



Financial Services Tax News

Financial Services Tax Group

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2007 Tax Reform in relation to Lease Transactions

The 2007 tax reforms included changes to the taxation treatment of tax lease transactions defined under the Japanese tax law (herein "Tax Lease Transactions"). Previously, Tax Lease Transactions were only treated as sales and purchase transactions for Japanese tax purposes when certain requirements were satisfied. In accordance with the 2007 tax reform, all Tax Lease Transactions entered into after April 1, 2008 will be recognized as sales and purchase transactions.

This Newsletter summarizes the impact of the 2007 tax reform on Tax Lease Transactions.

1. Introduction

The 2007 tax reforms are designed to be consistent with the recent reform of Japanese accounting standards announced on March 30, 2007, i.e., the revised "*Accounting Standards for Lease Transactions*". Due to this, this Newsletter briefly summarizes the revised treatment for lease transactions under Japanese accounting standards.

2. Accounting Standards for Lease Transactions

In August 2002, the Accounting Standards Board of Japan ("ASBJ") began its review of the "*Accounting Standards for Lease Transactions*", in particular, abolishing the accounting treatment as rental transactions for finance leases in which title to the leased asset deems not to be transferred to the lessee (*syoyuken iten gai*). In the 125th ASBJ meeting, a revised "*Accounting Standards for Lease Transactions*" and "*The Implementation Guidance of the Accounting Standards for Lease Transactions*" was announced on March 30, 2007.

Under the prior “*Accounting Standards for Lease Transactions*” announced on June 17, 1993, a *syoyuken iten gai* lease could be treated as rental transaction if it is noted in the footnotes. However, under the revised accounting standards for lease transactions, both *syoyuken iten gai* leases and finance lease transactions in which title to the leased asset deems to be transferred to the lessee should be treated as sales and purchase transactions. However, under the revised accounting standards, leases of land, other than land leases that have a transfer of title clause and a bargaining purchase option clause, are prima facie operating leases and should be treated as a rental lease transaction for Japanese accounting purposes.

The new Japanese accounting standard is applicable to accounting years and consolidated accounting years beginning on or after April 1, 2008. With regard to the applicability, conceptually it is necessary for *syoyuken iten gai* lease transactions entered into and still in existence prior to April 1, 2008 to re-classify their Japanese accounting treatment from rental leases to sales and purchase transactions, unless the conditions in the explanatory note to the revised accounting standard permits continuation of the pre-existing accounting treatment as a rental transaction (with the exception of companies operating mainly in the lease transactions).

The following summary outlines the impact of the 2007 tax reforms made in relation to the revised Japanese accounting standard for lease transactions.

3. Tax Treatment Related to Lease Transactions

Under the corporation tax law, a lease transaction is defined as a Tax Lease Transaction when: (1) there is no rescission during the lease period (non-cancelable); and (2) the borrower or lessee bears substantial interest and expenses for the asset (the “**90% rule**”).

With regard to the treatment of Tax Lease Transactions under the Japanese tax law before the 2007 tax reform, for instance, where (1) title to the leased asset is transferred to the lessee for free or nominal value; (2) the lessee is granted a bargaining purchase option to the leased asset; or (3) the leased asset is designed specifically for the lessee’s business use, the lease is deemed to be a sale and purchase of lease properties. Such transaction would be recognized as the lessee owns the property during the lease period.

The 2007 tax reforms excluded land leases in which title to the leased asset is not transferred to the lessee from the definition of a Tax Lease Transaction.

Under the 2007 tax reform, Tax Lease Transactions other than the lease transaction which has been treated as sale and purchase transactions before the 2007 tax reform (*syoyuken iten gai*) are treated as follows:

- (1) *Syoyuken iten gai* leases are treated as a sale rather than a rental transaction.
- (2) The lessee depreciates the leased asset using the straight line method for Japanese tax purposes. Even if the lessee recognizes lease expenses rather than depreciation expenses for Japanese accounting purposes, lease expenses should be treated as depreciation expenses for Japanese tax purposes. The straight line method for tax purposes is used to calculate depreciation and is named the “**Straight Line (Lease Period) Method**”, where its formula is: acquisition cost over the total months of the leasing period multiplied by the relevant months in a fiscal year.
- (3) In a *syoyuken iten gai* lease, the lessor can recognize interest portion of the total lease income as interest income over the lease period based on the **Interest Method**. The Interest Method is whereby the interest income attributable to the lease period by the relevant months

in a particular fiscal year is recognized as income, assuming that interest would be accrued based on the remaining liability of total lease income less interest income. And the remainder of the total lease income is recognized equally over the lease period. In addition, by attaching explanatory details to the lessor's Japanese tax return, out of the amount after deducting costs arising from total lease revenue (the "**Lease Profit**"), 20% of Lease Profit can be deemed as interest income under Interest Method when calculating profit and the remainder would be recognized equally over the lease period.

The rules set out above in (1) to (3) are applicable to *syoyuken iten gai* leases entered into on or after April 1, 2008. With regard to *syoyuken iten gai* leases entered into before April 1, 2008, the lessor can begin to depreciate the leased property from the fiscal year after the day filing a tax report with its local tax office, using straight line (lease period) method.

The above is a general summary only and may not be relied upon in respect of any transaction for which we recommend consultation with your regular PwC Japanese tax advisor.

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