

JAPAN INTERNATIONAL COOPERATION AGENCY (JICA)

**General Department of National Taxation
MONGOLIA**

**THE STUDY ON THE SUPPORT
FOR THE ECONOMIC TRANSITION AND
DEVELOPMENT IN MONGOLIA**

**TAX COLLECTION ENHANCEMENT PHASE
(DEVELOPMENT OF TAXPAYER INFORMATION SYSTEM)**

FINAL REPORT

VOLUME : ANNEX

March 2003

INSTITUTE FOR FINANCIAL AFFAIRS, INC.

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ANNEX-1

Land Valuation System

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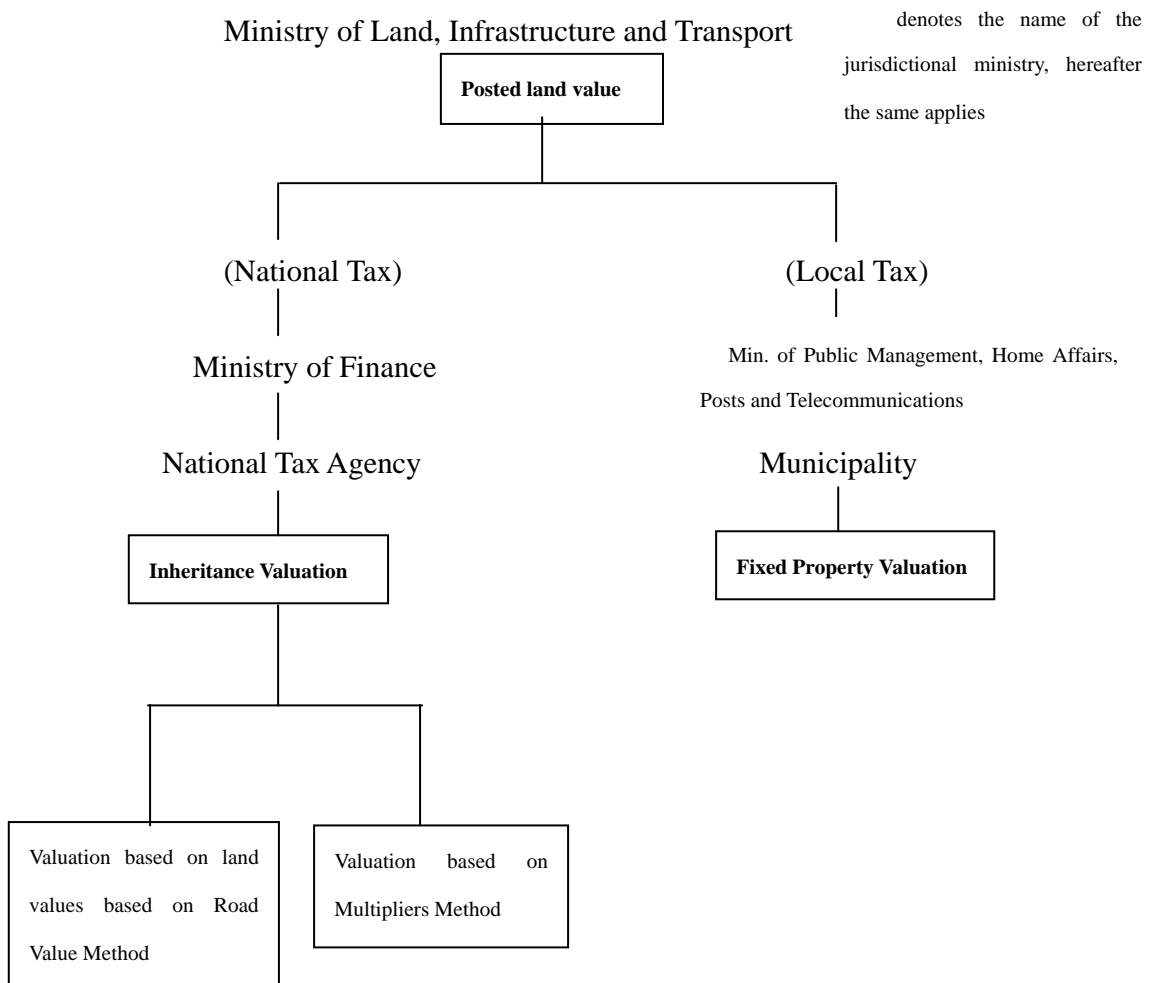
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1. State of Land Valuation System in Japan

1.1 Summary of the Land Valuation System

With respect to the land valuation undertaken by Japan’s public agencies, it is as shown in the following diagram.

There are three types of valuations, Posted land values, Inheritance Tax Valuation and Fixed Property Valuation.



The public valuations above are performed to meet objectives of each of tax system but there are substantial gaps between the valuations arrived and from the point of view of preventing confusion among the people, balancing • correction of each valuation should be performed.

Comparative summary of each of the public valuation systems are presented in the table below.

Classification	Posted land value	Inheritance Tax Valuation	Fixed Property Tax Valuation
Objectives	<p>Guideline for general land transactions</p> <p>Calculation basis for appropriate compensation for public works</p> <p>Posted every year (as of January 1 of each year)</p>	<p>For Inheritance Tax and Gift Tax assessment</p> <p>Taxes levied at the time of inheritance or receipt of gift</p> <p>Valuation performed every year (as of January 1 of each year)</p>	<p>For Fixed Property Tax assessment</p> <p>Tax levied annually</p> <p>Valuations performed every 3 years (as of July 1 of 2 years prior)</p>
Valuation Method	<p>For Posted land values, appraisal of the real estate is requested from 2 or more real estate appraisers or assistant real estate appraisers and the results are reviewed by the Land Appraisal Committee established in the Ministry of Land, Infrastructure and Transport and after necessary adjustments the normal value is determined and posted.</p>	<p>Residential land in the urban areas</p> <p>Road value method</p> <p>Other residential land Multiplier Method applying multiplier to the Fixed property Tax Valuation.</p> <p>Based on the posted land value, value based on expert opinions, transaction example value, evaluate the posted value based median value and based on this maintaining a balance with each road and each district evaluate the road value or the multiplier.</p>	<p>Based on the normal transaction value from transaction example values, establish a fair value and based on this value calculate the valuation. In this case, in areas where urbanization is progressed, use the Road Value Method and for other areas, method that compare with valuation for standard residential land to calculate the valuation</p>

Legal Basis	Posted land value Law Article 2 clause 1 “The Land Appraisal Committee shall ... determine the normal value per unit area of standard lot of property on a fixed base date, and post such values”	Inheritance Tax Law Article 22 “The value of property acquired through inheritance, bequest or donation shall be according to the market value of the said property at the time of acquisition” (Basic Notice on Property Valuation) ..Circular issued by the Director General of the National Tax Agency	Local Tax Law Article 341 item 5 “Value ... means fair market value” (Circular under orders) ...Circular issued by the Vice Minister for General Administrative Affairs
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Below, the details of each of the land valuation system will be discussed.

1.2 Summary of the Posted land value System

Posted land value is posted each year for normal value for the standard plot by a Land Appraisal Commission composed of 7 land appraisers appointed by the Minister of Land, Infrastructure and Transport and has as its objective of contributing to the formation of fair land values by providing a guideline for values for general land transactions and forming the criterion for the calculation of land value for restrictions on land transactions based on the National Land Utilization Plan Law.

1.2.1 Selection Criteria for the Standard Plot

The standard plot needs to be “body of land that is deemed to be normal in the state of usage of land and environment in an area that is deemed to possess a similar utilization value from the point of view of natural and social conditions” (Posted land value Law Article 3), and, in addition. “Body of land in the said area that is deemed to be normal in the usage conditions, environment, acreage and the shape, located in a unified area in which the use of land is deemed to be homogeneous” (Posted Land Law Implementation Rules Article 2). Further, “a body of land” means a continuous plot of land used for the same purpose by the same user.

In addition, in selecting the standard plot, stipulated requirements for the selection are:

- in a district, in a municipality it must be a location that is representative of the overall land value levels;
- the usage status, environment, acreage and shape is

average; land usage status is stable and conforms to general usage; and it can be clearly differentiated from other land by land cadastre, dwelling address, building, shape of land, etc. An annual review is performed to determine its appropriateness as the standard plot and if determined to be unsuitable, an alternate selection is made. In 2002, from among the urbanization promotion areas in the country, 31,520 standard plots had been selected.

1.2.2 Determination of Value of the Standard Plot

The value that will be posted will be the per-unit “normal value” for the standard plot as of January 1 of every year. “Normal Value” means “value which is deemed to enable a land transaction to be transacted if the transaction were to be transacted freely”, that is to say, with respect to marketable real estate a value that will fairly indicate the market value in a rational market, in other words, an objective value that favors neither the seller nor the buyer.

If there is a building existing on the standard plot of land or if rights exist such as surface rights and the like that limit the use and benefit associated with the land, a normal value that assumes that such rights did not exist (in other words a “vacant lot”) will be determined.

“Normal Value” will be determined by a process of having the Land Appraisal Committee seeking appraisals from 2 or more real estate appraisers or assistant real estate appraisers appointed by the Land Appraisal Committee for each standard plot and reviewing the results and making the necessary adjustments.

The Land Appraisal Committee, in order for smooth posting of land values, will assign the real estate appraisers who have been appointed to be appraisal evaluators to subcommittee established in each district which is comprised of a prefecture or a part of a prefecture that has been divided into two or more parts and it, not only coordinate communications among the appraisal evaluators, but also will examine the balance among standard plots and areas.

The number of sub-committees nation-wide totaled 196 in 2002 and the number of real estate appraisers involved in the appraisal evaluation of standard plots nation-wide totaled 2,551.

The real estate appraisers or the assistant real estate appraisers in performing the appraisal of the standard plot will consider the values arrived at using “transaction example comparison method”, “discounted income method” and “cost method” to make the appraisal (Land Value Posting Law Article 4, Ministerial Ordinance Relating to Criteria for Appraisal of Standard plot Lots” Articles 7, 8 and 9).

(1) Transaction Example Comparison Method

“Transaction Example Comparison Method” is a method in which many examples of transactions are collected from among which appropriate examples are selected. To these values revisions and amendments are performed to reflect the particular circumstances and timing relating to the transaction values of the relevant transactions and the values that have been determined by comparison of regional and specific factors are weighed to determine the trial value for the standard plot. The trial value arrived using this methodology is referred to as Comparative Value.

(Note)“Regional factors” means factors for value formation affecting the level of land values in a specific unified region, the usage of which is deemed to be the same.

“Specific factor” means, with respect to land value, factor for value formation, which causes individual difference in comparison with the value level of unified land in the region in which the said property is also located and which is deemed to be the same in land usage.

(2) Discounted Income Method

“Discounted Income Method” refers to a method in which the net profit relating to the rents on the standard plot calculated by deducting the gross expenses from the gross revenues and discounting the amount using the rate of return to derive the principal to determine the trial value of the standard plot. The trial value arrived at using this method is referred to as “Earning Value”.

[Calculation Formula]

Net profit per unit area of the standard plot arising over 1 year from rental of land – (A)

Gross rental revenue per unit area of the standard plot in 1 year – Gross

$$= \frac{\text{expenses related to rents of the standard plot for 1 year}}{\text{Area of the standard plot}}$$

Rate of Return (determined by setting an investment rate of return that is considered most common, and taking into consideration the investment targets and the liquidity, ease of management, and safety of the investment target and the standard plot as the investment target) – (B)

Per Unit Area Earning Value of Standard Plot (C) = (A) ÷ (B)

(3) Cost Method

“Cost Method” refers to a method in which making the supposition that the standard plot were to be developed on the base day of value determination, trial value is determined by taking fair expenses (development cost) that is deemed to be needed for

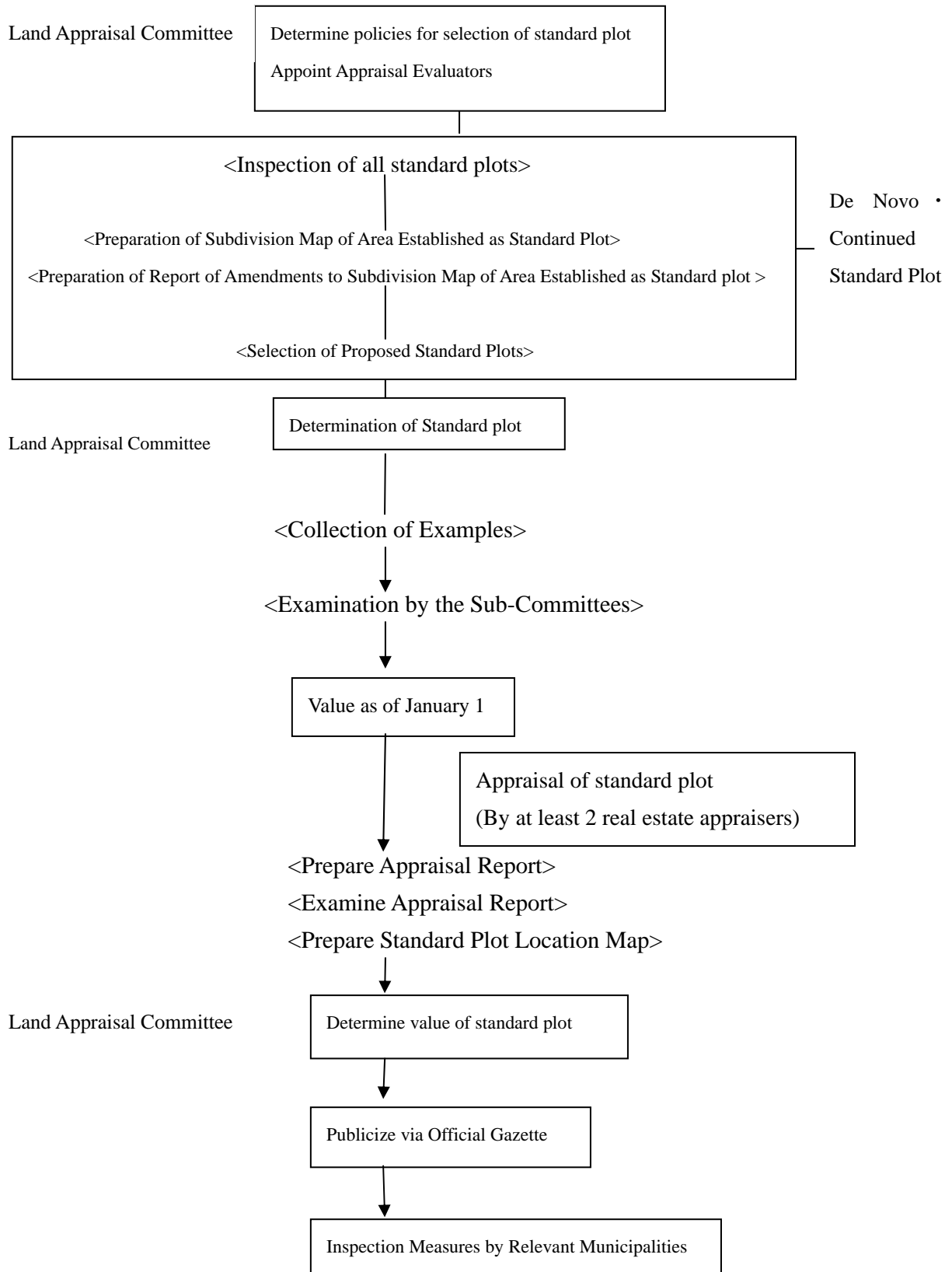
the development as the trial value of the standard plot. The trial value arrived at using this method is referred to as “Estimate Value”.

1.2.3 Posting and Inspection Measures Relating to Value of Standard Plot

The Land Appraisal Committee after determining the normal value per unit area of the standard plot, will promptly, through the Official Gazette, disclose publicly the location and lot number of the standard plot, per unit area value of the standard plot and the base date for the value determination.

The Land Appraisal Committee shall, after public disclosure, promptly send to the heads of the relevant municipalities, documents that records the portions relating to the standard plot located in the prefecture in which the said municipality belongs as well as maps that indicate the location of the said standard plot. The relevant municipality shall establish the location for the inspection of documents and the rules for the inspection and make necessary announcements and shall make available for public inspection the above documents and maps for a period of 3 years from the day of receipt.

1.2.4 Procedures for Land Price Posting



1.3 Summary of Fixed Property Tax Valuation

The fixed property tax is primarily a local tax (municipality tax) assessed on land, house and depreciable assets but as the objective for this paper is the valuation of land value, a summary of the tax with a focus on the fixed property tax that pertain to land will be presented below.

1.3.1 Fixed Property Tax Summary

The method of taxation is referred to as “Taxation by Cadastre Principle”, as the assessment is according to the registration on the cadastre and the tax obligor is the registered owner recorded on the Fixed Property Taxation Cadastre (in the case of land, “Land Taxation Cadastre”) as of January 1 each year (referred to as assessment date).

The fixed property tax is, in principle, a local tax assessed by the municipality in which the fixed property is located. The tax base for the fixed property tax is the fair market value (in the case of land “fair land value”) and an appraisal of the value as of the tax assessment date (January 1) is performed every 3 years and recorded in the taxation cadastre.

The year in which the appraisal of the value is performed is the base year and value is unadjusted, in principle, during the subsequent second and third years, but if deferment is inappropriate or if the land has been acquired through a government disposition and no value for the base year exists, a comparable value as of the base year for a land that is similar to the said land and recorded in a tax cadastre will be applied as the tax base. Further, the country, prefectures and municipalities, due to their public nature are exempt from fixed property taxes (personal exclusion from taxation). In addition, land owned by various public corporations established under special laws (Green Resource Corporation, Teito Rapid Transit Authority, etc) and land related to agricultural sewage facility or tunnels for transportation that serve public uses are tax exempt (impersonal exclusion from taxation). In addition land that are eligible for impersonal exclusion from taxation are determined by legislation.

1.3.2 Calculation Procedures for Fixed Property Tax

Fixed Property Tax is calculated using the following formula.

$$\text{Tax Base} \times \text{Tax Rate} = \text{Fixed Property Tax Amount}$$

A. Tax Base

The tax base for the fixed property tax is the “fair market value”.

Fair market value is determined by a procedure provided for in the “Fixed property Valuation Criteria” prepared by the Minister of Public Management, Home Affairs, Posts and Telecommunications.

Appraisal of the value as of the tax assessment date (January 1) is performed triennially and recorded on the tax cadastre. This value is, in principle, deferred for a period of 3 years as the tax base.

B. Exceptions to the Tax Base

The tax base for fixed property taxes for land, on which a house that is used solely as a residence, is set at one third of what normally would have been the tax base. In addition, the tax base for small-scale residential land (residential land of less than 200 m²) under a special exception is set at one sixth of what it would have been without the exception.

C. Tax Rate

The standard tax rate on fixed property tax is 1.4%.

Even if a tax rate exceeding the standard tax rate were to be applied, such rate cannot exceed 2.1% (=limited tax rate).

[Reference]

In the case of acquisition of real estate, such as a house or land, as local taxes (prefectural tax) “real estate acquisition tax” is assessed, and in this case the tax base is the value at the time of acquisition of the real estate, and if the said real estate is registered in the fixed property taxation cadastre, the value that should be the tax base is determined by the said value and for real estate whose value is not registered the value that should be the tax base will be determined according to the Fixed property Valuation criteria indicated by the Minister of Public Management, Home Affairs, Posts and Telecommunications. The standard tax rate applied for the real estate acquisition tax is 4%.

D. Tax Exemption Threshold

In the case of land, if the tax base for fixed property tax relating to a fixed property owned by one person within one municipality area is less than ¥300,000, the fixed property tax is exempted and if it exceeds this amount the entire amount will be subject to taxation.

E. Fixed Property Valuation Criteria and Practical Valuation Method for Land

Fixed property tax is assessed based on the valuation based on the present state of the fixed property as of January 1 of each year. The head of a municipality is required to appoint “Fixed property Evaluator” or “Assistant Fixed Property Evaluator” to conduct site examination at least yearly of the state of fixed property located within the municipality.

The fixed property evaluator will prepare a “Valuation Report” based on the valuation results of the fixed properties and the head of the municipality, based on the said valuation report, determines the value by end of February of each year.

With respect to valuation of fixed property, as it is necessary to ensure uniformity of valuation nation-wide and balance among municipalities, the Minister of Public Management, Home Affairs, Post and Telecommunications has published “Fixed property Valuation Criteria”, which defines the criteria for fixed property valuation and the execution methodology and procedures for the valuation. Items relating to its details are determined by the governors of the prefectures.

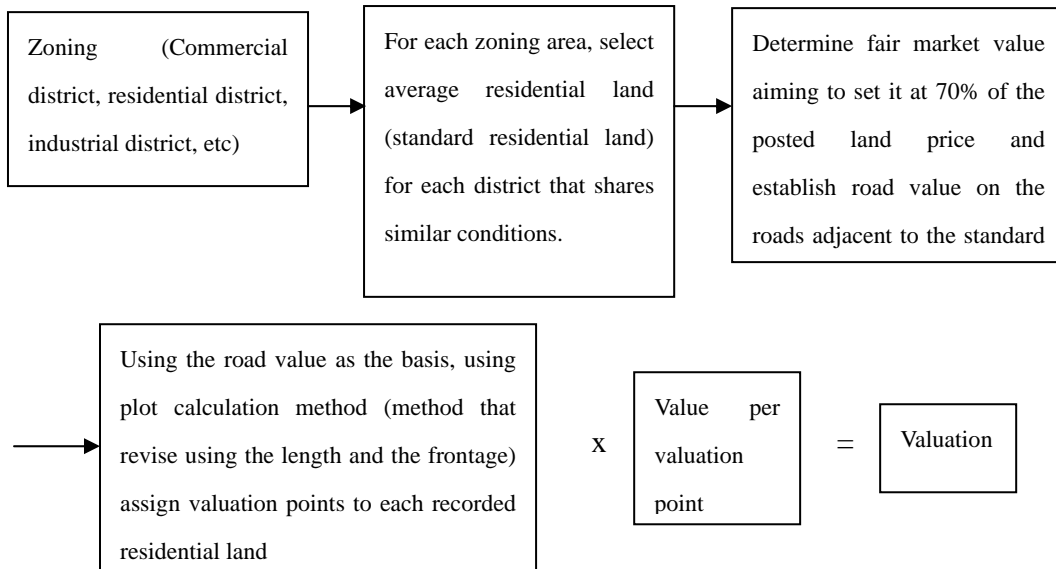
Therefore, the value of the fixed property decided by a valuation based on the Fixed Property Valuation Criteria is the “fair market value” and this is the value that ought to be the tax base for the fixed property tax.

According to the above criteria, the land valuation is “a valuation method using transaction example value as criteria”. This is a valuation method in which from actual transaction example prices, land in which special factors exist are excluded, and prices that are deemed generally normal are selected to be applied as criteria.

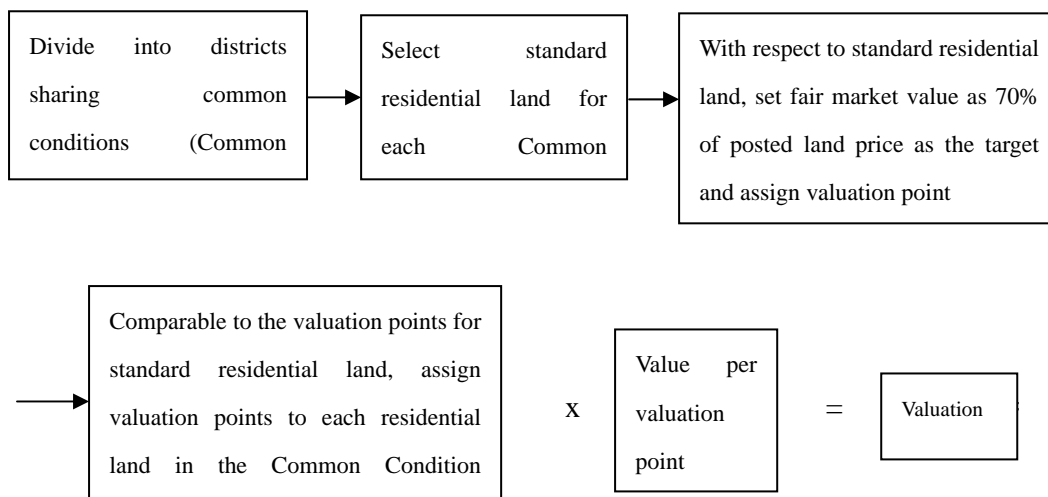
Practically, with respect to residential land, “Posted land value”, “Prefectural Land Price Survey Value” and “Value Determined from Appraised Value by Real Estate Appraisers or Assistant Real Estate Appraisers” are used for criteria and valuation is set at 70% of these values.

[Practical Valuation Methods in Case of Residential Land]

(1) Residential Land in Areas Promoting Urbanization (Urban Residential Land Valuation Method)



(2) Residential Land in Areas that are not urbanized (Other Residential Valuation Method)



(Note) “Value per Valuation Point” and “Plot Calculation Method”

- The road value of a standard plot assumes that the land’s frontage and length of the land selected in calculation of the road value is an average value and assigns a valuation point of 1. Therefore, in valuing land other than the standard plot, if the frontage and length in comparison with the average frontage and length of the

standard plot are short and long the valuation point is decreased. This is referred to as plot calculation method. An example of a calculation is shown below.

(Valuation Point by Frontage)
Less than 4 M. - Valuation Point 0.9
Over 4 M. – Valuation Point 1.0

(Valuation Point by Length)
Less than 4 M – Valuation Point 0.9
Over 4 M but less than 8 M – Valuation Point 0.93
Over 6 M but less than 10M - Valuation Point 0.96
Over 10 M but less than 18M – Valuation Point 1.0
Over 18M but less than 26M – Valuation Point 0.96

(Calculation)

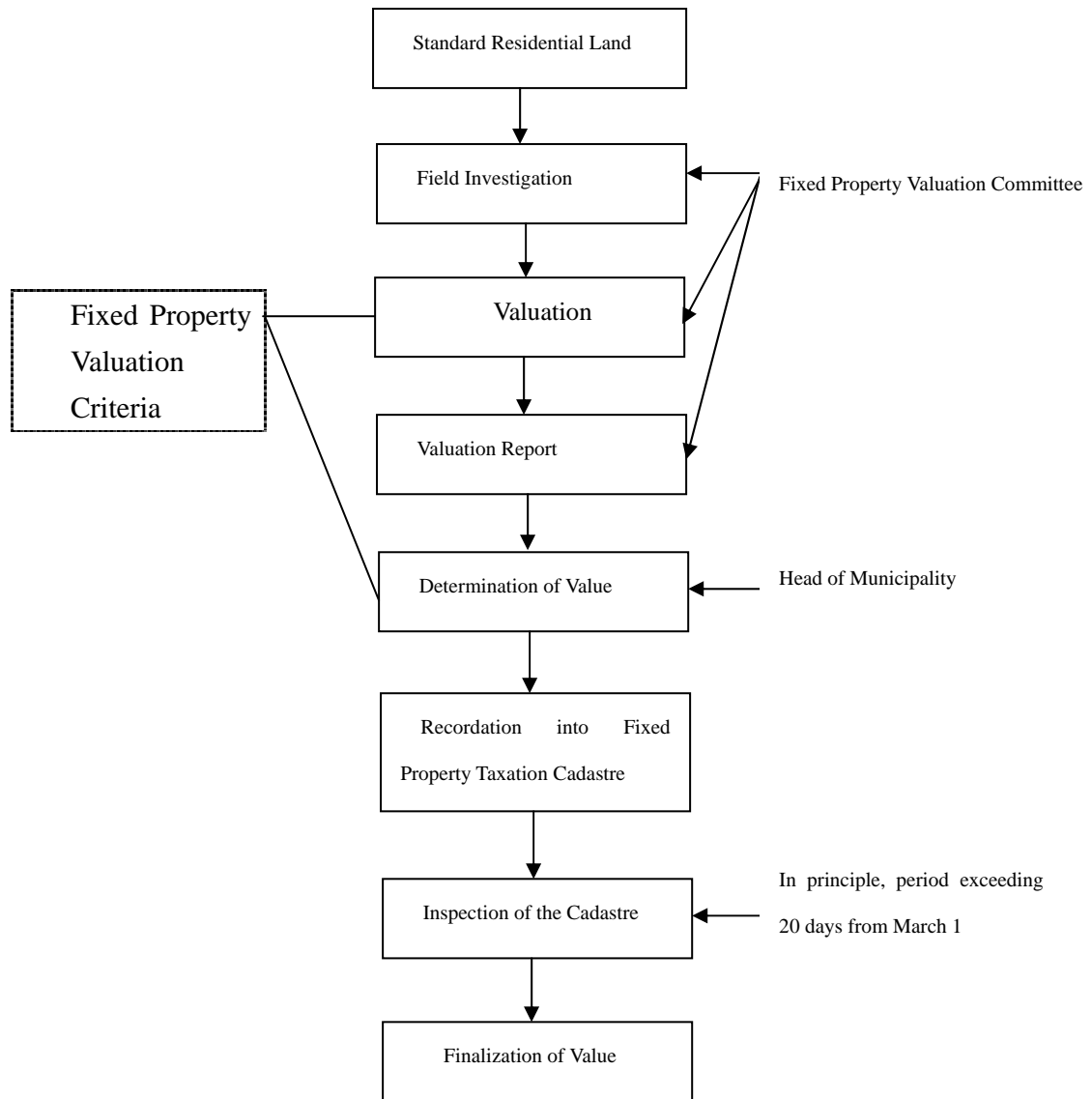
Per unit area valuation of land with frontage of 3 M and Length of 18M
= Frontage of 3M Valuation Point 0.9 X Length of 18M Valuation Point 0.96 X Value per Valuation Point (Road value)

1.3.3 Inspection of Fixed property Taxation Cadastre

The head of a municipality will determine the values of fixed properties and if they are recorded on the fixed property taxation cadastre, from March 1 of every year for a period exceeding 20 days, the fixed property taxation cadastre must be placed in a designated location for inspection by relevant parties.

If as a result of inspection by relevant parties, discontent arises, a request for review may be submitted to the “Fixed property Valuation Review Committee” established in the municipalities. With respect to disputes regarding value and the like resulting from a request for review, the ultimate determination of the court may be sought.

1.3.4 Valuation and Value Determination Schematic



1.4 Valuation According to Road value and Multiplier Method

As methods of valuation, there are also road value method and multiplier method.

The fixed property tax valuation is a value that indicates fair market value of land for assessment of fixed property tax on the land, which is a local tax, whereas valuations according to road value and multiplier methods are values that indicate fair market value of land in the case of calculation of inheritance tax and gift tax, which are national taxes.

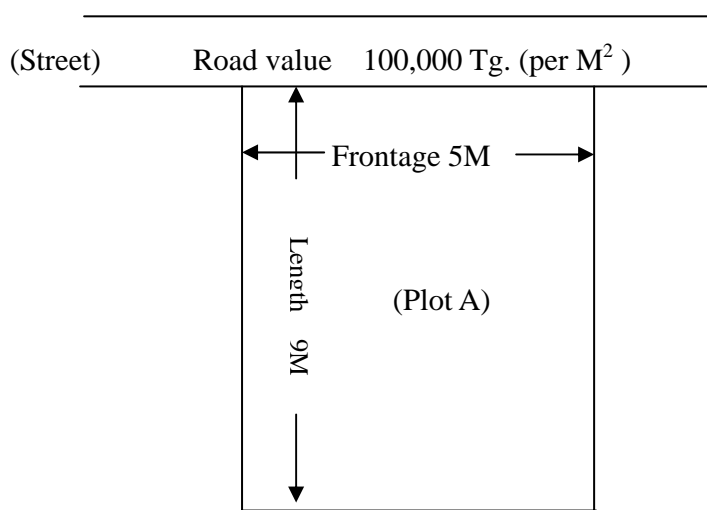
Primarily, the fair market price of land should be unique but due to the difference that exist in the purpose and the nature between national tax and local tax, even for the same plot of land such divergent market prices are allowed to coexist.

1.4.1 Valuation According to Road value Method

Road value method is a valuation method in which value is calculated by taking the road value (contained in the “Road Value Map”) assigned to the road facing the residential land and making revisions for the specific features of the plot (length value revision, add impact of adjacent streets, add impact of sandwiching streets, revisions for irregular shape, revision for lack of road access, revisions for narrow frontage, etc.).

It is a methodology that basis the calculation on the road value assigned to each road, thus it is appropriate for application for valuation of residential land in urbanized areas where the road network is developed.

[Road value map] (Segment map) – Plot A in a Commercial Zone



Length Value Revision Table (Commercial)		Frontage Limitation Revision Table (Commercial)	
(Length)	(Revision Factor)	(Frontage)	(Revision Factor)
Over 2M less than 5M	0.9	Less than 4M	0.9
Over 5M less than 8M	1.0	Over 4M less than 6 M	1.0
Over 8M less than 11M	0.9	Over 6M less than 8 M	1.0
...		...	

Valuation of Plot A

$$\begin{aligned}
 & \text{(Road value)} \quad \text{(Area)} \quad \text{(Length Value Revision Factor)} \quad \text{(Frontage Limitation Revision factor)} \\
 & 100,000 \text{ Tg.} \times (5\text{M} \times 9\text{M}) \times 0.9 \times 1.0 \\
 & = 4,050,000 \text{ Tg.}
 \end{aligned}$$

[Method of Determining Road value]

A. Meaning of Road value

Road value refers a value per square meter of residential land fronting a street determined by the Director General of the National Tax Agency for each road (road that is used by general public for passage) that is deemed to be fronted by series of residential land that are deemed to have generally the same value based on transaction example prices, posted land prices, value based on expert opinions, etc.

In such cases, the following items are taken into consideration:

It is roughly located in a central portion

The series of residential land share topographical features

The road is the only road fronting the land

The land is rectangular or square having a standard length and frontage (length value revision factor and the frontage limitation revision factor are both 1.0 and does not require application of excess length revision factor) of residential land fronting the street.

B. Method of Determination of Road value

Generally determination is through the following process.

The time of valuation for road value for the year is January 1.

As the first step in all road values, a value for a representative plot (standard plot) as of January 1 is determined based on transaction example value, posted land price, value according to expert opinion, etc. In other words, the valuation for the plot is determined.

Following the above step, based on the value of the standard plot the process of determining the road value of land surrounding the standard plot is undertaken. In order to determine the road value of the surrounding plots, value range vis a vis the standard plot is taken into account. In this way the street valuation is expanded from a single point to an area and the road value map is gradually created.

In the step above, as the valuation area expands from the standard plot to cover an area, there will be overlaps with areas that have also expanded from their respective standard plot to area and in this case, theoretically the value of the overlapping area should be equal but, in reality, due to many factors in most cases the two valuations diverge. Adjustments are made to the difference and an expanded area road value map is would be created (adjustments between standard plots).

By repeating the step above, a road value map covering all streets within the jurisdiction of each tax office will be created, but finally for a road value maps that have been created by each tax office will be adjusted among the tax offices to achieve overall standardization (adjustments between tax offices).

The road values are determined following the above procedures but as this requires substantial operational burden the person responsible for valuation (evaluator at the National Tax Agency, evaluators in property valuation department in each regional tax bureau, inspectors responsible for valuation at each tax office, etc.) is dedicated throughout the year to performing valuation of road values and in August of each year the road value for that year is made public. Further, the publication of road value is by subdividing the nation-wide residential map into jurisdictional area of each tax office and “Road Value Map” is created for each tax office displaying the road value for each road and made available for inspection at tax offices and libraries nation-wide.

1.4.2 Valuation Using Multiplier Method

Multiplier method is a method that calculates the value by applying a fixed multiplier determined by the director general of regional tax bureaus to the fixed property valuation determined by the head of the municipalities and is adapted to residential land in areas where the road value method is not applied.

Fixed multiplier is determined for each area sharing common land factors, by the director general of regional tax bureaus, based on transaction example value, posted land price, value by expert opinions, etc. for residential land in the area and is contained in “Valuation Multiplier Table”.

[Multiplier Method Formula]

Fixed Property Tax Valuation X Valuation Multiplier = Land Valuation According to

Application District	Multiplier				
	Residential	Farm Land	Pasture		
.....					
City xxx District yyy Street	1.1	0.8	0.7		
ZZ Aimag WWW Town	1.0	0.6	0.5		
.....					
.....					
.....					
.....					

1.5 Draft Calculation Method for Land Values in Mongolia

1.5.1 Introduction

With the implementation of “Land Privatization Law”, it has now become possible for individuals and enterprises to own land.

With the privatization of land, relating to taxation, issues relating to “Real Estate Acquisition Tax” arising from acquisition of land, “Real Estate Tax” from the ownership of land, “Gift Tax” from donation of land, “Inheritance Tax” from inheriting land and “Real Estate Sales Tax” from the sale of land will arise.

Of these, “Real Estate Tax” and the “Real Estate Sales Tax” are taxes that have already been implemented, it will be possible to deal with the issues by adding land to definition of real estate that includes land usage rights and buildings and by partial amendments to “Real Estate Tax Law”, “Individual Income Tax Law” and the “Corporate Income Tax Law”.

In any case, in cases where compensation is associated with the transfer of title to the land, it is sufficient to determine the tax base based on the compensation and to apply a tax rate.

The issue is the method of dealing with a case of title transfer without associated compensation and how to perform a valuation to establish a fair price upon which to base the tax base.

1.5.2 Methodology for Land Valuation

Using Japan as an example, as already mentioned there are three methods for calculation of fair market value for the land: transaction example method, discounted income method, and cost method.

If these are applied to Mongolia, faces the issue that there exist no transaction examples, thus this would be a method applicable in the future and is based on assumed “land development cost”, considering the current land utilization conditions in Mongolia, this cannot be said to be the most appropriate methodology.

Therefore, by this process of elimination, , the discounted income method, is based on the income arising from the use of the land can be said to be the most appropriate method.

1.5.3 Valuation Procedures Using “Discounted Income Method”

(1) Firstly, create a segment of map of all land in the country grouping similar land from the viewpoint of usage conditions of the land (residential • farmland • pasture • forest • plain), zoning (residential zone • commercial zone • industrial zone • other), type of building, and environment by each prefecture and Ulan Bator.

(2) From an area that had been divided by similar lands, select a typical land (standard plot), and calculate an annual net income (revenues – related expenses) related to land rents and the like on per square meter of the said land.

(3) Form of earning revenues using land could include earning rent by allowing usage as vacant lot (for example open-air parking), construct apartments on the land and rental of the apartments.

To look at the profitability of the land, a more effective utilization of the land needs to be assumed and reflecting revenues that are possible from rentals such as apartments on the value of the property is considered reasonable. In such a case, calculation of the profitability of the land based on information regarding rents relating to rent of land and rents relating to rental of apartments obtained from each of the land management bureaus will be performed.

(4) Value per square meter of the standard plot is calculated using the formula below.

$$\text{Value per M}^2 \text{ of standard plot} = \text{Net income per M}^2 \text{ of standard plot} \div \text{rate of return}$$

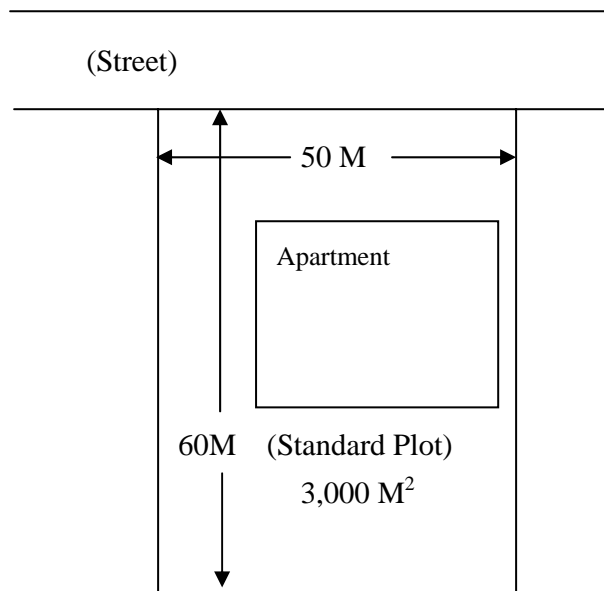
(Note)The value derived from the above formula is the valuation under the “Discount Income Method”, and for details, see 1.2.2 (2) on page1-5.

(5) With respect to land other than the standard plot, determine the value in relation to the value of the standard plot by taking into consideration the specific circumstances.

(6) With respect to Ulan Bator and each of the prefectures, adjust the standard plot value by taking into consideration the regional differences.

1.5.4 Example of Calculation of Land Valuation Using “Discount Income Method”

Here an example of a calculation using “Discounted Income Method” is shown for land shown below as the standard plot.



The land is assumed to be owned by the recipient of the income from the apartment

The annual revenues from the apartment are assumed to be 30 million Tg.

The necessary expenses (total of depreciation, repairs, management, liability insurance premium and other various expenses) during the same period are assumed to be 15 million Tg.

Rate of return is assumed to be 3% per annum.

[Calculation of Net Income from the Standard Plot]

Annual Rental Revenues.....	30 million Tg.
Annual Expenses.....	15 million Tg.
<hr/>	
Annual Net Income (-)	15 million Tg.

[Calculation of Per Unit Area Value of the Standard Plot]

$$\begin{aligned}\text{Value / M}^2 \text{ of the Standard Plot} &= 15 \text{ million Tg.} \div 3\% \div 3,000 \text{ M}^2 \\ &= 166,666 \text{ Tg.}\end{aligned}$$

[Determination of Road value]

If, from the above calculation, the per square meter value of the standard plot is calculated to be 166,666 Tg., to apply this as the road value, one way to simplify the calculation is to round the figures and set 160,000 Tg. as the road value.

2 Japan's Real Estate (Land and Buildings) Taxation System and its Execution System

2.1 Taxation System Relating to Land and Buildings

2.1.1 Basic Structure of the Tax System and the Philosophy

In the countries in Europe and Americas, various taxes are levied on land and building with respect to its acquisition, ownership and disposition. Japan, in this respect, is similar and the table below shows an example of the taxes that are levied.

[Principle Taxes on Land Levied in Japan]	(National) – National Tax, (Local) – Local Taxes
Transfer of Title:	income tax (National), corporation tax (National), Inhabitant's Tax (Local)
Ownership:	Land Value Tax (National), Fixed Property Tax (Local), City Planning Tax (Local), Special and Ownership Tax related to ownership (Local)
Acquisition:	Real Estate Acquisition Tax (Local), Special Land Ownership Tax relating to acquisition (Local), Registration License Tax (National), Inheritance Tax (National)

There seems to be a general consensus that as a part of asset taxation, land and buildings ought to bear a heavy tax burden. On the one hand, many voice opinions that for property that have particular features such as those providing residence or being a necessity in the implementation of economic policies restraint ought to be exercised in taxation. The taxation on land and buildings incorporates this dichotomy and depending upon the economic conditions prevailing at that point in time, one of the two takes priority but each act as a check on the other; in other words, the system is structured embodying this contradiction. The resulting complexity forms a particular feature of land taxation that is not found in other taxation systems.

With respect to a question of how to establish, in Japan today, a tax system relating to land and buildings that are intertwined with varied factors, in the report of the Government Tax Commission "Status and Issues in the Country's Tax System – Citizen Participation and Options Toward the 21st Century"(August 2000), the following comment can be found with respect to the land capital gains tax.

"With respect to land, in the Basic Land Law, it is defined as having the quality of being intricately relevant to public interest being among other things, limited and precious resource of the people today and in the future, an essential infrastructure for the activities of the people, and its use having a strong relationship with use of other land. In addition, land also possess a feature as an asset such as its value appreciating

principally as a result of external factors including changes in population trends and industrial activities and the state of social capital formation.

With respect to taxation on land, giving consideration to land playing a role in the public interest and its characteristics of being an asset, from the point of view of securing the fairness of tax burden, it is important to seek appropriate tax burden in each phases of acquisition • ownership • transfer of the assets, namely land, and in addition it is desirable that the system is one that is stable from a long term perspective.

Under this basic philosophy of land taxation, with respect to taxation on the capital gains on land, in view of the land possessing public nature, and the appreciation of its value principally being derived from external factors, it is necessary to seek appropriate burden giving due considerations to ensure fairness of tax burden in relation to taxation levied on income derived by wages and enterprise.

With respect to the method of taxation, based on capital gains on land being accrued with the passage of time from acquisition to transfer, ensuring appropriate and fair tax burden, and making explicit the tax burden amount associated with land transactions, a separate taxation applying an appropriate tax rate is considered to be the most realistic. In addition, with respect to the special deductions related to the land capital gains taxes, as significant portion of capital gains are already excluded from the taxation base based on these deductions, based on the nature of capital gains from land and giving due considerations for fairness vis a vis other types of income, from both the viewpoints of seeking reasonable tax burden and simplification of the tax system, there is a need to undertake a review.

Further, with respect to the capital gains tax on land, it is also necessary to pay sufficient attention to the viewpoint of restraining speculative transactions...”

2.1.2 Capital Gains Tax

Income related to capital gains of land and buildings, namely “Capital Gains”, is subject to a levy of income tax if the recipient is an individual and corporation tax, if the recipient is an incorporated entity (at the same time, as local taxation, inhabitant’s tax will be levied but the taxation base assumes the taxation base of income tax and corporation tax). However, as mentioned earlier, with respect to land and buildings, taxation based on various policy considerations is demanded and it is necessary to be cognizant of the frequent occurrence of treatments that differ from the fundamental taxation methods.

(1) Income Tax

Japanese income tax adopts what is referred to as Comprehensive income taxation in which the income is classified into ten categories and income from each category is computed and summed upon which the tax rate is applied to calculate the income tax amount. The tax treatment differs according to the determination of the income category to be applied and as differences in tax burden may result, the classification of income is a matter of great interest for both the taxing agency and the taxpayer. With respect to capital gains on land and buildings, summarily speaking, if it is an income relating to disposal of land and/or building as an inventory asset, it is business income and in other cases it will be categorized as capital gains.

1) Taxation of Capital Gains as Business Income

Capital gains derived from transfer of land and/or building that had been held for the purpose of selling the said land and/or building (in another words owned as an inventory asset) by a person who makes a business of buying and selling real estate is subject to taxation as business income and, in such cases, it will be treated in the same way as sales and purchase of any other merchandise.

In other words, “Gross Revenues – Required Expenses = Business Income” holds and combining this with other income and applying a progressive tax rate the tax amount will be computed.

With respect to capital gains, even in the case of business income, if it is of a short term capital gains nature, “Punitive Taxation on Capital Gains from Land (taxation applying a special high taxation rate against capital gains arising from sale of land. Cannot be combined with other incomes)” will be applied.

(Note) However, currently due to the declining trend for land prices, the application of the Punitive Taxation on Capital Gains from Land is suspended. Therefore, normal comprehensive taxation is applied also to business income related to short term capital gains.

2) Basic Calculation for Capital Gains

The amount of capital gains is derived by deducting special deductions for capital gains from the remaining sum after deducting expenses needed in the said transfer and the acquisition cost of the said asset from the gross receipt of either transfer of short term property (income from sale of assets whose ownership period is 5 years or less) and sales of long term property (income from sale of assets whose ownership period exceeds 5 years).

However, as the treatment given to long term capital gains and short term capital gains differ significantly as described below, it could be considered as being separate income classifications.

[Calculation of Capital Gains]

Gross Revenues Relating to Assets Held Long Term – (Acquisition Cost + Selling Expenses) = Long Term Capital Gains ●●● i

Gross Revenues Relating to Assets Held Short Term – (Acquisition Cost + Selling Expenses) = Short Term Capital Gains ●●● ii

(i + ii) – Special Capital Gains Deductions (¥500,000) = Capital Gains

(Note) However, the Special Deduction is first applied against the short-term capital gains and then applied to long-term capital gains. In addition, with respect to long-term capital gains, amount corresponding to one half of the amount will be taxed under comprehensive taxation along with other income. Therefore, “long term capital gains X 1 / 2 + short term capital gains” are capital gains amount that are calculated into the total income amount.

3) Issues Relating to Calculation of Capital Gains

Issues with respect to calculating the capital gains and the thinking on these issues are outlined below.

Asset Giving Rise to Capital Gains and the Sale – The concept of assets include all transferable assets including not only personal and real estate but also includes leaseholds, intangible property rights, de facto rights arising from permits or allocation by administrative agencies (for example taxi medallions).

As transfer broadly refers to transfer of ownership without regard whether it is with or without compensation, capital gains is said to arise from not only from buying and selling but also from exchanges, auctions, public auctions, expropriation, and investment-in-kind. In addition, even if no transfer of rights takes place, in case payment such as insurance proceeds are made in association with the extinguishments of assets that would have given rise to capital gains in accordance to an agreement or contract, the said insurance payments and the like are deemed to be revenues associated with capital gains. In more concrete terms, compensation for eviction in rented housing, distribution of property in divorce settlements, compensation against extinguishments of fishing rights all fall under this category. Other than these, if the premium received at the time of establishing leasehold interest over land exceeds five tenths of the value of the said land, it is deemed to be capital gains (This is a burden reduction measure as if this were to be taxed under

comprehensive taxation as is as real estate income, it will be subject to prohibitively high tax burden under the progressive taxation rates)

(Note)With respect to the treatment above, there are precedents, which are described below.

Premium (Supreme Court Decision dated October 23 1970)

“Of the premium paid to the landowner at the time of establishing leasehold interest, the said Land Lease allows for a long term occupation and further recognizes the transferability of the leasehold interest and, in such a case, a result is the landowner abandoning its rights to revenues form usage for an indefinite period, if the amount of payment as compensation is an amount that is very high relative to the value of the vacant plot, economically and effectively, it may be deemed to be compensation for transfer of part of the function of ownership and it would be appropriate to infer that such deposits are capital gains”

Property Distribution (Supreme Court Decision dated May 27 1975)

“When a married couple divorces, one party may claim against the other party distribution of property. The details of the distribution of property is determined by mutual consultation, mediation by the domestic court, judgments handed by domestic court or regional court but the said right and obligation arise from the conclusion of a divorce and become a substantial right and obligation and the discussions among the said relevant parties is simply a process of realizing the contents. The said relevant parties consult with respect to distribution of property and the content of such discussion is realized and when the payments of money, transfer of real estate and other distribution in accordance to the details, are completed the said obligation for distribution of property is extinguished; however, this extinguishments of obligation itself can be considered an economic benefit. Therefore, in the case of assigning assets such as real estate as distribution of property, the assignor should be regarded as having received an economic benefit of extinguishments of his or her obligation for distribution

In such a case, the original verdict, that of the transfer of the real estate the portion relating to the distribution of property will cause rise to capital gains for the appellant, may be deemed admissible in its conclusion as being fair”.

Compensation For Eviction (Osaka District Court Decision dated January 28 1969)

“With respect to handover of a house, a compensation payment by the owner of the

house to the person(s) vacating the house, the nature varies according to the particular circumstances and cannot be determined in generality or in abstract, but in this particular case, the buyer of the said building, “A”, recognized that the plaintiff was a rightful tenant of the building and in order to extinguish the rights of the lease, paid a compensation for eviction, and the plaintiff abandoned his right of lease by accepting the payment, and associated with this received a sum of ¥ 4.3 million with the intent to handover the building to A; therefore, the ¥4.3 million compensation for eviction can be deemed to possess the nature of a payment for the extinguishments of the right of lease held by the plaintiff with respect to the building.

- Capital gains is captured and taxed if the asset appreciates in value and when the asset is liquefied into cash by a sale or by some other means and a profit from appreciation is realized – the cause need not necessarily be limited to a sale or transference of the asset to another party – and it must be deemed that a capital gain has arisen.

Therefore, the ¥4.3 million that the plaintiff received as a compensation for the extinguishing of the lease corresponds to a capital gain”.

Gross Revenue Amount – Gross Revenue refers to the total sum of compensation for the transfer. Specifically, if the quid pro quo for the transfer of the asset is money then that amount and if it is non-monetary “item or a rights or other economic benefits”, then the market value of the item • right or some other economic benefits. Therefore, in the case of a buy and sell of an asset, the sales proceeds is the quid pro quo and if asset is exchanged, then the market equivalent value of the acquired asset, in the case of an onerous gift, the economic value of the onus, and if asset is provided in investment-in-kind then its receipt value are, in each case, calculated as the gross revenue amount.

Further, gifts to incorporated entities or transfers at a substantial discount are made, then it would be deemed that there was a transfer at market value (substantial discount means an amount less than one half of the price of the asset giving rise to the capital gain at the time of the transfer).

Acquisition Cost – Acquisition Cost refers to the total of the amounts expended for the acquisition (including acquisition cost), cost of equipment and remodeling expenses (if the asset assigned is a building an amount after deduction of amounts corresponding to depreciation expenses). If the asset is acquired by a gift or an inheritance, or if the asset is acquired at a substantial discount, person acquiring the

asset is deemed to have continuously held the asset. In other words, the acquiror will takeover the acquisition price of the grantor • ancestor as is.

With respect to interest payments made on funds borrowed for the acquisition of the transferred asset, if it is a business asset, the portions corresponding to the period prior to initiation of use of the said asset is deemed to be included in the acquisition cost but the treatment for non-business assets has not necessarily been made clear. With respect to this point, the Supreme Court decision dated July 12 1992 indicated that it should be treated in the same manner in the statement “ Incidentally, when an individual acquires real estate to use as a primary residence there are cases where all or part of the payments are borrowed, in which case a payment of interest will be necessitated. Generally, interest on such borrowings does not constitute an objective value of the said real estate and further, it would not correspond to an associated expense of acquiring the said real estate but rather similar to interest payments on individual’s borrowing for other domestic reasons, it is no more than the individual’s daily expenses or domestic expenditures. If this is the case, the interest on the said borrowing is, in principle, can only be said not to constitute “amounts needed for the acquisition of the asset” as defined under Income Tax Law Article 38 Clause 1 for the purposes of calculation of capital gains amount arising out of sale of real estate for use as a primary residence. However, considering that normally it will take a period of time from the time of the said borrowing to occupation of the said real estate as the primary residence, resulting in the individual having to pay interest on the said borrowing without having the benefit of the use of the said real estate during the said period, of the interest paid on said borrowing, the portion corresponding to the interest paid for the period up until the time of initiation of use of the said real estate can be construed as necessary preparatory expenses for the start of use of the said real estate as primary residence and it would not be appropriate to exclude such amounts as being the said individual’s daily living or household expenses and it will be appropriate to make the interpretation that it corresponds to the associated expenses of acquiring the said real estate and to include the said amounts in the above “amounts required in acquisition of the asset”. As seen above, an appropriate interpretation is that of the said interest on the borrowing, the amounts corresponding to the period prior to the start of use of the said real estate is included in the fore-mentioned “amount required for the acquisition of the asset” and those corresponding to the period after the beginning of the use of the said real estate shall not be included”.

Expenses Required for the Transfer – Expenses required for the transfer refers to expenses directly required to complete the transfer of the property. Specifically, it refers to broker fees and recordation expenses expended at the time of the transfer, compensation paid to tenants for eviction, expenses required to take down buildings located on the land in order to facilitate the transfer, and penalties paid to terminate existing sales agreements that had already been in place in order to transact an transfer at a more favorable conditions to another party.

Taxation Method – The comprehensive taxation is the basic taxation method. However, for long term capital gains, since this is a one-time realization, as the result of the transfer of the property, of capital gains that had accumulated over the years, it is necessary to ease the burden that would result from the application of progressive taxation rates, thus it is subject to the one half comprehensive tax.

4) Exception in Capital Gains Taxation Relating to Land and Building

With respect to land and buildings, particularly with capital gains related to transfer of land, various policies have been taken, as mentioned earlier, to realize the topical policy objectives including the necessity of breaking the myths surrounding land (in Japan, steady economic growth had continued and associated with this the price of land continued to rise, thus a myth had evolved that as long as one owned land, one would always profit. This was what was called the “land myth” but there was rising awareness of the public that this has caused a rise in impediments including breakdown in confidence in “fairness” and “equal opportunity” ideals that had long supported the social prosperity in Japan until that time and the correction of the various imbalances surrounding land became an important social issue), restraining land speculation, promotion of supply of land for housing, facilitation of acquisition of public sites, promotion of effective land utilization, activation of land transactions among others. Major exceptions that are currently in effect are as follows:

Adoption of Separate Taxation – For income related to transfer of land and buildings, Separate Taxation is applied irrespective of whether the transaction is long or short term.

Long Term Capital Gains – With respect to income from transfer of land whose period of ownership exceeded 5 years as of January 1 of the year the sale, is deemed to be long term capital gains and for capital gains amounts up to ¥40 million after

deduction of ¥1 million as special deductions, a tax rate of 20% is applied and for portions exceeding ¥40 million a tax rate of 25% is applied.

However, in consideration of the recent land price trend, although it is a time-defined measure to expire at the end of 2005, a tax reduction measure of an application of uniform tax rate of 20% is in effect.

From the point of view of securing public land and promotion of construction of good quality housing, if the transfer qualifies as transfer for the purpose of land development for good quality housing, as a time-defined measure to expire at the end of 2005, a reduced tax rate of 15% is applied for amounts below ¥40 million and 20% applied on amounts exceeding ¥40 million is in effect.

Short Term Capital Gains – For capital gains for land whose ownership period as of January 1 of the year of the transfer was less than 5 years, as short term capital gains an amount corresponding to 40% of the capital gains or 110% of the tax amount computed by adding the said capital gains to other incomes (refers to tax amount computed by application of normal progressive tax rates to the sum of income relating to transfer of land and other income from which tax amounts calculated by applying normal progressive tax rates to only the other income amounts are deducted) whichever is higher is considered as the tax amount related to the said capital gains.

[Computation of Tax Relating to Short Term Capital Gains]

Capital Gains X 40%

(A – B) X 110%

A = (Other Income + Taxable Capital Gains - ¥500,000) x tax rate

B = Other Income x tax rate

i or ii whichever is the greater is deemed to be the income tax Amount relating to the said capital gains.

(Note)With respect to the application of punitive taxation on short-term capital gains, it is aimed at restraining land speculation and to absorb the profits gained from land speculation.

Other Major Exceptional Measures

In cases of expropriation – If an transfer is executed under the Land Expropriation Law, the said transfer is not one of individual's will but one that has been forced upon the individual, thus the following special measures have been put in place:

- a. If an alternative asset is acquired using the compensation payment, it is deemed that the transfer did not take place (in such a case, the acquisition price of the assigned asset is deemed to be the acquisition price of the alternate asset. In other words this is a deferment of taxation)
- b. Acquisition of alternative asset by exchange and acquisition of land by substitution will conform to a. above.
- c. If an alternative asset is not acquired using the compensation payment, a special deduction of ¥50 million may be taken.

If a residential property is assigned – Normally, if a residence is lost due to transfer of residential property, a residential property as a replacement needs to be found. In consideration of this, in order to minimize the tax burden resulting from the said transfer, the following special measures have been put into effect:

- a. If no special relationships between the seller and the buyer, such as parent and child or husband and wife exist, without regard for the period of ownership, a special deduction of ¥30 million may be taken against the said capital gains.
- b. If, as of January 1 of the year of transfer, the period of ownership of the house and the lot both exceed 10 years and does not meet the requirements for the special treatment for replacement (exchange) or does not receive the benefits of the special measures afforded the replacement (exchange), the capital gains is taxed by applying a tax rate of 10% to the capital gains amount less than ¥60 million after deduction of the ¥30 million special deduction and 15% tax rate is applied to amounts exceeding ¥60 million.
- c. If, as of January 1 of the year of the transfer, property in which the ownership of the house and the lot both exceed 10 years is assigned and the period of residency exceeds 10 years, and a substitute residential property is acquired for his or her own residential purposes, it will be deemed that transfer did not arise (in other words, taxation is deferred). In addition, if the said residential property has been acquired as an inheritance from parent(s) or grandparent(s) and certain conditions are fulfilled, including a period of residency exceeding 30 years, the same treatment is afforded.

Exchange and replacement – In the case of exchange and replacement of business assets, for those satisfying certain conditions, tax deferment measures are applied.

(2) Corporate Tax

In the case of incorporated entities, all profits constitute the profits across the board. Therefore, profits relating to land and buildings are treated in the same way as other profits. Further, as the treatment of business income of individuals follow that of taxation of corporate incomes, Income Tax Law and the Corporate Tax Law have similar provisions and this would also apply with regard to special measures relating to capital gains on land and buildings.

(Note)Also with respect to Corporate Tax Law, the application of Punitive Taxation on Capital Gains on land is currently suspended as in the case of income taxes; therefore, capital gains related to land are summed with other profits for the purposes of calculation of corporate taxes.

(3) Local Taxes

It has been noted earlier that inhabitant's tax is levied as a regional tax and the tax adopts the same tax base as the income tax and corporation tax. It is noted also that a Business tax is also levied on corporate income and individual's business income.

[Tax Rate of Individual Inhabitant's Tax on Capital Gains]

In case of short term capital gains – 12%

In case of long term capital gains – 6%

Reduced tax rate in the case of transfer for development of good quality residential land –
5% on amounts below ¥40 million
6% on amounts exceeding ¥40 million

Reduced tax rate applied if residential property is transferred –
4% on amounts below ¥60 million
5% on amounts exceeding ¥60 million

2.1.3 Ownership Taxes

(1) Land Value Tax

Land Value Tax is a national tax that is levied on land (land and leasehold rights) owned by incorporated entities and individuals as the taxable object and the nature of the taxation is that of a property tax on land. The land value tax was introduced as a part of the 2001 tax revision but the taxation has been suspended in 1998. Therefore, only the history and the summary of this tax will be given here.

1) In the report of the Tax Commission in August 2000 referred to above, the following comments can be found relating to Land Value Tax.

“The land value tax following the basic philosophy defined in the Basic Land Law, while it aims to secure appropriate and fair tax burden on land which is an asset possessing public nature, from the viewpoint of reducing the advantages associated with land as an asset, seeks to establish a tax burden corresponding to the asset value of the land and has been created as a part of the land taxation reform of 1996.

In 1996, based on the rapid and continuing fall in land prices after the land taxation reform, an overall review was made of tax burden on all stages of land acquisition • ownership • transfer and certain adjustments were made. As a part of this review, the Land Value Tax rates were reduced and basic deductions were increased.

Further, in 1998, under the Basic Land Law, while the importance as the tax on assets that seeks to levy appropriate burden on the assets continues to be recognized, considering the protracted decline in land prices, the conditions existing in land transactions, environment surrounding land, economic conditions and further the instability of the financial system, the application of the land value tax has been suspended for the time being”.

2) Summary of the Land Value Tax

Tax Obligor: Individuals and incorporated entities that own land and leasehold interest

Taxable Object: Land and leasehold

Tax Base: Market Value of land (calculate by Inheritance Tax Valuation)

Tax Rate: 0.15%

Basic Deductions: Whichever the higher of the following:

- i. ¥1 billion (for individuals and small and medium scale corporations ¥1.5 billion)
- ii. The product of the area of the land to be taxed and ¥30,000

Taxation Timing: January 1 every year

Tax Exempt: i. Land owned by public corporations

ii. Land serving public interest

iii. Residential land

(2) Fixed Property Tax

1) Summary of Fixed Property Tax

Fixed property tax is a property tax levied on fixed property (land, house and depreciable property) by municipalities. Further the tax, along with the municipal tax,

is a principal source of fiscal resources.

[Composition of Municipal Tax Revenues according to Fiscal Year 2002 Municipal Fiscal Plan] (%)

Municipal Tax	Fixed Property		Tax	Municipal Tobacco Consumption Tax	Special Land Ownership Tax	Other
	Land	House	Depreciable Property			
40.3	18.3	19.2	8.5	4.2	0.2	9.3

As features of fixed property tax, the following can be identified:

It is a tax that focus on the beneficial relationship between the citizens owning fixed property and the municipalities

The existence of the tax source is permanent and stable

Principle of taxation according to registration is adopted

2) Significance of Fixed Property Taxes and History of Balancing • Correction of Land Valuation

The Tax Commission referred to earlier, first defined the tax stating “fixed property taxes are levied each year by municipalities in which the said fixed property is located based on its value” and “the rationale for the assessment of fixed property taxes on land, house and depreciable is based on the existence of a general beneficial relationship between the ownership and the administrative services of the municipalities. However, this does not equate to a determination of the tax amounts according to any specific amount of municipal administrative services provided but is determined using a proportional tax rates against the prices that indicate the value of the property”.

However, with the soaring land prices during the Bubble Period and the ensuing fall in the land prices, it has been pointed out that a significant strain in the land valuation relating to fixed property taxation has arisen and the need for correction has been a focus of much debate. With respect to this point the report makes the following comments.

“With respect to the valuation of land for fixed property taxes including the balancing • correction of land valuation, amidst the soaring land prices during the period from the latter part of the Showa Era to the beginning of Heisei Era, in addition to the declining ratio of fixed property valuation against the assessed land prices, the divergence in valuation base have become obvious. Due to these factors, in the valuation review conducted in 1994, based on the aims stated in the Basic Land Law Article 16,

“Essentials of Promotion of Comprehensive Tax Policies” and “Report on 1993 Tax Revision”, measures for balancing • corrections were taken setting 70 percent of assessed land prices as a rough measure.

The basic aim of the valuation review in 1994 was to balance • correct the land valuation and comprehensive measures were taken so as to avoid sudden changes in the tax burdens of the taxpayers associated with the changes.

Subsequently, in the valuation review in 1997 and 2000, in the same way as 1994, balancing • correction of land valuation was effected.

In addition, with respect to fixed property tax valuation of land, from the point of view of simplifying the taxation operations, in principle, valuation review is performed every three years and the valuation established in the year of the valuation review (base year) are applied as tax base for the second and third year (grace year) following the base year. However, as the fall in the land prices are continuing on a nation-wide basis, in the tax revision in 1997, in order to reflect the trend, a special dispensation was given whereby the head of the municipality may effect certain changes to the prices set in the base year even during 1998 and 1999, which were grace years if it is deemed that the land prices have declined. Further, also in the tax revision in 2000, the declining land prices persisted and the same dispensation is continued for the grace years 2001 and 2002”.

3) Principle of Taxation by Tax Register

Fixed property taxes are levied on fixed properties in the municipality in which it is located and the tax obligor is defined to be the owner of the said fixed property. Such owner is defined as the “person or entity registered as the owner in the fixed property tax register” and the tax base is defined as “the price recorded in the fixed property tax register”. Thus, Principle of Taxation by Tax Register means that tax is assessed according to the records in the fixed property tax register.

(Note) Fixed Property Tax Register is a generic name for tax register for fixed property taxation including the Land Tax Register and the House Tax Register, and is required to be prepared by each municipality in order to make express the conditions of fixed property and the tax basis (price of fixed property). Variety of items are contained in the register, for example in the Land Tax Register, the recordation items based on the Immovable Property Registration Law, title, mortgage status and name of registered owner of surface rights that have continuation of over 100 years as well as the price for the base year or the comparative value. With respect to the rationale behind the adoption of the Principle of Taxation by Register, Professor Hiroshi Kaneko opines, “ due to the large numbers of fixed property, in order to smoothly and quickly

perform taxation operations for fixed property taxation, prior to the making the final disposition, it is necessary to make an early determination based on objective clarification of the status of all fixed properties and the taxation requirements for fixed property taxes relating to the property and such be made available for public inspection by the relevant parties; and through the public inspection of the fixed asset tax register, it is necessary to provide an opportunity to verify the appropriateness of the valuation of the owned fixed property and the fairness when compared with other taxpayers”.

4) Obligor

The tax obligor is the owner of the fixed property as of the base date of the assessment. As stated earlier, the owner in this case is the owner registered on the fixed property tax register. Further, if the land or the building is jointly owned by multiple parties, the joint owners are severally and jointly are responsible for the taxes (in case of land used for site of condominiums and the like, tax obligation is borne pro rata individually according to the share of ownership).

(Note) Precedent Regarding Tax Obligors for Fixed Property Tax (Supreme Court Decision dated march 23 1955)

“From the related provisions in the Local Tax Law, fixed property tax on land is levied on the owner of the land and the owner of the land is defined as the person(s) or entity(ies) registered as owners in the land tax registry or supplemental land tax registry as of January 1 or the first day of the year; therefore, if the person(s) or the entity(ies) are registered as owner on January 1 of that year, that in of itself, determines the person(s) or entity(ies) to be the legal tax obligor and regardless of whether the person(s) or entity(ies) does or does not have ownership of the land in the fiscal year beginning April 1, it does not alter the fact that the said person(s) or entity(ies) is the tax obligor for that fiscal year. Thus, Local Tax Law adopts a formal standard to facilitate determination of tax obligors of fixed property taxes for ease of taxation.

Under the democratic politics, a basic tenet is that the citizens through their representatives in the parliament, themselves bear the national expenses, and the citizens, based on tax laws that reflect this collective will voluntarily bear their tax obligations, while to levy new tax or to change existing taxes requires a law or conditions determined by the law. Under the Japanese Constitution, it should be construed that not only the creation of new taxes and elimination of taxes, but also procedures regarding tax obligor, tax basis, and procedures for tax collection must be according to law as stated earlier but at the same time entrusted to that determined by law. That is why it should be construed that the propriety of the Local Tax Law

eliminating land tax and institution of a land fixed property tax and considering the infrequent nature of transfer of ownership and with the intent of facilitating tax collection determining the base date for the assessment must all be entrusted on deliberation and decision in the course of legislation. Therefore, the provision in the Local Tax Law which defines the registered land owner as of January 1 as the tax obligor irrespective of whether or not such party being the owner as of the due date of tax payment for the fiscal year is in compliance with the provisions in the Constitution, above is clear and one's views are, in the end, own legislative views.”

5) Taxable Object

The taxable item of the fixed property tax is fixed property and fixed property is defined as land, house and depreciable property. Land includes varieties of classification of land and house includes house for all types of uses.

In fixed property taxation, there are many tax-exemption provisions: the state, and prefectures, municipalities, special districts and their cooperatives are tax-exempt persons and tax-exempt objects include fixed properties used by the state for public use, cemetery plots, roads and the like that are serving public use, property that are used by social welfare organizations for social welfare activities. .

6) Tax Base

The taxation base for the fixed property taxes is the price at the time of the base date of the assessment of the said land or the house and registered on the fixed property taxation register and in this context “price” means “fair market value”. In concrete terms, the valuation is performed by a fixed property assessor appointed in each municipality and finalized by the head of the municipality but at the time of the evaluation, the evaluation is stipulated to be performed in accordance with the criteria and methods indicated in the “Fixed Asset Valuation Criteria” as established by the Minister of Public Management, Home Affairs, Posts and Telecommunications.

Price calculation method according to the Fixed Property Valuation Criteria is as follows:

For land, a method based on comparative transaction pricing examples

For house, a method based on cost of replacement

For depreciable assets, a method based on the acquisition cost

According to the circular from the Vice Minister for Home Affairs issued in 1992, in establishing the land value, a new factor of making an allowance for the posted land prices has been added. In other words, it provides instructions to set the valuation of the land in the base year at roughly 70 % of the posted land price as of January 1 of the

prior year. With respect to this instruction Professor Kaneko points out, “Since the transaction prices for land have a range, valuation for taxation purposes require a sound basis, (ii) there is a need to eliminate abnormal elements in the posted prices, (iii) there is a possibility that land prices may fall during the year prior to the beginning of the base year” and indicates his appreciation.

(Note) Court Precedence Relating to Valuation of Residential Land (Decision by Osaka District Court dated February 26 1999)

“Fair market value . under the Local Tax Law while it should be construed as a transaction price for the subject land that would have been transacted under a what would be a normal transaction from a common sense standpoint, it stipulates with respect to the determination of the land’s fair market price to base it upon the Fixed Property Valuation Criteria determined by the Minister of Public Management, Home Affairs, Posts and Telecommunications and it could be said that by this with respect to repetitive • continuous valuations performed on the large volumes of fixed properties, it aims to secure balance in the valuations determined by each municipal bodies. In other words, the Fixed Property Valuation Criteria provides for technical methodologies and criteria to perform valuation that is fair to the extent possible with respect to large volume of land under various constraints without having to perform individual valuation on each. Assuming the contents of which is appropriate and applied appropriately, the market price derived using the method may be considered fair value. However, this notwithstanding, generally, in the past, land has been valued at a level that was substantially lower then the fair market value and further, at the time of the issuance of the circular, the valuation amounts for the fixed property tax valuation were disparate among the local public bodies and it could not hope to provide fairness among taxpayers. Under an environment in the society that securing of fairness of taxation by establishing a national balance in valuation was an urgent issue, receiving a societal mandate to take measures to establish balance • fairness among public land valuations, posted land prices (Posted Land Price Law with the aim of securing formation of fair market value selects a location as the standard and posts the normal price (Article 1) and “normal price” is defined with respect to land a price that would be deemed sufficient to complete a transaction in a transaction without constraints (Article 2 clause 2) thus, it can be said that “normal price” above and “fair market value” in Local Tax Law are concepts that have the same intent) based on prices of comparable transactional examples in the same way as the fixed property valuation, and there is nothing unreasonable of setting the valuation of a standard residential land, based on the above, as a fixed proportion of the posted land prices as an interpretative

guiding principle to achieve further appropriateness in the contents of the fixed property valuation criteria and its application in order to achieve a nationally unified balance in the fixed property valuations”.

7) Tax Rate

Standard tax rate is 1.4 per one hundred and the limited tax rate is 2.1 per one hundred. The minimum taxable amount is, in the case of land ¥300,000, in the case of a house ¥200,000 and in the case of a depreciable property ¥1.5 million.

(Note) Standard tax rate is the rate that the prefectures and municipalities apply normally in assessing taxes except when it is deemed that there is a special fiscal requirement, when the use of this rate may be waived. Assessing tax with rates higher than the standard rate is excess taxation and the upper limit applied in such case is referred to as limited tax rate).

8) Exceptions to Tax Amounts

There are many exceptions provided for in newly built residential housing and land. The major exceptions are noted below:

Newly built general residential housing – For cases meeting certain requirements, the tax amounts will be reduced to one half for a period of 3 years (floor space of up to 120 square meters).

Newly built medium and high rise fire resistant housing – for medium and high rise fire-resistant housing 3 storied or higher and that meet certain requirements the tax will be reduced to one half for a period of 5 years.

Residential land – General residential land will have the tax base reduced to one third and for small-scale residential land (up to 200 square meters), the tax base will be reduced to one sixth.

Residential Land - In order to smoothen the rise of tax burden, burden adjustment measures have been applied. In other words, for fixed property tax that exceeds the Residential Land Adjusted Fixed Property Tax Amount, this will be reduced to the adjusted amount.

[Calculation Method for Residential Land Adjusted Fixed Property Tax Amount]

Residential Land Adjusted Fixed Property Tax Amount = prior year's fixed property tax base x burden adjustment rate x tax rate

(Burden adjustment rate is a fixed coefficient set according to the degree of increase in the fixed property tax burden)

(3) City Planning Tax and the like

As taxes that share common characteristics with fixed property tax, there are City Planning Tax and Special Land Ownership Tax, which are taxes applied to ownership.

1) City Planning Tax

Municipalities, to provide for money to be allocated to expenses required for city planning activities that are undertaken in accordance with the City Planning Law, are empowered to levy a city planning tax on land and houses located within an urbanization promotion area.

The tax base for city planning tax is the same as that for fixed property tax (however, for general residential land there is a special dispensation that reduces the tax base to two thirds and for small scale residential land to one third), the limited tax rate is 0.3 per one hundred.

The assessment and collection will be done at the same time as the fixed property tax.

2) Special Land Ownership Tax against ownership

Municipalities in order to restrain speculative trading in land and to promote the effective utilization of land, can assess Special Land Ownership Tax against those who own land having an area in excess of the set standard.

The tax base for the special land ownership tax is the acquisition cost of the land and the tax rate that is applied is 1.4 per one hundred (however, this tax has the same characteristic as the fixed property tax, thus in order to avoid duplicative taxation in calculating the taxes on this tax, the amount corresponding to the fixed property tax is deducted). In other words, the tax amount is defined to be: (acquisition cost of land \times 1.4% - amount corresponding to the fixed property tax \times 1.4%).

2.1.4 Acquisition Tax

At the time of acquiring land bearing of taxes including inheritance tax (national tax) assessed on property acquired through inheritance • gifts, immovable property acquisition tax (prefectural tax), special land ownership tax (municipal tax) relating to acquisition of land and immovable property registration tax (national tax) assessed at the time of recordation of land are required.

Further, in the tax revision of 2003, from the viewpoint of promoting effective utilization of land and rejuvenation of urban areas, further measures to lighten the tax burden relating to land distribution (including reduction in tax rates for registration

licensing tax) are being considered.

(1) Inheritance Tax • Gift Tax

1) Inheritance Tax • Gift Tax Summary

Japanese inheritance tax since its inception had adopted the “Donor Based Inheritance Tax Method” in which the tax was levied against the estate of the ancestor, but with the Shoup’s Recommendations it was changed to the “Donee Based Inheritance Tax Method”. However, under the current law, in order to provide consideration for the ease of execution and to ensure that sole inheritance, which often is the case in farming families who generally wishes to avoid fragmentation of farmland, are not disadvantaged from the taxation aspect, “Taxation According to the Legal Portion of Legacy Method” has been adopted. Under this system, while it maintains the principle of Donee Based Inheritance Taxation Method in which the tax is assessed on the estate acquired by the recipient of the inheritance, it also includes some elements of the Donor Based Inheritance Taxation Method, it is, as it were, eclectic taxation system.

Summary of the Inheritance Tax is as follows:

- i. Tax Obligor: Individual acquiring property through inheritance
- ii. Taxable Object: Inherited property including land and houses
- iii. Tax Base: Acquisition cost (cost based on inheritance tax valuation)
- iv. Tax Rate: 9-step progressive rates from 10% to maximum of 70% (a proposal to reduce the maximum rate to 50% is being considered for the 2003 tax revision)
- v. Basic Deduction: ¥50 million + ¥10 million X Number of Legal Heirs

Gift Tax is positioned as a supplementary tax to the Inheritance Tax and although there are some differences in the degree of graduation and the allowed basic deductions (the slope of graduation of the gift tax is very steep and the deduction is small, limited to ¥1.1 million), it is provided for within the same Inheritance Tax Law and, in many cases, receive common treatment.

(Note 1) In the 2003 tax revision, in addition to the correction to the tax rates, unification of the inheritance tax and the gift tax is being examined. In other words, an introduction of a Inheritance Settlement Taxation System (with respect to living grants, upon the option of the recipient, a gift tax is paid on the property received as a gift at the time of receipt and subsequently, at the time of inheritance, deduct the gift tax already paid from the inheritance tax calculated based on the sum of the property inherited and property received as gift). This was intended to facilitate a

smooth transfer of property to the next generation, given the continued aging of the society.

(Note 2) In Japan, there is an overwhelmingly uneven distribution of inheritance assets in favor of land, as shown below. This fact gives a negative impression of the inheritance tax as being an onerous taxation levied on land. For example, this is one of the reasons for the derisive name “exorcize tax” (“Exorcize Tax” is a common expression meaning that in order to pay the inheritance tax, one is forced to sell the land and buildings that one inherited, as a result, being chased out of the house where one had been living).

[Composition of Inheritance Property Value by Types (%)]

Type Composition (%)	Land	House	Securities	Cash • Deposits	Other	Total
	62.4	4.3	8.5	14.8	10.0	100.0

2) Burden Reduction Measures for Small Scale Residential Land

One of the roles played by the inheritance tax is the redistribution of wealth. However, the combination of the soaring land prices and the effect of the graduated tax rates exacerbated the perception that the “inheritance tax is excessively onerous” and giving considerations to thinking along the lines of “placing an excessive burden on the propertied class, dampens the motivation to expand the assets to pass onto his posterity and will provide a negative impact on the revitalization of the economy”, special measures were put in place to facilitate the transfer of business and enable the heirs to live on the same property.

That is to say, in general, it is a special measure positioned as a “business succession tax” and as shown below, for residential land used for business or residence and used as a site for a building by the ancestor or family within the same household as the ancestor, the valuation is reduced as a measure to reduce the burden of the inheritance tax.

[Summary of Burden Reduction Measures for Small Scale Residential Land]

	Proportion of Reduction	Applicable Area
i. Business-Use Business Succeeded	80%	Up to 400 Square Meters
Not succeeded	50%	Up to 200 Square Meters
ii. Residential Use Residence Succeeded	80%	Up to 240 Square Meters
Not succeeded	50%	Up to 200 Square Meters
iii. Real State Rental • Parking Lot, etc.	50%	Up to 200 Square Meters

(Note)Regardless of the nature of the special measures, a constant verification as to its

appropriateness is needed. This applies also to this particular special measure, and the Tax Commission Report of August 2000 referred to earlier makes these comments regarding the point.

“From the point of view that in a case residential land used for the ancestor’s business or residence (hereinafter “business and the like”) is used by the heir to succeed the business and the like, residential land up to a certain size may be considered the foundation for business and living and should be given a different treatment from other properties. Under the current system for residential lot for small scale business • residential use an exception is made in the taxable value has been established.

With respect to the establishment of such exceptions, there are opinions that especially with respect to business, succession, and a smooth succession of the business to the next generation heightens the management motivation of the entrepreneur and leads to the vitalization of small and medium scale enterprises. On the other hand, by favoring business succession this creates an imbalance in the opportunities between those who create their own business without reliance on parents and those who succeeds businesses and by promoting the transfer of business assets without regard for the ability to manage by the next generation, it detracts from the efficient allocation of resources. As can be seen, it must be taken into account that there may be two opposing opinions with regard to the need to give consideration to business succession in examining the desirable state.

In any case, even if it is a small scale, if the residential land is given excessive favorable treatment, it may lead to a inflicting major damage to the inheritance tax’ wealth redistribution function. In addition, there are views that the structure needs to be reviewed from various viewpoints, for example, are their situations in which owners of residential land in an area where the land prices are high are favored, is there an issue with the exclusion of 50% of the residential land price (Road Rating) from taxable value calculation irrespective of succession of business, is the structure such that it meets the intent of giving consideration to succession of business. In addition, there are views that, in view of the long-term decline in land prices, the cutbacks in these measures should be sought. The desirable state of the exceptions is an issue that can affect the fundamentals of inheritance taxes and, as such, it needs a constant review, keeping in mind its intent, trend of the land prices, its impact on the neutrality of property selection”.

3) Exceptions for Tax Deferment for Agricultural Land

Considering the special nature of agricultural land and for the intent of preventing the

fragmentation of agricultural land, with the condition that agriculture will be succeeded, also provided that certain conditions are met, certain amount of the inheritance tax on farmland may be deferred. With respect to the deferred tax, if the agriculture is continued for a period of 20 years after deferment or until the next inheritance whichever comes earlier, the payment of the tax is exempted. This can be looked at as a de facto exemption in consideration of the agricultural policies (however, with respect to agricultural land surrounding major urban areas, except for certain agricultural lands, the application of this system has been eliminated).

[Reference] Exceptions Relating to Gifts Tax

Spousal Deduction for Gifts Tax

If a gift of residential property or funds to acquire the same is given between a married couple, if a Gift Tax return is filed, in addition to the basic deduction of ¥1.1 million up to ¥20 million in spousal deduction can be applied (however, this is available only once in a lifetime for gifts from the same spouse).

[Requirements for Spousal Deductions for Gift Tax]

- i. The married couple has been married for a period equaling or exceeding 20 years
- ii. By March 15th of the year succeeding the receipt of the gift, he or she actually resides in the land and building received as a gift with the expectation to continue to reside in the premise.

Exception on Gift Tax Calculation Relating to House Acquisition Funds

If funds to acquire or to remodel a residential property are received from parents or grandparents, if certain requirements are met, an exception on the calculation method for gift tax may be applied in which Income Splitting is allowed (the value of the property received as gift is reduced to one fifth for the purposes of tax calculation and multiply the resultant tax by 5 to arrive at the tax amount) for the first ¥15 million portion. This measure is pre-empting the ¥1.1 million basic exemption for gift tax for 5 years and as a result, up to ¥5.5 million will be tax exempt

Further, in the 2003 tax revisions a proposal to eliminate this system in return for an expansion of the tax-exempt allowance for gift tax is being examined.

(2) Registration and Licensing Tax

The registration and licensing tax is a tax levied on receipt of various recordation • registration and is one of the transfer taxes. With respect to land and buildings, taxable items are title transfer recordation in the case of a sale and purchase and recordation of

reservation of title in case of construction. The tax base for the registration and licensing tax in the case of immovable property is the price at the time of recordation (however, if a value that has been recorded in the fixed property taxation register exists, for the time being, the registered value is the tax base. This measure is being considered as being subject to elimination in the 2003 tax revision proposal).

[Principal Reduction Measures for Registration and Licensing Tax Relating to Land • Residence]

Those relating to land

Registration and licensing tax (transfer record of title to land in sales / purchase) = fixed property valuation (posted land price X 70%) X tax value exception (1/3) X tax rate (5%)

Those relating to record of reservation of title of residential house: Principle tax rate 6 per mille → 1.5 per mille

Those relating to transfer recordation of residential house: Principle tax rate 50 per mille → 3 per mille

(3) Real Estate Acquisition Tax

Real estate acquisition tax is a prefectural tax that assesses taxes on the acquisition of immovable property (Real Estate) and the summary is as follows:

Tax Obligor: Individual or an incorporated entity acquiring real estate

Tax Object: Land and house

Tax Base: Acquisition cost (fixed property valuation)

Tax Rate: 4%

Exemption Limits: Land up to ¥100,000, house - ¥230,000 (in the case of new construction, ¥120,000 for other cases)

Exceptional Provisions:

- i. In the case of acquiring residence, the tax rate is reduced to 3%
- ii. With respect to tax base for newly constructed residence, there will be a deduction of ¥12 million
- iii. With respect to tax amounts on residential land, it will be reduced by amount corresponding to one fourth of the tax amount

(4) Special Land Ownership Tax Relating to Acquisition

This is the same nature of tax as the real estate acquisition tax, and the structure of the tax is common with the special land ownership tax relating to ownership. Further, the tax rate is 3% (however, as this has the same characteristic as the real estate acquisition

tax, in order to avoid duplicative taxation, in the calculation of the tax amount the amount corresponding to the real estate acquisition tax is to be deducted).

In other words, the tax amount is: land acquisition cost X tax rate (3%) – amount corresponding to the real estate acquisition tax = tax amount.

2.1.5 Taxes on Rentals

Rental income from land and buildings is included in the categories of income tax. For individuals, income tax (in this case the class of income is in principle real estate income) and in the case of incorporated entity corporation tax will be assessed. Further, inhabitant tax is assessed the same as in the case of income taxation in the case of transfers.

(1) Income Tax

Rental income relating to land and buildings is subject to income tax as real estate income, as has been noted earlier, but the method of calculation of income differs depending upon whether or not the rental is being undertaken as a business activity (depending upon the scale of the rentals, a determination of whether it is a business scale real estate income or whether it is a operational scale real estate income is made). In addition, depending upon the form of the rental, income may be classified as business income or miscellaneous income (a comprehensive determination is required with respect to the details of the rental operations but if personal services are involved it may be classified as business income). In addition, with respect to transfer of deposits associated with the establishment of easements, as stated earlier, this will be treated as capital gains.

“Real Estate Income Amount = Gross Revenues – Required Expenses” but there are issues to be examined in each of the items.

For example, with respect to Gross Revenues, as a customary practice in real estate rental in Japan, there are many cases of transfer of money in addition to the payment of rent and the treatment in such cases of deposit or guarantee deposit which are returned at the termination of the lease are “deposits” and are not required to be included in the Gross Revenues but key money or indemnification payments that are not returned are to be included in the Gross Revenues at the time of receipt.

On the one hand, with respect to required expenses, depending upon whether it is business scale or operational scale, that the treatment of wages for family employees and losses on assets differ need to be borne in mind. Further, existence of preferential measures, including “Additional Depreciation for Designated Superior Rental

Housing”, are items of interest for taxpayers.

(2) Corporate Tax.

In corporate tax, rental income is to be included in the profits in the same manner as the other profits and in terms of a system, it is generally common with business income in income tax is a point that has already been discussed. However, with respect to taxation relating to leasehold interest, it is more aggressive than is the income tax is a minor difference. Here, an expansion on this particular point will be presented.

In Japan, as a result of enhancing the protection of the rights of the renter by the Land Lease Law, limitations were placed on the ownership, which is a right belonging to the owner, and as a result its value declined and leasehold interest so enhanced became to have asset value and today is even being subject of buying and selling. As a result, receiving a premium has become a customary practice at the time of establishing leasehold including the implication of disposition of a part of the ownership functions. Therefore, in the Corporate Tax Law, also defines the taxation relationship that recognizes that a transaction that follows this custom as a normal transaction. In other words, the premium received is deemed to be income is a matter of course and in spite of the transfer of premium being the custom, if the premium is not transferred an amount corresponding to the premium is deemed to have been granted to the lessee and is so taxed (therefore, with respect to the amount corresponding to the premium, a tax on donation is assessed to the lessor and tax on receipt of a donation is assessed to the lessee). This is referred to as constructive taxation on leasehold and in the case of in the place of receiving a premium, a corresponding amount of rent (currently 6% of the value of vacant lot) is received, the constructive taxation is not applied.

(3) Local Tax

Against income arising from rental revenues, just as in the case of income relating to the transfer, inhabitant taxes are assessed. In addition, if the rental is on a business scale, a business tax is assessed on the real estate income and business income.

2.1.6 Other

(1) There are many other taxes relating to land and buildings but general items are illustrated below.

1) With respect to the consumption tax, transfer • rental of land, from the nature of the

transaction, is not compatible with consumption tax and is exempted, and rental of housing is also exempted for political considerations. Commissions received by the real estate brokers are subject to consumption tax.

2) In transactions involving land, documents including contracts are essential, but in principle these documents are subject to heavy stamp duties. However, for residential property, there are many cases in which special exceptions have been established.

With respect to income taxes, one of the tax features that the general taxpayers are most familiar with is the special deduction for housing loans. Under this system, if a housing loan is taken out for building, acquiring or remodeling a residence, providing certain conditions are met, for 10 years from the time of taking up residence, special deductions that are outlined below are available against income taxes.

Year end balance of the housing loan (Maximum¥50million) x 1% = Deductions (Maximum ¥500,000)

4) Relating to the method of collection of income taxes relating to transfers, to deal with cases that have been uncovered from time to time of non-residents transferring land and the like located in Japan and remitting the money abroad prior to the deadline for filing of income taxes and leaving the country, there is a system that places an obligation for a 10% withholding to buyers of property in Japan from non-residents. As the sure collection of taxes is essential to the effectiveness of the tax system, this is just one example of system preparedness (this is said to be created using the American tax system as a reference).

5) Today, in Japan also, securitizations of real estate using various schemes are taking place. This trend cannot be ignored from the standpoint of taxation on land and buildings going forward. Professor Yoshiaki Hirano comments, “Looking at the securitization of real estate from the point of view of utilization of real estate, the scheme differs from the scheme which was prevalent in traditional real estate investments where the same principal undertook the real estate investment and operational management functions and further the same principal, through indirect financing, undertook the fund raising and bore the business risks. In other words, real estate securitization, segments the real estate investment from operational management functions in the unified scheme and raises funds through direct financing from the market based on the real estate and its related assets. That is to say, it opens up direct financing and widely distributes the business risks associated with the investments, while the investors look at this as a way to utilize their financial assets” and suggests that taxation that relate to investment forms, in addition to the voluntary associations

and anonymous associations, special purpose companies, special purpose trusts, investment companies, and real estate investment trusts will have a significant meaning in the future.

2.2 Executive System

2.2.1 Tax Administration

(1) Agencies Relating to National Tax

The Tax Bureau, an internal department within the Ministry of Finance is responsible for the operations relating to research, planning, formulation, preparation of tax reform bills relating to domestic taxation and the National Tax Agency (hereinafter “NTA”), an external organ of the Ministry of Finance is responsible for the execution of the operations relating to the domestic taxation. NTA has at its core, the NTA central office and in the regions as its arms in the regions maintains 11 regional tax bureaus and 524 taxation offices. The main office performs the planning • coordination of the execution of tax administration and supervision over the regional tax bureaus and taxation offices while the regional taxation offices oversee the taxation offices’ assessment and collection operations. The taxation offices are responsible for the assessment and collection operations of domestic taxes within their jurisdictional district (however, with respect to complex items such as a large scale case, the NTA staff are also involved in the assessment and collection operations).

Of these the basic organization and the assigned operations of the taxation offices are shown below. In addition, as an agency attached to the NTA, there are National Tax College and National Tax Tribunal and including these institutions, some 56,700 staffs are engaged in national tax operations.

[Taxation Office Organization and Responsibilities]

Chief of Taxation Office	<ul style="list-style-type: none"> — General Affairs Dept -coordination, administration, accounting operations, etc — Management Collection Division -management of tax claims, arrears administration, etc — Personal Taxation Division -Examination and consultations relating to Income Tax • Consumption Tax for Self-Employed, information operations, etc. — Property Taxation division -Examination and consultations relating to Inheritance Tax • Gift Tax • Capital Gains Tax, preparation of road value map and inspection operations — Corporate Taxation Division - Examination and consultations relating to Corporate Tax • Consumption Tax for corporations • Income Withholding Tax • Stamp Duties
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(Note 1) In a large taxation office, as needed, special national tax inspectors are stationed to be responsible for comprehensive examinations, individual examinations (income tax or property tax), corporate examinations (corporate income tax or income withholding tax), data information, etc and are engaged in examination operations through a team comprised of several inspectors.

(Note 2) Further, it has been noted that examples of measures for enhancement of review operations are being taken even at the taxation office, including performing reviews of examination results and ensuring accurate responses to consultations.

(Note 3) With respect to registration and license taxes, the operations and consultations performed by the NTA are limited as the tax is paid via revenue stamps and the confirmation of the payment amount of the tax and related operations are performed by each recording agency.

(2) Agencies Related to Local Taxation

National agencies relating to local taxation include the Home Tax Bureau, which is established within the Ministry of Public Management, Home Affairs, Posts and Telecommunications and is responsible for supervisory operations of each municipality, in addition to planning and formulation of local taxation. Further, the assessment and collection operation for local taxes are performed by taxation departments of each prefecture and taxation departments of each municipality.

(Note 1) In the case of Metropolitan Tokyo, Taxation Bureau is responsible for the operation. The Taxation Bureau is composed of the main office, 35 external offices comprised of 29 metropolitan tax offices and 6 automobile taxation offices. The main office is responsible for planning • formulation of each taxes, overall management of the bureau, supervision of the external offices and each external office is responsible for the assessment and collection of taxes.

(Note 2) Regional governments have autonomous taxation rights but with respect to such right to taxation, the country has the power to determine a unified framework through legislation. The legislation that performs this role is the Local Tax Law. The Local Tax Law only provides for the rules for local taxation and the bases for the taxation by each local government are the ordinances set down by the local governments. That is to say, taxation is only made possible by the ordinances.

2.2.2 Country's Property Tax Operations

With respect to the taxation operation relating to land and buildings, for taxation on corporation it is processed as a part of the corporate tax operations but operations for

taxation on individuals are divided into property tax operations which deal with taxation relating to capital gains and inherited • gift property and income tax operation which deal with taxation on real estate income and business income. Major components are handled by the property tax division, and, here, explanation focusing on property tax operations will be discussed.

(1) Property Tax Operations

Property Tax operation and administration is defined as: “in principle the bulk of the taxable subjects are based on temporary and accidental events, firstly bureau and the offices will take unified actions to always accurately identify changing tax subjects and take actions that balances the related operations, secondly, giving consideration that many of the taxpayers do not possess sufficient knowledge regarding the tax laws and, further, have limited opportunities to interact with the tax offices, endeavor to make well known the contents of related laws and regulations and endeavor to enhance tax counseling, and against those who are deemed not to be filing correct returns perform appropriate examinations and ensure that a fair • impartial taxation is performed”. Under this basic policy, enhancement of valuation operation functions have been taken including securing efficiency in property taxation operations through establishment and review of operational compendium relating to internal operational procedures, enhancement of examination function by the supervisor system and establishment of property evaluator (regional tax bureau) and special national tax inspectors assigned for valuation (principal taxation offices). In addition, progress made in the mechanization of property tax operations is also one factor that had brought major changes in operation and administration.

(2) Valuation Operations Relating to Inheritance Tax

Valuation operations relating to inheritance tax is one of the pillars of the property taxation operations and priority has been placed on its enhancement, a point, which has already been mentioned.

1) Enactment of Basic Notice on Property Valuation

Inheritance Tax Law defines the method of valuation of the value of property, which forms the basis for the inheritance tax and gift tax, as: “market value at the time of acquisition”. However, objective valuation of the market value of a property is not necessarily simple, excepting for certain properties, for many properties, the law leaves the valuation method open to interpretation. As a result, the NTA has established the

“Basic Notice on Property Valuation” (hereinafter “valuation notice”) as an evaluation methodology common to inheritance tax • gift tax and land value tax. The said valuation notice for the maintenance of impartiality among taxpayers and for ease of both taxpayers and taxing agency, establishes a uniform valuation method for various properties and it should be noted that not only will it serve as the guide in valuation operations in the taxing agencies but also has been widely accepted by the taxpayers and has become the foundation for filing returns.

(Note 1)With respect to Basic Notice on Valuation, in a decision handed down on January 26 1993, the Tokyo Supreme Court commented as follows (it is also supported by a Supreme Court decision), and it can be regarded as a general view. “Inheritance Law Article 22 provides, to the effect, that the value of inherited property, except in cases that are specially defined, is to be set according to the market price prevailing at the time of acquisition of the said property, and market value referred to in this context should be interpreted as the objective exchange value of the said property at the time of initiation of inheritance; however, objective exchange value is not necessarily uniquely determinable, thus for the purposes of practical taxation operation the general basis of the inherited property valuation is established by the Basic Notice on Valuation and it is defined that the inherited property shall be valued according to the uniform valuation method established therein.

This is construed as being based on the rationale that if a method in which the valuation of objective exchange value for inherited property is performed individually, it will be difficult to avoid incidence of diverging valuation amount based on the selection of valuation methods or basic data, in addition, it increases the operational burden on the taxing agency and may give rise to situation in which swift processing of taxation operations would be impeded and thus performing the valuation uniformly using an evaluation method that have been established in advance is reasonable from the point of view of ensuring impartiality among taxpayers, convenience for taxpayers and reduction of tax collection expenses.

If, such is the case, especially from the point of view of equality in taxation principle, as it may be construed that so long as the valuation method established in the said notice is reasonable, its formal application to all taxpayers will realize effective impartiality of tax burden and valuation using methodologies other than the methodology set forth in the said notice for a specific taxpayer or specific inherited property, even if the valuation arrived at using such methodology itself is a value that is within the permissible range as provided for under Inheritance Law Article 22, will result in effective impairment of impartiality of burden among taxpayers and shall not

be permitted.

However, on the other hand, it should be interpreted that if the intent that the methodology method should be as set forth in the Basic Notice on Valuation is as above, by single-mindedly applying the equality in formality in uniformly applying the valuation methodology, there may be situations in which there are extenuating circumstances which would clearly bring about significant damage to the fairness of tax burden by such application, in which case, a different valuation methodology may be permitted and this is clear from its establishment of “valuation of property for which valuation according to the provision of this notice is deemed to be obviously inappropriate, valuation shall be performed under the instruction of the Director General of the National Tax Agency” in the said notice”.

(Note 2)Further Professor Hiroshi Kaneko, although he affirms that Basic Notice on Valuation is reasonable and the reliance upon it, he adds, “however, the valuation of property has a significant impact on the interest of the taxpayers and further considering that there is a necessity to continuously and routinely value variety of properties, the basic items relating to valuation should rather be provided for by a government ordinance or ministerial ordinance”.

2) Land Valuation

In the Inheritance Law Article 22-3, it is defined, “a Land Valuation Council will be established in each Regional Tax Bureau” and the Land Valuation Council will with respect to “per area value of land or leasehold in major standard areas for each type of land usage (by residential, commercial or industrial) in the prefectures” in response to a request from the Director General of the regional tax bureau, conduct examinations and deliberation.

Looking at a specific example, in determining the land valuation base for 2002 for the jurisdictional area, the Director General of the Tokyo Regional Tax Bureau convened the Tokyo Regional Tax Bureau Land Valuation Council (Chairperson Professor Hiroshi Kaneko) in May of 2002 and presented “Valuation Base for the highest standard residential land in the prefectural capitals (draft)” and within this with respect to the highest standard residential land valuation he sought opinions on the determination of the plot “Ginza Chuo Dori located 7-4 Ginza 5-chome, Chuo-ku” and its value of “¥12 million”.

[Summary of the Standard Plot]

Area: 204 square meters

Usage: Retail outlets, steel framed steel reinforced building with 10 stories

Land Usage of Surrounding Areas: Highly developed commercial area with high rise retail building

Status of Fronting Street: Road width 27 meters, national road

Proximity to railway and other transportation facilities: 450 meters to the JR Yamanote Line Yurakucho Station

Principal limitations under the City Planning Law and other laws and regulations:

Zoned as commercial, fire prevention district, maximum building to land ratio 80%, maximum floor area ratio of 800%

(From Reference Data submitted to Council)

(Note 1)The preparation of the proposal and the tasks for establishment of each road value are performed by persons responsible for property valuation in each taxation office led by special national tax inspectors responsible for valuation posted in the principal taxation offices under the coordination • guidance of property valuation official in regional tax bureaus.

(Note 2)In the National Tax Agency, valuation planning officers are established and perform planning • formulation related to valuation operations and supervision of operations performed in bureaus and taxation offices.

(Note 3)As mentioned earlier, with the mind to achieve appropriateness • balance in public land valuations, the National Tax Agency set the inheritance tax valuation as the posted land prices and 80% of the said value starting 1992 and the Ministry of Home Affairs also from 1994 set the fixed property tax valuation to 70% of the same. By these measures, the goal of achieving balance in land valuation is said to have made some progress but with respect to the relationship between the inheritance tax valuation and posted land prices, it is said “as a result of the soaring land prices due to the bubble economy from circa 1985, a focus was placed on the advantages of land as an protection asset against inheritance taxes and this led to demands for further correction of the inheritance tax valuation. In addition, in 1992 the Land Value Tax was introduced and as the inheritance tax valuation served as the tax base, starting from

land valuation for 1992 the timing of valuation was synchronized with the valuation timing for the posted land prices (as of January 1 every year) and raised the valuation level to posted land price and 80% of the same. From the valuation for 1994, a system of real estate appraisal valuation by real estate appraisers was introduced to further correct • balance valuations (50 Year History of the National Tax Agency)”.

(Note 4)Using the introduction of the land value tax as an opportunity, in order to enhance the national tax staffs’ abilities in land valuation operations, enhancements in “Valuation Training” given at the National Tax University were implemented. The trainees for this program challenged the Real Estate Appraiser Examination (one of the national certification examinations and said to be high in the degree of difficulty comparable to the Tax Accountant Examinations) and produced a substantial number of successes. This is a manifestation of the motivation levels of the participants as well as the high level of the training that is given but, at the same time, it indicates the level of importance the authorities are placing on the land valuation operations.

3) House Valuation

Valuation of houses, unlike the valuation of land, there is no significant divergence between inheritance tax • gift tax valuation and the fixed property valuation; thus, the fixed property tax valuation has been used as the proxy valuation for inheritance tax valuation.

(3) Examinations

1) Examination of tax items relating to land and houses are handled by the taxation office’s individual taxation area or the property taxation area, if the taxpayer is an individual, and by the corporate taxation area, if the taxpayer is an incorporated entity (however, for incorporated entities with capital of ¥100 million or more, the examination division of the regional tax bureau has jurisdiction). At the taxation office, the taxpayers are allocated by districts or by industry classification and from among the allocated taxpayers, the supervising national tax inspector will select the examination target and directs the examination to the person responsible for examination. This is the basic examination organization, but for example, when a multi-faceted examination is needed, such as in a case of an owner of a family owned business, a special national tax inspector group responsible for comprehensive examination, in a case of large asset owners, a data examination team from the regional tax bureau will handle the examinations. In addition, at times, joint examination by bureau and taxation office staff under the supervision of the responsible department of the regional tax bureau or data examination department will

be undertaken, partly with the intention of regional tax bureau providing guidance to the examination areas of the taxation office (further, there are cases where, in order to provide on-the-job training for person responsible for examination with relatively little experience, using this type of an opportunity and such staff are added to the team).

Although this is an examination of tax items relating to land and buildings, the methodologies themselves do not differ particularly from other types of examinations. That notwithstanding, it should be noted that tax examinations involving land and buildings because oftentimes the tax amount is substantial, the motivation to avoid taxation is that much greater and the methods are sophisticated and the requirements set down by the law are severe and complex, careful and thorough examination examinations are demanded. For example, it is an examination that requires utilization of highly sophisticated examination methodologies, as the examination will focus on effective attribution of assets and income and existence of hidden agreements, therefore, examination that is based on understanding of the taxpayer mind and bank examinations in order to identify the source and destination of funds will be needed.

(Note 1) Among the tax items relating to land and buildings examinations that are performed in ordinary course of operations are income taxation relating to capital gains, inheritance tax taxation relating to inheritances while examinations for gift property taxation are performed time to time as needed.

(Note 2) The taxation departments in a taxation office, in each area, headed by the supervising national tax inspector they are composed of 6 to 8 inspectors. The daily operation of each taxation area can be said to be left almost entirely on the supervising national tax inspector. In practical terms, the supervising national tax inspectors bear the responsibilities relating to the overall implementation of the examination including selecting the examination cases and instructing each inspector the implementation of the examination, obtaining the daily developments of the examination and, based on the understanding of the progress, providing necessary instructions, and making a comprehensive judgment on the examination results and, as needed, preparing data in order to obtain the final determination by the head of the taxation office.

In addition to this, the supervising national tax inspector for the maintenance of the organization and development of successors, playing the role of a personnel manager bears the most important function. In other words, he or she bears the role of general guidance • counsel with respect to his or her staff's daily professional conduct (if necessary for personal activities of his or her staff).

(Note 3) Special national inspector group in charge of comprehensive examinations is a

special examination area established to deal with cases that cannot be dealt with sufficiently by the traditional divisional structure by tax classifications and is comprised of inspectors who are responsible for income • property • corporate taxation and jointly undertake multi-faceted examinations. Further, the area is only established in the major taxation offices and operates over a wide area, on an as needed basis.

(Note 4) Data Examination Department is established within the taxation area in the regional tax bureaus and is a department that performs thorough examinations by regional tax bureau personnel who are knowledgeable • experienced in complex and large-scale cases that cannot be handled by normal examinations by the tax office. Because of their thorough and dynamic examinations, some of the unscrupulous taxpayers are wary of their borderline methods in voluntary examinations as being a “mini-investigation”.

(4) Data Information Operations

That tax examination is only functional with the substantiation by data information goes without saying. This also holds true of tax examinations relating to land and buildings.

1) Collection of Real Estate Registration Information

With respect to land and buildings, in order to clarify the legal rights, when there is change in rights the right holder will register the changes related to the rights. In other words, this can serve as the basic information source relating to taxation on land and buildings, and the tax authorities (property taxation area of taxation offices and responsible departments in the prefectural taxation bureaus) periodically collects cadastre information from the cadastre office. In land transaction there are many transactions that are transacted without the involvement of an intermediary (intermediately do not cadastre to avoid the complexity and registration costs). The taxing agency is endeavoring to identify data on land transactions from diverse sources, such as requiring from real estate trade that are general transactional data, including data relating to brokerage commission relating to buying and selling of real estate and loans, data relating to payment of purchase price, data relating to usage payments as statutory data and, in addition, collects data as a part of their examinations.

The property tax area of the taxation office sends to the buyer or the seller of land and buildings so identified, a “letter of inquiry” as needed. This is to query the relevant party of the said transaction with regard to the details of the transaction, and it is a control mechanism against illicit transactions with some element of corroborative examination effect to induce appropriate filing. This query covers items in some detail,

thus, it appears to have effectiveness in its way. For example, by inquiring the buyer of a land or building of the source of the funds, it imparts on the general taxpayer the need for appropriate filing of gift taxes.

2) Separate Management of Large Asset Holders

In order to efficiently perform inheritance tax examinations, efforts are made to “collect various data that can serve a clue for identification of transactions relating to financial assets and data relating to ownership of highly valued assets and store in the data information system, and when the death notice has been issued, the stored data relating to the deceased is output and utilized in identification of a case, return inquiry, and examinations and the like. In addition, owned property or moneys held in large amounts are selected and, including special relationships with relatives, generation of income and movements of property are continuously are followed (50 Year History of the National Tax Agency)”.

(Note 1)Municipalities are required by the Inheritance Tax Law to notify the taxation office with respect to death notices submitted to the municipality.

(Note 2)Further, in order to identify real estate income relating to rental of houses, in the individual taxation area also, special national tax inspector responsible for income tax examination whose principal task is the management and examination of large asset owners will be established in order to be thorough in management and examination of information on large asset owners.

2.2.3 Local Tax Operations by Each Local Government

Of the local taxes relating to land and buildings, the portions relating to inhabitant’s tax and business tax is linked to the income tax and corporation tax, thus, in this aspect the operational burden on the local government is not significant but fixed property tax is an important tax that has some autonomy for each local government and the fixed property tax operation is an important operation in local taxation.

Local governments possess information networks that are closely knit with the community, and information that are collected utilizing this advantage is a valuable source of information in uncovering new taxpayers. Thus, the agencies related to national tax are endeavoring work with the local organizations to enhance • maintain cooperative relationships between the parties.

(1) Valuation for Fixed Property Tax and Determination of Value

Head of a municipality is required to determine the value of fixed property, which is

the tax basis of the fixed property tax based on the valuation by the fixed asset evaluator on assets located in the municipality as of January 1 of every year and record them in the fixed property tax cadastre.

Here, fixed property evaluator is a civil servant in a specialist position in the municipality who, as his responsibility, performs valuations and supports the determination by the head of the municipality, of fixed property value and, at least once a year, carries out site examination of the conditions of the fixed properties located in the municipality and based on this result perform valuation on the fixed property as of the assessment date and prepare a valuation report for submission to the head of the municipality.

(Note)With respect to the status of the fixed property evaluator system, Professor Mitsuaki Usui points out the following.

“With respect to the appointment of a fixed asset evaluator, the law takes considerable care. That is to say, of people who possess knowledge and experience relating to valuation of fixed property, the head of the municipality shall appoint “upon the consent of the competent assembly”. Not only the effective requirement, namely, knowledge and experience requirement, but one has to focus on the procedural requirement of legislative consent. It is evident that even among the various jobs in the municipality, it is one that is of significant importance. It can be surmised that the law intended that a specialist evaluator be appointed rather than appoint a person from the staff who is engaged in normal tax affairs.

However, in practice, appointment that is buried under normal tax administration such as appointing the tax administration manager or deputy to carry dual functions has become generalized. In addition, under the administrative interpretation that the fixed asset evaluator must only be one person, in reality it would appear that the valuation tasks are being routinely performed with assistant fixed property evaluators (appointed when a need is recognized from among persons having knowledge and experience regarding valuation of fixed property and assists the fixed property evaluator in the conduct of the tasks). It would be surmised that this type of operational form is not what the law intended but it is not now possible to make amendments to the course of events. In addition, it could be said that the current way of operation may contribute to the “continuity • stability of valuation”.

However, in the future, appointment of persons who are qualified as real estate appraisers and who have knowledge and experience as a staff in a specialist post should be examined. Under the current law, it can be interpreted that only natural persons may be appointed to be fixed asset evaluators, but consideration should be

given to privatizing the valuation operations and contracting out to an incorporated entity that performs valuations in the future”.

(2) Inspection of the Fixed Asset Taxation Cadastre

When the head of the municipality has determined the value of the fixed property, the said value is recorded in the fixed property taxation cadastre has already been noted. As the fixed asset taxation cadastre is the basis of taxation, the taxpayer is provided the opportunity to inspect the fixed property taxation cadastre in order to confirm the value.

If there is a difference in opinion by the taxpayer with respect to the value recorded, a petition for a review may be made to the Fixed Asset Valuation Council and if there is a petition the Fixed Asset Valuation Council must perform the necessary review and make a determination. The taxpayer, if he or she is not satisfied with the determination, may file a suit.

(Note)The Fixed Asset Valuation Council is a protest deliberation agency composed of 3 or more committee members and established by the municipality to review protests regarding valuation recorded on the fixed asset taxation cadastre. Therefore the council needs to be fair and neutral but with respect to this point Professor Usui comments, “there is court decision precedent stating that it was an illegal procedure pointing out that ‘the review procedures can be seen as biased toward the agency giving the original decision and an assessment that it went blatantly against the independence and neutrality of the council is inevitable’ recognizing the fact that tax administration manager • property tax department manager who are assistant agency of the head who made the determination of the value was not requested to leave the meeting and meeting was held in the presence of property tax department manager and staff who assisted in the fixed asset valuation” and advocates the necessity for caution for prudent council operation.

(3) Other

With respect to registration items relating to lands and buildings owned by the same taxpayer, from the fixed asset taxation cadastre, a ledgers organized by owner of the land and owner of the house are created to promote efficiency of the operations.

3. Land Valuation System in Asian Countries

3.1 Land Valuation System in Korea

For this project, the following literature has been referred to as reference.

- * Yoshikazu Sunagawa (Professor Hiroshima University) • Ken (Korea Inspection, Deputy Auditor) – “Land Taxation and Land Policies Comparison of Japan and Korea” (July 1993, Yushindo)
- * 1990 Report of the Tax Commission (relating to the introduction of the “Land Value Tax”)
- * Reports from other related ministries and agencies

3.1.1 Prior to the Introduction of Posted Land Prices System

In Korea prior to the introduction of the Posted Land Price System, various institutions applied pluralistic land valuation methods including the use of Base Land Value as a indicator for land transactions (Construction Div), Base Land Value as the indicator for tax valuation for national tax (National Tax Division), and Taxable Market Price Standard as an indicator for local taxation valuation (Domestic Affairs Div), and market value of land as an indicator used as reference data for collateral value appraisal (House of Appraisal). In other words, each administrative agency performed valuation of the land in a way to meet its respective administrative objectives, but as the basis for the valuations were not uniform, not only were the valuations disparate, they were also not necessarily reflective of reality and the confidence by the people of the public land valuation was low.

As an example of application of multiple land valuation methods to suit each valuation objective, for example, land valuation policy introduced to strengthen the taxation on capital gains as a part of the land policy during the second real estate speculative wave (1977 – 1979) can be cited. That is to say, the National Tax Agency designated • announced “Designated Districts” as districts where land prices have risen steeply but at this time, the National Tax Agency rather than applying taxation using the “Taxable Market Price Standard Amount” put together by the Domestic Affairs Division as has been done historically, instead applied taxation based on “Base Market Value (Taxation Market Value Standard Amount multiplied by a multiplier set by the National Tax Agency” based upon its own survey results.

(Note)With respect to a summary of the Designated District Designation System and the situations that existed and providing the history and background for the system introduction, Professor Sunagawa and Ken made the following comments. “In

principle, for transaction the price was applied as the basis, but where there was no voluntary reporting, as an exception, the taxation based on government survey prices was applied. However, as the great majority of the sellers did not report the transactions, the government taxed one of the following methods (i) prices surveyed directly by tax civil servants or (ii) “Taxable Market Price Standard Amount” as compiled by the Domestic Affairs. While the method (i) has the merit of being consistent with the “Substance over Form Principle”, it had its weakness such as being faced with limitation in its inclusiveness (due to lack of manpower) and issues relating to unfair taxation, (transactions that had been surveyed for its details were taxed based on the survey valuation while the transactions that were not surveyed were taxed using Taxable Market Price Standard thus raising the issue of unfair taxation j). Method (ii), while it eliminates that unfair taxation issues and has the benefit of ease of taxation, it has the weakness of not being able to impose taxation on ultra-short-term capital gains arising from a sharp increase in the land prices. Thus, under method (ii), it could not be expected to play a role as a taxation system to deal with real estate speculation. The government undertook to consider a methodology, which would provide ease of taxation, securing taxation fairness and able to be effective in controlling real estate speculation, and the method that the government had arrived at was the “Base Market Value System”. That is to say, a land under real estate speculation or districts that are experiencing sharp rise in land prices are designated • announced as a Designated District and any assignment transactions occurring within such area that are not reported or even if reported if the reported capital gain amount is substantially different from capital gains calculated using the Base Land Value, the National Tax Agency would tax using the National Tax Agency’s Basic Market Value”.

3.1.2 Unification of Land Value Structures based on Posted Land Prices

(1) Land Problems in Korea

In Korea, with the absolute scarcity of land resources and population increase, increased urbanization • industrialization and the Olympics, the land prices have soared since about 1978 and land speculation worked to fuel the fire (4th Land Price Wave). This situation was compounded by the concentration of landowners in limited strata of people, brought about expansion in the asset holding disparity and exacerbated the land problems. As a result, the government of Korea announced the “fundamental Land Measures” in October of 1998 and decided upon the introduction of a comprehensive land taxation, strengthening of capital gains tax, unification of land valuation system

and recovering development profits.

(2) Unification of Land Valuation System

As stated earlier, the application of pluralistic land valuation method invited criticisms of lack of homogeneity in the concept of land value and the need for a unification of public land valuation system was pointed out. In response, the Korean Government established “Law Relating to Land Value Posting and Land Valuation” in April of 1989 and unified the public land valuation system. In other words, a posted land value system that is based on transaction prices was introduced and Construction Division Examination Bureau was charged with the valuation operations. In other words, the “Posted Land Price” announced by the Director of the Construction Division is provided by the Construction Division by a computer tape to the National Tax Agency each June. This data was also applied for valuation of the land for Land Excess Profit Tax and Inheritances.

[Reference] Law Relating to Land Value Posting and Land Valuation

Article 4 (Posting of Land Value) (i) The Director of the Construction Traffic Division shall with respect to a average land value selected from among land deemed to be generally similar in usage, surrounding environment and other natural conditions and social conditions, shall conduct an examination and valuation of appropriate price each year on the posting base date and in accordance with the provisions contained in Article 12, upon deliberation by the Central Land Valuation Committee, post the appropriate price.

Article 5 (Examination and Criteria for Evaluation) (i) When the Director of the Construction Traffic division performs examination and valuation of the standard land in accordance with the provisions contained in Article 4, he must take into consideration comprehensively the prevailing transaction prices of surrounding land and rent levels as well as estimated expenses required to develop land that is deemed to have similar use value as the said land. (ii) When the Director of the Construction Traffic Division undertakes to examine and perform valuation of the standard land in accordance with Clause (i) hereof, he must appoint two or more appraisers.

3.1.3 Major Land Related Taxation and Land Valuation in Such Taxes

(1) Comprehensive Land Tax (This is a major local tax and is a representative approach to the land owner tax)

According to Messrs Sunagawa and Ken, the tax base of the tax is, in principle, price as valued based on the “illustrative transaction prices” obtained through examination of samples by the taxing principal (city, county, district), but in practical terms, “for each of the 24.57 million some land lots (as of 1988), assign land rankings (from 1 to 365 grades, 1 Won – 200 million Won per square meter in value) and if there is change in the valuation amount, a method in which the assigned grade is adjusted has been adopted. In other words, 120,000 plots are selected as standard land (0.5% of all land plots) and each year (April 1 basis) the change value of the land value is examined and based on the examination price, the grades of each of the land plots are adjusted. This type of valuation scheme has been in use since before the unification of the posted land price system and has not changed even after the unification (local taxes are excluded from unification of the land price system). However, the Local Tax Law Enforcement Ordinance was amended such that in valuation of the land, the individual land grading is determined taking into consideration the “posted land price”, thus, the posted land prices have come to affect directly and indirectly the amendments to the tax basis in local taxes”.

[Reference] Law Relating to Land Value Posting and Land Valuation

Article 10 (Application of Posted Land Price) (i) When the country, local government, government investment institution established under Basic Law for Government Investment Institution Management and other public organizations provided for by other Presidential decrees performs calculation of land prices for the purposes outlined in each of the following items, using posted land prices of one or 2 or more standard land deemed to be similar and possess benefit value as the said land as the basis must maintain equilibrium between the price of the said land and the posted land price of the standard land (remaining portion abbreviated). (ii) If the Director of the Construction Traffic Division deems it necessary for the calculation of the land price for the objective cited in Clause 1, he must prepare a representative comparative table (hereinafter referred to as the “land price comparison table”) relating to the standard land and factors determining the valuation of the land on which the valuation is being performed and submit it to each related administrative institution.

(2)Capital Gains Tax (It is a major national tax and is a representative approach for capital gains taxation)

The computation of capital gains is defined as Sales Price – (Acquisition Price + Necessary Expenses) but according the Messrs. Sunagawa and Ken, this can be

summarized as follows.

“Selling Price and Acquisition Cost: Currently, the “Base Market Price” at the time of the acquisition and assignment is adopted in principle and as an exception “actual land transaction price” is allowed. The “Base Market Price” is the price arrived at by valuation by a multiple of “Land Price for Individual Land Plots” calculated based on the posted land price announced by the head of the local government (a method adopted in areas where the Director General of the National Tax Agency has designated as a district where the land has sharply appreciated). “(ii) Necessary Expense: incidental expenses associated with the acquisition, capital expenditure after the acquisition and expenses associated with the sale are stipulated as the necessary expenses that can be deducted from the selling price. However, in case of calculating the capital gains using the Basic Market Price, 7% of the “Taxable Market Price Standard” prevailing at the time of acquisition can be deducted as necessary expenses”.

[Reference] Base Market Price of Individual Land Plots

This refers to the land price for individual land plots calculated by the head of city • county • district in accordance with the provisions in the laws relating to posted land price and valuation of land. This was initiated in fiscal 1990 and since that time under the supervision of the Construction Division, Domestic Affairs Division, the National Tax Agency, Korea Land Development Corporation, Korea House of Appraisal jointly implemented detailed examination of approximately 300,000 land plots and established these as the base value and based on a comparative table based on the width of the road, the existence of production facilities, valuation of 24 million land plots were performed.

(3) Inheritance Tax • Acquisition Tax (as taxes on acquisition of land the Inheritance Tax is a representative type among the national taxes while the Acquisition Tax is representative among local taxes)

As the basis for land valuation of the acquired land, for Inheritance Tax, the Base Market Price as determined by the head of city • county • district based on the posted land price is applied while for Acquisition Tax, the Taxable market Price Standard for local taxes is applied. Further, the local tax Taxable Market Price Standard amount references the individual land plot Base Market Price.

3.2 Land Assessment System in the Republic of the Philippines

3.2.1 Background

(1) Land Assessment

The current land assessment system in the Republic of the Philippines is one faced with many challenges. On the issue of land valuation, multiple systems exist. To add to the confusion, local politics play a role in influencing the valuation of land. Due to the archaic data management system, maps suitable for assessment are unavailable. In the past, various Philippine government administrations have attempted to address these issues along with a multitude of other land issues such as land market, land policy, and land administration. However, due to the fragmented approach in addressing the different land issues faced by the government, effective solutions to the problems were not achieved. Due to a concept proposal submitted by the Lands Management Bureau (LMB) in November, 1997 to the Department of Energy and Natural Resources (DENR) which, through the help of the National Economic Authority (NEDA), was eventually endorsed to the World Bank, a fact-finding mission was sent by the World Bank in 1998 to investigate the many different land issues confronting the government. After a joint World Bank and Government of the Philippines mission, Executive Order No. 129 was signed in July, 1999 to create the Inter Agency Coordinating Committee (IACC)* to manage the Land Administration and Management Project (LAMP). The two and a half to three year project cost \$11.3 million project and was jointly financed by the World Bank (\$4.79 million loan), the Australian Agency for International Development (AusAID)(\$5.1 million grant) and the Philippine Government (\$1.42 million) to address the land issues as a whole rather than in a piece-meal approach. Under the LAMP, a Land Valuation study was conducted under the AusAID Technical Assistance with the cooperation of the Department of Finance (DOF) and the National Tax Research Center (NTRC) to analyze the current system in place, identify the land valuation system's strengths and weaknesses, and finally to perform a cost analysis on the possibility of developing a uniform valuation system. This paper will provide an overview of the following: Land Price Announcement System, Zonal Valuation, Mechanism and Procedure in Determining the Zonal Valuation, Organizational Structures, and the Types of Property Taxes and Applicable Tax Rates.

*In March, 2002, Executive Order No.82 repealed Executive Order No.129 thus replacing the IACC with the Task Force for the Expedient Implementation of the

LAM (Land and Administration Management) Program.

(2) Land Price Announcement System

For Government-Owned Property:

Applicable when government-owned land is sent out for a bid and an announcement is carried out in the major newspapers. Prequalification requirements must be submitted to the government before an entity is allowed to submit a bid. After the bids have been submitted and evaluated, the government then announces the winning bid once again via the newspapers.

For Privately-Owned Property:

The City/Provincial Assessor Office is assigned the task of sending a notice via the postal services to notify the affected taxpayer of any changes in the zonal valuation of his/her property. There is no general announcement made via the newspapers to address the general public regarding changes in the zonal valuations.

(3) Zonal Valuation

Taxation of property is based on zonal valuation. For example, Makati City commercial land has a zonal valuation of 150,000 pesos/sq. meter. Therefore, this is the basis of real property tax, sales tax, and etc... The Bureau of Internal Revenue of the Republic of the Philippines has segmented the country into 19 Revenue Regions with Revenue Regions 1-10 in Luzon, Revenue Regions 11-14 in Visayas, and Revenue Regions 15-19 in Mindanao.

(4) Mechanism and Procedure for Determining Zonal Valuation

Prior to 1991, tax assessments were centralized on the national level. However, in 1991, the Local Government Code was passed to decentralize this hierarchical structure giving the Local Government Units (LGUs) more power and responsibilities, thus the ability to be self-sufficient in lieu of the old system where funding for its functions came in the form of national grants from the national government.

The Department of Assessment in every Local Government Unit (LGU) has the authority to assess real properties for the purpose of taxation. The Department is obliged to incorporate in its assessment the City/Local Council's approved schedule of market values in order to arrive to a fair zonal valuation. The City/Provincial

Assessor's Office is then given the task of collecting real property taxes.

For example, in the City of Manila, the Assessment Data Division is responsible for the following: all types of statistical reporting containing information on all real property assessed valuation for reporting to the Secretary of Finance, City Mayor of Manila, City Treasurer of Manila, and the Governor of the Metro Manila Commission, life-cycle of usable sales for its market value for the purpose of preparing the Schedule of Market Values which is used as the basis for the General Revision and for assessing private properties sequestered by the government, and supervision of all parcels of land in the City of Manila to verify the inventory as well as determine its usage.

As for the effectiveness of devolution through the passage of the Local Government Code, studies have shown that its effectiveness depends to a large extent on the available technical expertise and resource base.

(5) Organizational Structures

Relevant agencies under the umbrella of the Department of Finance (DOF):

National Tax Research Center (NTRC): responsible for the promotion of a just and fair taxation system for all Filipino taxpayers. Conducts research studies to facilitate improvements in the tax system.

Bureau of Local Government Finance (BLGF): responsible for extending the necessary assistance to Local Government Units (LGUs) in areas such as revenue administration, fund management and Real Property Tax Administration projects.

Central Board of Assessment Appeal (CBAA): a government body that ensures that the due process of the law is observed in Real Property Taxation. Through the CBAA, taxpayers are given a chance to be heard.

On the national level, the Bureau of Internal Revenue is the governing body and on the local level, the City/Provincial Assessor's Office is mandated to collect the taxes.

(6) Types of Property Taxes and Applicable Tax Rates

Local Taxes:

Real Property Tax:

Real property tax is an annual ad valorem tax imposed by cities, municipalities within

Metro Manila, and provinces to real properties within their jurisdiction.

When is it payable?

It accrues on the property on January 1st but payable through 4 equal installments on the last day of each quarter; a 20% discount is given if the total amount due is paid on or before January 20th.

Who is liable?

The Real Property Tax is chargeable against the entity who had the possession of the property regardless if the entity is the owner or not of the taxable property.

Tax Rates:

Municipalities within Metro Manila & Cities: not exceeding 2% of assessed value

Provinces: not exceeding 1% of assessed value

Tax Base:

Fair Market Value (Zonal Value) x Assessment Level x Tax Rate=Real Property Tax

Zonal Valuation is based on a schedule fixed by local assessors.

Assessment Levels are fixed by local ordinances.

Example:

Residential Property

Zonal Valuation= P6M

Assessment Level = 30%

<u>Zonal Valuation</u>		<u>Assessment Level</u>		<u>Tax Rate</u>		<u>Tax Amount</u>
P6M	x	30%	x	2%	=	P36K

Local Transfer Tax:

A tax imposed by the city/provincial assessor's office whenever there is a transaction that involves a transfer of ownership of real property or title to real property.

When is it payable?

It is payable within 60 days from the date of execution of the deed.

Who is liable?

Seller, Donor, Transferor (but in practice, may be passed on to transferee)

Tax Rates and Tax Base:

Cities: 75% of 1% of consideration or Zonal Valuation, whichever is higher

Provinces: not to exceed 50% of 1% of consideration or Zonal Valuation, whichever is higher

3.2.2 National Taxes

(1) Capital Gains Tax

As defined by the Bureau of Internal Revenue (BIR), “Capital Gains Tax is a tax imposed on the gains presumed to have been realized by the seller from the sale, exchange, or other disposition of capital assets located in the Philippines, including pacto de retro sales and other forms of conditional sale.”

Who is liable?

Seller of any capital asset.

Tax Base:

The tax base will be based on the gross sales price or zonal valuation (fair market value), whichever is higher.

If the zonal valuation has not been established by the Commissioner, the taxable base is the gross selling price or the fair market value per the latest tax declaration, whichever is higher.

If an improvement has been made, the value of improvement is the construction cost as declared in the occupancy permit/ building permit plus 10% per year to commence after the year of construction, or the fair market value per latest tax declaration.

Tax Rate: 6% (different treatment for real estate companies)

Examples:

1) A residential lot with an area of 500 sq. meter was sold at P10K per sq. meter. At the time of the sale, the zonal valuation (fair market value) per the Commissioner of the BIR was P12K per sq. meter while the assessed value was P5K per sq. meter.

Sales Price: P5M

Zonal Valuation: P6M

Fair Market Value per Tax Declaration: P2.5M

In this scenario, the taxable base is P6M. The Tax Due will be P360K.

In the scenario where there is no zonal valuation established by the Commissioner, the taxable base will be P5M. The Tax Due will be P300K.

2) In the event an improvement was made, the value of improvement is the construction cost as declared in the occupancy permit/ building permit plus 10% per year to commence after the year of construction, or the fair market value per latest tax declaration.

3) For foreclosure sales, the taxable base will be based on the selling price per the Sheriff's Certificate of Sale or the bid price per the Contract to Sell.

4) For taxable exchanges, the taxable base will be based on the zonal valuation (fair market value) of the property exchanged.

(2) Value Added Tax:

As defined by the Bureau of Internal Revenue (BIR), "the Value-Added Tax is a tax imposed and collected on every sale, barter, exchange or transaction deemed sale of taxable goods, properties, lease of goods or properties, or services in the course of trade or business as they pass along the production and distribution chain, the tax being limited only to the value added to such goods, properties or services by the seller or transferor."

Tax Rate: Transactions may be subject to 10% VAT on gross sales or receipts.

(3) Documentary Stamp Tax:

“The documentary stamp tax is an excise tax on documents, instruments, loan agreements and commercial papers, and on acceptances, assignments, sales and transfers of the obligation, right, or property incident thereto.”

Who is liable?

Maker, signor, issuer, acceptor, or transferor

Tax Rates:

Rates vary depending on the type of transaction.

As Outlined by US-Asean.Org	
Debentures and certificates of indebtedness P1.50 for every P200 of the face value	P1.50 for every P200 of the face value
Deeds of sale and conveyances of real property	P15.00 if the consideration does not exceed P1,000; additional P15.00 for every P1,000 in excess of P1,000 of the consideration
Bonds, loan agreements, promissory notes, bills of exchange, drafts, instruments and securities issued by the Government	P0.30 for every P200 of the face value

(4) Conclusion:

Without a shadow of a doubt, the Republic of the Philippines has taken one step forward in trying to solve its rather complex land problems. With the Republic of the Philippines saddled with a large foreign debt and an ever-recurring fiscal deficit problem, the sources of revenue need to be constantly examined. It would be naïve to think that the land assessment problems as well as the other land-related issues can be solved by the government on its own. Rather, the Republic of the Philippines needs the political will as well as the technical expertise of industrialized nations in solving

the various complex issues. Education is the key to put the Filipinos one step away from the dependency on foreign loans and assistance to the road of self-sustenance.

ANNEX-2

(1) Corporate Income Tax (Introduction)

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Corporate Income Tax (Introduction)

Chapter 1

Corporate Income Tax is a wide and complex taxation imposed on the business performance of an enterprise and are frequently amended to meet with the changes that take place in the economy. Corporate Income Tax is an important component of taxation and as a taxation staff, it is a tax that you need to have an understanding of its fundamental structure.

In this chapter the following topics will be discussed.

Study Guidance

How is the current taxes structured?

What is the composition of current tax revenues?

Summary of Corporate Income Tax

1. Current Taxation System

The initial tax reform after the transition to market economy was implemented in 1993. At that time, under the guidance of foreign aid institutions, taxes relating to income taxation including General Tax Law, Income Tax Law, Corporate Income Tax Law, Sales Tax Law, Individual consumption Tax Law were enacted and introduced. Subsequently, in 1997 a tax revision on the General Tax Law was implemented and in 1998, the Value Added Tax Law was enacted and value added taxation under the EU-type invoice method was introduced and replaced the Sales Tax.

Under the current Mongolian taxation system there are 18 types of national taxes that are Personal Income Tax, Corporate Income Tax, Customs Tariff, Value Added Tax, Special Tax, Vehicle Tax, Inheritance • Gift Tax, Real Estate Tax, Arms Tax, Urban Tax, Pet Tax, Official Document Issuance Fee, Gasoline • Diesel Fuel Tax, Hunting Fee • Hunting Permit Fee, Subterranean Resource Utilization Tax, Land Rent, Forestry Resources Utilization Tax and Hydro Usage Fees. As local taxes there are 5 items of taxation: permit fees for utilization right of resources other than subterranean resources, natural plants utilization fee, Zaha (Bazaar) Utilization Fee, Subterranean Resource Utilization Fee and Mineral Springs Utilization Fee. Currently, the Income Tax Rates are two-tiered at 15% and 40%, Corporate Income Tax Rate is 40% while the Value Added Tax Rate is 15% and the right to set rate of taxation for each type of tax is given to the State Congress for national taxes and People's

Congress for local taxes.

The distinction between national and local taxation is by only classification under the General Tax Law and there are some taxes that are national taxes but are effectively distributed to the regions as their fiscal resources.

2. Current Composition of Tax Revenues

The result of central government revenue results for fiscal 1999 is shown in Table 1, the Revenue total was 159.4 billion Tg. and the Gross Expenditure totaled 259.4 billion Tg. resulting in a fiscal deficit of 344.3 billion Tg. Recurring revenues made up of tax revenues and passage fees, a non-tax revenue composed 92.8% of the revenues followed by capital revenues made up of proceeds from the sale of state assets accounting for 4.6% and foreign aid that was posted into the budget which accounted for 2.6%.

[Table 1 Fiscal 1999 Central Government Revenues]

(Unit: Million Tg)

TOTAL REVENUE AND GRANTS	259,437.0	(100.0%)		
CURRENT REVENUES		240,795.8	(92.8%)	
I. Tax revenue			182,510.7	(70.3%)
1. Income tax				41,932.7
2. Social Security Contributions				29,707.2
3. Value added tax				58,863.6
4. Excise tax				26,667.7
5. Property tax				820.9
6. Tax on Foreign Trade				9,011.0
7. Other taxes				16,007.6
II. Non-tax revenue			58,285.1	(22.5%)
CAPITAL REVENUE		11,948.6	(4.6%)	
FOREIGN GRANTS		6,692.7	(2.6%)	

Tax revenues comprise 70.3% of all revenues. The largest component of the tax revenue is the Value Added Tax and accounts for 32% of all tax revenues. Following this, are the Personal and Corporate Income Taxes which. Combined, account for 23% followed by Social Insurance Contributions, which comprised 16%.

Under the current tax system the Value Added Tax raises the largest amount of tax revenues and is an important tax category. Combination of the Value Added Tax and the Individual Consumption Tax represents about 60% of all tax revenues. The ratio of direct taxation and indirect taxation is 4 : 6 and it can be said that the current taxation system is an indirect

taxation oriented system.

3. Summary of Corporate Income Tax

Corporate Income Tax is a tax imposed on profits, the result of an enterprise's economic activity. Corporate Income Tax Law was enacted in 1992 and has subsequently gone through several amendments. Currently, there are 20 tax laws and ordinances and 22 types of state and local taxes. Regulations relating to corporate taxes are contained also in General Tax Law, in addition to the Corporate Income Tax Law, and together as a unit, comprise the legal structure relating to Corporate Income Taxes. Under this legal structure, various types of incomes are subject to taxation and all organizations, representative of which is the juridical person are the principals against which taxes are levied. Depending upon the law, taxation base is determined by income and although the tax rates differ, in the calculation of Corporate Income Tax, knowledge of corporate accounting will be required.

In the current taxation system, Corporate Income Tax, along with the Personal Income Tax and the Value Added Tax, occupies an important position and as a taxation official it is a tax law for which there is a necessity to have adequate understanding of the fundamental structure of the taxation.

Chapter 2 Significance of Corporate Income Tax

Under the law, there are two types of entities that have juridical personality. Individuals have juridical personality and there is also organization of persons and organization of assets that under the Commercial Code and other laws are given juridical personality. Such organization is referred to as juridical person. There are various types of juridical persons and the method of imposition of corporate income tax differs depending upon the type of juridical person. All juridical person must, for tax purposes, register with the state.

In this chapter, the following topics will be covered.

Study Guidance

What is a juridical person

How is juridical person registered

1. Significance of Juridical Persons

Corporate Income tax is a tax that is imposed on the income of a Juridical Person, such as joint stock companies. For the initiate, this may be somewhat difficult to understand but, in essence, Corporate Income Tax is a tax on Juridical Person's profits.

Then, what is a Juridical Person? What does Juridical Person refer to?

Juridical Person is an organization that is composed of relationships other than personal or individual. The form with which we are most familiar is the "joint stock company" but in Mongolia there are other Juridical Persons that are subject to corporate taxes in addition to joint stock companies such as associations, cooperatives, foreign investment companies, and joint ventures.

Juridical person, unlike individuals, is intangible. Although the buildings or billboards and people working in the buildings can be seen, juridical persons do not stand up or walk around. It only exists conceptually.

Individuals are born with inherent juridical personality but juridical persons are given juridical personality by laws and registration is required. Through these acts, juridical persons are able to transact businesses. Of course, those that are actually taking the actions are people working for the juridical person.

2. State Registration of Juridical Persons and Taxpayer Registration Process

(1) Basic Operations of the State Registration Office

The basic operations of the State Registration Office are as follows.

- * State registration and the monitoring of juridical persons in the country
- * Execution of laws relating to state registration and counseling • guidance to juridical persons and taxpayers regarding the Tax Law
- * Guidance and management of persons responsible for registration at the prefectural national tax offices
- * De novo registration, amending registration and deletion of registration of juridical persons under the prefectural national tax offices
- * Provision of information regarding state registration to each taxing institution
- * Sorting documents relating to state registration of juridical persons and storage and maintenance of taxpayer files
- * Promptly perform registration of businesses and foreign affiliated juridical persons that require special permission and specialized knowledge jointly with the state juridical institutions.

(2)State Registration Procedures

- 1) State registration of a juridical person begins with the selection of the company name and a name that is unique and does not duplicate another company name must be chosen. A name search must be performed at the State Registration Office to ensure that the name chosen is not duplicative. If it is not duplicative, an approval to use the name will be granted.
- 2) In registering, de novo registrants must complete a TM02 Form and those making amendments to the State Registration Certificate must complete Form TM05.
- 3) If all of the required documents for registration are complete, the said juridical person will be registered within that legal expiry and the tax officer in charge of the said taxpayer will record de novo registration and each time registration amendment is made for the taxpayer given the registration certificates. Further, the recorded data are re-recorded into the State Registration Program. The Registration Program will be installed in each tax officer's PC.
- 4) Juridical person must notify the jurisdictional tax office and the State Registration Office in the event of occurrence of any of the events listed below:

- * A change of location is made to the small-scale cooperative and company and cooperative.
A written notification to such effect will be provided to the jurisdictional tax office
 - * A branch office is opened by small-scale cooperative and company and cooperative
State registration is required
 - * A business or services are performed that is not provided for in the charter
After making changes deemed necessary, notify to that effect to the jurisdictional tax office and prepare related materials and amend the State Registration Certificate.
 - * If changes in capital is effected by small-scale cooperative and juridical person
Each time a notice to that effect shall be given to the jurisdictional tax office and after preparation of related documents, amend the State Registration Certificate
 - * When changes are made to the Representative Board of Directors and the Chairman of the board
Notify the jurisdictional tax office to that effect
 - * Cooperative based on the decision by the members an organization is reformed or dissolved
Establish a Dissolution Processing Committee and the committee shall register with the State Registration Office
- 5) The tax office, during the said week, with respect to all taxpayers that had registered or amended registration, will notify the persons responsible for registration at the tax offices with jurisdiction over the said taxpayers.
 - 6) The State Registration Office will send the TM-02 Form and 1 copy of the beginning of the period balances to the tax office in the district in which the subject registrant will conduct business and will request the registrant to undertake taxpayer registration at that jurisdictional tax office.
 - 7) Based on the above and other related data, the tax office in the district will perform taxpayer registration and will notify the State Registration Office to that effect.
 - 8) The details of the registration at the district tax office will match with the information stored in the computer at the State Registration Office. A reconciliation of registration will be performed each quarter to ensure that there will be no unregistered juridical persons.

9) Each district tax office has a special program for taxpayer registration and the content of which possess the same information as the registration program used by the State Registration Office.

10) The State Registration Office will perform registration of juridical persons using the following two basic programs.

* Juridical person name research program: A program to search for duplication of new registrants

* Juridical person state registration program: A program containing information such as the name of the juridical person, registration number, business policy, business changes (organization change, dissolutions, etc), location, capital, name and address • contact of the founder, bank accounts, address of the chairman.

* Other tax offices uses “Taxpayer Registration Program” but it contains similar information as the program used at the State Registration Office

Chapter 3 Tax Obligor and Reporting

Corporate Income Tax is calculated by applying a tax rate as determined by the Corporate Income Tax Law on the taxable income. The tax obligors subject to the Corporate Income Tax are of several types. In this chapter, the following topics will be discussed.

Study Guidance

(What types of juridical persons need to pay the Corporate Income Tax
How do juridical persons report taxation

1. Tax Obligators for Corporate Income Tax

The juridical persons listed below are tax obligors (Law 3).

All forms of companies, associations, cooperatives, foreign investment corporations, and joint venture corporations under any form of ownership.

Foreign corporation agencies that are earning income within Mongolia (Note 1).

Commercial banks, financial institutions, insurance institutions and similar institutions

Non-governmental institutions (Note 2)

Religious organizations (Note 3)

State owned corporations and other local management corporations (Note 4)

Non-resident corporations (Note 5)

Corporations engaged in business other than – (Note 6).

(1) Companies

All forms of companies, associations, cooperatives, foreign investment corporations, and joint venture corporations under any form of ownership in Mongolia will be tax obligors.

(2) Agency for Foreign Companies with Revenues in Mongolia

For example, foreign corporation is defined to be a permanent establishment such as a branch of a foreign corporation engaged in a business and generating income under an agreement or other such similar corporations. Foreign corporation agency is required to be registered with the taxing institution 10 days prior to the commencement of business and receive a certificate. “Agency” means a permanent location of activity

where all or part of the businesses of the taxpayer is conducted or an institution that are associated with construction site, installation object, assembly object or supervisory operations related to the same and include the following activities:

- 1) Permanent establishment of business that performs all or part of the economic activities of a taxpayer (branch, office, factory, oil drilling site, natural resource development site)
- 2) Construction site, installation • assembly facility, and facilities management of the same
- 3) Machinery, buildings, facilities, boring derrick for natural resource exploration and operational supervision of the same
- 4) Commercial • services facility
Excludes diplomatic agencies and international agencies that are not engaged in for-profit

(3) Commercial Bank, Financial Institutions, Insurance Institutions and other similar institutions

Commercial banks, financial institutions, insurance institutions, and other similar institutions will be tax obligors for Corporate Income Tax.

(4) Non-government Institutions

Non-government institutions will also be tax obligors for the Corporate Income Tax. Non-governmental institutions shall form their organizational rules at its inception meeting and register with the Ministry of Justice and Internal Affairs and in accordance with the Corporate Taxation Law submit a quarterly report by the 20th of the month following the close of the quarter and an annual report by February 15th of the following year to the jurisdictional tax office.

The following types of juridical persons will be considered non-government institutions.

- 1) Non-profit organization established by citizens, state institutions (excluding legislative and executive agencies) and other corporations. An example would be a Friendship Association.

- 2) Non-governmental Public Corporation. Non-governmental organization engaged in non-profit activities such as cultural promotion, education, sciences, sports, environmental protection, and human rights protection, for example specialized associations.
- 3) Organization for the protection of the interests of its members (Hotel Association, Manager Association, etc.)

(5) Religious Organizations

Religious organization means persons, temples, and its executive organs that have official permission to engage in religious activities and religious education and the like activities. Religious organization, with the approval of the regional people's representative assembly, must register with the Ministry of Justice and Internal Affairs. It must also register with the taxing institution 10 days prior to commencing activities.

(6) State Owned Juridical Persons and Other Regional Managed Juridical Persons

Corporations established using state assets are corporations that are state owned and are obligors for Corporate Income Tax. These include state institutions and state enterprises. State institution refers to corporations, other than state enterprises, that receive loans from the state budget. State enterprise refers to state owned enterprise that receives financing from the state budget. The state enterprises, based on the property rights are divided into self-supporting accounting enterprises and state budget enterprises. In other words, State Enterprises are enterprises that manage under their own profit and losses while the State Institutions receive financing from the state budget and performs production • services for the state.

With respect to state institutions and state budget enterprises, unless otherwise specially provided for, and self-supporting accounting enterprises must register with the taxing institution.

(7) Non-Resident Juridical Persons

A non-resident corporation means a non-resident corporation that realizes income from assignments of certain property and rights to Mongolian corporations or property and rights assigned to it from a Mongolian corporation.

(8)Juridical Person Conducting Business Other than those in above –

These are corporations that have registered as corporate non-profit organizations but are engaged in for-profit activities other than those provided for in Article 1 Clause 1.7 business. These would include, for example, state university, private university, paid education and hospitals. These corporate taxpayers must register with a taxing institution 10 days prior to commencement of activities.

Chapter 4 Incomes that are tax exempt or receive relief on taxation

Corporate Income Tax imposes taxes on profits of enterprises that are the fruits of enterprise activities that are wide-ranging and complex but for certain types of incomes the incomes are exempted from taxation or receive relief from taxation.

In this chapter, the following items will be covered.

Study Guidance

What types of income are exempt

What types of income receive taxation relief

1. Income that are Exempt

Incomes of taxpayers listed below are exempt from taxation.

(1) Income from Interest from National Bonds

National bond interest income means interest earned from ownership of national bonds purchased by a corporation that have been sold in accordance with the government regulations. (Ordinance 5 –). In determining the national bond interest income, the owner of the national bond shall deduct the expenses associated with the purchase of the national bonds from the amount distributed in accordance with the government regulations.

(2) Membership Fee and Contributions of Non-State Organization Member and Supporter

Contributions from non-state institution member or supporters are exempt from taxation (Ordinance 5 –)

(3) Income from donation of Blood and internal organs

Income of enterprises engaged in the production and sales of blood • blood products for transfusions are exempted from taxation for the incomes derived solely from these activities (Ordinance 5 –).

Calculation

Example: Company C obtained permission to market blood for transfusions, production of blood products and sales from related institutions. Assume that the income for the reporting year totaled 20 million Tg., of which 8 million Tg. was from sales of blood for transfusions and blood products. 8 million Tg. would be tax-exempt income and the remaining 12 million Tg. would be taxable income.

(4) Social Insurance Fund and Social Welfare Fund Income

Public non-government institutions are based on Non-Government Institution Certificate issued by the Ministry of Justice and Internal Affairs (Law 5 –).

(5) Revenues of Bank of Mongolia

The revenues of Bank of Mongolia are exempt from taxation.

(6) Other

With respect to the Mongolian Government and petroleum product industry in the petroleum development area, with respect to foreign enterprises who are engaged in business in accordance with a production sharing agreement with the Government of Mongolia, the dividend income and the overseas remittance of that income, under the Law Article 6 Clause 1 Item 1 and 2, and clause 3 of the same Article, are exempt from taxation (Ordinance 5 –).

2. Income Receiving Tax Relief

(1) Enterprises that produce grain and vegetables receive a 50% relief on income earned from these activities. However, enterprises that procure grains and vegetables for resale are not eligible for such tax relief (Ordinance 6 –).

Let us calculate

Example: The taxable income for Company A is 7 million Tg. and of this 2 million Tg. is incomer derived from production of grain. The tax reduction calculation for Company A is as follows.

- a) If the tax amount against the 7 million Tg. were determined, it would be 2.1 million Tg. (7 million Tg. X 30/100).
- b) Tax amount per 1 Tg of taxable income is 2.1 million Tg. / 7 million = 0.30 Tg.

- c) If the tax amount against the grain sales income is calculated, it would be $0.3 \text{ Tg.} \times 2 \text{ million Tg.} = 600,000 \text{ Tg.}$
- d) The tax relief amount for Company A would, then, be $600,000 \text{ Tg.} \times 50/100 = 300,000 \text{ Tg.}$
- e) The amount to be paid into the budget by Company A would be $2.1 \text{ million Tg.} - 300,000 \text{ Tg.} = 1.8 \text{ million Tg.}$

(2) For enterprises that constructed international, state and local automobile roads using its own funds and perform maintenance on such roads will be allowed to deduct the amount of funds used for the project from its taxable income. However, this excludes cases in which the road construction and the road maintenance take place on land owned by the said enterprise (Ordinance 6 –).

(3) Foreign affiliated enterprises engaged in the following fields are afforded reduction in Corporate Income Taxes from the date in commencement of such production business.

1) For enterprises engaged in thermal electrical generation plant, electricity • heating transportation network, automobile road, railroad, air transportation or civil engineering, long distance transmission facilities, taxes will be exempted for the first 10 years and 5 years after such period the taxes will be reduced by 50%.

2) For an enterprise engaged in the drilling • development of petroleum and solid fuels, metallurgy, chemicals, metals, manufacture of machinery, and electronics are exempted from taxation for 5 years and for 5 years after such period its taxes shall be reduced by 50%.

(4) Foreign affiliated enterprise that is established for purposes other than those in (3) above and that exports 50% or more of the products, the taxation for the first 3 years shall be exempted and for the 3 years subsequent, the taxes shall be reduced by 50%. However, this provision does not apply for enterprises engaged in wool, washing cashmere, brushing, and primary processing of furs (Ordinance 6 –).

(5) If a foreign investor reinvests income allocated to itself, the taxable income shall be reduced in accordance with the amount of such reinvestment. In such a case, the foreign investor shall notify the Foreign Investment Agency of the reinvestment in writing and upon the approval of the Foreign Investment Agency, it shall register with the State Registration institution.

(6) In cases where the business activities of the foreign affiliated enterprise provided for in clause 5 of this Article span several fields, the preferential tax treatment shall be determined according to its principal business field.

(7) For foreign affiliated enterprises formed through purchases of juridical person's stock, dividends or other securities sold by the right to investment document based on the Privation Law, the tax reduction and exemption measures provided for in this Article Clause 4 and Clause 5 shall not apply.

(8) Enterprises and institutions that have invested in electrical power, electricity transportation network building, reforms in basic industrial technology shall have for a period of 10 years commencing on the date of commencement of such business, shall have taxes exempted and for 5 years subsequent to this period shall have the taxes reduced by 50%. This shall not apply to individuals and juridical persons that produce electrical power for their own consumption and those who construct network within their own land and buildings.

(9) Juridical persons who establish registers with the prefecture's National Tax Bureau in prefectures that have established the conditions for the production • services to prosper to engage de novo in production • services in such area shall have their first year's income exempted in entirety from taxation and for 2 years subsequent to this period shall have their income tax reduced by 50% (Ordinance 6 –).

Juridical persons who register with a prefecture's National Tax Bureau in prefectures where the environment has not been readied for prospering of production • services to engage de novo in production • services in such area, their first year's income shall be exempted in entirety from income taxes and for the subsequent 2 years after this period shall have their income tax reduced by 75% (Law 6 –).

Juridical persons who engages de novo in business • services in a Som located over 100 kilometers from the prefecture capital in a prefecture where the environment for prospering of production • services are not adequately prepared shall have their

income for the first two years entirely exempted from income taxes and for one year subsequent to this period shall have their tax reduced by 50% (Ordinance 6 –).

List of prefectures and Soms that will be subject to the tax reduction measures above shall be approved by the Government (Law 6 –).

The treatment of the above shall not apply to juridical persons that are juridical persons engaged in mining or in production of alcohol or to juridical persons who is engaged in centralized preparation of financial reports and tax reports and perform budget and tax computations.

Chapter 5 Types of Taxable Income and Calculation

Corporate Income Tax is imposed on the profit of juridical persons and the profit that is subject to taxation is referred to as “Taxable Income” and a tax rate is applied to the taxable income to calculate the tax amount. However, the taxable income for a juridical person is similar to the profit of the juridical person but it is not exactly the same.

In this chapter, the following points will be covered.

Study Guide

Types of income subject to Corporate Income Tax
Determination of Taxable Income

1. Types of Income Subject to Corporate Income Tax

Taxpayers will be taxed on the following types of income (Law 4 – I).

Income from principal business and secondary business
Income from commercial bank and financial institutions
Income from insurance businesses
Income from exchanges and securities business
Income from operation of pawn shops
Income from disposal of real estate
Income from disposition of personal property
Income from assignment of business rights
Dividend income and shareholder income
Income from interest earned on lending
Income from rental or property
Income from brokerage business
Income from lottery and other amusement businesses
Interest income from bank deposits
Income from foreign exchange trading
Other taxable income

(1) Income from Principle Business and Secondary Business

Income from principle and secondary businesses, income derived from sales of merchandise and provision of services will be subject to taxation (Ordinance 2 – I).

However, with respect to agency of a foreign enterprise deriving revenues in Mongolia (taxpayers as defined under Law 3 –), the income from only those businesses engaged in Mongolia will be subject to taxation (Law 4 –). With respect to foreign currency denominated transactions, conversion into Tg. shall be performed using the exchange rate posted by the Bank of Mongolia on the date of sale of such currency (Law 4 – , Ordinance 2 – 1).

(2) Income from Commercial Bank and Financial Institution Business

The income from commercial banking and financial business are taxable, but income include many types of income including income from loans, sales of foreign currencies, deposits, remittance fees, securities transactions, investment finance counseling service, financing businesses approved by the Bank of Mongolia, interest on loans, loans on overdue loans, penalties obtained from others, etc. In addition, if loans that had been processed through the bad loan reserves are subsequently repaid, that amount shall be included into taxable income. With respect to revenues from sales of assets that had been seized in satisfaction of a loan claim and if the loan had been recorded on the financial statement, then only the portion representing interest will be recognized as income for tax purposes. The reason for this being that this is a loan that has been processed by bad loan reserves (Ordinance 2 –).

(3) Income from Insurance Business

Income derived from insurance business is taxable, and among the types of incomes that are included are various insurance premia, compensation for damages from re-insuring institutions and other income ((Ordinance 2 –).

(4) Income from Exchanges and Securities Business

Income from exchange and securities businesses are taxable and within transaction brokerage businesses, includes businesses concerning property and property assignment, safekeeping of securities, transactions of securities, gifts of securities, inheritance, assignment without consideration and other businesses (Ordinance 2 –).

(5) Income from Management of Pawn Shops

Income form management of pawn shops refers to income from a business in which based on an agreement a collateral good owned by the borrower is provided as collateral until the repayment of the principal and interest and amount that represent interest income and income derived from the disposition of the collateral item are

considered taxable income (Ordinance 2).

(6) Income from Sale of Real Estate

Income derived from sales of real estate is taxable and included in such income are income from the sale of buildings and related real estate (Ordinance 2 –).

(7) Income from Sale of Personal Property

Income from sale of fixed assets excluding real estate is taxable (Ordinance 2 –).

(8) Income from Assignment of Business Rights

Assignment fees received from assignment of copyright, patent right, trade mark and other intellectual property rights are taxable (Ordinance 2 –).

(9) Dividend Income, Shareholder Income

Dividend income from stocks and shareholder income are taxable. That is to say, income arising from profit participation rights excluding claims and similar income (distribution income) are taxable (Ordinance 2 –).

(10) Income from Interest on Loans

Interest income on loans is taxable and includes income from claims such as various public bonds. For example, income from national bonds and other securities (corporate bonds, securities, notes) and income from remuneration for its sale, interest from loan of funds • property (excluding interest income earned by commercial banks and pawn shops) (Ordinance 2 –).

(11) Income from Rental of Property

Income from rental of property, in other words, fees received for making available real estate, personal property for use by others are taxable (Ordinance 11).

(12) Income from Brokerage

Income from brokerage activities, or fees for intermediating between parties or income derived for acting as agent for another party shall be taxable (Ordinance 2 –).

(13) Income from Lottery and other Amusement Business

Income from various pay-for –play games, copy • sale of audio and videotapes, lotteries, quiz, and casino is taxable (Ordinance 2 –).

(14) Interest Income on Bank Deposits

Interest income from banks for bank deposits is taxable (Ordinance 2 –).

(15) Income from Foreign Currency Trading

Income derived from the differential in foreign exchange rates of foreign currencies in exchange business is taxable (Ordinance 2 –).

(16) Other Taxable Income

Excluding those included in (1) through (15) above, gifts, remuneration, interest obtained through law • agreement, fines, items found and kept with the approval of relevant authorities as the true owner’s identity is not known, surplus fixed assets and current assets as a result of taking inventory, and income from subsidiary business are taxable (Ordinance 2 –).

E.g.: Clearing settlement incentives from the Bank of Mongolia are include in taxable income for commercial banks.

Further, for taxation, exemption and relief provided for in Articles 4, 5, and 7 of this Law, it complies with “Various Economic Activity Classification” approved by jurisdictional administrative agency.

2. Determination of Taxable Income

With respect to the following types of income, deduct “direct and indirect expenses that can be substantiated with evidence” to determine the taxable income (Law 5- -1, Ordinance 3 –).

- Income from principal business and secondary business
- Income from commercial banking, loan business
- Income from Insurance Business
- Income from Exchange, Securities Business
- Income from Management of Pawn Shop
- Income from National Bonds
- Income from Rental of Property
- Income from Brokerage Business
- Income from Sales of Foreign Currency

(1) Expenses to be Deducted from Taxable Income

1) Direct Expenses • Indirect Expenses

Direct and indirect expenses that are deducted from taxable income include the following (Ordinance 3 –).

These expenses must be substantiated by evidence.

- Wages and remuneration
- Materials, raw materials, sub-material
- semi-finished products
- Heat • water • electricity • fuels • parts
- Wrapping materials
- Seeds, fertilizer, feed, chemicals
- Book value of young livestock that died of diseases
- Consumables expense
- Labor protection expense
- Automobile spare tires (cost of spare tire)
- Health and social insurance premium (according to tax Rates as established by law)
- Depreciation of fixed and intangible assets

2) Depreciation

“Assets that can be depreciated is referred to as “depreciable assets” and depreciable assets through its use contributes to the enterprise’s profits. Therefore, the expenses (acquisition price) of such assets are prorated over the usable life of the asset and recognized each year as expenses. The process of expensing is referred to as “depreciation”. Under the Corporate Income Tax Law, life of an asset is determined for each category and applies a straight-line method for depreciation. Land, livestock and materials are fixed assets but are not considered depreciable assets. Land also contributes through its use to the profits of the enterprise but the useful life of the land is considered in perpetuity thus except for the time of sale of the land, cannot be expensed”.

The useful life for each fixed asset category for depreciation purposes are as shown below (Ordinance 3 –).

(a) Useful Life

Fixed Asset	Useful Life
Building:	40 years
Machinery and equipment: of which machinery for scientific research, leading technologies export and mining machinery, environmental protection machinery specialized infrastructure machinery, computers:	10 years
Other Real Estate:	5 years
	10 years

(b) Depreciation Method

In calculating depreciation for tax purposes, a straight-line method using the above useful life will be applied (Ordinance 3 –).

Let us calculate

E.g., Company A has a factory with original cost of 120 million Tg. with a useful life of 40 years, 6 units of testing equipment with useful life of 5 years (normally it is 10 years but since the use is for research it is 5 years) valued 700,000 Tg., and 1 automobile with a useful life of 10 years valued 24 million Tg. Let us now calculate the depreciation on the fixed asset using the straight-line method.

1. Calculate the annual depreciation

a) Factory building: $120 \text{ million} \div 40 = 300,000 \text{ Tg.}$

b) Equipment : $700,000 \div 5 \text{ years} = 140,000 \text{ Tg.}$

$140,000 \times 5 \text{ units} = 840,000 \text{ Tg.}$

c) Automobile: $24000 \div 10 \text{ years} = 2.4 \text{ million Tg.}$

2. Let us calculate the annual depreciation rate.

a) Factory Building: $300 \div 12000 = 2.5\%$

b) Equipment $140000 \div 700000 = 20\%$

c) Automobile $1200000 \div 12000000 = 10\%$

If the annual depreciation rate is clear, apply it to the cost to calculate the annual fixed asset depreciation.

E.g. a) Annual depreciation for the factory is $120000 \times 2.5/100 = 3,000,000$ Tg.

b) Annual depreciation for the equipment is $700000 \times 20/100 = 3,000,000$ Tg.

c) Annual depreciation for the automobile is $24000000 \times 10/100 = 2,400,000$ Tg.

3) Advertising and Training Expense

Advertising expense • promotion expense, training and retraining expenses for employees are calculated at their actual value but its total value must not exceed 10% of the said juridical person's total taxable income (Law 5 – – 1). That is to say, if the total of the advertising and training expenses does not reach 10% of the taxable income, that actual amount may be expensed as a deduction but if the sum exceeds 10%, that portion exceeding 10% cannot be included in the deductible expenses (Ordinance3 –).

Specifically, the enterprise shall perform final calculation method for advertising expense and training expenses and include in the reporting. The amount of advertising • training expense to be deducted from taxable income shall be calculated as follows (Ordinance 3–). Further, with respect to these expenses, they need to be substantiated by evidence.

Let us calculate.

E.g. Company A's income during the reporting period was 5 million Tg. and amount of deductions to be taken against the taxable income was 2.7 million Tg. and of this the advertising • training expense totaled 270,000 Tg.

a) Income Subject to Taxation

$$\begin{aligned} \text{Taxable Income} &= \text{Taxable Income} - \text{Deductible Expenses} \\ &= 5000000 - 2700000 = 2300000 \text{Tg.} \end{aligned}$$

b) Deductible Limit for Advertising • Training Expenses

$$2300000 \times 10\% = 230,000 \text{ Tg.}$$

c) Deductible Advertising • Training Expenses

$$270,000 \text{ Tg.} > 230,000 \text{ Tg.}, \text{ therefore, } 230,000 \text{ Tg.}$$

d) Excess Advertising • Training Expenses Above the Deductibility Limit

$$270000 - 230000 = 40,000 \text{ Tg.}$$

$$\text{e) Taxable Amount} = 2300000 + 90000 = 2,390,000 \text{ Tg.}$$

4) Expenses for Materials for Production • Services, Raw Materials, Spare Parts, Fuels, etc.

In calculating the expenses for materials for production • services, raw materials, spare parts, and fuels, according to the Minister of Fiscal Economy Directive No. 116 dated December 22 2000, the “Expense Calculation Method” as provided for in the Corporate Accounting Principles, Financial Statement Preparation Manual will be applied. If the prices of materials, raw material and fuels to be expensed are determined at a level higher than the market price without due substantiation, the expense shall be based upon the average market prices.

5) Losses Due to Unavoidable Causes

Losses that are due to causes that are unavoidable and can be proven (flood, disaster, earthquakes, communicable diseases), the losses shall be deducted from taxable income.

6) Funds Expended in Road Construction in the case International • National • Local Roads are Constructed by an Enterprise Using Own Funds

Funds expended in road construction in the case international • national • local roads are constructed by an enterprise using own funds shall be deducted from taxable income.

7) Other Expenses

Other expense category includes items that are listed below. With respect to these expenses, they will need to be substantiated by evidence (Ordinance 3 –).

* Maintenance and administration (daily maintenance to ensure normal operations of the fixed assets)

* Provisional building that has been included in the construction budget and bonus expenses
Losses in sale of foreign currency

* Losses arising in payment for transactions denominated in foreign currency
Contracting fee

- * In order to deduct the contracting fee from taxable income the following conditions need to be satisfied:
 - a) If contracted to a juridical person, the existence of a contracting agreement
 - b) If contracted to an individual, withhold at source and record in personal income records
- * Rent
- * Interest expense recorded in the accounting books for borrowing from a bank, a juridical person or individuals at an interest rate comparable to average commercial bank interest rates (excludes interest paid within the period of borrowing for investment)
- * XXXXX at the beginning of the reporting period
- * Vehicle Tax paid to the national treasury
- * Land rent, resource utilization fee
- * Real Estate Tax paid into the national treasury (excludes taxes on real estate sales)
- * Mandatory insurance premium paid to an insurance institution
- * Commercial bank allowance for bad loans

3. Calculation of Expenses that are not Deducted from Taxable Income

The expenses listed below are not recognized as deductible expenses:

- * Investment expense, extension of use period of fixed assets, expenses for the purposes of enhancing performance
- * Various bonuses
- * Contributions (except those for which there is special provisions under the Tax Law)
 - Entertainment expense, subscriptions
- * Commutation allowances for employees, housing subsidies, etc
- * Packaging expense
- * Allowance for Bad Loans
- * Voluntary Insurance Premium
- * Interest paid on overdue loans
- * Normal depreciation on materials
- * Expenses exceeding income from supplementary business
- * Damage compensation paid by the taxpayer to a third party (penalties for non-compliance of agreements, damage compensation due to default on fire prevention measures, etc.)
- * If the aggregate liability of the amount of the loans extended to juridical person taxpayer with a comprehensive relationship and interest exceeds 30% of the investment amount of the lender, the excess loan amount and the interest thereon

Let us calculate.

E.g.: Company A on February 1 20xx invested 100 million Tg. into Company B. On April 1 20xx lent for 3 months 50 million Tg. at an interest rate of 3% per month. On July 1 B paid 4.5 million Tg. to A as interest. The loan amount is in excess of 30% of the invested amount, thus only the interest expense relating to 2.7 million Tg. (3% interest on 30 million Tg. for 3 months) is deductible.

- * Penalties levied by relevant institutions for illegal activities
- * Personal expenses
- * Losses due to foreign currency exchange rate

4. Calculation of taxable Income on Real Estate Sales Income

The residual price of the real estate is deducted from the real estate sales income to determine the taxable income. In calculating the residual amount, depreciation expense calculated using the straight-line method from cost will be deducted from the cost of the real estate.

For other current assets, the acquisition price and the maintenance expenses and associated sales expenses are deducted.

Income received in advance and sales return is not included into the taxable income.

5. Determination of Taxable Income against Businesses such as Lottery, Quiz Games

With respect to businesses such as lotteries and quiz games, expenses that can be substantiated by evidence for the said income as provided for in the Law Article 4 Clause 1.13 (lottery printing, transportation, storage, sales, advertisement, pay-out amount) are deducted to determine the taxable income (Ordinance 3 –).

Let us calculate.

E.g. Company A issued and sold lotteries totaling 600 million Tg. Expenses associated with this were 80 million Tg. for the printing and sales, 340 million in pay-out of winnings. The taxable income will be: (600 million – 80 million – 340 million).

6. Insurance Business

The taxable income for insurance business is determined using the method described below

(Ordinance 3-). From the total premium amount for the reporting year, deduct the amount paid out as re-insurance premium to determine the net premium income. Add to the net premium income, income derived form other businesses to determine the taxable income.

Deduct an amount equal to 60% of the taxable income as reserves for damage compensation payment funds and deduct expenses that can be substantiated by evidence to determine the taxable income.

Chapter 6 Calculation of Tax Amounts

Corporate Income Tax is calculated by applying a fixed tax rate to the income amount that is the tax base, which we have been learning of up to this point. In this chapter the following topics will be discussed.

Study guidance

Does the tax rate for corporate taxes differ by types and the amounts of income

1. Income Provided for in Corporate Income Tax Law Article 4 Clause 1 Items 1.5, 1.7, 1.10, 1.12, 1.15, and 1.16

With respect to the income listed below, for the first 100,000,000 Tg. a tax rate of 15% is applied, and on portions exceeding 100,000,000 Tg. a tax rate of 40% shall be applied to calculate the tax (Law 6).

- Income from principal and subsidiary businesses
- Income from commercial banking, loan business
- Real estate sales income, national bond income
- Rental income, income from brokerage
- Income determined in accordance with the Enforcement Manual Article 3 (excludes 3.7) in the enforcement of Corporate Income Tax Law Article 5 Clause 1 relating to the determination of taxable income on income such as sales income from sales of foreign currency

(Tax Rate) Taxation applying the following tax rates

Annual Taxable Income (Tg)	Tax Rate
a. 0 ~ 100,000,000	15 %
b. Over 100,000,001	15,000,000 + (amounts exceeding 100,000,000) × 40%

Let us calculate.

E.g.: Company K's income according to the Fiscal 2002 settlement is as follows:

- Sales from principal business – 400,000,000Tg
- Income from the sale of company car - 9,000,000Tg
- Interest from National Bonds - 4,000,000Tg
- Rent - 800,000Tg
- Brokerage business - 2,000,000Tg
- Sale of Foreign Currency - (US\$1000) (\$1 = 1090 Tg.)
- Other Income - 6,000,000Tg

If expenses of 280,800,000 Tg. of expenses are assumed to obtain the above revenues, the taxable income would be calculated as follows:

Company K Gross Income is

422,890,000Tg

(400, 000,000+9,000,000+4,000,000+800,000+2,000,000+1,090,000+6,000,000) Taxable
Income is 142,090,000 (422,890,000 - 280,800,000)

and the Tax is 18,336,000Tg (1,500,000 + (142,090,000 - 100,000,000)×40 % =
18,336,000 Tg).

Tax against foreign currency income can be paid using foreign currency.

The income of wholly owned foreign affiliated enterprise or joint venture enterprise shall be taxed in accordance with the Law, unless in the presence of special provisions under the Mongolian laws or Mongolian international treaties. In addition, if the profits allocated to taxpayers indicated in the Law Article 3 Clause 1 Item 2 (Agent of foreign juridical person deriving income in Mongolia) are remitted overseas, a tax of 20% of such amounts shall be imposed.

With respect to taxpayers indicated in the Law Article 3 Clause 1 Item 5 (Religious Juridical Persons), their taxable income for the reporting year shall be taxed at a tax rate of 20%.

2. Income from Sale of Real Estate

In levying taxes on income derived from the sale of real estate, regardless of the period of use of the real estate, its cost, and the residual value, it shall be taxed at a rate of 2% of the sales price that can be substantiated by evidence.

Even in the case of assigning real estate as satisfaction of an obligation, it will be treated as if it were a sale.

Let us calculate.

E.g. Assume that Company A sold a building that cost 45 million Tg. having a useful life of 20 years at 6.4 million Tg. after 10 years of use, the taxable income would be 6.4 million Tg. and the tax would be 128,000 Tg ($6400000 \times 2\%$)

3. Income Derived from Rights Fees

A tax of 10% is levied on income derived from rights fees.

Let us calculate.

E.g.: An agreement is concluded whereby Company B uses Company A's trademark to sell products and went into force from January 1 2000. If Company A was to receive from Company B on January 5 2000 100,000 Tg. as the royalty fee for use of trademark, the tax amount will be calculated as follows.

- a. Company B on January 5 2000 withholds Income Tax of 10,000 Tg on the 100,000 Tg. royalty fee ($100,000 \times 10\%$) and remits to Company A 90,000 Tg.
- b. With respect to the taxes withheld at source from Company A's income, Company B shall pay to a taxing institution by January 12 2000.
- c. Company B processes the royalty fee as intangible assets

4. Dividend on Stocks

A 15% tax is levied on dividends on stocks but the dividend paying enterprise shall withhold 15% of the gross dividend payment and pay into the national treasury.

Let us calculate.

E.g.: Bank M's net profit for the reporting year was 42.5 million Tg. At the shareholders' general meeting, 10 million was allocated to investments and other purposes while 32.5 million Tg. was allocated as dividends to shareholders. Assume Company N's investment represented 30% of the bank's fixed assets and let's calculate the dividends and the taxes thereon.

- a. Dividends to be paid to Company N – 9.75 million Tg. ($32.5 \text{ million} \times 30\%$)
- b. Bank M will withhold 1,462,500 Tg. as taxes for the above income ($9750000 \times 15\%$) and pay into the national treasury.

The payment of dividends to the state budget from state enterprise and semi-state enterprises will be determined each year by the Ministry of Fiscal Economy and the State Property Commission.

5. Interest Income from Banks

Interest income from banks is taxed at 15%.

For example, if the bank pays to Company A interest totaling 2 million Tg. as interest on its demand deposit balances, the bank shall withhold 300,000 Tg. (2 million X 15%) as income tax.

6. Mongolian Non-Residents

A 20% tax will be levied on incomes listed below received in Mongolia by a non-resident juridical person taxpayer.

- Dividends on stocks of an enterprise registered and engaged in business in Mongolia
- Profits paid against investment in taxpayers engaged in business in Mongolia
- Interest received on loans made to an enterprise or other juridical persons registered and engaged in business in Mongolia and fees for assigned idle assets, special rights, patents, trademarks, promissory note received from enterprise or other juridical person registered and engaged in business in Mongolia
- Income from provision of work • services to Mongolian state institution, juridical persons, or other institutions

For Mongolian non-residents of a country that has entered into a double taxation treaty with Mongolia, in the absence of other rules, the treaty shall take precedence.

7. Income from Lotteries and the Like

A 40% tax is levied on income from lotteries, other amusement businesses and audio • video reproduction, and casinos.

Let us calculate.

E.g. : Company issues 40,000 tickets for lottery and from its sale raised 12 million Tg. income. If the associated expenses such as procedures for approval of lottery issuance, printing, sales, and award money totaled 6.5 million Tg., the tax will be as follows:

- a) Taxable Income: 5.5 million Tg. (12 million Tg. – 6.5 million Tg.)
- b) Tax: 2.2 million Tg. (5.5 million Tg. X 40%)

8. Foreign Affiliated Enterprises

In accordance with the Corporate Income Tax Law Article 6 Clause 2, unless otherwise specified under Mongolian International Treaties, taxes shall be imposed on foreign affiliated enterprises and joint venture enterprises as provided for in the Corporate Income

Tax Law and in this Rule.

In accordance with the Corporate Income Tax Law Article 6 Clause 3, if branches of foreign enterprises (petroleum) remit profits, dividends, interest, or royalty is remitted overseas, a 20% of the remittance amount shall be levied as tax (Ordinance 4 –).

Chapter 7 Payment and Reporting

1. Self-Assessment

Under the system of self-assessment, the taxpayer, based on its accounting period and the annual fiscal settlement report, must autonomously determine the cumulative taxes from the beginning of the fiscal year and pay into the budget (Law 8 –).

In this chapter the following items will be discussed.

Study Guidance
How are Corporate Income Taxes paid and filed

The taxpayer shall based on monthly • quarterly payment schedule, determine the cumulative amounts from the quarterly • annual financial statements the cumulative and pay into the budget on the 25th of each month (Ordinance 7 –).

The tax return for the first, second and third quarter will be submitted to the jurisdictional tax offices by the 20th of the first month following the close of the quarter and the fourth quarter return shall be filed by February 10th of the following year (Ordinance 7 –).

Returns for 1st, 2nd, 3rd quarters 20th of the first month following the close of the quarter

Return for the 4th quarter February 10th of the following year

Income derived from business • service provided for in the Corporate Income Tax Law Article 5 and Article 6 1.1 shall be paid within the same period as the above filing period. However, taxpayers with taxable income of 1 million or less may prorate the tax amount and pay in quarterly installments with payment of each installment due by the 25th of the last month of each quarter. A notice to that effect must be submitted to the tax office at the beginning of the relevant period and receive approval from the tax office (Ordinance 7 –)

2. Year-End Tax Return and Settlement of Taxes

Taxpayers prepay the taxes that are due to be paid during the accounting year on 25th of each month and quarterly tax returns are filed with the National Tax Agency by the 20th of the following month after the quarter for the first three quarters and the final quarter tax return filed by the February 10th of the following year and settle the taxation (Law 8 –).

Taxpayers who have 500,000 Tg. of taxable income may pay taxes once a quarter by the above due date (Law 8 –).

3. Taxes Levied on Capital Gains on Real Estate and Stocks

Taxes levied on capital gains on real estate and stock must be paid into the budget within 10 days of the date of sale of said asset and stocks (Law 8 –).

4. Taxes Levied on Dividends on Stocks

Taxes levied on income indicated in the Law Article 6 Clause 1 No. 2 (shareholder dividends), No. 3 (income on disposition of stock), No. 4 (lotteries and the like), No. 6 (bank deposit interest), and No. 7 (income of non-residents of Mongolia) shall have taxes withheld at source by the juridical persons making such payments and paid into the budget within 7 business days (Law 8 –).

ANNEX-2

(2) Accounting : Basics of Tax Examination

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Accounting : Basics of Tax Examination

1. The Objectives of Tax Examination

Under the self-assessed taxation system, a major issue arises regarding whether discrepancies exist between the “juridical person’s reported tax payment amount” and the “tax amount determined by tax examination”. There are several patterns of causes for the incidence of discrepancies including tax evasion, difference in the recognition of facts between the taxpayer and the tax examiners, and differences in the legal interpretation and its application among the most typical

Self-assessed taxation system is a system in which the juridical person calculates its own taxes and voluntarily files a report and pay the tax and the system itself is worthy of some credit, but on the other hand, the tax laws are extremely complex and complicated making it difficult for all to correctly understand and there are no guarantees that all will make appropriate filing and payment. In addition, there are many cases where tax laws are not complied with and taxes are not filed or paid. In such cases, if these are ignored, it can only lead to failure in the fairness of taxation. As cases of non-filing and non-payment of taxes are rampant, conspicuous sense of unfairness is beginning to appear.

The fundamental of tax examination is to reconcile the filings by the taxpayer with the tax law to ensure its correctness and therein lies the need for tax examination.

The taxation on juridical person is established based on the self-assessed tax system, and under this system the juridical person, the taxpayer, calculates and reports its own tax base and the tax amount. Under the system, without “tax examinations”, it is difficult to ensure fairness of tax burden and would not be able to achieve the protection of the citizens’ property rights and, furthermore, satisfaction of public demand or state’s fiscal demand will not be able to be met.

In other words, tax examinations, under the self-assessed taxation system, performs the important function in the achievement of appropriate taxation and it is essential that tax examinations be conducted efficiently and effectively.

2. Preparations for Tax Examination

In this chapter, preparations required by tax examiners for conducting tax examinations will be discussed.

The objective for tax examination is the fair execution of tax laws and the appropriate identification of tax base, the basis for appropriate taxation that goes along with this. Tax

examinations are performed under these objectives and examinations are conducted under the authority of the state. Therefore, regardless of the preferences of the taxpayers, or regardless of whether it goes against taxpayer's wishes, there are times such examinations need to be performed. This is why the responsibilities of the tax examiner are all the more important and each and every actions of the taxation staff, not only concern internal issues of appropriate and fair imposition of taxation and securing of tax revenues but also from tax ideology, has direct vital interest with the taxpayer and the appropriateness of its execution is taken seriously as a social issue.

Let us consider the responsibilities of the tasks of the tax staff.

The tax staff's primary responsibility is to ensure strict performance of the tax laws and through this ensure fair payment of taxes. Tax administration agencies function is to apply the tax laws that has been reasonably enacted to individual taxpayers and must bear the responsibility for the correctness of the results of such application. The taxpayer is not obligated to bear heavy burdens over and above the limits set out by such reasonable tax laws but, at the same time, does not possess the right to avoid burden below this limitation.

Individually apply taxes, in other words, in order to levy taxes individually on taxpayers require two elements. One is the "establishment of the facts" and the other "appropriateness of the application of the tax laws". Only after these two elements are satisfied, it is completed but the basic element would become the identification of the genuine facts. To identify this fact requires polished techniques and accumulated experience and ensure thoroughness without any constraints.

In application of the tax laws, it is necessary to follow the laws and notices and established interpretations and leaves no room for examiner's arbitrary opinions and interpretations. Adherence to this principle and based on the foundation of faithful interpretation of tax laws make the appropriate application of tax laws are demanded from the person conducting a tax examination.

Considering the responsibilities, the preparation for those undertaking tax examinations may be summarized in the following points.

(1) Person conducting tax examination must base themselves on the tax laws and related laws and regulations.

This is an obvious tenet as a tax staff and examination that is not based on laws and regulations will become arbitrary and dogmatic and likely lead to unfair taxation.

(2) Persons conducting tax examination must possess the knowledge of

bookkeeping and accounting.

This, again, is obvious, and a person without the knowledge and skills in auditing and accounting has no qualification to be an examiner goes without saying and this defect can lead to arbitrary estimated taxation and facilitates incidence of compromise taxation and, in addition, a logical and reasonable examinations cannot be carried out and a fair and appropriate taxation cannot be expected.

(3) Tax examiners shall not yield to pressure exerted from interested parties.

Person conducting a tax audit has the official authority to mandate the taxpayer to follow the tax laws and in the examination and taxation, he or she must possess the capacity to maintain the impartial fairness and without any fear of third parties and eliminating any temptations that may be cast his or her way, and perform his or her duties according to what he or she believes to be right.

(4) Persons conducting tax examination must be of a character that is honest to any relevant person and be a person worthy of respect.

This applies not only to the tax examiners but applies to all tax staff but particularly those who are involved in tax examinations are in direct contact with the taxpayers and undertakes detailed examinations thus their attitudes and actions are emphasized. In order to conduct taxation under the full appreciation of the fairness of taxation, the examiner himself must be honest and be respected by the counterparty.

(5) Persons conducting tax examination must have excellent deductive posers and fair judgment.

As with all examiners, those who conduct tax examiners must examine propriety and impropriety of books, accounting records and calculation based thereon and determine the appropriateness based on the tax laws. In order to determine the propriety of the accounting records that has been prepared, he or she must have a level of skills and capabilities that is above than those who prepared them. In examinations, he or she must possess excellent eye for observation, deductive powers, and capacity to make judgments.

(6) Persons conducting tax examination must possess qualities of being a good

leader in order to guide the taxpayers toward correct taxation.

In order for the persons conducting tax examinations to be democratic and considerate, he or she needs to keep this in mind. He or she needs to stand in taxpayer's shoes and be the taxpayer's ally and with kindness guide, lead the taxpayer and any items that may work to the favor of the taxpayer, volunteer such benefits and never unfairly force the taxpayers to pay tax but always with a warm heart guide the taxpayer to keep proper books and proper tax filings.

(7) Persons conducting tax examination must not interfere in the taxpayer's conduct of transactions.

Always pay meticulous attention in examinations and transactions by the taxpayers should never be impeded.

Above lays out the needed preparation for persons undertaking tax examinations and, in essence, the person who conduct tax examination must be democratic and considerate is the primary requirement. By being democratic and considerate means not only that the examiner when dealing with the taxpayers uses polite word and quiet and take a low posture but means that a tax examination that truly takes into considerations the taxpayer's perspective and properly implement the tax laws and it must be an attitude taken by the examiner.

3. Tax Information and its' Utilization

3.1 Necessity of Tax Information

Regarding the necessity of tax information, explanation based on a specific example will be made. For instance, if you are to examine Company A, there may be many cases in which you will be perplexed as to from where you should start the examination. This is presumably because information about the company is scarce. Therefore, what would be the situation if you have information about the business activities of Company A, its sales to Company B, its president's possession of an expensive car, and his purchase of a grand house? Isn't it much easier to implement tax examination?

Speaking more specifically, if you have information that Company A records sales of 1

million Tg to Company B, it is justifiable to check during tax examination if Company A's sales of 1 million Tg to Company B are actually posted in the settlement of accounts documents of Company A. If the sales are not posted, tax evasion has been carried out.

If examination is made as to how the president obtained money to purchase the expensive car or the grand house, and the president is pursued regarding these points, there will be a greater possibility of finding money amassed through tax evasion, if it is the case. In other words, if the profit of the company is not much, and if the president does not receive such a high salary, he/she must have been unable to purchase such an expensive car or grand house. Therefore, it can be considered that, although large profit has been obtained, such fact is hidden, or that, although the president receives a high salary, he/she does not declare such income. Accordingly, if information about Company A is collected and sorted out beforehand, efficient tax examination will be possible. Also, there may be a case in which, during the course of tax examination, you doubt the accuracy of the amount of Company A's payment to C (expenses paid to C). What will you do in such a case?

Usually, it is justifiable to confirm the accuracy of the amount through reverse examination. However, there may be a case in which Company C is located very far away or in which Company C refuses examination. In these cases, reverse examination will be difficult. So now, what will you do?

How about turning transaction relations (in other words, expenses posted by Company A) into information data, and making such data usable in the course of examination on the other party (Company C)?

Because A's payment to C must be recorded as income of the other party (Company C), you should use the said tax information during tax examination on Company C and check if the paid amount is actually posted as income. If it is not posted as income of Company C, tax evasion was committed, or Company A's recording of the payment as expenses is incorrect. Therefore, it will be justifiable for you to pursue the actual development of events. If it turns out, as a result, that C did not post what should be recorded as income, tax evasion was committed by Company C.

If it turns out that the amount is not an item that should be posted as income by Company C, Company A's posting practice was wrong, representing disguised posting of expenses and tax evasion. For this reason, if information (about the facts that Company A's

disbursement of the amount as expenses is wrong, and that Company C has not received the amount) is reversely sent to the tax office in charge of Company A, it can be used as a type of clue to find Company A's tax evasion, without the need for reverse examination. It is justifiable for you to carry out examination again and reject the practice.

Furthermore, such information is useful for not only tax examination but also for preliminary examination.

To explain this, if such information is collected for individual enterprises, suspicious companies can be easily identified, if such information and financial statements submitted by the concerned companies are compared and examined at your desk.

For example, as a result of examination of collected information it was found that some company posted a profit of only 500,000 Tg in its settlement of accounts documents, although it should have recorded at least 1 million Tg based on the collected information/data. In this case, it is justifiable for you to conduct tax examination on such a company on a priority basis only. Also, there will be cases in which collected information has no destination. Conceivable development of events in these instances can be the non-filing by the company stated in the collected information or the padded posting of expenses through the use of a fictitious enterprise by the company that was the source of the said information.

3.2 Content of Tax Information to Be Collected and Collection Methods

Content of tax information to be collected and collection methods are explained as follows:

(1) What information should be collected

Concerning various kinds of materials, there are limitless data, such as files regarding the establishment of companies, data files on sales, purchases, rebates, etc., and files on data collected during the examination of other companies. It is necessary for tax officials to strive to supplement facts about tax assessment and to convert these facts into data without losing any available opportunity. Regarding collected information, a system for their supply and exchanges should be established among tax offices and national tax bureaus throughout the nation.

Study of financial statements through data files is highly important for preliminary

examination, because it clarifies advisability of examination and helps in the appropriate selection of examination targets.

Although the number of examination days is limited, corporate transactions tend to become complicated. Therefore, collection of data and information, in addition to analysis of financial statements, is quite important in order to effectively conduct examination. For this reason, effective data and information shall be collected on all occasions, such as during the examination process, and collection shall be carried out from the content of publicity activities done through newspapers, magazines, TV, radio and etc.

(2) Methods of utilizing tax information

Collected materials should be utilized in preliminary examination.

Study of financial statements based on tax information files is highly important for preliminary examination, as stated before, because it clarifies the advisability of tax examination and accurately selects examination targets.

Although the number of examination days is limited, corporate transactions tend to become complicated. Therefore, collection of data and information, in addition to analysis of financial statements, is quite important in order to effectively implement examination. For this reason, effective data and information shall be collected on all occasions, such as during an examination process, and collection shall be carried out from the content of publicity activities done through newspapers, magazines, TV, radio, etc.

Depending on the cases, it may be possible to pickup a clue in finding tax evasion by checking information and content of declarations. If sales of 500,000 Tg are declared, although the total of sales, learned through information files, is 2 million Tg, it is considered that there is a possibility of sales record curtailment, namely, tax evasion. The suspicion is serious, but it cannot be said at this stage that the company actually committed tax evasion.

It is possible that some error was implemented at the data source (namely, the company through which the related information was obtained). Accordingly, the suspected company shall be made the target of actual examination on a priority basis. The financial content of such a company will be examined in connection with the suspicion.

4.Preliminary Examination

Next, explanation will be made regarding preliminary examination (or desk-top examination).

4.1 Meaning of Preliminary Examination

With regard to the definition of the term, examination mainly designed to select companies that have considerable possibilities of tax evasion is referred to as “preliminary examination.” Because this examination is carried out at the desk in a tax office and the like without visiting the company concerned, it is also called “deskwork examination.”

4.2Purposes of Preliminary Examination

Preliminary examination may be considered to be prior preparations to accurately determine problems with the content of tax return by the target company, and to carry out efficient on-site investigation with regard to these problems.

For this objective, the outline of the examination target company should be grasped based on the analysis and examination of written tax return submitted by the target company, as well as various kinds of data, information, etc., accumulated at tax offices, etc. Specific examination course and plan should be sufficiently prepared to set what and how actual examination will be executed.

In the case of preliminary examination under the setup for simultaneous examination of corporate income tax and consumption tax, the consumption tax-related study should also be carried out at the same time.

Although preliminary examination is implemented within a limited period of time, it shall be enforced precisely and accurately, based on the suitable recognition that its appropriateness/inappropriateness will have great effects on the progress and results of ensuing examinations.

4.3 Procedure for Preliminary Examination

In the course of preliminary examination, conduct multilateral examination regarding the content of the written tax return for the business year under review while considering the reason for the selection of the company concerned as the target. Specifically, extract suspicious matters, select examination items to be investigated concentratedly among them, and set actual examination methods for efficient examination.

The examination shall be carried out under the following procedure.

- (1) Grasp the content of the company's business, its financial condition, degree of its understanding of taxes, characteristics of its representative, and the like through the written declaration of corporate income tax and the "tax record" of the company.
- (2) Compare figures for principal items among settlement of accounts statements and the detailed statement of the breakdown of accounting items with those of the previous year (by writing the latter figures in red pencil) and check increases/decreases of the figures.
- (3) Carry out study based on the financial analysis of the gross profit ratio, inventory turnover, and the like.
- (4) Examine the content of past declarations, examination and guidance content, etc., based on the tax record of the company.

Based on the outcome of the preliminary examination, determine whether to implement on-site investigation or omit examination for the fiscal year concerned. For this reason, select on a priority basis cases (a) in which information or examination data exist for illegal transactions, (b) in which operational scales are expanding remarkably, and (c) in which transactions are held with other examination targets.

Below, a description of examination using (1) examination using corporate tax returns, (2) examination using data information, (3) examination method using examination of related items, (4) using tax analysis method, and (5) presumptive method

(1) Examination Using Corporate Tax Return

Perform consecutive year comparison of accounting values of the taxpayers as they appear in the Corporate Tax Returns. Details of the results of previous tax examinations will also be used as reference.

(2) Examination using data information

In order to secure an appropriate level of tax returns, it is essential to collect information on transactions, assets and others of taxpayers jointly with proper, accurate tax examination.

Effective data and information should be collected through all opportunities, for instance by collecting, during on-site examination of an enterprise, data on its transactions with other companies that may be engaged in the omission of tax returns. It is necessary to collect such data from the contents of individual enterprises' publicity activities through newspapers, magazines, TV, radio, and other means.

(3)Method of examining related items

The method of examining related items refers to a method of investigating relations between sales and gross profit, between purchases and gross profit, or between purchases and purchasing-related transport expenses, for example.

If gross profit is smaller compared with sales, examination should be carried out as to whether or not exclusion of sales, posting of fictitious purchases, or exclusion of inventories were implemented. Of course, if a company lowered sales prices, if the purchasing price rose, or if the company took steps to reduce inventories, these represented cases with justifiable reasons. Therefore, when such a company prepares settlement of account documents, it is necessary for this side to conduct analysis and study in advance. It is desirable to state results of such analysis in the tax record, if possible.

If personnel expenses and subcontract cost are at high levels compared with sales or production amounts, attention should be made as to:

Whether or not sales omissions have been carried out.

Whether or not fictitious posting of personnel expenses or subcontract cost is committed.

At any rate, it is frequently stated that "business management is a kind of common sense." If a business operator pays a fixed amount of personnel expenses, he/she plans to attain some level of production, and if he/she pays a fixed amount of subcontract cost, he/she considers how much profit should be gained from the related subcontracting action. Also, if the business operator pays purchasing transport expenses, he/she does so based on a generally accepted price level.

Accordingly, a figure greatly different from past figures does not suddenly appear, and if compared with other companies in the same business line, such an abnormal figure

usually does not arise. If an abnormal figure is shown, it will be actions based on common sense to implement tax analysis or tax examination, based on the suspicion that the abnormal figure may be due to sales exclusion, posting of fictitious purchasing, or posting of fictitious expenses.

(4)Tax analysis method

Tax analysis methods can be divided into “ratio-based method,” and the “comparison method.” The ratio of gross profit on sales is the ratio obtained by dividing gross profit with net sales (amount derived by deducting sales discount and rebates from gross sales), and if this ratio is abnormally low, attention should be paid as to whether or not sales exclusion was committed, whether or not fictitious posting of purchases was carried out, or whether or not exclusion of inventories was implemented. It goes without saying that the inverse number of this ratio of gross profit on sales is the sales cost ratio.

If labor cost is divided by net sales, the result will be the labor cost ratio, and if subcontract cost is divided by net sales, the outcome will be the subcontract cost ratio. And if these are abnormally high, analysis or study should be made to check for fictitious labor expenses or fictitious subcontract cost.

The “ratio-based method” represents a formula for comparing these ratios with those of previous terms or those of other companies in the same business line, while the “comparison method” is a formula in which amounts themselves are collated with those in the previous terms, etc.

(5)Presumptive examination method

This refers to an examination method in which estimated amounts are used in checking if posted figures are appropriate or not. Namely, estimates obtained based on objective and reasonable standards and methods and amounts posted in financial statements are compared and examined, existence/nonexistence of abnormal figures or appropriateness/inappropriateness of the posted figures is studied based on the comparison results.

The rational and reasonable examination methods, based on estimates of revenue amounts, include the methods shown below. In addition to these, there are also the “living expense-based backward calculation method,” which is to conduct backward

calculation based on the standard living expenses, and the “balance-with-a-similar-company-based method,” in which estimation is implemented based on comparison with similar figures of another company of approximately same size, in the same business line and in the same area.

1) B/S method

This is a method in which net asset amount (derived by deducting liabilities from assets) as of the beginning of the term is subtracted from the net asset amount as of the end of the term, and the balance is adopted as the corporate income during the said term. In other words, this is a method of examining income based on the asset method. Here, let us call this method the “B/S method.” This method has a shortcoming of involving technical difficulties in determining actual amounts of assets and liabilities at the beginning and ending of the term concerned.

Therefore, a more reasonable method based on the parallel use of the “P/L method” explained below for supplementation can be considered.

2) P/L method

If income based on cash or bank deposits or expenses are clarified, revenue amount can be calculated by supplementing or modifying the income/expenditure based on an accrual basis. Also, if one of revenue or expenditure is recognized as appropriate, it is possible to calculate a revenue amount recognized as appropriate, by estimating unclear or incomplete portions and comparing them with other portions. Here, let us refer to this examination method to examine the appropriateness/inappropriateness of the posted revenue figure based on the calculated revenue amount as the “P/L method.” Namely, this is an examination method to examine appropriateness/inappropriateness of a revenue amount using the “profit/loss method.” By utilizing this method and the aforementioned net asset increase/decrease method in parallel or supplementation, more reliable examination can be carried out.

3) Per-unit method

The examination method of estimating revenue or income amounts based on fixed “efficiency” and “income standard ratio” and examining the appropriateness/inappropriateness of posted amounts can be widely utilized in preliminary examination. Here, let us call this examination method the “per-unit method.”

“Efficiency” refers to the ratio of effects that external factors, such as the number of employees, number of machines, and sales area have on revenue amounts. Specifically, it is expressed by means of per-employee sales, per-machine unit sales, and per-unit floor sales. In other words, “efficiency” means the ratio of sales for each unit of items for the estimation of sales amounts.

“Income standard ratio,” meanwhile, is an income ratio obtained by averaging and standardizing the actual figures of other companies in the same line, to estimate a revenue amount based on sales.

In the course of preliminary examination, check for abnormal figures among posted sales or profit, or examine appropriateness/inappropriateness using these methods. The examination of revenue amounts, based on efficiency ratios in “preliminary examination tables,” is tantamount to that type of checking.

As items for the foundation of sales estimates to be used for efficiency, those that can be easily judged and are in close correlation are chosen. Accordingly, they are different from business line to business line, so it is impossible to list them down generally. This being the case, only principal cases are shown in Table 1 as reference information.

Table 1 Efficiency Examples for Individual Business Lines

Line of business	External element	Efficiency item
Construction	<ul style="list-style-type: none"> • No. of employees • Labor expenses • Material consumption • Material cost • Work area 	<ul style="list-style-type: none"> • Work revenue per employee • Work revenue per labor cost unit • Revenue per unit of material consumption • Work revenue per unit material cost • Work revenue per 10m² of work
Manufacturing	<ul style="list-style-type: none"> • No. of workers • No. of main machinery units • Power consumption • Material consumption • Machinery repair cost 	<ul style="list-style-type: none"> • Sales per worker • Sales per unit of principal machines • Sales per 1 kWh of power consumption • Sales per unit of material consumption • Sales per unit of machinery repair expenses

Wholesaling	<ul style="list-style-type: none"> • No. of employees • Area of buildings • No. of operating dates • Inventory goods • Packed item transport cost 	<ul style="list-style-type: none"> • Sales per employee • Sales per 10 m2 of buildings • Sales per operating day • Sales per unit of inventory goods • Sales per packed item transport cost
Retailing	<ul style="list-style-type: none"> • No. of employees • Sales floor area • No. of operating days • Inventory goods • Packaged product consumption volume 	<ul style="list-style-type: none"> • Sales per employee • Sales per 10 m2 of sales floor area • Sales per operating day • Sales per unit of inventory goods • Sales per unit of packaged product consumption volume
Eating/drinking Establishments	<ul style="list-style-type: none"> • No. of employees • No. of customer chairs • Customer floor area • No. of customers • No. of operating days • Lighting consumption volume • Water consumption volume 	<ul style="list-style-type: none"> • Sales per employee • Sales per customer chair • Sales per customer room • Sales per customer • Sales per customer on an operating day • Sales per kilowatt of lighting energy consumption • Sales per unit consumption of city water
Transport Business	<ul style="list-style-type: none"> • No. of vehicles • No. of employees • Fuel consumption • Traveling distance • Repair expenses • Fuel cost 	<ul style="list-style-type: none"> • Transport revenue per vehicle • Transport revenue per employee • Transport revenue per unit consumption of fuel • Transport revenue per 10 km covered • Transport revenue per unit repair expenses • Transport revenue per unit fuel cost

5. Tax Examination Method

Self-assessed taxation system is a system in which the juridical person calculates its own taxes and voluntarily files a report and pay the tax and the system itself is worthy of some credit, but on the other hand, the tax laws are extremely complex and complicated making it difficult for all to correctly understand and there are no guarantees that all will make appropriate filing and payment. In addition, there are many cases where tax laws are not complied with and taxes are not filed or paid.

It would be desirable to conduct tax examinations on every return from juridical persons to examine the correctness of the returns but, in reality, due to the limitation of staff and time this is not possible. It is thus necessary to diversity the types of examinations to fit the applications • objectives and in this chapter the basics of (1) examination of actual values based on tax Evidential Data and (2) examination based on estimation for those companies that have no books or whose accounting records are inadequate (estimate examination) will be explained.

5.1 Examination of Actual Amounts Based on Tax Evidential Data

The fundamentals of the tax examination is the examination of whether the values calculated by the taxpayer is correct according to the tax laws, and this is why a tax examination is required and tax examination must be performed in an efficient and effective manner and “tax Evidential Data” becomes necessary.

However, in the existing tax administration practice, the tax accounting system has not been adequately been instilled in the economy and the system for such tax Evidential Data has not been adequately been prepared. This has resulted in inefficient tax examinations. If the system can be instilled in the economy as a whole, it will enable very efficient tax examinations. In addition, for the taxpayers as well, it will provide them with data with which to counter the examiners in tax examinations to avoid unreasonable taxation by the taxation authorities.

In tax examinations, tax evidential data plays an extremely effective role.

(1) Role of Evidential Data in Tax Examination

Tax examinations carried out on the taxpayers are to determine the correctness of the facts contained in the return and as a tool, an examination of “data” that enable confirmation of the return contents will be performed. In other words, with respect to the application of the tax laws, if a “verifying data” that correspond to the tax treatment a confirmation can be made and the tax examination would be complete and the return approved.

However, if the data is insufficient to confirm the return contents, or if such confirmation cannot be made, issue arises from the point of view of tax administration. Often such issues arise from whether or not the tax laws are being properly applied.

Under the self-assessed taxation system ignorance is not an acceptable justification and if a fact is not known, estimated or constructive taxation should be performed. Thus, for the tax examinations, with respects items against which questions or examination is raised, the taxpayers should be required to present “evidential data” that enable the confirmation of the contents • facts. This will also provide protection of taxpayer’s own rights.

(2) “Evidential Data” and Certification of Fact Determination

The basic issue for the tax examinations is the “certification of fact”. This certification of fact means the judgment to perform accounting processing and tax classification for defined series of transactions and such certification is made initially by the enterprise

that undertook the transaction and based on which the enterprise perform the corresponding tax processing, but in tax examination an external judgment is rendered on such independent certification. In such cases, conflicts often occur in the objectives and the vested interests between the autonomous certification and external certification and the necessity for rendering of “objective judgment” becomes necessary. The foundation for such objective certification of facts is the “evidence”.

In trials, evidence can be “personal evidence, physical evidence and the entire content of arguments” but in the tax examination there are documentary evidence (evidence that takes the meaning and the content of documents as evidential data) and hearsay evidence (evidence submitted in writing from a person experiencing certain fact or from someone who had heard of such) play important roles.

These documents that are evidential data can be classified into two categories as described below.

1) Disposition Document

This is the subject of the proving and is performed directly as a result of the document. These would include an agreement, notice to rehabilitate or determination, note, judgment, will, notice for cancellation, etc.

2) Reporting Document

This is a document, other than a disposition document, containing the writer’s observations, opinions, impressions, or report. Report document is a document that reports on the facts as experienced by the writer and includes such items as letter, dairy, commercial books of accounts, shareholder meeting minutes, board of directors meeting minutes, various types of application forms, records, receipts, invoices, order forms, packing list, sending slip, estimate, statement by the party in question, interview memo, approval circular, etc.

At the stage of tax examinations, exchange of opinions regarding certification of facts primarily based on “documents’ should be conducted.

With respect to “certification of fact”, there is an issue of certification of fact and interpretation but with respect to this they should be considered in separation and as acceptance of an interpretation is a prerequisite for the certification of facts, as the taxpayers performing the tax and accounting processing, it is necessary to possess the capacity to adequately interpret the tax laws and notices and be able to make express the foundation for its application.

Next, criteria for determining the correctness of the tax treatment relative to the actual

transaction need to be developed.

The basic issue in tax examination is the “certification of the facts” and in order to achieve this, the foundation for the interpretation of the tax accounting treatment and all evidence supporting the factual foundations are needed. However, considering the state of the current economy, the details of economic transactions are diverse and complex and further, the progress and with the spread of office automation, which can be described as document revolution, the scope of data and documents that form the evidence are expanding.

Naturally, evidential power of documents created by the transaction counterpart (a related party with opposing interests) will be emphasized, but documents that have been prepared internally, so long as the data and documents are those for which legal foundation for the application is clear and correct interpretation has been made and the facts of the transaction can be justified even indirectly, it will have important significance as tax evidence.

(3) Proving Data and Explanatory Data in Taxation

For the taxpayer, in order to avoid the discrepancies in the certification of the facts, which is the basic issue in tax examination and thus having its tax filing approved and avoiding incidence of unnecessary tax burden, it is necessary to, in addition to performing appropriate accounting treatment on the facts of the transaction, perform legal and reasonable tax treatment.

This set of responses is referred to as tax management and is one step forward from isolated tax saving measures taken after or during a transaction. What supports the efficacy of tax management is “tax evidence for transaction treatment that enable approval of tax filings in a tax examination”.

Evidence demonstrates its efficacy by its evidential value and the evidential value is its evidential power. In legal terminology, in a case of “proving” it refers to clarification of facts by unassailable evidence that is able to convince the judge or the court. Further in contrast the terminology “justify” refers to presenting evidence not sufficient to convince the judge or the court but sufficient to enable the judge and the court to surmise some degree of certainty. .

Tax examination is not a trial or legal actions and the stance relating to evidence differs from the difference in its nature but the certification of the facts are immediate and it is a certification that takes place between the relevant parties thus it can be said that the more practical, the wider and larger the volume of data, the more advantageous.

Thus, with respect to data for tax evidence, following the “proof • justification”

discussed above has been classified according to their objectives as follows.

- Tax evidential data
- Tax proof data
- Tax explanatory data

1) Contents and Objectives of Tax proof Data

These data prove by clarifying the facts of the transaction that the accounting treatment and the actual transaction are consistent.

Specifically, refers to vouchers that records daily transactions. For example, if there was an expenditure necessary for the performing tasks in the business, rather than paying cash and receiving a simple receipt, make the payment by a check that will enable tracing the crediting of the counterpart's account when the check is cashed and cleared providing a dual source of evidence and this type of processing can be referred to as transaction processing that enable composite proof.

Therefore, tax proof data primarily refers to documents that have the counterpart's stamp or signature on the document, but it also refers to data that from the transaction processing side processing is implemented that further providing proof of the fact and is data that no one will dispute its objectivity in the confirmation of the fact from anyone's perspective.

Thus, tax proof documents serve the purpose of responding to questions using the documents in the case of examination on the facts of the transaction.

2) Types of Tax Proof Data and its Administration

Proof data as tax evidence refers to reports of series of accounting steps from recording the enterprise's management activities and reports of individual economic transactions to management results and financial conditions.

(Classification of Accounting Documents as Tax Proof Data)

- Journal and entry vouchers
- Trial balance sheet, monthly profit and loss summary
- Book closing settlement table, book closing journal voucher
- Supplemental ledger, various account supplemental register
- General ledger, specified itemized edger
- Closing financial statements, calculation documents
- Voucher file

- Deposit passbooks, note collection register
- Demand deposit reconciliation table, balance certificate
- Agreements and other proof data

These data are documents in addition to being required relating to tax returns but also essential for performance of the enterprise's accounting responsibilities • fiduciary management responsibilities and for the protection of creditors • shareholders and the Commercial Code and other laws and regulations should make express the obligation to maintain such documents.

In tax examinations, will include “legal books” prepared under the accounting responsibilities • reporting obligations, calculation documents as evidential data to determine the tax base for the tax return as primary target for the examination. The specific method for the tax examination will require the verification of the veracity of the reported amount and confirmation of appropriateness of the application from a tax law perspective and for this purpose, an implementation of a confirmation examination on the data proving the facts of the computation.

Examination of whether the sums that have been calculated are based on the facts of the transaction will be performed on voucher documents for transactions, which are external proof data.

(Classification of “Voucher Documents” that would be tax proof data)

- * Monetary transaction data – receipts, accountable receipt, remittance slip, payment * certificate, etc
- * Merchandise transaction data – delivery slip, accountable receipt, instructions, packing slip, etc/
- * Personal transaction data – Wage / compensation calculation skip, withholdings related documents
- * Financial transaction data – passbook, certificates, receipt, reconciliation table, balance table, etc
- * Contractual transaction data – agreement, contract, deed, guarantees, etc.

These voucher documents play an extremely important role in tax examinations and of there are errors, deficiencies or fraud in these documents, corrections will certainly be required and for items that related to the reported income requirement for amendment or correction will arise.

Therefore, these data are classified into the above classifications and such data must be collected with the awareness of the purposes for their need as proof data. It will also be necessary to check where specific proof requirements are found such

as the notation of items that coincide with the objectives.

C. Checking and Administration of Tax Proof Data

Receipt of vouchers increases with the increase in the daily transaction volume and its volume • numbers will be become a large number. As these are items that are handled on a daily basis and often are issued • received during busy times and the checking of the details are often not adequately performed.

In the accounting section of enterprises that are the ultimate administrator of the vouchers may make checkings from the point of view of control of internal frauds but in many cases checkings from a tax point of view are not often performed. As a result, it is not rare that during examinations of vouchers in tax examinations that an unexpected issues arise.

Thus, in order to effectively utilize vouchers as tax proof data, it is necessary to perform checkings from a tax point of view.

The most important areas to check in vouchers for “monetary transactions” are as follows:

- * Expenditure corresponding to employee fraud • executive household expenses
- * Is there deficiency or erroneous recording in required items for completion
- * For vouchers that are of low reliability by checking by the preparer, has there been supplementing measures
- * Is there suspicion of diversion • alteration • counterfeiting
- * Is it from counterparty that may have colluded in its preparation
- * Is the addressee correct and is there any points of doubt in the entry methods
- * Does the date match the accounting treatment date
- * Is there any improprieties in the issuer’s address • name • telephone numbers
- * Is the type and method of stamp / signature proper
- * Is the form used reliable, is there propriety in the age and issuing number
- * Is the posting of the revenue stamp and the postmark proper
- * Check on reasons if form used is other than the specified form
- * For vouchers that are sent after the processing date, are the reasons proper and has it been replaced
- * Continuously check on the numbering

The above are checkpoints from the point of view of tax examinations but if proper accounting procedures are followed, these will be items that would have naturally been checked. However, in the daily accounting practice these items do not

necessarily receive adequate checking. Using this opportunity review of the examination and administration are needed. Further these properly administered vouchers will be enhanced in order to function as tax proof data that possesses primary proving powers. In addition, for these proof data, an orderly and clear sorting and administration of records in a way that it facilitates reference are needed.

D. Contents and Objectives of Explanatory Data

Explanatory data, in addition to supplementing the “proof data”, plays the role of site evidence for the facts of the transaction in ahead of proof data.

In a more concrete terms, it can be said to be a record book that incorporates data that provides explanations of documents that contain notes on transaction details including original records such as notebook type reports, approval forms, minutes.

Therefore, it is necessary to recognize that explanatory data are diverse and it is not typical or uniform and covers a wide range of items. Further, new data types brought about by the document revolution incorporating the advances made in scientific technologies are also included in this category.

Generally, accounting books and documents that substitute for account books and vouchers are referred to as tax evidential data, but from the factors cited below, the importance of explanatory data can be appreciated.

- * Existence of concept of legal uncertainty or marginality
- * Transactions are complex and diverse
- * Often vouchers alone cannot explain the realities of the transactions
- * There are cases that are unavoidable in commercial transactions that vouchers cannot be obtained
- * For internal transactions, data are needed to show the necessity and objectivity and clarify the propriety of the treatment
- * Data are required to actively formulate practical criteria for tax accounting treatment and through continuity in application establish it as criteria for certification of the fact
- * If facts of the transaction arises, the proof data can be obtained but if circumstantial evidence prior to the transaction can be had, it would be evidence of the necessity for the transaction
- * Data for business activities that do not require accounting treatment are also needed in tax examinations
- * As tax examinations are ex post facto examinations, explanatory documents that

provide information regarding that period may become necessary

- * If there are checking documents that acts as internal controls, it will serve as explanatory data as is

Therefore, for also the taxpayer, in managing the enterprise, managing personal assets the significance of preparing “explanatory data” as a proof of the facts underlying these acts, its justification and at the same time as preventative measure against unfavorable tax treatment is significant. Further, a point that must be kept in mind regarding explanatory data is not only procuring the data but it is necessary to make efforts to bring out the explanatory function of the data.

By such efforts, the explanatory data can be transformed from a simple internal document to an objective data bringing about its effectiveness as explanatory data. Of the doubts raised in tax examinations, existence of explanatory data that can supplement portions that cannot be explained by the proof data will form, on the examining authority side, “impression” of “possibility of proof” and promote the progress of the examination and enhance the probability of approval of the filing and this should be

5.2. Examination Based on Estimation for Enterprises that Have no Books or Those Whose Accounting Records are Inadequate (Estimate Examination)

(1) General Remarks

It goes without saying that for an accurate grasp of the tax base accurate books and posting are absolute necessities but the reality is that there are hardly any enterprises and individual taxpayers that are maintaining records that have any semblance to bookkeeping records. Given this situation, the target population for the tax examination by the tax offices is within this category. Even if sales and purchase journals are kept perchance, it is not possible to make scientific examinations using tools of management analysis and the difficulty encountered in tax examination is not difficult to imagine.

However, with that being said, simply due to the fact that bookkeeping records do not exist an examination is not performed and taxation by estimation without any foundation or tax on an arbitrary or compromising way are outside of permissible actions by a tax staff.

However, despite the difficulties involved, it is not impossible. It may be difficult quantitatively to create something out of nothing but if a fact exists that a party is

engaged in business there will be stores, there will be employees and there will be business Counterparties. The operator is making a living by engaging in the business. Even if it is difficult to grasp the actual amount of the transactions or income straight from the bookkeeping records, by making observations on the store layout, physical conditions, amount of merchandise, customer traffic, the level of living, the number of employees can all be easily grasped by making a visit to the premises. Once these facts are known, make a close examination of these items one by one and by seeking answers to what is the transaction value? What is the profit rate? What is the cost of selling? Then what is the differential or profit? The pieces of the puzzle of the causal relationships will come together and be able to uncover the “real income”. When undertaking this type of estimation examination, utilize tools for company analysis, management ratio analysis and efficiency analysis for example, the estimation of transaction amount from the current inventory and the turnover ration, or from the efficiency of personnel expenses estimating the sales amount or using standard profitability ratio, estimate the profit and by criss-crossing using these ratio analysis there are many ways to estimate the income.

Examination to estimate the basics of transaction value or income amount by such external based assessment method is referred commonly to as “on-the-spot examination” or “status examination”, and depending upon the degree of precision of such examinations, “accurate income” with some degree of certainty can be achieved. Obviously, this examination method, compared with actual examination based on a set of books, lacks the precision, but if this is conducted with precision and scientifically, certain degree of accuracy can be maintained and can potentially have the power to prove. In a situation where actual examinations cannot be performed on the bulk of the small and medium sized enterprises, there is but no other alternative than rely on this methodology and it is an extremely effective examination method to estimate the enterprise size based on externalities. The point is how such an estimation method can be made scientific and rational and much is expected of the skills of the person performing the examination.

(2)Method of Estimating Income

The method of estimating income must be the most reasonably appropriate method selected from among many that are possible based on the taxpayer’s business, facts identified during the course of the examination, and data relating to the business. Below we have attempted to outline methods that could be generally considered.

When displaying the method of estimation of income, the method of computation of

the business profit (Editor’s Note: in Japan this is generally referred to as “Business Profit”) must be made clear as a precondition, and the terminology used in the estimation needs to be made consistent. Thus, after a discussion of the formula and definition of terminology and classifying the estimation methods, detailed discussions on specific estimation methods will be made.

1) Formula for the Calculation of Gross Income and Business Profits

$$\begin{aligned} \text{Sales (Revenue)} - \text{Cost of Goods Sold (Cost of Procurement)} &= \text{Gross Income (‘‘gross profit’’ in Japan)} \\ \text{Gross Income} - \text{General Expenses} &= \text{Business Profit (‘‘income’’ in Japan)} \end{aligned}$$

[N.B.]

General expenses are expenses (e.g., personnel expenses, rents and cost of consumables) that are authorized by Law as expenses, in addition to the Cost of Goods Sold (hereinafter “CGS”).

2) Definition of Terminology

“Cost of Goods Ratio” is the proportion of the CGS in the Sales.

$$\text{<Formula>Cost of Goods Sold Ratio} = \text{CGS} \div \text{Sales}$$

“Gross Income Ratio” means the proportion of Gross Income to Sales.

$$\text{<Formula>Gross Income Ratio} = \text{Gross Income} \div \text{Sales}$$

“General Expense Ratio” means the proportion of General Expenses to Sales

$$\text{<Formula>General Expense Ratio} = \text{General Expenses} \div \text{Sales}$$

“Expense Ratio” means the proportion of the sum of CGS and General Expenses to the Sales.

$$\text{<Formula>Expense Ratio} = (\text{CGS} + \text{General Expenses}) \div \text{Sales}$$

“Business Profit Ratio” means the proportion of Business Profits to Sales.

$$\text{<Formula> Business Profit Ratio} = \text{Business Profit} \div \text{Sales}$$

3) Classification of Estimation Methods

A. Ratio Method

Estimation Method using the Ratio Method is a method for estimation

Business profits or the basis of its calculation, sales, CGS and others by the application of specified ratios to the amounts of revenues and expenses, production, sales of the taxpayer. The followings are four major types:

Peer Standards (editor’s note: “Peer Ratio” in Japan)

The peer standards is a method of estimating business profit by selecting a number of companies in the same business (as many as possible would be preferable but a minimum of 2 to 3 if the number of similar business is limited) that share similarities in terms of characteristics such as the format and scale of the business and location (“similar peer”). The next step is calculating the average CGS Ratio, gross income ratio, expense ratio, business profit ratio and sales per employee of the similar peers (these are referred to as the “peer standards”, and the ratios referred to respectively as “CGS Standard”, “gross income standard”, “expense standard”, “business profit standard”, “per employee sales standard”, etc.) and applying such standards.

[N.B.]

This methodology is used when either sales (including sales estimated using efficiency method described below), CGS or general expenses of the taxpayer is known (in such case sales, CGS, or general expenses that used as the base data for the estimation is referred to as the “basis for the estimation”). Furthermore, it has objectivity and the resulting estimate is considered to approximate actual income, which shall facilitate acceptance by the taxpayer. This is Method 2.3 (1) outlined in the Director General directive “Rules Relating to Presumptive Taxation”.

If a self-employed taxpayer wishes to use incorporated enterprises as similar peers in estimating income, the differences between individual and corporate income in calculation methods must be considered and the following formula, which converts corporate income to an individual income base, must be applied:

Equivalent Individual Income = pretax corporate income + (compensation paid to directors and, of employee wages, amounts paid to the representative and his family included in operating expenses) + (of interest paid and rents paid included in the expenses, amounts paid to representative and his family) – (of the amounts included in profit amounts income received from the representative and his family such as rent income, interest on loans, etc.)

【Formula for the Estimation Method using Peer Standards】

- (a) If sales of the examined entity is used as the basis of the examination:
sales × similar peer’s business profit standard = business profit

- (b) If CGS of the examined entity is used as the basis for the estimation:

$CGS \div \text{similar peer's CGS standard} = \text{sales}$

$\text{sales} \times \text{similar peer's business profit standard} = \text{business profit}$

(c) If general expenses of the examined entity is used as the basis of the estimation:

$\text{general expenses} \div \text{similar peer's general expense standard} = \text{sales}$

$\text{sales} \times \text{similar peer's business profit standard} = \text{business profit}$

Own Ratios

The estimation methodology using own ratios estimates the business profits, etc. by calculating and applying the average CGS ratio, gross income ratio, expense ratio, business profit ratio, sales per employee from:

(a) business performance or record for a specified period of time,

(b) partial records and data,

(c) records or examination results, etc, from the previous year or past years and, ratio of omissions from the records (results are referred to as “own ratios”).

[N.B.]

This is applied when the taxpayer's bookkeeping records or transaction documents for the tax year in question or for past years is incomplete but usable. However, records of past years can be only used if there have been no material changes in business conditions or format since the time of the past records. Own ratios have a higher level of similarity than similar peers and it is a reasonable method.

【Formula for the Estimation Method using Own Ratios】

If the estimation is based on the prior year's business results (base quantity (numerical value) for water usage fees, power usage fees):

$(\text{prior year's revenues} \div \text{prior year's base quantity (numerical value)}) \times (\text{basic quantity (numerical value) of the year in question}) = \text{year's revenues}$

Example:

$\text{prior year's income } 10,000,000 \text{ Tg.} \div \text{prior year's water usage } 400 \text{ liters} \times \text{year's water usage } 500 \text{ liters} = \text{year's revenue of } 12,500 \text{ Tg}$

If bookkeeping records for a specified period are used:

a. $(\text{sales during a specified period of the examined entity}) \times (\text{ratio of Sales of a$

similar peer during the same specified period to annual sales) = sales for the year for the examined entity.

Example:

(sales of 4,000,000 Tg representing the examined entity's sales from January through April) \times 12,000/3,000 (ratio of similar peer's sales from January through April which was 3,000 compared to its annual sales 12,000 Tg) = 16,000,000 Tg examined entity's sales for the year

b. (sales during a specified period of the examined entity) \times (ratio of annual procurements (consumption) to the procurement (consumption) of the examined entity's principal product (expense) during a specific period) = sales for the year of the examined entity

[N.B.]

This formula is used when the sales for the examined entity can be determined only for a specific period but annual procurement of principal products can be determined.

Example:

5,000,000 Tg examined entity's sales from January through April
 \times 3000/1000 (ratio of examined entity's annual procurement of its principal product of 3,000,000 Tg to 1,000,000 Tg representing procurement of the principal product for this period)
= 15,000,000 Tg the examined entity's sales for the year

Examination Ratio

This is an estimation method that uses examination ratios to estimate business profit based on the results of field surveys of all business peers located within the jurisdiction of the tax office by calculating the average business profit standards and applying the business profit standard.

[N.B.]

This method attempts to estimate income by using the average values of multiple taxpayers while the ratio method attempts to approximate actual income as precisely as possible. The tax office would need to compile data relating to the average value of the peers that are targeted in the examinations.

Example:

In the tax jurisdiction of S tax office, the ratio of business profits to sales for all restaurant operators examined in 1999 averaged (business profit standard) 40%. If the year's sales for R, the examined entity, were 30,000,000Tg., the year's business profits would be $30,000,000 \text{ Tg.} \times 40\% = 12,000,000 \text{ Tg.}$

Average Ratio

This is an estimation method that uses average ratio to estimate business profit (business profit standard) using a ratio that has been derived by taking average business profit ratios, that have been purged of abnormal values, based on examination results from a significant number of cases to which actual amount taxation has been applied (not limited to the examination results from the jurisdictional area of the tax office but from all tax offices in the country)(this ratio is referred to as "average ratio").

[N.B.]

The average ratio method is based on the same basic approach as the examination ratio method. While the examination ratio method limits the subject area of the business profit standard to the jurisdictional area, the average ratio method takes entire country as the subject area. Therefore, the examination ratio takes the regional peculiarities into account, enabling it thereby to provide a figure that more closely approximates the actual income than estimation using the average ratio. The average ratio is prepared at GGNP level based on tax examination results of all classifications of business; however, as a non-disclosed data, it would be appropriate to use it as an indicative level of business profit standards when conducting income examinations.

B. Per-Unit Method (Per Unit Value Method)

With the estimation method using the per-unit method, indices of business activity or business scale data, for example sales (revenues) per unit of sales volume, raw material unit volumes, number of employees, equipment, power and water are calculated when the taxpayer's sales, procurement account, etc., are unknown. Based on this data, the sales (revenues), CGS, business profits etc are estimated. In this case, it is used in tandem with the ratio method.

[N.B.] For specific examples see 2.5.4 1) below.

C. Asset and Liability Fluctuation Method (Net Asset Comparison Method)

Instead of utilizing the profit and loss calculation method of revenues and expenses,

the estimation method using asset and liability fluctuation uses net fluctuations in net assets, or the balance sheet method [(end of period assets – beginning of period assets) – (end of period liabilities – beginning of period liabilities) + consumption (living expenses etc.) – non-operating income = business profit] to directly estimate the business profit. It can be considered a reasonable methodology since the resultant business profit coincides with the business profit derived from profit and loss calculation based on the principle of double entry bookkeeping.

[N.B.]

This method of estimation assumes that the amount calculated by deducting income derived from non-business sources from the sum total of the increase in net assets and household expenses, such as living expenses, is income derived from business without the need to know anything at all about operating revenues and expenses. The difficulty with this methodology is whether or not it is possible to precisely ascertain all assets and liabilities at both the beginning and at the end of the term.

D. Consumption Method

This method, which should probably be considered a variation of the asset and liability fluctuation method, and estimates income from the taxpayer's living expenses and other consumption expenditures.

[N.B.]

This method is based on the assumption that, if there is no change in the asset or liability and there is no inflow from sources other than business, there must be at least sufficient business income to apportion amounts to living expenses and other consumption expenditures.

(3) Estimation Method by Case Studies

Estimation of Sales (Revenues) by the Per-Unit Method

If there are no accounting books or original business records, it will be necessary to determine sales, procurement and general expenses by means of interviews with the taxpayer and employees, confirmation of the product volume and prices on the premises and checking with clients or suppliers; in many cases, however, it is difficult to accurately ascertain values for all items. This is especially true when all sales, procurement and general expense items are transacted in cash. In such cases, one effective method would be to calculate business activity indices and business scale

data, or formal factors (“efficient factors”), such as per unit revenues of the taxpayers or a similar peer (“efficiency coefficients”) and estimate revenues or business profit based on efficiency coefficients.

In using this methodology, the efficiency factor must fulfill the following conditions:

- (a) here must be a correlation exists with the value to be estimated and they must have a proportional relationship,
- (b) it must be a major component in ascertaining the taxpayer’s revenues,
- (c) it must be accurately ascertained, and
- (d) it must be possible to collect the same item from similar peers.

Thus, it is important to select the efficient factors that most closely conform to the business and business format and, at the time of the examination, the business conditions and equipment capacity of the taxpayer must be ascertained accurately and concretely.

1) Types of Estimation Methodologies using Per-Unit Method

The following are some types of estimation methodologies using the per-unit method:

- (a) Estimation using the usage volume of raw materials
- (b) Estimation from the volume of usage of consumables
- (c) Estimation from the volume of consumption of electricity, water and fuels such as gasoline
- (d) Estimation based on size indicators such as number of employees and equipment
- (e) Estimation based on operating days and etc.

2) Efficient Factors and Efficiency Coefficients

The Table 2 outlines the efficient factors and efficiency coefficients thought to be reasonable for principal types of business.

Table 2 Efficient Factors and Efficiency Coefficients

Business Classification	Efficient Items	Indication of Efficiency Coefficient
Merchandise retailers	Number of employees	Revenue per employee
	Retail floor space	Revenue per 1 square meter of retail floor space
	Number of operating days	Revenue per operating day
	Inventory	Revenue per 10,000 Tg. of inventory
Eating and drinking establishments (continued)	Number of employees	Revenue per employee
	Amount of liquor procured	Revenue per 10,000 Tg. of liquor procured
	Number of tables and chairs	Revenue per chair (table)
Eating and drinking establishments	Number of guest rooms	Revenue per guest room
	Consumption of electricity and water	Revenue per 1 unit of electricity and water consumed
Wholesalers	Number of employees	Revenue per employee
	Number of operating days	Revenue per operating day
	Inventory	Revenue per 10,000 Tg of inventory
	Packing and freight charges	Revenue per 10,000 Tg of packing and freight charges
Manufacturers	Number of employees	Revenue per employee
	Consumption of electricity and water	Revenue per 1 unit of electricity and water consumed
	Machinery and equipment	Revenue per 1 machinery and equipment
	Materials expenses	Revenue per 10,000 Tg of materials consumed
	Contracting expenses	Revenue per 10,000 Tg of contract expenses
Transportation	Number of employees	Revenue per employee
	Number of vehicles	Revenue per vehicle
Coffee shops and tea salons	Consumption of coffee beans	Revenue per kg. of coffee beans consumed
Automotive Service and Repair	Number of vehicles tested	Revenue per vehicle examined
Beauty parlors and barber shops	Materials used	Revenue per 10,000 Tg of materials consumed
	Consumption of electricity	Revenue per 1 unit of electricity
	Number of chairs	Revenue per chair

3) Formulae for Per-Unit Method

A. Estimating revenue using machinery, equipment and etc.

a. Per chair : e.g. bars, saloons, barber shops, beauty parlors, etc.

$$\begin{aligned} & (\text{similar peer's average revenue per chair}) \times (\text{examined entity's number of chairs}) \\ & = \text{revenue} \end{aligned}$$

Example:

Similar peer for a barbershop has an average revenue per chair of 500,000 Tg × examined entity operates 2 chairs = revenues of 1,000,000 Tg

b. Per machine: e.g., printing, etc.

$$\begin{aligned} & (\text{similar peer's revenue per machine}) \times (\text{examined entity's number of machines} \\ & \text{owned}) = \text{revenue} \end{aligned}$$

Example:

The similar peer of a printer has an average revenue per machine of 1,000,000 Tg × examined entity owns 2 machines = revenues of 2,000,000 Tg

c. Revenue per employee: e.g., bars, saloons, barbershops, beauty parlors, etc.

- $(\text{similar peer's revenue}) \div (\text{similar peer's number of employees}) = \text{similar peer's average revenue per employee}$
- $(\text{similar peer's average revenue per employee}) \times (\text{examined entity's number of employees}) = \text{revenue}$

Example:

- Saloon's similar peer's revenue 2,100,000 Tg ÷ similar peer's number of employees 3 = similar peer's average revenue per employee 700,000 Tg
- Similar peer's average revenue per employee of 700,000 Tg × examined entity's number of employees 2 = revenue 1,400,000 Tg

B. Estimating Revenue from Procurement (Consumed volume)

The consumed volume of the principal materials is first ascertained.

a. Eating and drinking establishment, sellers of goods, manufacturers

$$\begin{aligned} & (\text{examined entity's procurement of principal materials}) \div (1 - \text{similar peer's ratio} \\ & \text{of procurement of principal materials to revenue}) = \text{revenue} \end{aligned}$$

Example:

Examined entity's procurement of principal materials 30,000,000 Tg ÷ (1 – similar peer's ratio of procurement of principal materials to revenue 40%) = revenue 50,000,000 Tg

b. Bread Bakeries

(number of bags of flour purchased in a year) × (number of loaves per bag of flour)
= annual production volume of bread

(annual production volume of bread) × (average price per loaf of bread) = revenue

Example:

Number of bags of flour purchased in a year 30 × average of 100 loaves of bread per bag of flour = annual production of bread 3000 loaves

Annual production volume of bread 3,000 loaves × average price of 100 Tg per loaf = annual revenue 300,000 Tg

c. Bar Operators

(Number of bottles of beer purchased in a year) × (similar peer's average revenue per bottle of beer) = annual revenue

Example:

Examined entity's annual purchase of beers of 3,000 bottles × similar peer's revenues per bottle of beer 5,000 Tg = annual revenue 15,000,000 Tg

C. Estimating Revenue from General Expenses (Consumed Volume)

a. Estimating revenues from consumption of electricity: e.g., cleaners

(similar peer's annual revenue) ÷ (similar peer's electricity consumption) × (examined entity's electricity consumption) = annual revenue

Example:

Similar peer's annual revenue of 25,000,000 Tg ÷ similar peer's annual electricity consumption 1,000 KWH × examined entity's electricity consumption of electricity 900 KWH = annual revenue 22,500,000 Tg

b. Water Usage ; e.g., public bath-houses, saunas

(Similar peer's average bath usage revenue per unit of water consumption) × (examined entity's water consumption) = annual bath usage revenue

Example:

Similar peer's average bath usage revenue per 1 kiloliter of water consumed 300 Tg × examined entity's consumption of water 30,000 liters = revenues from bath usage

9,000,000 Tg

c. Gasoline Consumption :e.g., transportation

(Examined entity's annual expenditures for gasoline) \times (similar peer's transportation revenue per 1 kiloliter of gasoline \div similar peer's expenditures per 1 kiloliter of gasoline)

= annual transportation revenue

Example:

Examined entity's annual gasoline expenditure of 1,000,000 Tg \times similar peer's transportation revenue per kiloliter gasoline expenditure 30,000 Tg \div similar peer's average per kiloliter gasoline expenditure 15,000 Tg = annual transportation revenue 2,000,000 Tg

- (Similar peer's average revenue per unit of gasoline consumed) \times (examined entity's volume of gasoline consumption) = revenue

Example:

Similar peer's average revenue per 1 kiloliter of gasoline consumed 30,000 Tg \times examined entity's volume of gasoline consumption 70,000 kiloliters = revenue 2,100,000 Tg

d. Number of Polyethylene Bags Used :e.g., cleaners

- Total X polyethylene bags purchased \times revenues per X bag + total Y polyethylene bags purchased \times revenue per Y polyethylene bag + total Z polyethylene bags purchased \times revenue per Z polyethylene bag = revenue

[N.B.]

The classification of X, Y and Z polyethylene bags indicates differences in size and quality of the polyethylene bags used for different types of apparel each with a different cleaning charge.

e. Number of Packaging Cellophane Bags Used :e.g., socks finishing

- Number of cellophane bags used \times finishing revenue per pair of socks = revenue

D.Estimation from Number of Operating Days

a. Fortune tellers

Monthly fortune telling clients (actual figure) \times average fortune telling charge per customer (actual figure) \times 12 months (operating months) = annual revenue

b. Shoe repairs

Repair revenue per day (actual figure) × annual operating days = annual revenue

c. Bars

Revenue per day (actual figure) × annual operating days = annual revenue

d. Grocery stores

Sales during a specified period (actual figure) ÷ operating hours during the specified period × operating hours per day × annual operating days = annual sales

[N.B.]

When making estimations using operating days, estimate of per day or per month headcount and monetary amounts will be considered reasonable if they represent a general average value throughout the year; however, this method is prone to produce a variance in the estimate results, and, therefore, should be used only when other appropriate estimation methods cannot be applied.

Estimation Business Profit by Peer Standard

In estimating the business profit using peer standard, if either sales (revenue), CGS (cost of procurement) or general expenses or if a major cost component of CGS or major component of general expenses can be ascertained, the business profit is estimated by applying CGS standard, general expense standard, business profit standard, etc., using the ascertained value as the basis of the estimation. The basic thinking behind the estimation and the method of calculation is explained below, using the example of a bar operation and hypothetical values.

[Case Study]

The examined entity “X” operates a bar in a busy section of the city.

It was found upon visiting the bar that no bookkeeping records relating to business revenues and expenses were recorded or retained. With no other alternatives, interviews with the owner and onsite confirmation were conducted during night-time operations and it was confirmed that there were three employees in addition to the owner who tended to the customers.

In following up with the owner, it was found that beer, wine, vodka and other liquor was purchased in cash from Store “Y” nearby and, upon checking with Y, Y had fortunately kept a record of sales made to X and confirmed that liquor procurements totaled 2,100,000 Tg. The procurement of snacks and hor d’oeuvres was unclear since the owner stated that he purchased them from vendors that came to the bar directly and he was not aware of their names or addresses; therefore, the precise figures were not ascertainable.

In order to estimate the business profit from comparison with similar peers, the examiner selected three entities A, B, and C in the tax office jurisdiction that were generally similar to in business scale, employee number and location. Of the similar peers, the figures used for A were first adjusted as the result of an examination to the reported amount and the reported amounts for B and C were also rather small but not thought to be out of the ordinary; thus, were adopted for the estimation.

The breakdown of business profits and the CGS Ratio are shown in the Table 2-2.

Table 3 Calculation Table of Business Profit

(Unit: 1,000 Tg)

Similar peer Classification		A	B	C
Sales		18,000	16,000	10,000
② Cost of Goods Sold	Procurement of liquor	2,700	2,300	1,800
	Proportion of liquor to sales (÷)	0.15	0.14	0.18
	Procurement of snacks and hors d'oeuvres	600	400	300
	Total (+)	3,300	2,700	2,100
	CGS ratio (÷)	0.18 5,500	0.17 4,600	0.21 3,500
Gross income (-)		14,700	13,300	7,900
Gross income ratio (÷)		0.82	0.83	0.79
⑦ General Expenses	Personnel expenses Proportion of personnel expenses to sales (÷)	5,500 0.31	4,600 0.29	3,500 0.35
	Other expenses	900	700	500
	Total (+)	6,400	5,300	4,000
	General expense ratio (÷)	0.36	0.33	0.40
business profit (-)		8,300	8,000	3,900
Ratio of business profit to sales (÷)		0.46	0.50	0.39
Notes	Number of employees	4	3	3

- Liquor procurement standard (average proportion of liquor procurement in the sales of similar peers) = $\{(A) 0.15 + (B) 0.14 + (C) 0.18\} \div 3 = 0.16$
- Personnel expense standard (average proportion of personnel expenses to sales of similar peers) = $\{(A) 0.31 + (B) 0.29 + (C) 0.35\} \div 3 = 0.32$
- Business profit standard (average ratio of business profit to sales of similar peers) = $\{(A) 0.46 + (B) 0.50 + (C) 0.39\} \div 3 = 0.45$

Estimation using the proportion of liquor procurement to sales

- (Liquor procurement of examined entity X) 2,100,000 Tg ÷ (similar peer's liquor procurement standard) 0.16 = (X's sales) 13,125,000 Tg
- (X's sales) 13,125,000 Tg. × (similar peer's business profit standard) 0.45
= (X's business profit) 5,906,000 Tg

If the liquor procurement cannot be ascertained but only the personnel expenses of 4,300,000 Tg can be ascertained.

- (Examined entity X's personnel expenses) 4,300,000 Tg ÷ (similar peer's personnel expense standard) 0.32 = (X's Sales) 13,437,000 Tg
- (X's sales) 13,437,000 Tg × (similar peer's business profit standard) 0.45 = (X's business profit) 6,046,000 Tg

[N.B.]

Estimation using liquor procurement and personnel expenses as the basis for the estimation is allowable when a correlation is deemed to exist with sales.

Estimating Business Profit Using Asset and Liability Fluctuation Methods

As it has been pointed out, asset and liability fluctuation method is not based on revenues and expenses but is a balance sheet method that uses fluctuations in the value of net assets [(end of period assets – beginning of the period assets) – (end of period liabilities – beginning of period liabilities) + consumption expenditures (living expenses etc.) – revenues from sources other than business = business profit] . Thus, in order to make estimations using this method, the accurate value of asset and liability items must be ascertained. The procedure for estimation using this method is explained below.

1) Ascertaining Net Assets

The balances of asset and liability items at the beginning and end of the period are accurately ascertained for the year subject to the examination. In this case, care must be taken to assure that, if there has been an increase in an asset item, there is also an offsetting decrease in cash/deposits or an increase in a liability item. If there has been an increase in a liability item, it is necessary to check to see if there is an increase in an asset item acquired by the proceeds

A. Common Items

Accurately ascertaining the values of assets and liabilities items through taxpayer's financial statements, tax returns and interviews.

The beginning and end of the period can be treated as the same value in the case of items that are deemed to have been unchanged between the years such as Cash, Inventory, Merchandise, etc.

B. Deposits

Deposit amounts should be ascertained through examinations with financial institutions. In this case, deposits in the name of family members are also added as the basis for the calculation of income, but though it is necessary to confirm that family members do not have other sources of income such as wages since, if such exists, it would not be added to business profit and should be deducted. If there is a reduction in the balance of deposits, it is confirmed whether or not an asset was acquired with the proceeds.

C. Accounts Receivable, Accrued Receipts etc.

Accounts Receivable values should be ascertained by checking with customers

D. Building and Auxiliary Equipment

Acquisition Costs including construction costs and acquisition expenses are ascertained. Adjustments for depreciation should be made through the liability account accumulated depreciation

E. Vehicular Transport Equipment, Tools and Accessories

Acquisition prices are ascertained by acquisition expenses. Adjustments for depreciation should be made through the liability account accumulated depreciation.

F. Account Payables, Accrued payments etc.

Accounts payable should be ascertained accurately by checking with suppliers.

G. Borrowings

Borrowings should be confirmed with financial institutions. It is necessary in this case to confirm whether the borrowing is for business or personal use. If there has been an increase in borrowings, it is necessary to check to see whether other assets have been purchased using the proceeds.

H. Accumulated Depreciation

Accumulated depreciation is calculated by adding the year's depreciation expenses to the outstanding balance as of the period end in the prior year.

I. Changes in Net Assets

Changes in net assets are calculated by deducting the balance at the beginning of the period from that at the end of the period for each asset and liability item and subtracting the aggregate changes in net liabilities from the aggregate value of the changes in assets.

2) Ascertaining Consumption Expenditures (Living Expenses etc.) to be Incremented

It would be reasonable to assume that consumption expenditures (living expenses etc.) are made out of the revenues from the business. It would thus be necessary to add such amounts to net assets, when calculating business profits. The following are some examples of what would be considered consumption expenditures.

A. Living Expense

In regard to living expenses, if data such as standard household living expenses surveyed by region and by family size is available, it should be used; however, if no such data exists, aggregate groceries, clothing, furniture purchases, normal educational expenses, rents, ceremonial occasions, travel and other expenses would be ascertained through interviews with the taxpayer or his family, and annual living expenses would be estimated.

B. Incremental Amounts Other Than Living Expenses

Money expenditures for purposes other than living expenses and not classified as business expenses would include the following:

- Taxes such as income tax, regional taxes
- Repayment of household borrowings
- Large one-time expenditures such as university entrance fees, marriage expenses, overseas travel etc.

C. Ascertaining the Amount to be reduced as Non Business Revenues

Revenues from sources other than business are not included in the business profit calculations, and must be thus deducted from net assets. Non-business revenues may

include the following.

- Deposit interest
- Dividend income from stocks

Table 4 Calculation of Business Profit Using Asset and Liability Fluctuation Methods

(Unit: 1,000 Tg)

Item			Beginning of period value (January 1)	End of period value (December 31)	Change (-)
Assets	Cash	a	200	200	0
	Deposits	b	6,300	7,100	800
	Accounts receivable	c	1,000	1,000	0
	Inventory	d	3,000	3,000	0
	Buildings	e	6,000	6,000	0
	Equipment and motor vehicles	f	1,200	1,200	0
	Total	g	17,700	18,500	800
Liabilities	Accounts payable	h	420	650	230
	Borrowings	i	5,100	4,700	400
	Accumulated depreciation	j	2,518	2,761	243
Total		k	8,038	8,111	73

Value of net assets (g - k)		l	9,662	10,389	727
Addition	Living expenses	m			4,412
	Income tax	n			89
	Regional taxes	o			118
		p			
		q			
	Total	r			4,619
Deduction	Deposit interest	s			121
	Dividend income	t			0
	Total	u			121
Business profit (l + r - u)		v			5,225

Table 5 Presumptive Calculation of Depreciation

(Unit: 1,000 Tg)

Classification	Acquisition cost	Useful life	Depreciation expenses		
	Base value of depreciation	Ratio of depreciation using straight line method	Accumulated amount as of end of prior year ()	Current period depreciation expense ()	Accumulated depreciation expense (+)
Buildings	6,000	40years	2,160	135	2,295
	5,400	0.025			
Automobiles	1,200	10years	358	108	466
	1,080	0.100			
Total			2,518	243	2,761

[N.B.]

1. Since there are asset, liability and other items in addition to the above, they should be added as required.
2. If irregularities appear in annual business profits as a result of making estimations by the asset and liability fluctuation method but no changes have taken place in business conditions during the year, it may be due to the omission of some values, which will require a reexamination.

This method should be avoided if there are difficulties in ascertaining values, in which case it will be necessary to select another more appropriate estimation method to estimate business profit.