



*Financial Services Tax Group*

# **News Letter**

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## **Nagoya National Tax Tribunal ruling disallowing a deduction for losses incurred from the leasing of ships via a Nin-i-Kumiai (“NK”)**

On March 30, 2004, the Nagoya National Tax Tribunal upheld a decision of the National Tax Administration to disallow a deduction for individual income tax purposes for a loss incurred from the leasing of ships via a Nin-i-Kumiai (“NK”). In this News Letter, we summarize the ruling and its implications.

### **1. Structure of the ship leasing via an NK**

The taxpayer participated in an investment arrangement whereby an NK organized pursuant to Article 667 of the Japanese Civil Code purchased ships and contributed such ships to a limited partnership established in the Cayman Islands (“LP”). The LP leased ships to a shipping company in Panama and planned to sell the ships after expiry of the lease term. Any profit and loss incurred by the LP would be distributed to the NK investors. During the term of the lease, the NK investors claimed a deduction for a loss distribution from leasing in their individual income tax returns.

### **2. Recharacterization as a financial investment**

The Nagoya Tribunal ruling concluded as follows:

- (1) The NK investors bore the economic risk and responsibilities only up to the limit of

their investment amount and did not participate in the operation of the business of the NK; and

(2) There was in substance a sale and leaseback of the ships.

The Tribunal interpreted the commercial arrangements as a financial transaction combining a number of legal forms integrating a chain of inseparable transactions involving the leasing and selling the ships. The Tribunal found in substance the economic effect was not associated with the form of the leasing of ships. Rather, the investment was regarded as a financial product where it is scheduled that the return of the investment was derived from sales of ships at the exit. Accordingly, the economic benefit of the financial product was not finalized until realization of the sales of the ships at the termination of the lease. Until then, any taxable events should not be recognized.

The Tribunal ruling concluded that a distribution of a loss incurred from the leasing of the ships could not be recognized as a lease loss or deductible from other source incomes of the investors for their individual income tax purposes.

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**PricewaterhouseCoopers-Tax, Tokyo**  
**Kasumigaseki Bldg. 15F,**  
**2-5, Kasumigaseki 3-chome, Chiyoda-ku**  
**Financial Services (Tel 81-3-5251-2400)**

Partner :	Sachihiko Fujimoto	Senior Manager:	Hiroshi Takagi
	Katsuyo Oishi	Manager :	Kimihito Takano
	Yuka Matsuda		Hiroko Suzuki
	Tetsuo Imura		Kouji Ata
	Akemi Kitou		Shunji Suzuki
	Raymond Kahn		Kenji Nakamura
Director :	Stuart Porter		Yoko Kawasaki

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