

The Tax Issue Committee
Japanese Association for Business Recovery
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Announcement

The Tax Issue Committee,
Japanese Association for Business Recovery
July 25, 2007

**Announcement of Requests for 2008 Tax Reform
Concerning Business Recovery**

The Tax Issue Committee of the Japanese Association for Business Recovery has summarized requests for 2008 tax reform that are conducive to a swift and sustainable business recovery in Japan.

We have requested “Tax deferment of income arising from debt exemption” for enterprises under reorganization for a long period. Major tax reform implemented in fiscal 2005 substantially dealt with this issue by clarifying the treatment of certain valuation losses or losses carried over. However, requests have been made regarding aspects that have still not been remedied or points to which the revised law cannot be easily applied. The main points of the requests for revisions include:

1. More flexible treatment of debtor taxation
2. Practical treatment of bad debt loss in bankruptcy and related issues
3. Clarification of tax system for funds and investors

The Tax Issue Committee, a panel of professional business people and academics concerned with finding business recovery solutions, seeks early implementation of these and other requested revisions, which were compiled based on the results of a recent questionnaire survey of JABR members.

(Note) The Tax Issue Committee comprises businessmen and knowledgeable people, including scholars concerned with business recovery.

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Requested Matters	Rev. of law	Rev. of circular	Info. to public
I. For debtors			
1. Flexible treatment of Debt Treatment Plan	*		*
2. Revaluation of monetary claims added to assets under CTL Article 33	*	*	
3. Market value of credit under DES arrangement		*	
4. Disguised accounting 1 – Clarification of pertinent requirements in disguised accounting	*		
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II. For creditors			
7. Approval of partial bad debt loss loss		*	
8. Clarification of requirements for bad debt in private arrangement	*	*	
9. Statute of limitation and requirements for bad debt loss		*	
10. Calculation method of collectable amounts under a personal guarantee		*	
11. Timing and methods of bad debt loss in bankruptcy		*	
III. For recovery funds and P/E investors			
12. Clarification of how to treat collected receivables bought at discount		*	
IV. For business reorganization techniques			
13. Income tax on gains under DES arrangement based on a Reasonable Reconstruction Plan	*		
14. Lower taxation standards for per capita residential tax for corporations	*		
15. Permanent arrangement for special treatment measures of scale-of-capital tax standards for the Factor Based Tax	*		
16. Grants for company separation and fixed property tax burden, etc.	*		

See details for the above in a separate document, “Requests for 2008 Tax Reform Concerning Business Recovery”.

**Requests for 2008 Tax Reform
Concerning Business Recovery
(Summary)**

I . For debtors

1. Flexible treatment of Debt Treatment Plan (Revision of law, and info to public)

The Debt Treatment Plan (DTP) stipulated in Article 24-2, Para. 1, of the Government Order (GO) under the Corporate Tax Law (CTL) permits the application of Para. 3 of CTL Article 33 (valuation losses) to non-legal proceedings or to a private arrangement. On the other hand, the application of overdue losses before valid “blue losses” requires the same conditions for DTP, according to CTL Article 59, Para. 2, Item (3).

As a result, the above requirements for a DTP, which 2006 Tax Reform cited as the requirements for carrying over losses in business reorganization -- especially the involvement of two or more financial institutions and three or more independent specialists -- become a significant hurdle when losses are carried over not only in business recovery but also in business reorganization. We therefore request the lenient application of these requirements so that small- and medium-sized enterprises can take advantage of DTP.

It should be noted that there are other types of non-legal proceedings stipulated in Item (4) of Article 117 of GO under CTL and CT Basic Circular 12-3-1(3) (hereinafter collectively referred to as “Reasonable Asset Arrangement”) that shall be arranged to use overdue losses carried over after blue losses. We request that requirements for these types of non-legal proceedings be clarified further, for example, as to whether the above two conditions are exempt to Reasonable Asset Arrangement.

2. Revaluation of monetary claims added to assets under CTL Article 33 (Revision of law and revision of Circular)

CTL Article 33, Para. 2, permits deduction of asset valuation losses from income when the reorganization plan is approved in accordance with the Company Reorganization Law or law on special exemptions, etc., concerning reorganization proceedings for financial institutions, etc. (hereinafter collectively referred to as “Company Reorganization Law, etc.”), and where it is necessary to carry out revaluation under these laws, or where other certain conditions apply. However, loan receivables, trade-account and other receivables are excluded from assets with accountable revaluation losses, as they are collectively categorized as “deposits and the like” in CTL. It is therefore requested that monetary claims such as trade-account and loan receivables, security deposits/caution money, etc., be added to eligible assets for the purpose of revaluation losses.

3. Market value of credit in DES arrangement (Revision of Circular)

Following the promulgation of the new Company Law of 2005, the definition of “amount of capital and the like” under CTL was revised under 2006 Tax Reform. As a result of that revision and 2007 Tax Reform, treatment of debtors in a debt equity swap (DES) with investment in kind was interpreted as follows: The market value of the assets (monetary claims), other than the face values contributed in kind in DES, is treated as an increased

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amount of capital and the like under CTL. Except when the DES falls under non-tax Qualified Reorganization, the difference between the market value and the face value is included in calculated taxable income from evaporated debt on the balance sheet.

However, because the assets (monetary claims in DES), other than money invested in kind in DES, are credited to the debtor himself, it is still a matter of argument as to the value that the debtor should adopt.

Accordingly, we request a set of Circulars and the like showing examples of the evaluation methods acceptable under CTL.

4. Disguised accounting 1 – Clarification of pertinent requirements in disguised accounting (Revision of law)

According to current law, once they are unrecognized, bad debt loss and provisions for doubtful accounts that should have been deducted based on generally accepted accounting principles, will not be taken back retroactively as deductible expenses for the accrual period. However, to the extent that management responsibility is taken in a subsequent business year and concrete restatement or amendment proceedings are taken for past accounts, we request clarification under tax law that unrecognized bad debt loss and provisions for doubtful accounts should be included as misrepresentation by disguising a fact, as stated in CTL Article 70.

5. Disguised accounting 2 – Switch from a tax credit system to a refund system (Revision of law)

We request that the tax credit system currently in force be changed to a refund system concerning corporation tax for overstatements based on disguised accounting .

6. Disguised accounting 3 – Extension of the correction period in disguised accounting (Revision of law)

We request that the period of correction determined by the Director of the Tax Office be extended from the current five years to seven years in cases of overstatements based on disguised accounting .

II . For creditors

7. Approval of partial bad debt loss (Revision of Circular)

Bad debt loss cannot be recognized even for debtors clearly in the state of bankruptcy as long as a collectible guarantee by a person or a property exists. We therefore request a measure to allow partial bad debt loss as deductible expenses.

8. Clarification of requirements for bad debt in private arrangement (Revision of law and revision of Circular)

The following two requirements among others must be satisfied before bad debt loss of credit or the transfer of provisions of doubtful accounts can be recognized in private

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arrangements under CTL: □ liability arrangement under reasonable standards and □ creditors' meetings and negotiations between concerned parties through an arrangement by an administrative body, financial institution or other third party.

Concerning the first requirement, we request clarification to allow preferential or lenient treatment for small amount creditors and a tolerant compromise of affordable creditors, depending on circumstances.

Regarding the scope of other third parties, i.e., "financial institutions and other third party" with respect to the latter requirement, we request clarification that the third party may include persons in an independent position such as financial institutions that are business partners, lawyers, etc.

9. Statute of limitation and requirements for bad debt loss (Revision of Circular)

There are cases where bad debt loss is not deductible even where credit collection becomes impossible due to the establishment of extinctive prescription, because of the lack of provisions for treating such credits. Considering that the emergence of internet business creates a huge number of small lot transactions together with fractional receivables on the books of ordinary business, we request that the establishment of extinctive prescription be appropriately included in bad debt loss under CTL.

10. Calculation method of collectable amounts under a personal guarantee (Revision of Circular)

We request a set of new Circulars to treat the collectible amount pertaining to the human guarantee deductible from the amount of bad debt loss when the total amount becomes uncollectible due to the asset condition, solvency, etc. of the debtor, as well as to such deductions from the provisions for doubtful accounts.

Specifically, we request that the new Circular articulate an income-based allowance by which the payer may ignore a collectible amount from the human guarantee exceeding the annual income of the guarantor multiplied by five years.

11. Timing and method of bad debt loss in bankruptcy (Revision of Circular)

Where a debtor (an individual or a corporation) has filed bankruptcy proceedings, it is almost impossible to collect receivables.

Absent clear laws, regulations or Circulars on bad debt loss from bankruptcy receivables under tax law, application of the CTL Basic Circular 9-6-2 (bad debt loss on uncollectible monetary claims) can be explored. However, the requirements of that Circular seem so rigid for bankruptcy practice that the following bad debt provision will be examined.

While collection is practically impossible, only a formal transfer (50%) of provisions for doubtful accounts can be made according to Article 96 (amount of maximum transfer to provisions for doubtful accounts), Para. 1, Item (3-c) of GO under CTL, the remaining 50% of bad debt loss is shelved until the fiscal year when the bankruptcy is completed. This means the creditor must live with tax overpayment for a considerable period. Such a situation is too harsh, especially for small- and medium-sized enterprises.

We therefore request that, where a debtor is cleared to commence bankruptcy proceedings, bad debt loss be immediately allowed and that the creditor not recognize income from recovery until receivables are collected later.

III. For recovery funds and private equity investors

12. Clarification of treatment of collected receivables bought at discount (Revision of Circular)

We request that a Circular be issued stating to the effect that, when the amount of monetary claims bought at discount (lower than the principal amount) reflects the credit risk of the debtor, the purchaser of the claims can carry the claims at cost without adjusting the difference between the principal amount and the purchase price until the collected amount recovers the cost and that the collected amount exceeding cost should be recognized in gross revenue upon collection i.e., by the cost recovery method instead of the accumulation or installment method.

IV. For companies under business reorganization process

13. Income tax on gains under DES arrangement based on a Reasonable Reconstruction Plan (Revision of law)

DES arrangement for an unlisted company under a reorganization plan is usually carried out by issuance of preferred redeemable shares. The income from debt evaporation arising from offsetting acquired debt in this arrangement is brought over from the technical presentation on the debtor's balance sheet and is different from substantial debt extinguishment as creditors do not completely waive the amount of receivables. Moreover, it never increases the debtor's tax-bearing capacity. Therefore, if tax is levied on the income from debt evaporation for a debtor in the process of reorganization, it may become a fatal threat to the reorganization plan.

We request that taxable income arising from debt reduction under DES arrangement for an unlisted company be deferred to the extent that the redemption clause is compulsory or conditional and the requirements of a reasonable reconstruction plan are satisfied under the Company Reorganization Law, Civil Rehabilitation Law, a reasonable private reorganization (corresponding to the Debt Treatment Plan (DTP) under Article 24-2 of GO under CTL) and Reasonable Reconstruction Plan based on the Basic Circular 9-4-2. Nevertheless, when redeemable shares are converted into ordinary shares, or when it becomes certain that they will not be converted, deferment of income from debt reduction will be suspended at the time.

14. Lower taxation standards for the per capita residential tax for corporations (Revision of law)

Taxation standards of the per capita corporate residential tax involve "amounts of capital and the like" under CTL. The reason is understood to be that the amount of capital and the like are recognized as a certain tax-bearing capacity representative of the scale of the corporation. However, compensation for a loss also represents a reduced scale of business activities. We therefore request that amount-of-loss compensation be struck from taxation standards applicable to the per capita corporate residential tax.

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15. Permanent arrangements for special treatment measures of scale-of-capital taxation standards for the Factor Based Tax (Revision of law)

Regarding lower scale-of-capital taxation standards for the Factor Based Tax, where loss is compensated by reducing the amount of capital or the amount of capital reserves for a business year during the period April 1 2000, to March 31, 2008, the amount is to be deducted from the amount of capital and the like. However, this treatment should not be divided into time blocks. We therefore request permanent arrangements (or extension of the arrangements).

16. Grants for Corporate Divestiture and fixed property tax burden, etc. (Revision of law)

When Corporate Divestiture is carried out, a fixed property tax and a depreciated property tax are occasionally allocated between the corporation succeeding the separated unit and the corporation separating it in accordance with reasonable standards such as the holding period pertaining to the separated business. We request that a Circular stating that those taxes allocated to the succeeding corporation is considered just an expense at the time of unit succession and will not fall under the ineligible grants, which may disqualify above Corporate Divestiture from a non-tax reorganization for CTL purposes.

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What is the Japanese Association for Business Recovery?

■ The Japanese Association for Business Recovery (JABR), known as Jigyo Saisei Kenkyu Kiko in Japanese, was founded on March 16, 2002, to promote the study of practical proposals for a swift business recovery in Japan. The group includes business professionals and academics who exchange opinions and information among themselves and with experts overseas concerning bankruptcy, business-recovery methods and related processes. JABR's representative directors are professor Makoto Ito, of the University of Tokyo, and attorney Makoto Tahira.

JABR comprises full members (individuals) and supporting members (organizations) representing various professions. Full members include administrative and judicial authorities, attorneys, certified public accountants, licensed tax accountants and real estate appraisers, as well as managers of domestic and foreign financial institutions, business-recovery and PE funds, and consulting firms. Accounting firms, business corporations and financial institutions, which perform an active role in the first line of business recovery, participate as supporting members. As of July 2005, JABR had 230 full members and 22 supporting members.

■ JABR has a number of committees dealing with business recovery, in addition to the Tax Issue Committee:

- (1) The Corporate Reorganization Case Study Committee (chaired by professor Junichi Matsushita of Tokyo University) was set up to determine trends in business-recovery techniques centering on corporate reorganization plans of recent years, and to compile books that contribute to effective business-recovery practices beyond the scope of case studies. The committee has carried out detailed analyses -- identified as Reconstruction Techniques, Reorganization Security Right, Reorganization Credits and Others -- on about 300 reorganization cases nationwide that were approved on or after 1997. The results appear in the book, "Practice and Theory of Reorganization Plans" (Business Recovery Study Series 6) published in June.
- (2) The Study Committee of Revised Substantive Law on Bankruptcy (chaired by professor Katsumi Yamamoto of Kyoto University) was inaugurated following the across-the-board revision of the Bankruptcy Law. It has studied future application of the Substantive Law on Bankruptcy, to which important revisions have been made. Since "New Perspective in Business Recovery" was discussed at a May 27, 2004, symposium, six explanatory meetings for members have been held to discuss Repudiation, Corporate Bond, Leasehold and other significant issues following the keynote report for each issue.
- (3) The Modernization of Corporate Law and Business Recovery Committee (chaired by attorney Atsushi Toki) was set up to sort out possible impacts on business recovery and bankruptcy legislation by the complete amendment of the Corporate Law before the new law takes effect. At a May 28, 2005, symposium titled "Modernization of Corporate Law and Business Recovery", Financing, Corporate Governance and other issues were discussed from practical viewpoints.

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- (4) The Trust and Business Recovery Committee (chaired by attorney Masaya Miyama) was set up to study possible impacts on business recovery by the first overall revision of the Trust Law proposed in 80 years. Significant issues selected in terms of business recovery have been reported and studied. Based on those results, the committee is preparing comments on the exposure draft of the new Trust Law.
- (5) The M&A Examination Committee (tentatively named) was set up to survey and analyze the practical application of M&A techniques to the business recovery scene. Among the broad issues in this perspective, the committee started to discuss legal procedures, financial restructurings, business restructurings, etc. in order to report on aspects for a Nov. 29, 2005, symposium.

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