

Japan

Business Succession and M&A

"Business succession" means "the business is succeeded to the next generation". As most Japanese companies are family corporations and unlisted owner companies, "business succession" is perceived as "handing over unlisted company shares (the management right) to a successor (generally the owner's child)", and should be considered as a measure to avoid inheritance tax. It is not an exaggeration to say that tax accounts for a significant part of the Japanese economy. For example, as a result of hard work by employees, the profitability of a company can be improved, and then "corporate tax" is imposed on the company's profit and "income tax" is imposed on an employee as an individual. Also, consumptions made with the revenue trigger "consumption tax", and if one tries to leave assets to the next generation, those assets are subject to "inheritance tax". Out of all the taxes listed above, with "inheritance tax", it is not only monetary assets but also "treasury stocks" that cannot be turned into money and real estate that is valued at a fair market value at the maximum tax rate of 50% which are all subject to inheritance tax. Consequently, we cannot blame those who consider possibilities for saving tax in the case of such high-rated inheritance tax.

However, the basic concept of "business succession" means not only "handing over assets (treasury stocks and management right) to a successor" but also "handing over the business to the next generation". Thus, when we consider necessary measures for business succession, consideration should be given as to how to reduce inheritance tax and prepare the tax fund by taking into account human resources and business measures from an early stage. In this context, recently, the utilization of "M&A" has been increasingly observed as an effective measure to enhance corporate value and to develop it

continuously.

In this article, the basic concept of business succession and its measures are introduced and a further description is made concerning inheritance tax implications and the valuation of treasury stocks and measures thereof as well as the role that "M&A" plays in business succession measures and its effective use.

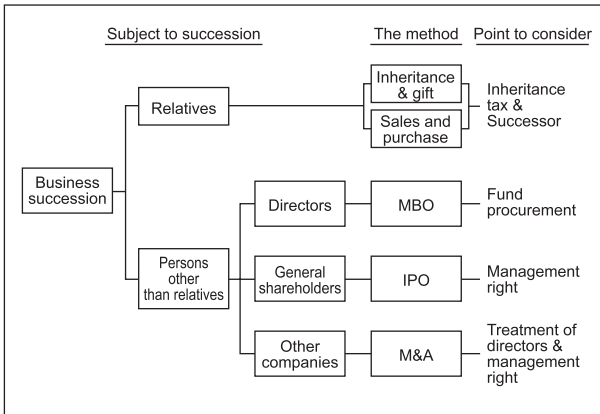
1. Business succession and its measures

(1) The definition of a business succession

A "business succession" is classified as a "succession of assets" as a narrow interpretation, and the "succession of a company" as a broad interpretation.

Classification	Definition	Subject to consider	Type	Key point
Asset succession (narrowly-interpreted)	Handing over assets (treasury stocks and management right) to the successor	Tax (tax saving)	Within a company	Transfer of treasury stocks to the successor with the minimum fund and tax payment
Company succession (broadly-Interpreted)	Handing over the business to the next generation	Business (management)	Other company involved	Utilization of M&A, MBO and IPO, etc.,

The chart below shows the subject to the succession and succession method.



(2) The definition of business succession measures

As described above, business succession measures are classified into "measures for the successor (human resources)", "measures for business (assets)" and "measures for inheritance tax (cash)".

(3) Issues to consider relating to business succession measures for tax saving purposes

It would be difficult for a company to continuously develop its business if it only focused on inheritance tax saving and left the corporate structure and assets (treasury stocks) as they were. In order to continuously develop business, a high management capability of the management personnel is required and such management must be supported by directors and employees.

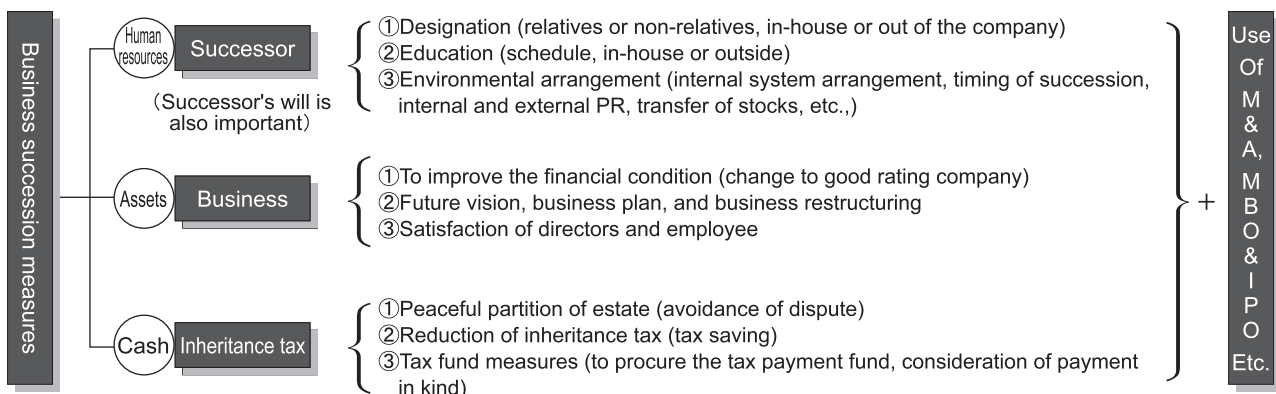
There might be cases where the financial condition of the company is weakened or worsened as a

result of giving priority to inheritance tax saving, i.e., with bankruptcy as the worst case scenario. For example, a typical case would be where real estate not necessary for current business is purchased using a loan to reduce the value of the treasury stocks or maybe where the establishment of a new company, a merger and acquisition or corporate division are carried out, even though they are unnecessary at the time.

It should also be noted that an excessive tax saving carries a significant tax risk. In the past, challenging tax saving measures have been prohibited or restricted under tax reform. In particular, there have been significant changes in the tax laws, such as the corporate reorganization taxation under the tax reform in 2000. Recently, as a result of the amendment of company law, the effect on tax issues and business succession taxation have been amended and issues have become more complicated, requiring more professional knowledge and careful consideration.

(4) Basic process of the business succession measures

With regards to the basic process of the business succession measures, the measures for the successor should be carefully considered by respecting the intentions of the successor candidate, and it is necessary to consider how to develop the "business" by taking into account the future treatment of directors and employees. The tax saving should then be implicated. Specifically, this would be concluded with the use of a loan to



enlarge business size and diversification, resulting in a tax saving.

What should be considered as most important is not for the mere tax saving, but the business development. In this context, it is important to become a good standing company in terms of a financial condition which will lead to good business succession measures (payment of retirement allowance, application of valuation method for treasury stocks and easy method for buy-out and IPO, etc.,).

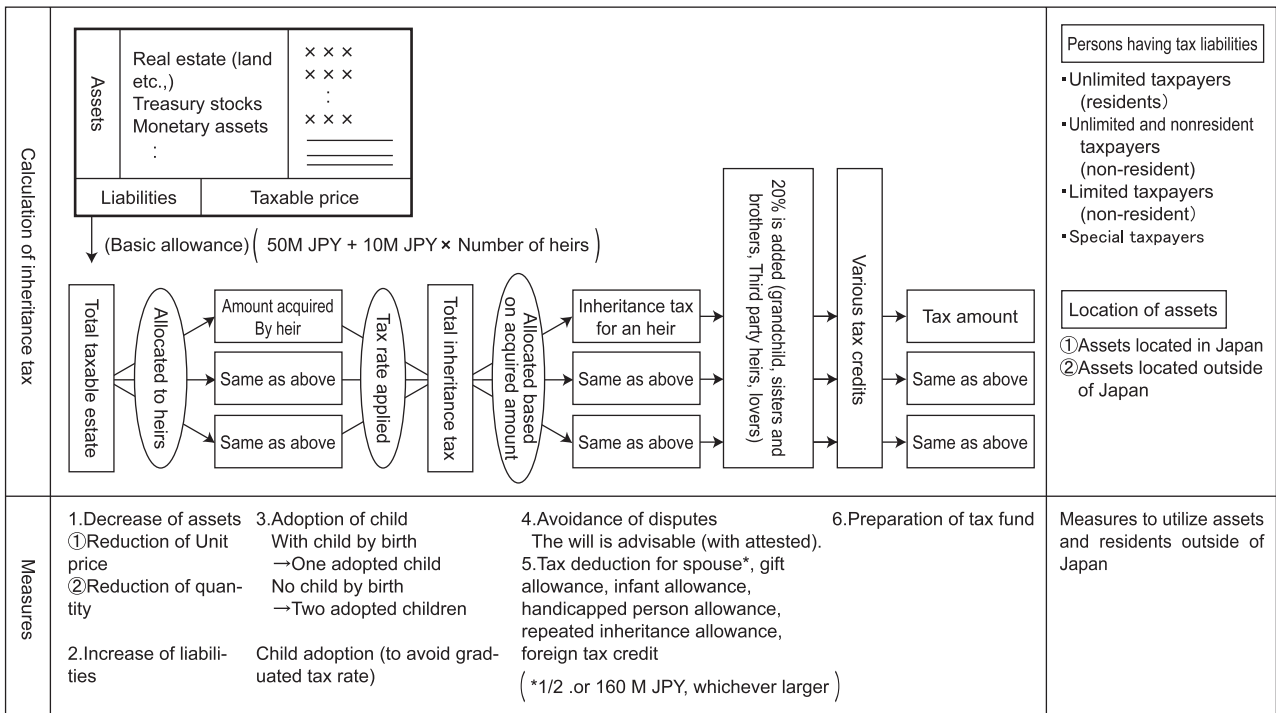
However, in principle, the value of the company stocks will be increased according to the improvement of the business performance of the company so that if inheritance occurs when a company owner holds most of the treasury stocks, such treasury stocks must be purchased back by the company to pay the inheritance tax, which usually a requires a significant amount. In order to avoid such a case, it is important to consider the transfer of the treasury stocks to the potential

successor when the value of the treasury stocks is small. In this sense, it is important to implement the business succession measures by taking into account the balance of the management and the tax saving measures.

2. Calculation of the inheritance tax and measures thereof

(1) Calculation of the inheritance tax and measures thereof

The calculation of the inheritance tax is made according to the formula below based on the valuation under the "Asset valuation basic circular" that is the basic rule of inheritance tax law.

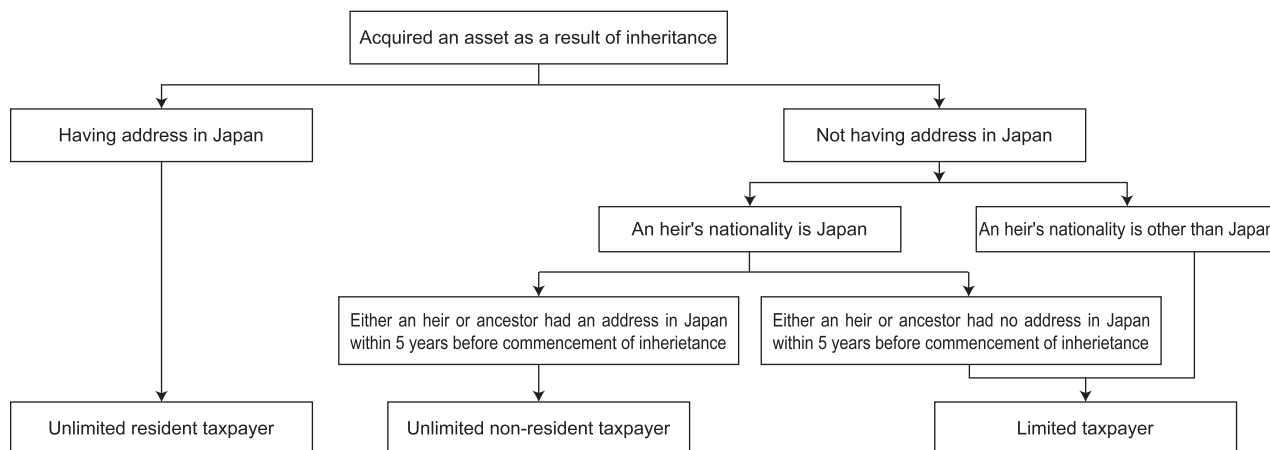


Note: As for the classification of the persons having tax liabilities, please refer to the chart below of "How to classify the persons having tax liabilities and scope of taxable assets".

How to classify the persons having tax liabilities and scope of taxable assets

Classification		Classification criteria			Scope of taxable asset
		Address at the time of acquisition of asset	Nationality	As to whether having the address in Japan within 5 years before commencement of inheritance	
1	Resident taxpayer without limitation	Domestic	All acceptable	-	Asset located in Japan and abroad
2	Non-resident taxpayer without limitation	Abroad	Japan	Either an heir or ancestor had an address in Japan within 5 years before commencement of inheritance	Asset located in Japan and abroad
3	Taxpayer with limitation	Abroad	Japan	Either an heir or ancestor has not had an address in Japan within 5 years before commencement of inheritance	Asset located in Japan
			Other than Japan	-	
4	Special taxpayer (Those other than 1 to 3 above and was subject to the inheritance settlement taxation)	-	-	-	Asset subject to the settlement taxation

Classification flowchart



(2) Chart for easy calculation of the inheritance tax and gift tax

Quick calculation of inheritance tax

The amount acquired by heirs	Tax rate	Tax deduction
10M JPY or less	10%	-
Over 10M JPY ~ 30M JPY or less	15%	0.5M JPY
Over 30M JPY ~ 50M JPY or less	20%	2M JPY
Over 50M JPY ~ 100M JPY or less	30%	7M JPY
Over 100M JPY ~ 300M JPY or less	40%	17M JPY
Over 300M JPY	50%	47M JPY

< Basic deduction for inheritance tax purposes >

50 M JPY + 10 M JPY × Number of heirs

Quick calculation of gift tax

Taxable amount after basic deduction (1.1 M JPY)	Tax rate	Tax deduction
2M JPY or less	10%	-
Over 2M JPY ~ 3M JPY or less	15%	0.1M JPY
Over 3M JPY ~ 4M JPY or less	20%	0.25M JPY
Over 4M JPY ~ 6M JPY or less	30%	0.65M JPY
Over 6M JPY ~ 10M JPY or less	40%	1.25M JPY
Over 10M JPY	50%	2.25M JPY

Inheritance settlement taxation

Flat rate of 20%

(3) Inheritance settlement taxation

Under the 2005 tax reform, the biggest amendment for inheritance tax purposes was an enactment of the "inheritance settlement taxation" which totally changed the relationship between inheritance tax and gift tax to expedite gifts before death. Merits and demerits of the inheritance settlement taxation are summarized below, which can be also utilized for business succession measures.

(1) An outline of inheritance settlement taxation and merits thereof

An outline of the inheritance settlement taxation	
Eligible person	The donor must be the parent aged 65 or more, and the donee must be the donor's children aged 20 or more (presumed heirs).
Subject assets	There is no limitation for types of assets and times of donations.
Gift tax	{Total gift value - 2.5 M JPY (Accumulated non-taxable amount)} × 20%
Inheritance tax	Inheritance tax on inherited asset and gift asset to which settlement taxation is applied - Gift tax already paid
Issues to note	Once the settlement taxation is elected, normal taxation on calendar year basis cannot be applied.



Merit of the inheritance settlement taxation

The value of gift assets to be included in the inherited assets is valued at the time of donation in lieu of the time of inheritance. Consequently, if it is certain that assets value will rise in future, it is possible to reduce the total amount of the inheritance tax.

(2) Comparison of taxation on calendar year basis and settlement taxation

Example

Gift assets are valued at 1,000 M JPY (unlisted shares. Market value at the time of donation)
 The value of unlisted share tripled at the time of inheritance.
 Inherited assets are valued at 100 M JPY other than in above.
 The number of heir is one child.

(Unit : Thousand JPY)

Tax calculation		On calendar year basis	Inheritance settlement taxation
Gift tax (A)		1 -	2 3 195,000
Inheritance tax	Unlisted shares ()	3,000,000	1,000,000
	Other inherited assets ()	100,000	100,000
	Taxable amount (+)	3,100,000	1,100,000
	Basic deduction	60,000	60,000
	Total inheritance tax	1,473,000	473,000
	Gift tax credit	-	195,000
	Tax to be paid (B)	1,473,000	278,000
Total tax to be paid (A + B)		1,473,000	473,000



- 1: All unlisted shares are subject to inheritance.
- 2: There is no gift other than shares.
- 3: Inheritance tax settlement calculation formula: (1,000,000 - 25,000) × 20%

Please note that if the share value decreases at the time of inheritance, this would be an adverse effect.

3. Valuation rule for unlisted shares

(1) Valuation method of unlisted shares

- Listed** ... Valued at the fair market value, in principle
- Unlisted shares** ... There is no rule to determine the valuation method other than those provided for inheritance and gift tax purposes (No objective valuation is feasible).



<Main valuation methods for unlisted shares>

Valuation basis	Specific method
Net asset basis	Net assets valued at market value (Liquidation value, Prevailing value), Net assets valued at book value etc.
Profit basis	DCF method, Capitalized value method, Dividend return method etc.
Comparable basis	Comparable company method, Comparable business line method, Transaction cases method, etc.



However, family corporations and family shareholders are subject to specific tax rule.

(2) Concept of unlisted shares

An outline of valuation for tax purposes

Tax	Inheritance tax	Income tax	Corporate tax
Purposes	Market value at the time of inheritance and gift	Market value at the fiscal year end for reporting valuation loss of shares held	Proper market value at the time of issuance of new shares
Calculation method	Based on valuation under Asset valuation basic circular	Buy and sell method Offered value method Comparable method Net asset value method Conditioned asset valuation method under the basic circular	Buy and sell method Offered value method Comparable method Net asset value method (Note)



(Note) In case where an individual transfer shares to a corporation with or without consideration, conditioned asset valuation method under the basic circular is allowed.

Thus, no rule to determine the direct value is provided for transactions (individuals and companies).



In practice, the asset valuation method under Asset valuation basic circular is applied in most cases.

(3) Valuation method of shares for inheritance tax purposes

Difference between listed shares and unlisted shares

A Listed shares

- Closing value at the date of inheritance and gift
 - Averaged closing value of the current month
 - Averaged closing value of the month prior to the current month
 - Averaged closing value of the two months prior to the current month
- } The lowest amount

B Unlisted shares

1. Basic valuation method (Valuation method of shares held by an owner)
 - Comparable method
 - Net asset value method
 - Combined method of and

} Determined by a company size, etc.,
2. Dividend return method (Valuation method of shares held by small number of shareholders)

(4) An outline of valuation methods provided under the Asset valuation basic circular

	Characteristics	Calculation formula
A	<p>· Comparable method in which shares value is determined based on dividend, profit (income) and net assets value at the book value (tax purposes) by taking into account the companies engaging with similar business.</p> <p>· While share value of companies conducting similar business can be reflected, this method is not feasible for companies without any comparables.</p>	<div style="border: 1px solid black; padding: 10px; margin-bottom: 10px;"> $\text{Share value of comparables} \times \frac{\frac{A}{A'} + \frac{B}{B'} \times 3 + \frac{C}{C'}}{5} \times \text{Referred ratio} = \frac{\text{Capital per share}}{50\text{JPY}}$ </div> <p>A, B, C: Dividend, profit, asset at the book value of valued company (50 JPY basis) A', B', C': Dividend, profit, asset at the book value of comparables (50 JPY basis) (Note) If the profit of the valued company is zero the denominator (5) will be 3. Referred ratios are 70% for large company, 60% for medium company and 50% for small company.</p>
B	<p>· Net assets value method in which the net assets value at the time of the valuation based on the net asset value at the market value is used.</p> <p>· The merit is that this method allows objective valuation. However, there is a demerit whereby future growth of the company cannot be taken into account.</p>	<div style="border: 1px solid black; padding: 10px; margin-bottom: 10px;"> $\frac{\text{Net asset value at the market value} - \text{Corporate tax on deemed profit (42\%)}}{\text{Total number of issued shares}}$ </div>
C	<p>· Dividend return method in which the dividend is discounted into the current value based on certain interest to determine the share value.</p> <p>· This method is appropriate for the valuation of shares that are held only by a small number of shareholders who do not participate the management directly and only receive the dividend.</p>	<div style="border: 1px solid black; padding: 10px; margin-bottom: 10px;"> $\frac{\text{Dividend per share on 50JPY basis (Note)}}{10\%} \times \frac{\text{Capital per share}}{50\text{JPY}}$ </div> <p>(Note): If there is no dividend payable, 2.5 JPY.</p>

(5) Valuation method by company size, content and shareholders under the Asset valuation basic circular

Company size, business	Shareholders		Controlling shareholders(basic valuation)		Minor shareholders (Specific valuation)
			Basic valuation	By election	
Generally valued company	Large company		Comparable business method	Net asset method	Dividend return method
	Medium company	Large	Combined method (Comparable method x 0.9 + Net assets method x 0.1)	Net asset method	
		Medium	Combined method (Comparable method x 0.75 + Net asset method x 0.25)	Net asset method	
		Small	Combined method (Comparable method x 0.6 + Net asset method x 0.4)	Net asset method	
	Small company		Net asset method	Combined method	
Specifically valued company	Company with only one comparable		Net asset method	Combined method	
	Special company holding shares		Net asset method	S1 + S2 method (Note)	
	Special company holding lands		Net asset method		
	Companies with less than three years history		Net asset method		
	Companies before starting business or dormant companies		Net asset method		
	Company under liquidation process		Valued based on estimated distributed amount after liquidation		

(Note) S1+S2 method: Simplified method

Assets held are classified into shares (S2) and other assets (S1). S2 is valued under the net asset valuation method, and S1 is valued by applying basic valuation method for "generally valued companies".

(6) Flow chart to determine the shareholders classification

Shareholders				Classification	Valuation method	
Company with family shareholders	Family shareholders	5% or more shareholding ratio		Controlling shareholders	Basic valuation method (Net asset method, comparable method)	
		Less than 5% voting rights ratio after acquisition	Without major family shareholders			
			With major shareholders			Major shareholders
		Directors				
Others	Minor shareholders	Special valuation method (dividend return method)				
Shareholders other than shareholders						
Companies without family shareholders	Shareholders belonging to the group holding 15% or more voting rights	5% or more shareholding ratio		Controlling shareholders	Basic valuation method (Net asset method, comparable method)	
		Less than 5% voting rights ratio after acquisition	Without major family shareholders			
			With major shareholders			Directors
		Others		Minor shareholders	Special valuation method (dividend return method)	
Shareholders belonging to the group holding less than 15% voting rights						

Note1:Family shareholders... Shareholders and their related persons whose number of voting rights are 30% or more of the total voting rights of the company. If there is a corporate shareholder group holding over 50% voting rights, family shareholders are those belonging to the said group.

Note2:Related persons (to the family shareholders)... Those listed in to below.

Family shareholders and relatives (spouse, blood relatives within 6th degree of consanguinity, Relatives in-law within 3rd degree of consanguinity) Those under common-law marriage, private employees, others receiving economical support Companies held by to in excess of 50% voting rights Companies held by to in excess of 50% voting rights, and Companies held by to in excess of 50% voting rights.

Note3:Major family shareholders... One of family shareholders and his or her spouse, blood relatives, sisters and brothers as well as relatives in-law within first degree of consanguinity whose holding voting rights are 25% or more of the total voting rights

Note4:Major shareholder... Shareholders of a company without any family shareholders, who belong to the shareholders group holding 15% or more of the voting rights, and also holds 10% or more of the voting rights or his own.

Note5:Directors... President, Director of the board, Vice president, Representativedirector, Executive director, Executive officer, Liquidator and other directors similar thereto, Auditor and Whip

(7) Judgment of the company size

- Companies with less than 100 employees are judged according to the table below. Specifically, the comparison is first made between total asset value and the number of employees, and the first comparison result is then subject to the comparison with the transaction volume.
- Companies with 100 or more employees are large companies.

Total asset value (book value)			The number of employees	Transaction volume			Company size
Wholesale	Retail and service	Other business		Wholesale	Retail and service	Other business	
2 billion JPY or more	1 billion JPY or more	1 billion JPY or more	Over 50	8 billion JPY or more	2 billion JPY or more	2 billion JPY or more	Large
Over 1.4 billion JPY and less than 2 billion JPY	Over 0.7 billion JPY and less than 1.4 billion JPY	Over 0.7 billion JPY and less than 1 billion JPY	Over 50	Over 5 billion JPY and less than 8 billion JPY	Over 1.2 billion JPY and less than 2 billion JPY	Over 1.4 billion JPY and less than 2 billion JPY	Medium (0.9)
Over 0.7 billion JPY and less than 1.4 billion JPY	Over 0.4 billion JPY and less than 0.7 billion JPY	Over 0.4 billion JPY and less than 0.7 billion JPY	Over 30 and 50 or less	Over 2.5billion JPY and less than 5 billion JPY	Over 0.6 billion JPY and less than 1.2 billion JPY	Over 0.7 billion JPY and less than 1.4 billion JPY	Medium (0.75)
Over 70 million JPY and less than 0.7 billion JPY	Over 40 million JPY and less than 0.4 billion JPY	Over 50 million JPY and less than 0.4 billion JPY	Over 5 and 30 or less	Over 0.2 billion JPY and less than 2.5 billion JPY	Over 60 million JPY and less than 0.6 billion JPY	Over 80 million JPY and less than 0.7 billion JPY	Medium (0.6)
Less than 70 million JPY	Less than 40 million JPY	Less than 50 million JPY	5 or less	Less than 0.2 billion JPY	Less than 60 million JPY	Less than 80 million JPY	Small

4. Measures for the treasury stocks

(1) The importance of the measures for the treasury stocks

As stated above, in the case of an unlisted owner company, the rate of the treasury stocks among the other inheritance assets is comparatively high. Although a better business performance would result in an increase of the value of the treasury stocks, the treasury stocks have poor marketability (as they are difficult to convert to cash), and purchasers would be limited because of the issue of the management right so that the company must purchase back the treasury stocks. As a result, the financial infrastructure would become weakened, which would potentially adversely effect the management (right) of the successor. Therefore, it is important to start the implementation of the business succession measures as early as possible by taking into account the other measures for successors and business succession.

(2) An outline of the measures for the treasury stocks

As the valuation of treasury stocks is calculated by $\text{Unit price} \times \text{quantity}$, the measures are classified into the "measures to reduce the unit price" and the

"measures to diversify the quantity of stocks held".

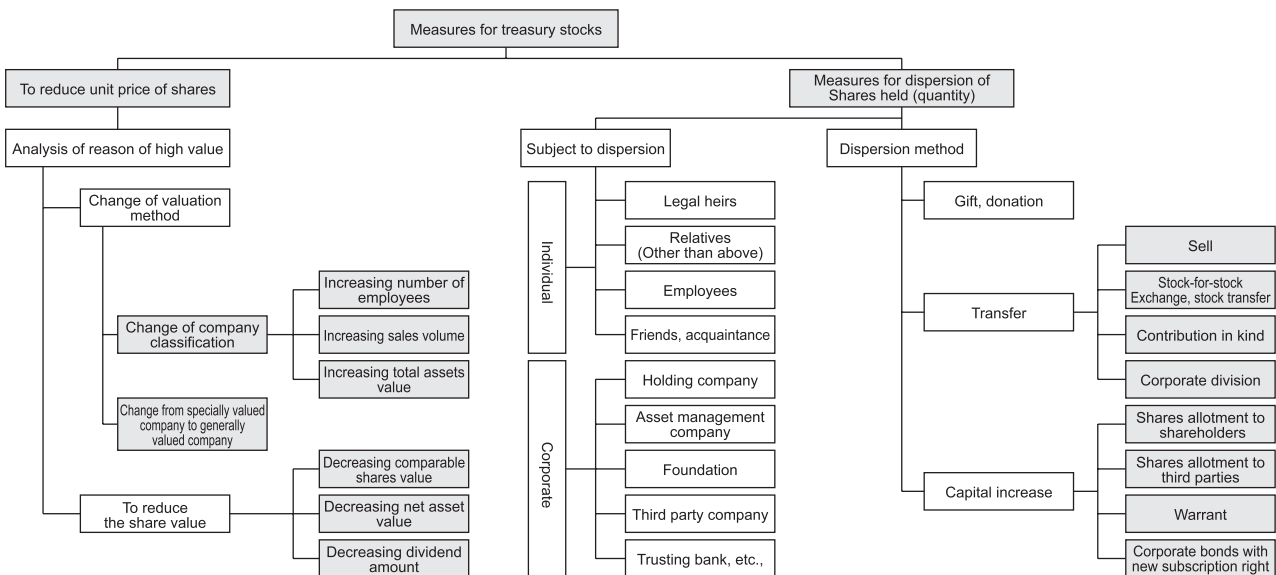
(3) Measures for the treasury stocks and utilization of M&A

Measures for treasury stocks	M&A to utilize
To change valuation method as a result of the change of company classification (i.e., from the net asset value method to comparable business method)	Merger, Business succession, etc.,
To change from the specially valued company to generally valued company	Merger, Business succession, corporate division, etc.,
To change line of business	Merger, Business succession, corporate division, etc.,
To improve marketability	Merger with listed company, etc.,
To change from controlling shareholders to non-controlling shareholders	Merger, Transfer of shares, etc.,

(4) Tax treatment with regard to the transfer of shares

Points

- The transfer of shares is subject to the tax for the transferor (42% corporate tax, 20% income tax).
- If the price of the transfer is either lower or higher than the "proper market value", the differential might be subject to the additional tax so that the careful consideration should be given.



· Tax treatment of transfer at low price

Transferor Transferee	Tax treatment for transferor	Tax treatment for transferee
Individual Individual	-	Gift tax
Individual Company	Deemed capital gain tax (Note 1)	Income arising from the gift (Note 2)
Company Individual	Salary, etc.,	Salary income, retirement income, temporary income
Company Company	Donation	Income arising from gift

· Tax treatment of transfer at high price

Transferor Transferee	Tax treatment for transferor	Tax treatment for transferee
Individual Individual	Gift tax	-
Individual Company	Salary income, retirement income, temporary income	Salary, etc.,
Company Individual	Deemed capital gain tax (Note 3)	-
Company Company	Deemed capital gain tax (Note 3)	Donation

Note 1: If an individual transfer his or her asset to a company at the price less than half of the market value, it is deemed for tax purposes that the transfer is made at the market value, and subject to tax.

Note 2: There is a possibility that the gift tax might be imposed by deeming that there is a gift to existing shareholders of the company.

Note 3: It is not the additional tax imposition. It is already subject to tax.

(5) Tax treatment of increase by allotting shares to third parties

Tax Points

- As the capital increase is a capital transaction, issuing company and undertaker are not subject to tax in principle.
- If the price of the issuance is either lower or higher than the "proper market value", the differential might be subject to the additional tax so that the careful consideration should be given.

· Tax treatment of interest bearing issuance (Note1)

Underwriter	Tax treatment of underwriter
Individual	Gift tax (Note 2) Income tax (Note 2)
Company	Income arising from gift

Note1: In case where shares are allocated to third parties at a market price lower than 90%

Note 2: Relatives of shareholders of the family company: gift tax; Directors and employees: Salary income, retirement income and temporary income; Other individual: Miscellaneous income

Note 3: For existing shareholders, the transfer of interest might be

treated as taxable donation as the transfer of economic benefit.

· Tax treatment of underwriting at high cost (Note 4)

Underwriter	Tax treatment of underwriter	Tax treatment of existing shareholders	
		Company	Individual
Individual	-	Income arising from gift	Gift tax
Company	Taxable donation, salary, etc.,	Income arising from gift	Salary income, retirement income, Temporary income

Note 4: In case where there is an intention of gift to the existing shareholders

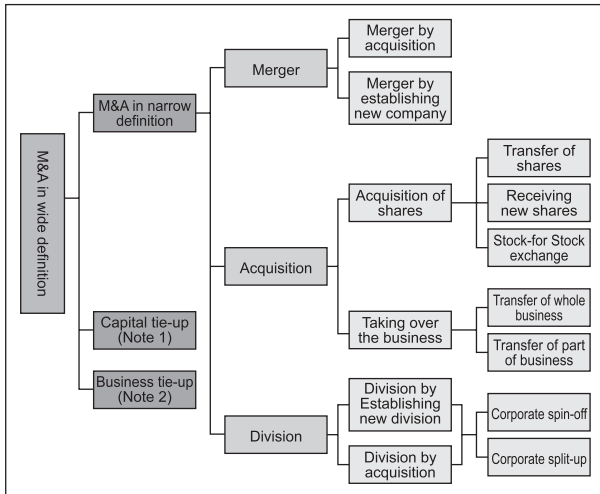
(6) Points to note for the measures for the treasury stocks

- Easy reduction of the unit price should not be implemented (which might lead to a worsening of the financial condition of the company).
- A careful consideration should be given to an appropriateness of the transfer price of the unit price at the time of the gift or the transfer.
- Attention should be paid to the change of the valuation method under the tax reform.
- Transfer of shares should be made as early as possible (when share value is still low).
- If there is any dummy share, its price should be noted and should be disposed as early as possible.
- Shares should not be dispersed too much.

5. M&A as the business succession measures

(1) M&A system

"M&A" stands for "merger and acquisition". However, the definition of "M&A" generally includes not only mergers and acquisitions but also corporate divisions, joint holding of shares and tie-up. The chart below shows the various forms of M&A.



Note1: Capital tie-up: acquisition of partial shares, joint holding of shares, establishing a new company by way of merger etc.,
 Note2: Business tie-up by consigning manufacturing or sales, technology tie-up, joint development, etc.,

(2) Utilization of M&A as a measure for business succession

Since 2005, M&A cases have been increasing rapidly. While the reasons for this may be an improvement of corporate value as a result of the synergic effect, strengthened international competition, defense against the merger, and difficulty in finding a successor, the main reason in terms of business succession would be difficulty in finding a successor.

Although there is an increasing number of companies in which ownership is being handed over to the next generation by aging owners who established companies in the 1950s to 1960s, there is also a number of cases where there is no appropriate successor or no suitable relative to succeed the business. According to the white paper on small and medium-sized businesses issued in 2006, the average number of small and medium-sized companies that closed down between 2001 and 2004 was 0.29 million and one-quarter of these closed because of a lack of a suitable successor. At present, the total number of Japanese entities is 3 million (of which 10% are dormant companies) and the figure above shows that approximately 10% all Japanese companies are forced to close their businesses.

On the other hand, as stated above, the shares of companies with a good performance are generally high, and there are a large number of cases where these companies are forced to dispose of their shares due to the heavy burden of inheritance tax or where they become targets of a hostile acquisition. In particular, in the absence of a suitable successor, the possibility of M&A increases. Recently, many cases of MBO (management buyout: acquisition of a company by the management) are observed. MBO is an acquisition of company shares and business by the members of its management. By way of MBO, the management who have experienced good and bad business times and who fully understand the business and its management policy take over, the dispersion of shares and hostile acquisition by other companies can be avoided, and employment and an increase in the variance of the management system would be ensured. However, MBO generally requires a significant amount of funds to acquire the shares, so most funds are obtained by outside investors such as investment funds. Consequently, in MBO cases, issues of procurement of funds and the difficulty of joint management is resolved.

M&A is also effective not only as a measure to solve the difficulty of finding a successor, but also as a means to develop the company. Specifically, M&A enables the shortening of times and cost reduction. For example, by way of M&A, the acquisition of land, the securing of human resources (recruiting and training), customers and know how can be realized in one go, something which usually takes time with significant costs. Further, M&A is also effective as a measure for business succession, since the successor may propose a merger and acquisition to diversify the business which results in a good measure for business succession. The table below shows some ways to utilize M&A as a measure for business succession.

Measures for business succession	Issues to consider	M&A approach
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To find out business successor	(1) It is difficult to find out the successor (2) To cope with a crisis to close the business	(1) Merger with competitors, sales of shares (including MBO), etc., (2) Merger, business transfer, etc.,
Measure for business	(1) To specialize the special business (2) To expand the business (3) To diversify the business	(1) Transfer of business that is not necessary, split-up etc., (2) Merger, acquisition of shares, taking over the business, establishment of joint company, joint development, etc., (3) Split-up, etc.,
Measure for inheritance tax	(1) To reduce the value of treasury stocks (2) To cope with tax fund preparation	(1) Merger, taking over the business, split-up (2) IPO, merger with listed company, business tie-up with major company

Asia(China)

Enactment of Transfer Pricing Documentation Requirements in China

I. Introduction

The State Administration of Taxation ("SAT") in China plans to release a set of administrative measures for transfer pricing documentation (the "Documentation Requirements") sometime this year. The Documentation Requirements are expected to address what constitutes transfer pricing documentation, requirements for documents to be prepared by taxpayers, and the consequences if a taxpayer fails to comply. It will also provide important information concerning the tax authority's enforcement, as well as rules and detailed guidelines on transfer pricing methodologies that taxpayers should apply in order to evaluate or substantiate the arm's length nature of their intercompany transactions.

In this article, we explain the expected contents of the Documentation Requirements, based on our prior discussions with the SAT. We also provide practical supplementary remarks from the perspective of the Japanese transfer pricing legislation, although there is no documentation law or ordinance in Japan.

II. What constitutes transfer pricing documentation?

We understand that the documents that need to be prepared and maintained by taxpayers can be divided into two categories:

- *principal documents that describe the transfer pricing analysis conducted by the taxpayer;
- *supplementary documents that provide the foundation for the transfer pricing analysis.

We anticipate that the documents required by the SAT, which draws upon international transfer pricing

practices, would be similar to those required by many other countries such as the United States, Canada, Australia and Japan. While the details of the required documents are not publicly available, we understand the Documentation Requirements may cover the following:

1. Principal Documentation

Taxpayer will likely be required to prepare and maintain certain documentation on a yearly basis. Such documentation may include the following:

- *The group organizational structure
- *Outline of the taxpayer's business, and the industry and market conditions
- *The controlled transactions, including identification of relevant internal data and agreements
- *Assumptions, business strategies, and transfer pricing policies, including information regarding factors that influenced the setting of prices
- *Analysis of functions, risks, and tangible and intangible assets
- *Selection of the transfer pricing method
- *Application of the transfer pricing method including comparability analysis
- *Conclusions on the arm's length nature of the intercompany transactions.

The Documentation Requirements are not likely to provide any specific format for the principal documentation; however, documents equivalent to transfer pricing reports that are commonly prepared in international practice are likely to contain much of the required information and analysis. It seems that taxpayers will be required to provide information on most of the items stated above at the time they file their annual enterprise income tax return.

2. Supplementary Documentation

We assume that supplementary documentation includes documents that support the principal documentation, and may include documents such as books of original entry and transaction records, documents evidencing transfer prices, such as invoices and shipping documents, and intercompany correspondence. It may also include analysis of special factors that have directly or indirectly impacted the intercompany pricing, such as an explanation of any continuous losses for a period of time, market entry strategies, and set-off transactions.

In Japan which is a member country of the Pacific Association of Tax Administrators ("PATA"), the Transfer Pricing Documentation Packaging released by PATA is considered documentation that supports taxpayers' transfer pricing.

III. Requirements for documents to be prepared by taxpayers

Chinese taxpayers are required to establish transfer prices in accordance with the arm's length principle. Under the Documentation Requirements, Chinese taxpayers will be required to prepare, submit and maintain documentation evidencing their effort to comply with the arm's length principle, and must promptly submit such documentation upon the request of the Chinese tax authorities.

1. Documentation to be submitted at the time of annual income tax filings

When Chinese taxpayers file their annual enterprise income tax return, which is due within four months after the end of the taxable year, they are currently required to attach basic information about their related party transactions subject to the transfer pricing legislation.

It is expected that under the Documentation Requirements, taxpayers will be required to prepare and provide more detailed information on their

intercompany transactions (i.e., most of the principal documents) when they file their tax return. In particular, they may be required to demonstrate that their transfer pricing methodologies comply with the arm's length principle specified in the transfer pricing regulations.

Moreover, the Documentation Requirements will likely provide clear guidelines on the selection of transfer pricing methods, including not only the three transactional methods (i.e., the comparable uncontrolled price method, the resale price method, and the cost plus method), but also the profit based methods (i.e., the comparable profits method, the transactional net margin method, and the profit split method). It is also expected that the Documentation Requirements will provide clear guidance on technical issues such as the comparability standards and adjustments for differences to improve comparability, profit level indicators, and the arm's length price/profit range.

Meanwhile, in Japan, taxpayers must attach the Schedule 17(3) "Detailed Statement Regarding Foreign Affiliated Companies" to their corporate tax returns.

2. Documentation to be provided upon request

We expect that, in addition to the documents that need to be provided with the annual enterprise income tax return, taxpayers will be required to maintain all other principal or supplementary documentation, and submit it to the tax authorities within the prescribed period upon the tax authorities' request.

Meanwhile, in Japan, taxpayers are required, as a practical matter, to prepare and maintain the documents specified in the Commissioner's Directive on the Operation of Transfer Pricing" (issued by the NTA in 2001), Paragraph 2-4, "Documents and so on to be inspected at the time of examination."

IV. What are the penalties for non-compliance?

China's current tax laws provides the following main forms of penalties for a taxpayer that fails to prepare, maintain or provide the documentation that forms the basis for the tax return:

*If a taxpayer fails to maintain or provide required accounting and other documents, the taxpayer is subject to a penalty ranging from RMB 2,000 to RMB 10,000 (approximately 30,000 yen to 150,000 yen)

*If a taxpayer does not comply with the arm's length principle, and it results in the underreporting of its taxable income, the tax authority is empowered to adjust the taxpayer's taxable income using a reasonable method under one of the following three conditions:

- (a)the taxpayer refuses to provide required documentation,
- (b)the taxpayer fails to provide required documentation within a prescribed period, or
- (c)the taxpayer provides false or incomplete documentation, and does not make corrections even after it is given an opportunity by the tax authority to do so.

Meanwhile, in Japan, there is no penalty for not preparing transfer pricing documentation.

V. Implications of the Documentation Requirements

The Documentation Requirements are expected to become effective as of the date of promulgation, and will require taxpayers, regardless of size, to invest substantial monetary and human resources to comply. Although the monetary value of failing to comply with the Documentation Requirements seems small, companies with high internal control standards may have no choice but to comply in order to satisfy their internal control standards.

In addition, for multinational groups with multiple

operations in China, where consolidated tax returns are not allowed, the Documentation Requirements will apply not only to their international cross-border related-party transactions, but also to their domestic (i.e., within China) cross-border related-party transactions, thereby forcing such groups to bear a substantial burden to comply with the Requirements.

VI. Conclusion

Although, as noted earlier, there is no law or ordinance requiring contemporaneous transfer pricing documentation in Japan, taxpayers are required to attach Schedule 17(3), "Detailed Statement Regarding Foreign Affiliated Companies," to their corporate tax returns. In addition, the Commissioner's Directive on the Operation of Transfer Pricing identifies "Documents and so on to be inspected at the time of examination." In practice, therefore, Japanese taxpayers need to maintain and keep certain documents regarding transfer pricing. Moreover, Paragraph 8, Special Taxation Measures Law Article 66-4, provides that taxpayers should endeavor to obtain from their foreign-related parties transfer pricing documentation that has been prepared overseas.

The Japanese tax authority is strongly interested in China's Documentation Requirements. It is likely that after the Documentation Requirements are promulgated, taxpayers will be required to submit documents based on the Documentation Requirements in transfer pricing examinations in Japan. It is recommended that taxpayers take into account the following when they provide such documents to the Japanese tax authority:

*The profit margins of overseas subsidiaries should be close to the range of profit margins of comparable companies.

*Methods of analysis used overseas (such as certain transfer pricing methods and multiple-year analysis) might not be accepted in Japan.

*The characterization of the overseas subsidiary (functions, risks and other aspects) should be

*Documents to be submitted to the Japanese tax authority should be prepared in Japanese.

North America

Abandoned and Unclaimed Property - Concepts, Compliance and Related Issues

consistent with the characterization of the head office in Japan.

Introduction:

While the majority of Japanese companies that conduct business in the United States may be familiar with income tax and sales and use tax filing requirements, many may not be familiar with state Abandoned and Unclaimed Property ("unclaimed property") laws. As a number of states increase audit activity related to unclaimed property, we are learning that an increased number of Japanese companies in the United States are receiving unclaimed property notices from states. This article assists in explaining the background, basic rules, compliance procedures, and issues related to unclaimed property.

Overview:

All 50 states and Washington D.C. have unclaimed property laws. Additionally, unclaimed property statutes have been enacted in the U.S. territories of Puerto Rico, the Virgin Islands and Guam. Many of these jurisdictions have come to recognize unclaimed property as a non-tax revenue source and have begun to monitor and enforce it more closely. The state unclaimed property laws are custodial in nature, meaning the state takes custody of the unclaimed property in perpetuity until the owner comes forward to present a claim to the state for payment of the property. As such, the public policies surrounding state unclaimed property laws serve two primary purposes:

- 1.The objective of reuniting owners with unclaimed property; and
- 2.Preventing unjust enrichment that holders would enjoy if they were allowed to retain property that they owe their customers, vendors, employees, or shareholders.

In general, when a true legal owner of the property does not claim the possession of the property or cannot be identified, the property is considered unclaimed after the prescribed dormancy period expires. For example, consider the issuance of a payroll check to an employee. At some point, the employee leaves the company. It is later discovered that the check issued has not been cashed. After the prescribed dormancy period expires, the company is required to either reunite the employee (i.e., owner) with the property or remit the property to the state. Similarly, if a gift certificate purchased by a customer is not used after a certain period and the company cannot identify or locate the customer, the gift certificate becomes unclaimed property.

As a matter of public policy, the states 'stand in the shoes' of the owners. The jurisdictions hold the monies remitted by the holders in perpetuity for the owners to claim, thus precluding the holders from unjust enrichment. However, in practice, as is often the case, properties remitted to the state by holders are never claimed by the owners. This excess portion of unclaimed property remittances is typically transferred to the state's general revenue fund, never to be reunited with the original owner of the property. In recent years some state legislatures

have benefited from unclaimed property remittances to help balance the state's budget.

History

There are several Uniform Unclaimed Property Acts that have been drafted since the inception of the initial 1954 Act issued by the National Conference of Commissioners. Although most states' unclaimed property laws adhere to portions of the Acts, other states, including California, Delaware, Massachusetts, and New York, have adopted their own statutory guidelines. While the states vary in their adoption of the various unclaimed property Acts, there are several common attributes among its rules:

Priority Rules - Under the priority rules that were established in the U.S. Supreme Court's decisions in *Texas v. New Jersey* (379 U.S. 674 (1965)) and *Delaware v. New York* (507 U.S. 490 (1993)), the state of last known address of the owner of the unclaimed property, as shown in the business records of the holder, has the first priority claim to the unclaimed property. If the owner's state of last known address is unknown or if that state does not claim the property, then the holder's state of corporate domicile (usually the state of incorporation) has second priority claim to the unclaimed property. Under the Uniform Acts, the corporate domicile of an unincorporated holder is the state where the holder's principal place of business is located. It should also be noted that when the last known address of the apparent owner is in a foreign nation, the state in which the holder is incorporated or domiciled may claim the property.

Legal Obligation on Behalf of Holder - In order for property to be escheatable, a contract must exist between the holder and the owner. The holder must have received legal consideration from the owner. In addition, all conditional requirements under the contract must be satisfied by the owner before the property can constitute abandoned property. If the holder's liability is disputed or otherwise remains

uncertain, it would not give rise to unclaimed property.

Types of Property - The various state statutes consider personal property to be escheatable. Certain tangible personal property is escheatable, such as unclaimed contents of a bank safe deposit box or unclaimed objects, including luggage or other personal items lost at airports. Also, certain intangible personal property may be considered escheatable, including ownership interest in a business being represented by a stock certificate as well as deposits, personal checks, gift certificates and other intangible property. However, real property (i.e., land and buildings) is not considered to be unclaimed property.

Dormancy Period - Property remains unclaimed for a prescribed duration, known as the dormancy period. State statutes dictate the dormancy period according to property type. Typically the dormancy period can range from one year, which is common in the case of payroll checks, to fifteen years, which is customary in the case of traveller's checks. In practice, most property types, specifically accounts payable checks and accounts receivable credits, range from three to five years. Recently, the states have been trending toward legislation to shorten the dormancy periods for all property types, thereby increasing annual remittances by the holders.

Current Market Climate

State legislators and officials have recently recognized unclaimed property as a primary source of non-tax revenues, significantly increasing the general funds in many states, without the implications of raising taxes. Accordingly, many states have increased their audit staff either internally, or by working with contingency fee based auditors, to audit holders in order to maximize collections of unclaimed property.

The states are becoming more assertive. Many states have not only increased their unclaimed

property audit staff, but have also made their systems more proficient in seeking out companies that are not in compliance. States are also focusing on specialized property types based on an entity's industry, such as retailer gift cards, hospital patient account credit balances, and insurance companies' claim payments.

On the other hand, in an effort to encourage compliance, many states offer voluntary disclosure programs. The benefits of a voluntary disclosure program could be significant, considering the limited look back period, and the potential waiver of interest and penalties. Over the past several years, as the holder community becomes more educated, more companies are electing to take advantage of these voluntary programs where available.

When business entities improperly report material amounts of unclaimed property as income in their financial statements, there is a risk that they will have to restate their financial statements to correct the overstatement of book income. For companies that are subject to oversight by the Securities and Exchange Commission ("SEC"), a restatement also carries the risk of negative publicity and a decline in the price of its stock.

With the passage of the Sarbanes-Oxley Act of 2002, the compliance requirements for public companies have increased. Section 404 requires publicly traded companies to include an internal control report in their annual filings with the SEC. Companies must assess the effectiveness of their internal controls and procedures for financial reporting purposes. Further, a company's external auditors must attest to, and report on, management's internal control assessment.

The risk of non-compliance could be damaging to the holder's reputation in the market, directly associated with the financial statement restatement risk. There have been recent examples of holders specifically named in the media for financial statement restatements resulting from non-compliance with the states' unclaimed property

requirements. The result of this could have a negative effect on a company's share price, its market position and ultimately, its reputation. A comprehensive compliance program could mitigate these risks.

Unclaimed property compliance has a high level of complexity. The variations between state laws and the high frequency of legislative activity in this arena contribute to an ongoing demand for attentiveness to compliance. Since unclaimed property has become a key non-tax revenue source for states, there is now a higher level of scrutiny and enforcement, adding even more importance to the need for companies to be in compliance.

Compliance Requirements

Most states require annual filings to report abandoned and unclaimed property. The compliance process consists of three steps:

1. Quantification of outstanding, potentially dormant property;
2. Performing Due Diligence and Accounting Research; and
3. Preparation of a Report.

Initially the holder will need to understand and quantify the potential unclaimed property due that currently resides on its books and records (in addition to property that may have erroneously been written off on the books). This process includes a review of disbursement accounts, account receivable credit balances and other types of property, focusing on the validity of the outstanding amounts. The following is a list of common types of unclaimed property by industry:

- *Banks - savings, checking, money orders, cashiers checks and safe deposit boxes
- *Healthcare - IRA, employee benefit plans, outstanding checks issued to vendors, expense checks and pension checks
- *Hospitals - patient credit balances, IRA, employee benefit plans, outstanding checks

issued to vendors, pension checks, and tangible personal property

- *Insurance - life insurance, casualty insurance, fiduciaries, matured endowments, death claims, annuity payments, agent's credit balances and policy dividends
- *Manufacturing - outstanding checks to vendors, expense checks, pension checks, customer accounts receivable balances
- *Pharmaceutical - rebates and commissions
- *Publishing - outstanding checks issued to vendors, expense checks, pension checks, subscription balances, advertisement balances and royalties
- *Retail - gift certificates, credit memorandums, merchandise credits, layaways, commissions, outstanding checks issued to vendors, expense checks, and pension checks
- *Trucking - customer accounts receivable credit balances
- *Utilities - consumer credits, deposits and refunds

Once the holder quantifies property, it has the opportunity to conduct internal accounting research and perform due diligence. It is through this process that the company confirms the outstanding balances on its books and records. Often, through this review, a company may identify items that remain outstanding on a company's books and records, but are not truly due for various business reasons (e.g., duplicate payment, voided not removed from the statement, stop payments issued and not removed from the system, etc.).

Furthermore, in addition to the internal accounting research, many states require that formal due diligence be performed. Due diligence is the process by which the holder reaches out to the owner via a letter, requesting a response confirming an outstanding balance. Several states, including the State of New York, require that this process be performed annually at a certain interval prior to the filing of the report.

Finally, holders are responsible for filing annual reports. Reports are typically due in November, with

the exception of several states which have a March due date. The filing due date may also vary based upon the type of business (i.e., insurance, financial institutions). Some states require negative reporting (i.e., zero reports) confirming from the holder that no amounts are due.

When considering its options, a company may elect to either maintain its unclaimed property compliance process in-house or elect to outsource the process to third-party providers. There are several software systems available that enable the user to monitor all aspects of the compliance process, including: due diligence, maintaining an audit trail, filing calendars; updates to dormancy periods; state rules and preparation of reports.

There are several factors to consider when making the decision regarding which compliance alternative is best, including:

- *How many legal entities are required to file;
- *How many individual disbursement accounts (i.e., accounts payable and payroll) does the company maintain;
- *What is the volume of disbursement transactions;
- *How many accounts receivable systems does the company maintain; and
- *Is your customer/vendor base consistent or forever-changing?

These factors and more will help you understand the magnitude of your company's unclaimed property compliance needs.

External Resources:

You are encouraged to learn more about Abandoned and Unclaimed Property. There are several resources and organizations available to the Holder community that can facilitate the education process:

- *Unclaimed Property Professionals Organization (UPPO);

- *Council on State Taxation (COST);
- *National Association of Unclaimed Property Administrators (NAUPA); and
- *State websites, education and outreach programs.

Glossary of Abandoned and Unclaimed Property Terms:

- *Abandoned property may be used interchangeably with unclaimed property, see below.
- *Administrator is the state official who administers and enforces its unclaimed property statutes (not to be confused with the Administrator of an estate).
- *Apparent Owner is the person or entity that is listed on the Holder's records as being entitled to the property.
- *Date of last activity is the last date of Owner initiated activity or the date of last contact between the Owner and the Holder; this could be the date a check was issued, the date a dividend was cashed, the date of a bank deposit, etc.
- *Domicile is the state in which a corporation is incorporated or for non-corporate business entities, their state of primary business operations.
- *Dormancy period is the statutorily defined timeframe property must remain dormant or inactive to be presumed abandoned, also referred to as abandonment period or escheat period.
- *Due diligence is the process of the Holder attempting to contact the Apparent Owner before turning property over to the appropriate state; most states require due diligence to be conducted and all states recommend it.
- *Escheat is, in modern terms, the act of the state appropriating unclaimed property that has been presumed abandoned and has run the dormancy period. Also, it refers to the process of Holders turning over the unclaimed property to the appropriate state.
- *Holder is a corporation or entity holding property belonging to an Apparent Owner.

*Intangible property is property that cannot be touched or seen; it is abstract and evidenced by a tangible document such as a stock certificate, a check, a passbook or a statement.

*Last known address is the last known address of the Apparent Owner as recorded by the Holder.

*Priority rules are defined by a series of Supreme Court decisions clearly directing Holders on how to determine what jurisdictional rules should be followed for unclaimed property and to determine the state to which the unclaimed property should be escheated.

*The **first priority** goes to the state of the Apparent Owner's last known address.

*When the Apparent Owner or the address of the Apparent Owner is unknown, **second priority** goes to the state of incorporation of the Holder.

*Rightful Owner is the person who has a legal right to property.

*Tangible property is property that is physical and can be touched or seen, such as an automobile, jewelry or artwork.

*Unclaimed property is a debt, liability or obligation being held for a person or entity that cannot be found, where there has been a lack of contact or Owner initiated activity for a statutorily prescribed timeframe. The term is used interchangeably with abandoned property.

Michael Giannettino, Director – New York Office
Makoto Takahashi, Director – San Francisco Office

Finance

Implications of Stamp Tax relating to Commitment-Line Contract

I. INTRODUCTION

For a standard commitment-line contract, a financial institution (as lender) and a borrower first enter into a basic contract which confirms the maximum permitted loan amount. The borrower then submits an individual loan application to the lender and the lender provides the loan and prepares the corresponding receipt of acceptance. An outstanding issue has been how to treat the commitment-line contract, application form and receipt of loan, for stamp tax purposes.

The National Tax Agency ("NTA") released a circular titled "Implications of stamp tax relating to commitment-line contracts" ("**NTA Circular**") on July 19, 2006. In the NTA Circular, the general treatment of commitment-line contracts is explained based on sample forms for stamp tax purposes. In this article, we set out a general explanation on the outline of the standard treatment of a commitment-line contract, application form and receipt of loan, for stamp tax purposes.

A commitment-line contract discussed by the NTA Circular is a contract where a borrower repeatedly draws down funds within a prescribed limit until the remaining balance of the loan reaches the maximum committed limit. In this article, we also provide an explanation on a contract where a borrower draws down up to the prescribed limit until the accumulated loan amount reaches the maximum committed limit, regardless of the remaining balance of the loan.

II. Outline of Commitment-Line Contract

1. What is a Commitment-Line Contract?

The term "commitment-line contract" is usually

defined as "a contract in which the financial institution, for a fee, as lender, sets the commitment-line for a certain period and will be responsible for making the loan to the borrower". Funding by entering into a commitment-line contract has become more popular recently due to its flexibility.

As stated above, for a standard commitment-line contract, lenders and borrowers first enter into a basic contract which establishes the maximum permitted loan amount, and then borrowers submit an individual loan application to the lender and the lender provides a loan and prepares the corresponding receipt of acceptance.

2. Types of Commitment-Line Contract

(1) Bilateral Basic Contract and Syndicate Basic Contract

Commitment-line contracts are usually entered into bilaterally, where there is only one party on each side; one borrower and one lender ("**Bilateral Basic Contract**"); or with a syndicate, where the borrower uses the same terms to establish commitment-line contracts with multiple financial institutions (as lenders), and at the same time, an administration agency agreement between an agent bank and other lenders is entered into ("**Syndicate Basic Contract**").

Under both the Bilateral Basic Contract and Syndicate Basic Contract, lenders and borrowers first enter into a basic contract setting up a commitment-line where basic conditions such as application and payment methods are agreed.

Once the above basic contract is signed, the lenders are obligated to offer a loan to a borrower

upon application by the borrower (through an agent bank in the case of a Syndicate Basic Contract) in accordance with the terms and conditions prescribed in the basic contract, to the extent that such terms and conditions have been complied with.

According to the types of contract stated above, stamp tax implications relating to the basic contract for setting up commitment-line, application forms for loan and receipt of principal of loan are explained as follows.

Chart 1: Bilateral Basic Contact

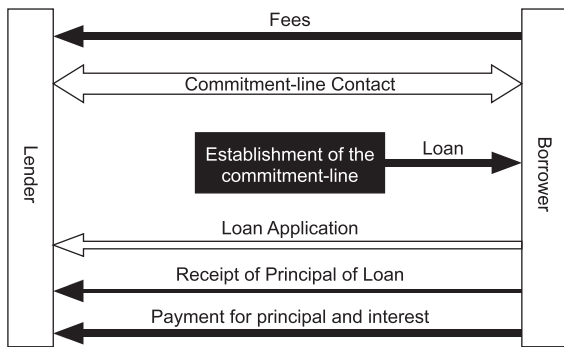
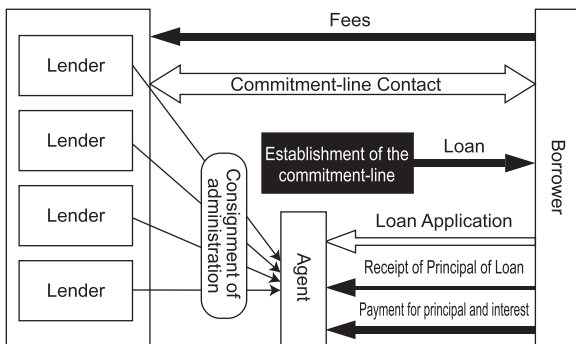


Chart 2: Syndicate Basic Contact



(2) Limited amount of the loan (Commitment-Line)

When establishing a commitment-line in the basic contract, there are two types of basic contract which are commonly used : (i) a contract where a borrower draws down the prescribed limit until the accumulated loan amount reaches the maximum committed limit, regardless of the remaining balance of the loan ("**accumulated limit commitment-line contract**"); and (ii) a contract where a borrower repeatedly draws down within the prescribed limit, until the remaining balance of the loan reaches the maximum committed limit ("**balance limit commitment-line contract**").

III. Stamp Tax Implications

1. Basic Contract for Setting up a Commitment-Line

Stamp tax implications for a basic contract should be considered with regard to the type of the contract (bilateral or syndicate) and how the commitment-line is established (accumulated limit or balance limit).

The general stamp tax implications are explained below, which vary depending on the types of the contract and commitment-line.

(1) Bilateral Basic Contract

Bilateral Basic Contracts that establish a commitment-line are treated as loan agreement (*Kinsenshoji taishaku keiyaku*) for stamp tax purposes.

A Bilateral Basic Contract where a borrower draws down the prescribed limit until the accumulated loan amount reaches the maximum committed limit, regardless of the remaining balance of the loan (accumulated limit commitment-line contract), is treated as specifying the loan amount. Therefore, this contract is treated for stamp tax purposes as a "Loan Agreement stating the contracted amount (Document 1-3-1)" and thus stamp tax will be imposed according to the contracted amount stated in the basic contract for setting up the commitment-line.

A Bilateral Basic Contract where a borrower repeatedly draws down within the prescribed limit until the remaining balance of loan reaches the maximum committed limit (balance limit commitment-line contract) is not considered as

specifying the loan amount, since the prescribed amount is just a limit for the remaining balance of the loan, not the actual loan amount. Therefore, this contract is treated for stamp tax purposes as a "Loan Agreement not stating the contracted amount (Document 1-3-2)" and as a result stamp tax is imposed at a rate of JPY 200 per document.

(2) Syndicate Basic Contract

As with a Bilateral Basic Contract described at (1) above, a Syndicate Basic Contract that establishes a commitment-line is treated as a loan agreement for stamp tax purposes.

A Syndicate Basic Contract where a borrower draws down the prescribed limit until the accumulated loan amount reaches the maximum committed limit, regardless of the remaining balance of the loan (accumulated limit commitment-line contract), is considered as specifying the loan amount. Therefore, this contract is treated for stamp tax purposes as a "Loan Agreement stating the contracted amount (Document 1-3-1)" and thus stamp tax will be imposed according to the contracted amount stated in the basic contract for the commitment-line.

A Syndicate Basic Contract where a borrower repeatedly draws down within the prescribed limit until the remaining balance of the loan reaches the maximum committed limit (balance limit commitment-line contract) is treated for stamp tax purposes as a "Loan Agreement not stating the contracted amount ("**Document 1-3-2**")", as described above. Under the Stamp Tax Law, a document which falls under both Document 1-3-2 and a "Contract for continuous transactions ("**Document 7**")" is classified as Document 7. Since the Syndicate Basic contract also refers to the administration agreement between the agent bank and other banks where services are provided on a continuous basis, this contract also falls under Document 7 as well as Document 1-3-2. This contract is classified as a Document 7 for stamp tax purposes and stamp tax of JPY 4,000 is imposed on

Syndicate Basic Contracts.

2. Application Forms for Loan

Merely submitting the loan application forms to the lender does not constitute a mutual agreement between the lender and the borrower, and it does not automatically come into effect as a contract between the parties under the Japanese Civil Law and thus it has been understood that application forms are not treated as contract documents for stamp tax purposes. For stamp tax purposes, "an Application Form", "Order Form" or any other documents with similar statement ("**Application Forms**"), are all classified as a "Contract", provided the following rules are met, disregarding the title of the documents:

- (1) Application Forms which describe that the application is made based on a basic contract; and
- (2) Application Forms where the application is automatically admitted upon application of one party.

The NTA Circular, based on general types of Application Forms, describes the submission of an Application Form as the automatic commencement of the loan obligation if the form satisfies the requirements prescribed in a basic contract. Therefore, Application Forms based on basic contracts, under the Stamp Tax Law, are automatically classified as loan agreements (Document 1-3-1), and stamp tax will be imposed according to the contracted amount stated in the Application Forms.

If it is clear that the loan agreement is or will be prepared separately from the Application Forms, Application Forms are not treated as "contracts" under the Stamp Tax Law, as described in the NTA Circular.

3. Receipt of Principal of Loan

A receipt which states that the loan principal has

been received from the lenders ("**Receipt**") is generally subject to stamp tax of JPY 200 as a "*receipt of cash or securities other than those related to sales proceeds (Document 17-2)*".

In addition, where the repayment date and repayment method and other loan conditions are clearly noted in the Receipt, the Receipt is classified as a loan agreement for stamp tax purposes (Document 1-3-1) and stamp tax will be imposed according to the contracted amount stated in the

Receipt.

The above explanation for a commitment-line contract is an explanation of the general tax implications without reviewing any specific documents of actual transactions. Therefore, when actually determining the stamp tax implications on specific documents, please note that investigation based on the contents of each document is necessary.

Transfer Pricing

"APA Program Report 2006" Released by the National Tax Agency and Recent Developments in Mutual Agreement Procedure Accompanying APAs

I. Introduction

According to an announcement by the National Tax Agency ("NTA") in relation to transfer pricing in the 2005 administrative year (July 1, 2005 through June 30, 2006), the number of transfer pricing cases assessed for additional taxation was 119 (up 45% year-on-year), with the additionally assessed income totaling 283.6 billion yen (up 31% year-on-year), resulting in a significant year-on-year rise both in terms of the number of cases and the additional income assessed. As recent newspaper reports indicate, there were a number of cases of heavy transfer pricing taxation focusing on Japanese companies during this administrative year.

While potential transfer pricing taxation risk for taxpayers has continued to rise, it is also true that advance pricing arrangements ("APA") are steadily evolving into an effective option for taxpayers to deal with transfer pricing exposure, as the Japanese tax authority improves the APA scheme. In order to eliminate double taxation and ensure predictability of transfer pricing taxation, the NTA recommends that companies wishing to request an

APA also make a request for mutual agreement procedures ("MAP").

In this article, we explain the usefulness for taxpayers of bilateral/multilateral APAs accompanied by MAP with reference to the rise of transfer pricing taxation risk, which underlies the increase in the number of MAP cases received, and the contents of the "APA Program Report 2006" issued by the Office of Mutual Agreement Procedures ("OMAP") of the NTA on October 13, 2006.

II. Increase in APAs accompanied by MAP

An APA is a framework under which a tax authority reviews and confirms the transfer pricing methodology proposed by a taxpayer. As a result, the tax authority gives their administrative commitment to refrain from auditing the taxpayer's transfer prices for transactions covered by the APA as long as the taxpayer files its tax return in accordance with the agreed conditions. Japan was the first country to adopt the APA system in 1987, a year after it introduced its transfer pricing legislation.¹

¹ At the time, the APA system was called the Pre-confirmation System ("PCS").

An APA involves either one country only (a unilateral APA) or two or more countries (a bilateral or multilateral APA accompanied by MAP: hereinafter referred to as "BAPA"). From the perspectives of both tax administration and corporate management, the NTA has actively promoted BAPAs, typically bilateral APAs, because a unilateral APA risks resulting in double taxation as the foreign related party may be taxed by that country's tax administration even after conclusion of the APA. On the other hand, with BAPAs this risk can be avoided through a MAP agreement with the foreign tax administration. To this end, the NTA specified in Paragraph 5-11 (1), Commissioner's Directive on the Operation of Transfer Pricing dated June 1, 2001 that: "To avoid double taxation and to ensure predictability, the division-in-charge of the Regional Taxation Bureaus shall recommend the applicant corporation to file a request for mutual agreement procedure in the case where the corporation has not filed one."

Should transfer pricing taxation be applied to a taxpayer and an additional tax imposed, MAP negotiations aiming to avoid double taxation usually take several years to reach an agreement. In addition, the possibility that the negotiations may break down, thereby locking in double taxation, cannot be ruled out. As an agreement reached through BAPA negotiations enables the avoidance of transfer pricing taxation risk and double taxation in future fiscal years (in some cases, BAPAs can be rolled back to cover previous fiscal years), a BAPA is a useful system for taxpayers to ensure predictable corporate management.

1. Reason for the increase in the number of BAPA cases received: escalation of transfer pricing taxation risk

The NTA announced that both the number of transfer pricing cases assessed for additional taxation and the additionally assessed income in the 2005 administrative year reached record levels. Table 1 below shows the number of transfer pricing cases assessed for additional taxation and the total

additionally assessed income during the past five years. As is clear from Table 1, both the number of cases and the additional income assessed have increased sharply during these years. From this fact alone, we can conclude that potential transfer pricing taxation risk for companies engaged in overseas expansion has increased year by year.

Table 1: Number of transfer pricing cases assessed for additional taxation and amount of additionally assessed income

Administrative year	2001	2002	2003	2004	2005
Number of transfer pricing cases assessed for additional taxation	43	62	62	82	119
Amount of additionally assessed income (billion yen)	85.7	72.5	75.8	216.8	283.6

(Source: NTA website)

According to newspaper reports, both the number of transfer pricing cases assessed for additional taxation and the additionally assessed income with respect to Japanese multinationals have increased sharply in recent years. In contrast, in the past there were many cases of transfer pricing taxation being imposed on Japanese affiliates of foreign multinationals.

In addition, previously there were many cases in which the transfer pricing legislation was applied to transactions between head offices in Japan and their distribution subsidiaries in Europe and the United States. Nowadays, however, it appears that the legislation is being increasingly applied to transactions between head offices in Japan and their manufacturing subsidiaries in Asian countries. In particular, the NTA has announced that in many cases, Japanese head offices did not receive sufficient payment from their overseas manufacturing subsidiaries in consideration for the provision of intangible properties such as manufacturing technologies and know-how. In view of the current situation, where many Japanese companies have moved a part or all of their manufacturing operations overseas, it is expected

that an increasing number of Japanese companies will be exposed to transfer pricing taxation.

2. Contents of the "APA Program Report 2006"

The APA Program Report is released by the NTA's OMAP every autumn. According to the APA Program Report 2006, the number of MAP cases received in the 2005 administrative year was 129 (up 43% year-on-year), a substantial increase over the previous administrative year. Among those, the number of transfer pricing cases was 119, while the number of BAPA cases was 92. The number of disposed BAPAs was 65. Table 2 below shows the changes in the number of BAPAs during the past five years.

Table 2: Changes in the number of cases received, the number of cases disposed of, and the number of cases carried over (BAPA cases only)

Administrative year	2001	2002	2003	2004	2005
Cases received	42	47	89	63	92
Cases disposed of	25	47	39	49	65
Cases carried over	88	88	129	143	170

(Source: APA Program Report 2006 (extract))

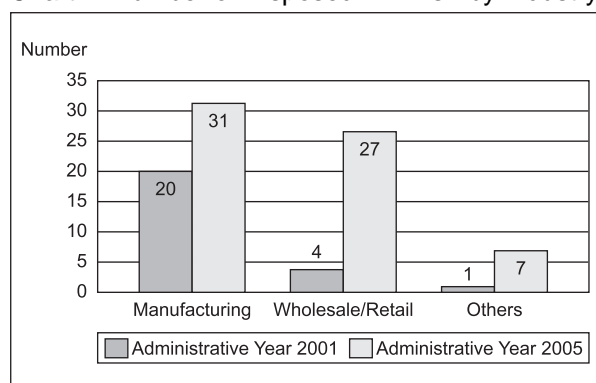
As is clear from Table 2, the number of cases received, the number of cases disposed of, and the number of cases carried over were all at a record high in the 2005 administrative year, with a sharp rise from the previous year. This data also shows that along with the rise of potential transfer pricing taxation risk stated earlier, many companies have come to recognize BAPAs as an effective method to avoid transfer pricing taxation risk and double taxation.

With respect to the 65 cases disposed of in the 2005 administrative year, the APA Program Report 2006 also provides a breakdown of cases by industry, transaction type, transfer pricing method and region.

The breakdown by industry in Chart 1 shows 31 cases for manufacturing, 27 cases for wholesale/retail and 7 cases for others. In

comparison to the 2001 administrative year, which had 20 cases for manufacturing, 4 cases for wholesale/retail and 1 case for others, the number of wholesale/retail cases in particular has increased substantially. It is expected that the number of manufacturing cases will also increase in coming years as transfer pricing taxation risk on transactions with overseas manufacturing companies rises, as stated earlier.

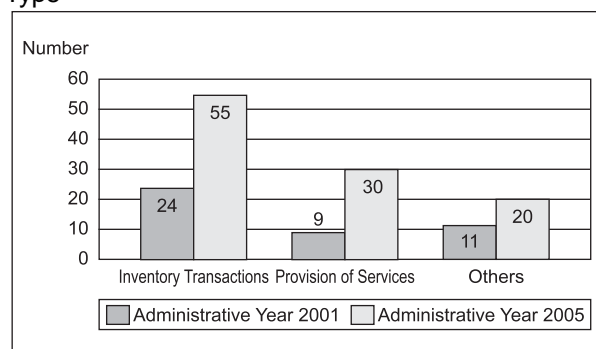
Chart 1: Number of Disposed BAPAs - by Industry



(Source: APA Program Report 2006)

The breakdown by transaction type covers 105 transactions in total, because some cases include more than one transaction. The breakdown in Chart 2 shows 55 cases for inventory transactions, 30 cases for provision of services and 20 cases for others (such as royalty and global trading). In comparison to the 2001 administrative year, which had 24 cases for inventory transactions, 9 cases for provision of services and 11 cases for others, the ratio of cases for provision of services in particular has increased over the last several years.

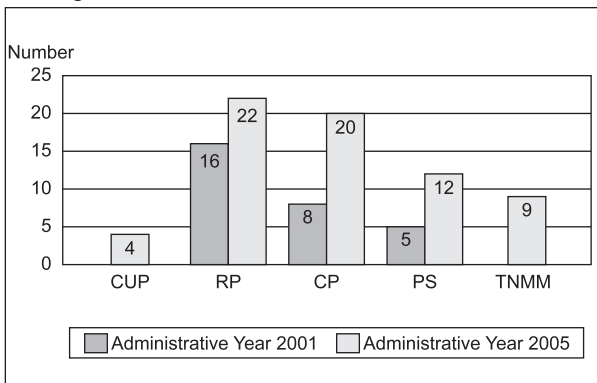
Chart 2: Number of Disposed BAPAs - by Transaction Type



(Source: APA Program Report 2006)

The breakdown by transfer pricing method covers 67 observations in total, because some cases include more than one method. The breakdown in Chart 3 shows 4 cases for the comparable uncontrolled price ("CUP") method, 22 cases for the resale price ("RP") method, 20 cases for the cost plus ("CP") method, 12 cases for the profit split ("PS") method and 9 cases for the transactional net margin method ("TNMM"). In comparison with the data for the 2001 administrative year, the number of cases for the CP method and the number of cases for the PS method have more than doubled. As the number of APA requests in connection with intangible properties has been on the rise, it is expected that the number of cases for the PS method will increase further in the years to come. In addition, it is worth noting that the number of cases for the TNMM, which was introduced in the tax reform of March 2004, has increased.

Chart 3: Number of Disposed BAPAs - by Transfer Pricing Method

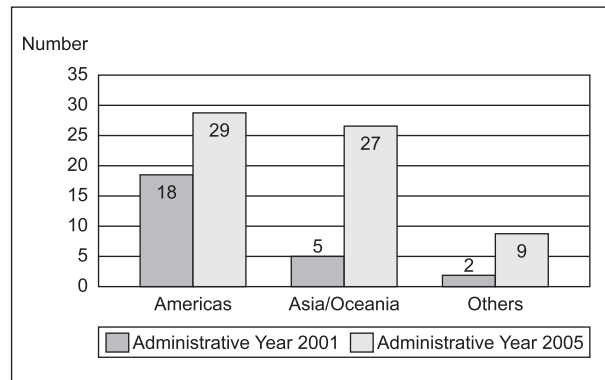


(Source: APA Program Report 2006)

The breakdown by region in Chart 4 shows 29 cases for the Americas, 27 cases for Asia/Oceania and 9 cases for others. Comparison with the 2001 administrative year, which had 18 cases for the Americas, 5 cases for Asia/Oceania and 2 cases for others, shows a notable increase in the number of cases for Asia/Oceania. Although the number of BAPA cases with the United States, Australia and Canada has constituted a majority of BAPAs, the number of BAPA cases with Asian countries with

little experience in BAPAs is increasing due to a change in attitude of these countries, which were not active in BAPAs in the past. The NTA expects that the number of BAPAs with such countries will increase. The number of countries with which the NTA negotiates BAPAs has increased from 11 in the 1995 administrative year to 23 in the 2005 administrative year.

Chart 4: Number of Disposed BAPAs - by Region



(Source: APA Program Report 2006)

III. Conclusion

Due to the recent rise of potential transfer pricing taxation risk for companies, as explained in this article, an increasing number of companies engaged in global business expansion have used BAPAs as an effective method to avoid transfer pricing taxation risk and double taxation. In order to promote the utilization of BAPAs, the Japanese tax authority has improved various legal and administrative procedures with reference to discussions including those at the Committee on Fiscal Affairs of the Organisation for Economic Co-operation and Development and the Pacific Association of Tax Administrators. In addition, it appears that there has been a gradual change in the attitude of tax administrations in many countries which have traditionally taken a passive approach to BAPAs. These changes seem likely to continue, leading to BAPAs becoming even more effective.

Customs

Customs Issues for Tax and Accounting Executives - Instalment #4 Fundamentals of Tariff Classification

I. Introduction

Goods crossing a customs border are codified using the national tariff nomenclature - a standardized system of numerals and commodity descriptions - of the importing/exporting country. The act of assigning a commodity description and numeric code (classification code) to the goods is commonly referred to as "classification".

In the fourth installment of Customs Issues for Tax and Accounting Executives, we would like to describe the fundamentals of tariff classification. As discussed below, the amended Harmonized Commodity Description and Coding Systems (or the "HS" for short) will take effect on January 1, 2007. Because a great majority of the international trade is conducted based on the HS, your companies' products could attract more or less customs duties beginning on that date. Thus, we believe that this is an opportune time for tax and accounting executives to understand the basics of the tariff classification, and in order to be able to analyze and understand the implications of the amended HS to your business.

II. General Perception

i) Easy task?

The first common perception among the tax and accounting executives may be that classification is a simple task of looking up an item in the national tariff nomenclature. The fact, however, is that classification involves a complex process of applying a set of rules of interpretation and understanding the relevant notes so as to identify the applicable code and commodity description from over 5000 commodity groups. However, often, companies only appreciate the complexity of

product classification when they encounter classification issues in either export or import transactions, or during customs audits conducted by the customs authorities in importing or exporting countries.

ii) Who is responsible for the classification?

Another perception may be that your customs brokers are responsible for assigning the correct classifications for your products. Exact rules vary from country to country, but in many countries, the importer or exporter are in fact responsible for the classification of the goods, and must bear the consequences of the incorrect classifications, including additional duties and financial and non-financial penalties.

II. Why is classification important?

i) Determination of correct amount of duty paid

Governments use the classification codes to differentiate products for purpose of collecting import duties and taxes, imposing anti-dumping and countervailing duties etc.

Companies need to know the amount of duties payable in order to price their products correctly. Should correcting the classification codes post importation result in additional duties, it may be difficult to recover the additional duties from the customers as prices may be finalized pre-importation or bound by long term contracts. Companies' profitability could therefore be affected.

Also, as noted above, the incorrect classifications could lead to the underpayment of customs duties, and if uncovered by the customs authorities, may result in financial as well as non-financial penalties

being imposed.

ii) Qualification for preferential duty rates under regional trade agreements

Products have to satisfy the rules of origin of regional trade agreements (RTAs) in order to enjoy preferential duty rates and market access provided under such. In numerous agreements, the classification codes dictate the rule of origin for eligibility, preferential duty rates, and market access.

iii) Identifies compliance procedures

Customs classifications are important from a non-customs duty perspective, and have probably become more important in the current environment. In many countries, import and export controls, licensing, and registration requirements are listed against classification codes. For example, goods deemed to be hazardous or of dual uses, which are subject to licensing and pre-approval, are often identified by classification codes. Accurate classification of the products is essential to the identification of the relevant import/export procedures, and keeping your companies in compliance with various laws and regulations.

III. Challenges faced in classifying the goods

i) Complexity of national tariff nomenclature

Many countries based their national tariff nomenclature on the Harmonized Commodity Description and Coding Systems (or the "HS" for short). The HS is an international product nomenclature developed by the World Customs Organization ("WCO"). It comprises of 5,000 commodity groups, each identified by a six digit code.

Generally, a national tariff nomenclature is only consistent with the structure of the HS up to the 6 digit level. Each country has the flexibility to include additional digits (national tariff tends to range from 8 to 12 digits) to allow for greater differentiation

between goods for the purpose of setting duty rates and collecting trade statistics.

The inclusion of additional digits to the HS codes has the effect of expanding the number of commodities covered in the national tariff nomenclature. Each of the 5,000 commodity groups is further broken down into various commodities creating a more complex and extensive national tariff nomenclature.

Although the HS provides explanatory notes for each commodity group at the 6 digit levels, countries are not required and generally do not provide additional notes to explain how the commodities should be classified according to the national tariff structure. The lack of guidance thus adds to the difficulty of classifying the goods accurately.

In addition, the complexity of classifying the goods at the national tariff level is compounded by the several other factors, such as:

- *Inaccurate translation of the HS from English or French into the national language, contributing to inconsistency in interpretation of the HS;
- *Multiple national tariff nomenclatures being used in a country, for example:
 - *Malaysia, which maintains two national tariff nomenclatures - one for goods originating from ASEAN countries and another for goods from non-ASEAN countries;
 - *The US uses different national tariff nomenclatures for import and export.
- *Classification might not be based on technical consideration but revenue pressure. Classification codes are used mainly by customs authorities for the collection of import duties and other indirect taxes. This monetary function often creates the potential for disputes between customs authorities and companies liable for duties.

ii) Amendments to the HS

The HS is amended periodically to reflect the changes in international merchandise trade, new technologies, etc. Each amended HS is denoted by a different "title" or "version" for example HS 1996, HS 2002 and HS 2007. With each new HS version, countries prescribing to the HS have to undertake immense amount of work to update their national tariff nomenclatures and systems.

In fact, only about half ¹ of the countries subscribing to the HS were able to implement the amendments to the HS on time. Companies would, therefore, find different versions of the HS in use internationally during the first few transitional years.

The introduction of a new HS version may not only herald a change in the HS codes, it could also potentially impact the customs duties payable on the imported goods.

Thus, companies should take into account and plan for changes to the HS in the territories which they operate as it could impact their customs duty burden and compliance, a significant for tasks for companies operating on a global basis.

iii) Convergence of technologies

Companies often find it a challenge to classify their products precisely as the distinctions between goods become harder to make as a result of the convergence of technologies. This is exacerbated by the fact that the HS is reviewed every four to five years while technologies and product cycles change in a matter of months resulting in a gap between the state of the science and technology and the commodity groupings in the HS.

IV. Best practice

It is a common commercial practice for companies to rely on their customs broker and freight forwarder

product knowledge and proper sign-off from the companies.

Many multi-nationals do undertake periodic reviews of the classification of their products, and attempt to correct inaccurate classifications in order to reduce compliance exposures. However, it is our belief that a great majority of companies do not pay sufficient attention to this area. For those who have not conducted a classification review, the following two actions may be suggested as a first-step toward the compliance:

- *Conduct a review of the current classification codes used

Companies can begin the review process on a sample basis. For example, a hundred products exported to a particular country may be reviewed from a classification perspective, and based on the findings from such a limited review, companies may assess the overall exposures, and begin drawing a going-forward strategy.

- *Implement a control procedure for new product introductions

As to new products, companies may wish to implement a system where brokers and forwarders are required to obtain the proper sign-off from companies when importing/exporting a particular product for the first time. Under such system, a potential misclassification is likely to be avoided, and it may alert companies on "difficult to classify products", enabling companies to take the appropriate actions such as applying for an advance classification ruling from the customs authorities of importing/exporting countries.

Finally, it should be noted that disputes with the customs authorities and human errors are inevitable regardless of how often and how thorough you conduct a review of classification codes, and in these circumstances, good documentations on your

¹ 45% and 58% of the signatory countries were able to implement the first and second set of amendments to the HS on time - source WCO

important factor during the dispute resolution process.

Tax Case and Analysis

Income Classification for Investment Income Earned through a US Limited Partnership (Tokyo Regional Tax Tribunal Decision issued on February 2, 2006) -

On February 2, 2006, the Tokyo Regional Tax Tribunal ("TRTT") handed down a decision regarding the classification of investment income earned by an individual through a US limited partnership (the "LPS 1"). It was held that the income does not fall within the category of real estate income or dividend income, and should instead be miscellaneous income. The plaintiff had filed the income tax returns as real estate income, however, the tax officer made an assessment on the grounds that the income should be treated as dividend income. As a result of the tribunal's decision, the assessment made by the tax officer was amended (i.e. the amount of the assessment and penalty was reduced). It is not known if this case has been taken to court. According to the new legislation under the 2005 tax reform, real estate income is not deemed to arise if an individual invests through a partnership (including a foreign limited partnership ("LPS")). However, this treatment does not apply to the above case (i.e. the rule is only applicable to income filed on or after January 1, 2006).

Facts

In 1996, the plaintiff (the "Plaintiff"), a Japanese individual, entered into a partnership agreement with a US LPS to form LPS 1, where the Plaintiff is a limited partner ("LP") and the US LPS is a general partner ("GP"). In 1996, LPS 1 and a real estate managing company entered into a partnership agreement to form another LPS ("LPS 2") which owns leased property (the real estate) in the USA. LPS1 acquired 99% of the beneficial interest in LPS 2 as a limited partner. The real estate managing company acquired 1% of the beneficial interest in

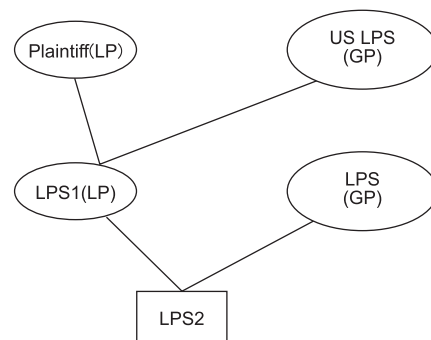
LPS 2 and carried out the property management activities of LPS 2 as a general partner.

In the individual tax returns filed by the Plaintiff for the years from 1999 to 2001, the Plaintiff reported the allocated income earned through LPS 1 as real estate income, claiming a deduction of the depreciation expense of the leased property owned by LPS 2.

The tax officer disallowed the deduction claimed by the Plaintiff arguing that the income earned through LPS 1 should be treated as dividend income and accordingly made an assessment on March 7, 2003. The Plaintiff filed an objection with the administrative agency requesting that the assessment be annulled.

Judgment by the TRTT

In the fact findings, the tax officer argued that (1) the LPS organized under US law is a foreign corporation from a Japanese tax law perspective, (2) the real estate is not owned by the Plaintiff but by LPS 2, and (3) as a result, the income earned by the Plaintiff through LPS 1 should be treated as dividend income from the investment in LPS 1.



In its judgment issued on February 2, 2006, the TRTT amended the assessment made by the tax officer. However, it rejected the claim by the Plaintiff that the income is real estate income, and concluded that the income of the Plaintiff should be treated as miscellaneous income.

(1) Dividend income

The TRTT acknowledged that the LPS has some elements of a corporate entity (e.g. the LPS is able to be a contracting partner in transactions), however, the allocable income of each partner in LPS 1 (i.e. the Plaintiff and the US LPS) is not identical to dividends distributed by a corporation. In the partnership agreement of LPS 1, it was agreed how the income earned by LPS 1 should be allocated between the partners, and based on this provision, the TRTT found that each partner's income was an allocation of income rather than a distribution from LPS 1 and therefore should not be characterized as dividend income.

(2) Real estate income or business income

The Plaintiff argued that the LPS formed under US law is equivalent to the Japanese Kumiai, and real estate leasing income earned and associated expense incurred by LPS 2 should be attributable to the partners of LPS 1. The tax officer found that the real estate is owned by LPS 2, which is a separate entity from LPS 1, and thus the income earned by the Plaintiff through LPS 1 should be dividend income from LPS 1, and not from real estate leasing that is carried out by LPS 2. The Plaintiff counter-argued that even if the income does not qualify as real estate income, it should be treated as business income due to the fact that the Plaintiff was engaged in the continuing activities of LPS 2 and was remunerated accordingly.

The TRTT rejected the argument by the Plaintiff concluding that the income would not be treated as real estate income or business income, but would be treated as miscellaneous income. From the interpretation of Article 26 of the Individual Income

Tax Law, the TRTT argued that the income would qualify as real estate income to the extent that the individual leases the real estate. However, the Plaintiff was not found to have leased the real estate in this case due to the facts below;

- 1)The leasing business of the real estate was entrusted to the general partner of LPS 2
- 2)The Plaintiff was not granted any right to be involved in the management of the leasing business and was not liable to indemnify third parties of the leasing business
- 3)The Plaintiff was guaranteed to receive the income as agreed in the LPS 1 agreement regardless of the earnings or loss of LPS 2

Further, the Plaintiff's investment in LPS 1 was not found to be business income, which should have characteristics of "continuity" and "repeated".

Since the income earned by the Plaintiff does not fall under the category of interest income, dividend income, real estate income or business income, it will be treated as miscellaneous income for the purposes of Article 35 of the Income Tax Law.

It is reported that a similar judgment was issued on August 14, 2006 by the TRTT, though details of the ruling have not yet been disclosed.

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The comments included in this brochure are not intended to be a complete definitive analysis of the law. Further information on any of the matters discussed herein may be obtained from PricewaterhouseCoopers, Japan.

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高橋 康子 Tel : 03-5251-2851
海老原 あや子 Tel : 03-5251-2491

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