

# Japan Tax Update

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## PwC Japan Tax Newsletter

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## Recent Tax Court Rulings

Due to the increase in the number and complexity of cross border transactions, Japanese Tax Tribunal and court cases are starting to deal with tax issues associated with such transactions.

This November issue of PwC's Japan Tax Update will introduce three recent court rulings for your reference as follows:

1. Deductibility by a Japanese investor of a tax loss from a Tokumei Kumiai (TK) investment in an aircraft finance lease. On July 27, 2007, the Shizuoka District Court issued a judgment in favor of the taxpayer and the judgment was finalized – the tax authority did not appeal.
2. Whether the loss incurred on the forgiveness of debt to a subsidiary company is non-deductible "Donation Expense". On June 12, 2007, the Tokyo District Court issued a judgment in favor of the tax authority that debt forgiveness in this case was Donation Expense.
3. Classification and recognition of income realized by Stock Awards using a trust. On Feb. 15 2008, the Osaka District Court ruled in favor of the tax authority that a stock award should be treated as employment income at the time of vesting.

## 1 . Deductibility of a tax loss incurred from an investment in a TK arrangement

A TK is the Japanese form of a silent partnership somewhat similar to a US limited partnership. A TK is created by a contractual agreement between a TK “operator” and a silent partner/investor. The TK investor contributes cash or other assets to the operator who then manages the assets for the TK business designated in the TK agreement.

The silent partner and the operator share the profits and losses of the business based on the terms of the TK agreement.

In this case, domestic corporation A as the TK investor entered into a TK agreement with a TK operator engaged in the aircraft finance lease business where the TK operator leased aircraft to foreign airlines. The TK investor claimed a deduction for a business loss arising from the loss allocated by the TK. Most of the loss arose as a result of depreciation expense on the leased aircraft. With regard to the deductibility of the loss distributed from the TK agreement to the TK investor, the following issues were considered by the Shizuoka District Court:

- 1) Nature of the contractual agreement (i.e., was the agreement a TK), and
- 2) Ownership of the depreciable assets (i.e., did the operator own the aircraft).

The tax authority took the position that the contract in question was a contract to distribute fixed income rather than a TK agreement. The tax authority argued that there are two key elements of a TK arrangement. In their view, a TK agreement required (a) a distribution of a variable profit from the TK business and (b) an intention on the part of the TK investor to take business risk by “joining” (*sankaishi*) the TK business. In the case at hand, the lease income of the TK operator and the TK profit from the entire lease period was fixed due to (a) a fixed lease with the lessee and (b) a guaranteed right to sell the asset at a minimum price at the end of the lease contract to either the lessee or a third party. Thus, the tax authorities argued that the arrangement did not meet the requirement of “distribution of variable profit”.

Second, the tax authority argued that a TK investor must have an intention to take business risk by “joining” the TK business as a silent investor by virtue of supervising the TK operator to some extent and taking economic risk of the TK business.

As far as the economic ownership of the leased property by the TK operator, since the TK operator had no business risk on the leased assets, the tax authorities argued that the TK operator should not be considered as owning the leased assets and the thus the TK investor should not be able to deduct the loss generated from the depreciation of these assets.

The judge ruled that a TK arrangement must include the elements where (1) a TK investor contributes to the TK business, (2) the TK operator uses the funds provided by the TK investor to carry out the TK business, and (3) the TK operator distributes a share of the variable profit and loss from the TK business to the TK investor. The judge concluded that the minimum guarantee of the aircraft residual value did not affect the nature of the TK profit distribution (variable profit and loss) because it was possible in some circumstances that the operator could sell the aircraft for more than the minimum price. Second, the TK investor’s interest was legally operative because the TK investor made a contribution to the TK operator. The investment itself was enough to prove that the investor had an interest in the TK business. As a result, the judge concluded that this contract was a valid TK arrangement.

Regarding the ownership of the leased aircraft, the judge used a precedent from a similar court case on the film leasing business (Judgment issued by the Supreme court on January 24, 2006). In that case, the court ruled that the operator did not own the films subject to the NK contract (general partnership arrangement) because the rights to the films were transferred to the film distributor. In this case, the TK operator retained legal ownership and under the accounting guidelines at the time the TK operator was considered to own the properties (these rules have subsequently been changed). Therefore, the TK operator could distribute the depreciation expense and the resulting TK loss to the TK investor.

## 2. Whether the loss incurred on the forgiveness of debt to a subsidiary company is non-deductible “Donation Expense”

Under Japanese tax law, a donation expense is subject a limitation on its deductibility for tax purposes (in most cases, it is non-deductible). Debt forgiveness to subsidiary company is generally treated as a donation expense (i.e. deduction is disallowed). However, an exception is provided under Corporation Tax Law Circular 9-4-2 which provides that debt forgiveness to a subsidiary is not donation expense if (a) “but for” the forgiveness the subsidiary would be bankrupt and (b) the parent corporation has a rational to rehabilitate subsidiary parent corporation. In this case, the Japanese parent corporation lent cash to a Chinese subsidiary that also had a third party bank loan in China. The parent argued that it forgave the intercompany debt to the subsidiary to avoid bankruptcy in China. The court considered whether “but for” the forgiveness the subsidiary would be bankrupt.

The judge made the following observations:

- 1) The subsidiary had been financially insolvent since March of 1999 and the parent forgave the debt in March of 2003. On the other hand, a third party bank that loaned to the subsidiary in China had not called the loan for payment or forgiven the debt and the bank continued to loan to the subsidiary.
- 2) The subsidiary made new investments in its business in China from 2002 to 2003.
- 3) The subsidiary only requested from the parent delayed payment and did not request debt forgiveness.
- 4) The purpose of the debt forgiveness was because the parent was trying to get a loan for its own new investment and understood that writing off the debt would help in obtaining the loan from the bank.

Based upon the above observations, the judge ruled that this particular debt forgiveness should be treated as donation expense because it was done for the purpose of obtaining a new loan for the parent and the subsidiary was not in danger of bankruptcy.

## 3. Classification and recognition of income from stock awards using a trust

Under Japanese tax law, stock options are taxable as wage income at the time of exercise and not at the time of vesting. Restricted stock awards are taxable at the time of vesting. In this case, a foreign parent with a Japanese subsidiary gave restricted stock to employees of the Japanese subsidiary with a three year vesting period. The parent company transferred the stock to a trust where the trustee held legal ownership. The employee received beneficial ownership from the trust on the vesting date while legal ownership of the shares remained with the trust until the employee notified the trust to distribute the shares. At any time after the vesting date, the employee could notify the trustee to distribute the shares.

The taxpayers treated the stock awards as (a) “occasional” income (rather than wage income) and (b) did not recognize the income until they requested distribution of the stock from the trustee. The tax authorities took the position that the employees should have reported the stock award as wage income on the vesting date.

The taxpayer made the following arguments with respect to income classification and the timing of income recognition:

- 1) The employee does not have an employee relationship with the parent company or an obligation to provide services to the parent. Therefore, the income from the stock award should not be considered as wage income but rather it should be treated occasional income.
- 2) After the vesting period, the employee can waive the right to the shares. Therefore, there should be no income recognition until the employee exercises the award and acquires the shares from the trust.

The judge agreed with taxing authorities that when the stock award was vested, all the rights and benefits with respect to the shares were transferred to the employee. Even though the legal ownership remained with the trust, the economic benefit had been transferred to the employee. Therefore, the judge concluded that the fair market value of the stock award should be recognized as income at the time of vesting.

As for the income classification, the judge explained that as a group this award was introduced as an employee incentive plan. Thus, this benefit was given to the employee as a reward in exchange for his performance as an employee. Therefore, the income realized on the stock award was employment income given for the consideration of employee's service to the company.

**For more information, please consult your international tax representative or contact any of the following members listed below:**

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