

# Japan Tax Update

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## PwC Japan Tax Newsletter

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## Amended Tax Treatment of Finance Lease Transactions (Shoyuken iten gai lease transactions) and Inventory Valuation in line with the Revised Accounting Standards

The revised accounting standards dealing with lease transactions and inventory valuation are applicable for accounting years beginning on or after April 1, 2008. In line with these revisions, the tax treatment for finance lease transaction and valuation of inventories were also amended as part of the 2007 tax reform. The revised tax law on finance lease transaction is applicable for the lease contracts entered on or after April 1, 2008 and the revision on inventory valuation is applicable for fiscal years beginning on or after April 1, 2007. This Newsletter summarizes the main points of the 2007 tax reform on finance lease transaction and inventory valuation.

## 1 . Revised Accounting Standards Dealing with Lease Transactions

In the past, corporations are allowed to treat finance lease transactions, Shoyuken iten gai, (title of the lease asset is not transferred to the lessee), as operating lease transactions. Under the new accounting standards, finance lease transactions are treated as sales transactions with an exception on finance lease of land where the agreement does not provide a provision that transfers the title of the leased asset at zero or nominal value or a bargaining purchase option, the transaction would be treated as an operating lease.

## 2 . 2007 Tax Reform Related to Finance Lease Transaction

### (1) Definition of a lease transaction under the corporate tax law

Under the corporation tax law, a lease transaction is defined as a finance lease for accounting purposes if the lease contract satisfies the following two conditions: (a) there is no rescission during the lease period (non-cancelable); and (b) the lessee has economic benefit and bears substantial interest and expenses of the leased asset. The 2007 tax reform treats finance lease transactions as sales transactions excluding finance lease of land where the agreement does not provide a provision that transfers the title of the leased asset at zero or nominal value or a bargaining purchase option.

### (2) Lease transactions other than Shoyuken iten gai lease transactions

In the 2007 tax reform, finance lease transactions (Shoyuken iten gai) are separately defined from the other lease transactions with regards to its depreciation method. Under the current corporate tax law, "lease transactions" which satisfy any one of the statutory requirements set out below are treated as sales transactions (of the leased asset) rather than as an operating leasing transaction.

- (a) title to the leased asset is transferred to the lessee for nominal value;
- (b) the lessee is granted a discounted purchase option to the leased asset;
- (c) the leased asset is designed specifically for the lessee's business use ; or
- (d) similar transactions.

Consequently, the lessee would depreciate the leased asset in the same manner as the depreciable assets purchased in a sales transaction by using the applicable depreciation method and useful life.

### (3) Shoyuken iten gai lease transactions

As for Shoyuken iten gai lease transactions, taxable income is recognized and calculated by the Lessor as if leased asset was sold upon the delivery of the leased asset. The lessee would depreciate the leased asset over the lease period using the straight-line method. Even if the lessee would recognize lease expenses for Japanese accounting purposes, the lease expenses should be treated as depreciation expenses for Japanese tax purposes, and the taxpayer would be able to claim a tax credit / special depreciation in relation to the acquisition of certain fixed assets.

#### - Tax treatment for the lessee

In general, the acquisition cost of the lease asset is the total amount of lease payable during the entire lease period. However, if the interest is separate from the aggregate lease amount payable in a reasonable manner, the interest portion of the acquisition cost is allowed to be excluded from the acquisition cost. The interest would be deductible as interest expense over the lease period using either interest method or straight-line method.

#### - Tax treatment for the lessor

Under the 2007 tax reform, the lessor would be allowed to recognize sales income and related expenses on installment sales basis using the following formula:

(a) Sales income = principal\* + lease interest (attributable to the fiscal year)

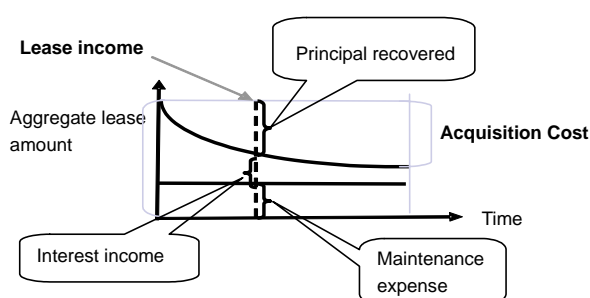
(\*) Principal=(total lease income - lease interest)  $\times \frac{\text{months in the fiscal year}}{\text{Total months in the lease period}}$

(b) Costs = Acquisition cost  $\times \frac{\text{months in the fiscal year}}{\text{Total months in the lease period}}$

As an alternative to the above, the lessor may recognize 20% of the lease revenue (20% x ((a) - (b))) by using Interest Method over the lease period and the remaining 80% using the straight-line method.

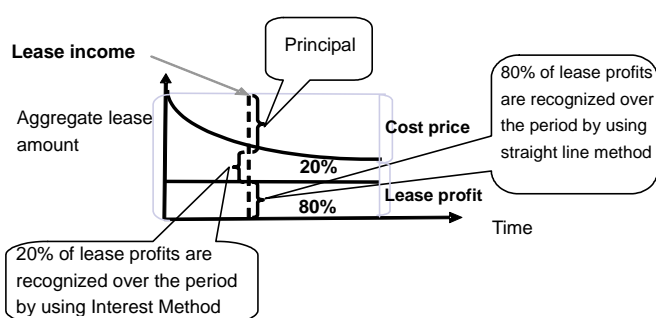
**Breakdown of lease income for the lessor**

**(Japan GAAP)**



**Breakdown of lease income for the lessor**

**(tax)**



**3. Revised Accounting Standards Dealing with Inventory Valuation**

Under the new accounting standards for inventory valuation, the lower of cost-or-market method becomes the default method. The underlying idea of the new accounting standards is to bring the accounting book basis of inventory down to net sales value in the same manner as devaluation under impairment. Inventories are classified based on the underlying purpose of the acquisition and different valuation method would apply (i.e., inventories owned for “sales” and “general sales and administration” purposes, the net sales value would apply and commodity owned for trading purposes, the market price would be used for valuation).

**4. 2007 tax reform related to inventory valuation**

(1) Definition of inventory under the corporate tax law

Upon the application of the new accounting standard, the definition of “inventory” was also reviewed for the corporate tax purposes. Inventory owned as commodity trade is no longer included in the category of “inventory” for the corporate tax law purposes. Thus, capital gain or loss is recognized in the year when the contract is concluded and valuation gain or loss at the end of the fiscal year would constitute as taxable income or loss.

(2) Fair market price in the context of inventory valuation

Prior to the 2007 tax reform, fair market value of inventory in the context of the lower of cost-or-market method would be the replacement cost (for a raw material). This was amended to the net sales value in the 2007 tax reform.

For corporate tax purposes, a taxpayer would be able to elect either historical cost or lower of cost-or-market method. To claim a deduction on the valuation loss of inventory, the taxpayer should elect the lower of cost-or-market method by filing the application with the relevant tax office, If the historical

cost is used for corporate tax purposes, an application to change the valuation method to the lower of cost-or-market would be required prior to the beginning date of the fiscal year which the taxpayer would change its inventory valuation method.

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