5. One of the purposes of activities carried out by the Bank of Japan is to ensure the smooth and stable operation of the settlement system, thereby contributing to the stabilization of the financial system.

[Sales Operations]

Q70. 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) ethical 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

<table>
<thead>
<tr>
<th>Question</th>
<th>Option</th>
<th>Answer</th>
<th>Volume, Chapter</th>
<th>Reference</th>
<th>Page</th>
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<td>Q1</td>
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<td>×</td>
<td>Vol. 1, Chap. 2</td>
<td>2-8(4)(i)</td>
<td>91</td>
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<td>Q2</td>
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<td>94</td>
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<td>Q3</td>
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<td>2-9(2)(xiv)(a)</td>
<td>109</td>
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<td>4-2(1)(2)(ii)</td>
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<td>Q12</td>
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