



*Financial Services Tax Group*

# **News Letter**

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## **Nagoya District Court ruling allowing a deduction for losses incurred from the leasing of aircrafts via a Nin-i-Kumiai**

On 28 October 2004, the Nagoya District Court (“Court”) overturned a decision of the National Tax Administration (“NTA”), and allowed a deduction for a loss incurred from the leasing of aircrafts via a Nin-i-Kumiai (“NK”) for individual income tax purposes. In this News Letter, we summarize the ruling and its implications.

### **1. Structure of aircraft leasing**

The individual investors and a business operating company entered into a NK agreement (“agreement”) that purchased an aircraft, leased it to an airline company, and planned to sell it after expiry of the lease term. Any profit or loss incurred by the leasing business would be distributed to the NK investors. During the term of the lease, the investors had claimed the profit/loss from the leasing business as real estate income and a loss distribution due to depreciation expense was offset against other sourced income in their individual income tax returns.

### **2. Ruling by the Court**

The main issues for determination in the law suit were whether: (1) the agreement should fall within a NK agreement or profit distribution agreement; and (2) the classification of income should be real estate income or miscellaneous income. (i.e., to determine whether the loss incurred from the leasing business can be offset against

other sourced income).

(1) The NTA had determined that the agreement should be treated as a profit distribution agreement in substance because it did not consider that all the investors had jointly operated the aircraft leasing business required for a NK under the Japanese Civil Code (“JCC”) and the agreement was only set out as the NK agreement for the purpose of allowing a deduction of distributed loss instead. However, the Court concluded the agreement was a NK agreement under the JCC, because the agreement satisfied the requirements for the formation of a NK stipulated in Article 667 Paragraph 1 of the JCC and was not classified as a profit distribution agreement whose characteristics differed from those of the NK agreement.

(2) The NTA had determined that the agreement was a mere profit distribution agreement, and therefore the profit and loss distributed should be treated as miscellaneous income which was not permitted to offset against other sourced income. However, the Court concluded that the classification of income derived from the NK should be determined by the business operated by the NK, as far as the agreement is treated as a NK agreement. Therefore, any profit and loss incurred by the aircraft leasing business operated by the NK, should be classified as real estate income. Furthermore, it was reasonable that the investors set up a business plan based on the examination of deductibility of depreciation and offset its loss against other sourced income for their individual income tax purposes.

In our News Letter dispatched on October 2004, we discussed the original Nagoya National Tax Tribunal ruling that disallowed a deduction for losses incurred from the leasing of ships via a NK. This judicial judgment by the Court may affect similar cases in the future.

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