



Japan Tax Update

Monthly tax update

August 15, 2004 Issue 2

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PricewaterhouseCoopers
Kasumigaseki Bldg., 15F
2-5 Kasumigaseki 3-chome
Chiyoda-ku, Tokyo 100-6015
Telephone: 03-5251-2400
<http://www.pwc.com/jp/tax>

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As we all know, the only thing constant is change. And the only way to stay successful is to keep on top of changes - in the economy, the industry, and with regulation.

"Japan Tax Update" seeks to update you on the latest developments in Japanese tax law that affect Japanese and foreign multinationals having operations in Japan. In addition to providing information on Japanese tax issues, the purpose of this newsletter is to make management aware of changes in the regulatory environment that may have an impact on their business.

Included in this issue are the following articles:

1. Investments by Individuals Utilizing Pass-Through Entities
(Kumiai) Subject to Closer Scrutiny
2. Revised Guidelines for Advanced Ruling System
3. Proposed Introduction of Japanese Limited Liability Company

1. Investments by Individuals Utilizing Pass-Through Entities (Kumiai) Subject to Closer Scrutiny

In July 2004, it was reported that the Nagoya Tribunal Ruling upheld a decision of the National Tax Administration ("NTA") to disallow a deduction for individual income tax purposes for a loss incurred from the leasing of ships via a Nin-i-Kumiai ("NK") organized pursuant to Article 667 of the Japanese Civil Code. The taxpayer participated in an investment scheme whereby NK purchased ships and contributed such ships to a limited partnership established in the Cayman Islands ("LP"). LP leased the ships to a shipping company in Panama. The loss incurred by LP (i.e. leasing income less depreciation expense) was distributed to the NK investors through the NK. The NK investors were treated as joint owners of the ships in LP and claimed a deduction for the loss distributed from LP through NK in their individual income tax returns.

The NTA disallowed the deduction, arguing (1) the NK investors do not bear the true economic risk of owning the ships nor do they actually participate in the business of leasing the ships, thereby disqualifying them from deducting depreciation expense relating to the ships, and (2) the investment in the NK should be

characterized as a financial investment structured as a combination of the leasing and ultimate sale of the ships to the lessee upon the termination of the lease. Because of these features, the NK investors cannot separate the scheme into individual transactions to recognize an operating loss separate from capital gains.

It is not known whether the NK investor in this case will appeal to the court. In recent years, investments by individuals in pass-through entities have been a target of the NTA and two court decisions in March and May 2003 involving NK film investments were decided in favor of the NTA. Another case involving aircraft leasing is currently being heard by the regional court. In March 2004, an individual investor in a US real estate limited partnership was reportedly subject to an income tax assessment - this case is currently under review by the regional tribunal.

2. Revised Guidelines for Advanced Ruling System

In March 2004, the NTA issued revised guidelines for the Advanced Ruling System. Under this system, the NTA is required to issue a written advanced tax ruling, if certain conditions are satisfied, to the taxpayer who requested the ruling.

Under the revised guidelines, effective for requests made on or after March 29, 2004, a taxpayer can request an advanced tax ruling for not only general fact patterns, but also for a particular set of facts. The taxpayer can request an advanced ruling for a proposed transaction or for a transaction that has already been carried out but before the filing of the tax return or payment of withholding tax relevant to the transaction.

To apply for an advanced ruling, a taxpayer must complete the required application form (a copy is available on the NTA's homepage) and submit it to the tax office together with certain documents (e.g. contracts and other documentation relevant to the transaction that is subject to the ruling request, a checklist prepared by the NTA and any additional documents requested by the NTA). The base information required by the application form includes a statement of facts, reference to the relevant statutes and interpretations of the statutes, business reasons for the transaction, etc. A reply from the NTA may take time and the NTA is not required to issue an advanced ruling if it concludes that the application has not been properly prepared and/or the guidance being requested does not meet the requirements for the issuance of the advanced ruling.

Only certified tax accountants may act as attorneys when applying for the advanced tax ruling.

It should also be noted that advanced rulings issued by the NTA will be made publicly available. Accordingly, a taxpayer is required to obtain prior consent from third parties involved in the transaction prior to filing the advanced ruling.

3. Proposed Introduction of Japanese Limited Liability Company

The Ministerial Advisory Committee for the corporation law is currently discussing an amendment to the Japanese Commercial Code to introduce a new form of corporation, "Godo Gaisha" [Limited Liability Company ("LLC")]. It is expected that the new legislation will be effective during 2006. In discussions to date, the specific features of the proposed LLC include (1) the liability of the equity owners (to the parties that deal with the LLC) will be limited to the amount of their contribution to the LLC, and (2) voting rights and profit distributions shall be determined in accordance with the LLC's corporate by-laws as agreed between the equity owners. In contrast, in the case of a Kabushiki Kaisha ("KK"), these matters are governed by the Commercial Code. Accordingly, the LLC will have more flexibility in its operations compared to a KK and is intended to be a more attractive form of entity for entrepreneurs in the high-tech industry. With the recent amendment to the minimum requirement for the capital infusion in a KK, it is expected that the LLC legislation will revitalize the venture market through an increase in new incorporations.

In the proposal by the METI published in May 2004, it was recommended that the LLC should provide tax

benefits to the entrepreneurs by treating the entity as fiscally transparent for corporate tax purposes so that the entrepreneurs will have an incentive to start their own businesses. Currently, the corporate tax treatment of the LLC has not been formally discussed by the Ministerial Advisory Committee. It is expected that a large scale tax reform covering the tax regime for pass-through entities will be announced in 2006.

You have a vision. PricewaterhouseCoopers helps bring that vision to reality. We hope you enjoy the current issue of Japan Tax Update and appreciate your comments or ideas for what you would like to see covered in future issues

For further information, please contact:

Takuro Tagai	03-5251-2413	takuro.tagai@jp.pwc.com
Al Zencak	03-5251-2431	alfred.zencak@jp.pwc.com
Ken Leong	03-5251-2945	ken.leong@jp.pwc.com
Kirk M. Dove	03-5251-9013	kirk.m.dove@jp.pwc.com
Yumiko Arai	03-5251-2475	yumiko.arai@jp.pwc.com