

Financial Services Tax News

Financial Services Tax Group

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Revision of Depreciation Method in Proposed 2007 Tax Reform

The Financial Service Tax News issued in December 2006 ("December Letter") summarized the main changes of the proposed 2007 tax reforms with regard to taxation of the financial services industry and the real estate industry together with international taxation based on the reform proposals released by the Liberal Democratic Party on December 14, 2006, the 2007 National and Local Tax Reform proposals released by the Ministry of Finance on December 19, 2006 and the Ministry of Internal Affairs and Communications also on December 19, 2006.

This Financial Services Tax News takes a step further and reviews the details of the reforms relating to depreciation methods from among the 2007 tax issues which were summarized in the December Letter.

1. Outline on Revision of the Depreciation Method

- (1) With regard to depreciable assets acquired on or after April 1, 2007, the concept of residual value will be abolished such that after the useful life has expired, depreciable assets can be depreciated until their book value is JPY 1.
- (2) An accelerated depreciation rule, the so called "250% declining balance method" is introduced (for details, please refer to 2.(2) below).
- (3) With regard to depreciable assets acquired on or before March 31, 2007, the residual value of 5% can be depreciable using a straight line method over 5 years starting from the next fiscal year following the fiscal year in which the available limit for depreciation applied to the assets (being 95% of the acquisition cost) is depreciated ("5 Years Average Depreciation").
- (4) The valuation method is maintained with regard to depreciable assets for fixed asset tax purposes.

2. Calculation Method and Example

The calculation method of the depreciation limit for corporation tax purposes has been amended as described below by the 2007 tax reform. We set out the calculation method under the 2007 tax reform and also the depreciation limit and residual book value which have been computed under the straight line method prior to the tax reform ("Old Straight Line Method"), the declining balance method prior to tax reform ("Old Declining Balance Method"), the straight line method after the tax reform ("New Straight Line Method") and the declining balance method after the tax reform ("New Declining Balance Method").

(1) Straight Line Method

The Old Straight Line Method is calculated by taking the acquisition price of an asset less its residual value (10% of the acquisition price) and multiplied by the depreciation rate. The New Straight Line Method will be calculated by multiplying the acquisition price by the depreciation rate, now that the residual value has been abolished.

(2) Declining Balance Method

The Old Declining Balance Method is calculated by multiplying the book value as of the beginning of the fiscal year by a predetermined depreciation rate. The New Declining Balance Method will be calculated by multiplying the book value as of the beginning of the fiscal year by the depreciation rate, which is 2.5 times the depreciation rate under the straight line method. If the amount calculated using the New Declining Balance Method is less than the "amount calculated by dividing the book value as of the beginning of the fiscal year by the remaining years (useful life less the elapsed year)", then the calculation method will be changed from the declining balance method to the straight line method when calculating the depreciation limit.

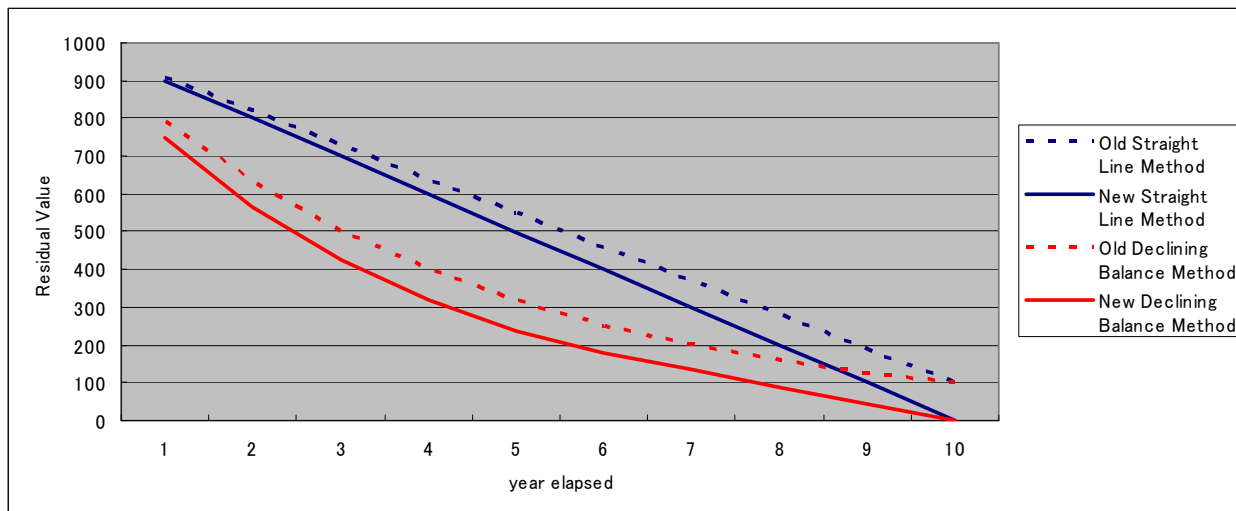
It is decided on a fiscal year basis whether the "amount calculated by multiplying the book value as of the beginning of the fiscal year by the depreciation rate which is 2.5 times the depreciation rate under the straight line method" is lower than the "amount calculated by dividing the book value as of the beginning of the fiscal year by the remaining years". A change of method from the declining balance method to the straight line method in the middle of a fiscal year is not permitted.

(3) Example on computation of depreciation limit and residual book value (assuming the acquisition price is JPY 1,000 and useful life is 10 years)

Depreciation limit calculated with each method

Year	Old Straight Line Method		New Straight Line Method		Old Declining Balance Method		New Declining Balance Method	
	Depreciation Limit	Residual Value	Depreciation Limit	Residual Value	Depreciation Limit	Residual Value	Depreciation Limit	Residual Value
1	90	910	100	900	206	794	250	750
2	90	820	100	800	163	631	187	563
3	90	730	100	700	129	502	140	423
4	90	640	100	600	103	399	105	318
5	90	550	100	500	82	317	79	239
6	90	460	100	400	65	252	59	180
7	90	370	100	300	51	201	45	135
8	90	280	100	200	41	160	44	89
9	90	190	100	100	32	128	44	44
10	90	100	99	1	26	102	43	1

Residual book values calculated with each method



3. Timing of Application of 5 Years Average Depreciation on the Existing Assets

For depreciable assets acquired on or before March 31, 2007, the residual value of 5% will be depreciable over 5 years starting from the fiscal year after the fiscal year in which the available limit for depreciation (95% of the acquisition cost) is depreciated. The decision whether the available limit has been depreciated will be made on a fiscal year basis. Therefore, 5 Years average depreciation will apply from the next fiscal year when the available limit is depreciated.

4. Accounting Implications

In the draft “Audit treatment for depreciation” proposed by the Japanese Institute of Certificate Public Accountants on March 18, 2007, the relationship between the 2007 tax reforms and treatments in the audit process were discussed. According to this draft proposal, when depreciating new or existing assets, although any of the Old Straight Line Method, the New Straight Line Method, the Old Declining Balance Method or the New Declining Balance Method can be applied, care should be taken when changing depreciation methods as it should be a reasonable change in accounting policy.

In particular, the following cases should be treated as a reasonable change of accounting policy based on the change in the relevant laws, due to the similarities in the depreciation methods.

- where the Old Straight Line Method was applied to existing assets, adopting the New Straight Line Method for newly acquired assets
- where the Old Declining Balance Method was applied to existing assets, adopting the New Declining Balance Method for newly acquired assets

On the other hand, in the following cases there will be no similarity in the depreciation methods and care should be taken as to the rationale and timeliness of the change in depreciation method.

- where the Old Straight Line Method is applied to existing assets, adopting the New Declining Balance Method for newly acquired assets

- where the Old Declining Balance Method is applied to existing assets, adopting the New Straight Line Method for newly acquired assets
- where the Old Straight Line Method is applied to existing assets, changing the method for existing assets to the New Straight Line Method, to the Old Declining Balance Method or to the New Declining Balance Method in order to apply the same method used for newly acquired assets to existing assets
- where the Old Declining Balance Method is applied to existing assets, changing the method for existing assets to the New Declining Balance Method, to the Old Straight Line Method or to the New Straight Line Method in order to apply the same method used for newly acquired assets to existing assets

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