

2004 Case Study Retrospect

Decision issued by Tokyo High Court on January 28, 2004

A plaintiff (XCo) held 100% of shares in a Dutch company, ACo. ACo issued new shares to BCo (a related company of XCo) under preferable conditions. The Japanese tax authorities argued that the portion of loss incurred in the value of ACo shares should be regarded as a taxable donation from XCo to BCo and consequently issued a tax correction to XCo.

The main issue in this case is whether or not the transfer of economic interest through the issuance of new shares under preferable conditions should be regarded as gift, i.e., a transfer of assets without consideration (as prescribed under Article 22, Paragraph 2 of Corporate Tax Law). As a result of a second trial at Tokyo High Court, it was decided it could be deemed that a transfer of interest without consideration had taken place between ACo and BCo, since the change of interest held by XCo had nothing to do with ACo and BCo. Specifically, XCo did not receive any interest from BCo, and BCo only acquired the right to control ACo and the status as a shareholder, while XCo lost this.

Decision issued by Matsuyama District Court on April 14, 2004

In this case, the main issue was the methodology for calculating the arm's length price. Matsuyama District Court decided that (i) while several methods have been prescribed for the calculation of the arm's length price with regard to sales and purchase transactions for inventory, there are no prescribed rules for choosing calculation methods from between the CPU, Resale method and the Cost plus method by the tax authorities. Therefore, such decisions are at the discretion of the tax authorities and in this case, they rejected the plaintiff's argument.

Decision issued by Supreme Court on June 24, 2004

A domestic corporation (X) conducted sales of a product in the US through a US corporation (Y). The product was manufactured in Japan using technology developed by X. A US manufacturing company A, filed a patent for the above product in Japan and in the US. Their application for a patent was publicly disclosed. A claimed a suspension of the import of the above product to the US International Trade Commission, arguing that the sale of the product by Y in the US violated the patent right held by A in the US. As a result of a series of negotiations, it was finally agreed between X and A that X would pay indemnity to A.

Under the terms of the above agreement, X paid as royalty fees to Z. Whether the US or Japan was the income source of the royalty was disputed in this case. The Supreme Court decided that the money paid by X should be regarded as a royalty of the US patent right with regard to the sales in US, rather than the manufacturing the products in Japan, and therefore should not be subject to the Japanese withholding tax.

Decision issued by Tokyo District Court on August 31, 2004

The plaintiff in this case conducted a cinema film leasing business by establishing a Nin-i Kumiai (film investment partnership). Film depreciation expenses and interest expenses with regard to a fund procurement agreement were treated as deductible expenses by the plaintiff. However, the tax authorities argued that the establishment of Kumiai and the agreements disclosed in documents regarding the film investment business were invalid. Therefore any expenses incurred from such invalid transactions could not be regarded as tax deductible. A tax correction was issued by the tax authorities.

According to the Tokyo District Court, the series of agreements, i.e., the agreement to purchase films and the agreement to procure the funds, had not been properly prepared to determine the rights and obligation relationship in practice, but it was further argued that these agreements had been prepared to provide an appearance of holding the rights to films and interest expense liabilities with regard to the funds procured. Thus, the decision supported the tax authorities, admitted that the agreements were invalid.

Decision issued on December 7, 2004 by Takamatsu High Court

At the first trial, the court's decision ordered the cancellation of a tax correction issued by the tax authorities stating that "It cannot be interpreted that Article 66-6 of Special Taxation Measurement Law prohibits the loss incurred from a special foreign subsidiary as a deductible loss" from taxable income of the Japanese parent.

At the second trial, the original decision issued by District Court was cancelled. Takamatsu High Court argued that "According to the purpose of anti-tax haven legislation, it should be interpreted that the provision of Article 66-6 of Special Taxation Measurement Law denies the report of the loss incurred from the special foreign subsidiary to be deductible from taxable income of the Japanese parent but forces the carry forward of such a loss by the special foreign subsidiary."

Decision issued on October 28, 2004 by Nagoya District Court

The plaintiffs argued that the Nin-I Kumiai Agreement and income earned from the air craft leasing business or from any losses incurred from it should be offset each other against real state income or other income. The tax authorities argued that the partnership agreement concluded between the plaintiffs could not be regarded as a partnership agreement as prescribed under the Japanese Civil Code, but rather as a mere profit distribution agreement. The tax authorities argued that the income should be considered as miscellaneous income (which may not be used to offset against other losses).

Nagoya District Court issued a decision under the principles of no taxation without law, stating that it could not recognize that the use of an agreement in an unusable manner could be used as grounds for arguing an intention to avoid tax liability.

Decision issued on January 25, 2005 by Supreme Court

In this case, it was argued whether income earned from exercising stock option granted by a US parent company to the director of a Japanese 100% subsidiary should be classified as occasional income or salary income.

According to the Supreme Court, (i) although benefit from exercising the stock option and resulting money was determined by stock market trend and the timing of exercising the option, such benefit was derived from the acquisition of shares granted by the parent company. Therefore it should be regarded as salary income and (ii) it is apparently clear that the stock option plan provides an economic benefit to certain executive directors and to key employees as an incentive for their services.

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