

*The Tax Issue Committee*  
*Japanese Association for Business Recovery*

( Located within Shojihomu KK ) 3-9-10, Nihonbashi-Kayabacho,  
Chuo-ku, Tokyo 103-0025. Tel: 03-5614-6086 Fax: 03-3664-8845

**Announcement**

The Tax Issue Committee,  
Japanese Association for Business Recovery  
August 2, 2005

**Announcement of Requests for 2006 Tax Reform  
Concerning Business Recovery**

To encourage a swift and sustainable business recovery in Japan, the Tax Issue Committee of Japanese Association for Business Recovery has summarized requests for 2006 tax reform.

The main points of the requests for revision include:

Flexible treatment of debtor taxation,  
Wider range of bad debt loss,  
Clarification of how to treat investors including recovery funds  
Early realization of other requests considered desirable

In particular, we have added "Tax deferment of income arising from debt exemption" to last year's requests. Although the main part of this request has been resolved by the comprehensive amendment on the treatment of valuation losses and net losses carried over, we continue to seek relief from pitfalls remaining after the 2005 reform.

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.

**\* Further details and answers to questions will be presented at a press conference at 4 p.m., Tuesday (Aug. 2), in the third-floor Conference Room of Shojihomu KK (see attached map).**

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Requested Matters	Revi- sion of law	Revi- sion of Cir- cular	Open- ing infor- ma- tion to public
<b>For debtors</b>			
1. Tax deferment of income arising from debt exemption	*		
2. Switch to a refund system for overstatements based on misleading accounting	*		
3. Extension of statutory limitations for correction of overstatements based on misleading accounting	*		
4. Clarification of treatment of debt equity swaps (DES) for debtors			*
5. Reduction of registration license tax when capital is increased by DES	*		
6. Reduction of per capita residential tax when capital is increased by DES	*		
7. Lower valuation standards for fixed property tax under reorganization procedures	*		
8. Extension of special treatment measures with respect to the scale of capital of the Factor Based Tax	*		
9. Wider scope of the guarantor's claim for indemnity with respect to special treatment of capital gain arising from performance of obligations of guarantee		*	
10. Clarification of treatment of income arising from debt exemption of individual debtors.		*	
<b>For creditors</b>			
11. Procedures for bad debt loss when security is doubtful etc.		*	
12. Wider scope of credits subject to provisions for doubtful debts		*	
13. Provisions for doubtful debts with respect to the guarantor's claim for indemnity		*	
14. Clarification of provisions for doubtful debts based on actual assessment		*	
15. Extension of the legal rate of provisions for doubtful debts based on specified events	*		
16. Deduction of consumption tax where provisions for doubtful debts are accounted for	*		
17. Clarification of the need for a reasonable reconstruction plan			*

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<b>For recovery funds and P/E investors</b>			
18. More flexibility in pricing new shares allocated to a third party		*	
19. Procedures for accumulation accounting of receivables bought at a discount		*	
20. Clarification of how to treat collected receivables bought at discount		*	
21. Clarification of the scope of Permanent Establishment for foreign partners of LLPs and the like		*	
22. Deferment of capital gain arising from investment in kind in LLPs	*		
23. Clarification of taxation for foreign entities	*		
24. Scope of financial income to be withheld from foreign partners of LLPs	*		

Regarding the contents of the above, please refer to a separate document, "Requests for 2006 Tax Reform Concerning Business Recovery." (This will be distributed at the press conference)

**Inquiries should be made to:**

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 (located within Shojihomu KK)**

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**Requests for 2006 Tax Reform  
Concerning Business Recovery  
(Summary)**

**For debtors**

**1. Tax deferment of income arising from debt exemption**

Where a rationale exists to create and agree to a reconstruction plan -- under the Corporate Reorganization Law, Civil Rehabilitation Law, or Article 24-2, Paragraph 1, Item 1 (commencement of corporate arrangement in accordance with the Commercial Code) and Item 2 (a fact corresponding to an authorization of a reorganization plan or the like) of the Government Order of the Corporation Tax Law -- and where it is clear that a company is expected to adopt a measure to use the earnings from debt exemption in the future process of reconstruction, we request that a deferment measure be taken to match the taxable period of the income arising from debt exemption with that of a specified minimum amount of related expenses that the company expects to accrue in the future. The above income, to be accounted for in a special reserve, would be offset by the expected expenses when the expenses were actually recognized.

**2. Switch to a refund system for overstatements based on misleading accounting**

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

**3. Extension of statutory limitations for correction of overstatements based on misleading accounting**

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 the case of overstatements based on misleading accounting.

**4. Clarification of treatment of debt equity swaps (DES) for debtors**

The Basic Circular of Corporation Tax Law 2-3-14 etc. clarifies treatment pertaining to creditors, such as acquisition prices etc. of shares acquired by creditors via DES, but not to debtors. Clarification of how to treat debtors (equity issuers) is therefore requested.

**5. Reduction of registration license tax when capital is increased by DES**

Where a corporation aiming for a certain type of reorganization increases capital by DES, we request that the registration license tax rate be reduced by separating the

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DES amount from other capital increases.

**6. Reduction of per capita residential tax when capital is increased by DES**

Where capital is increased by DES and losses brought forward are compensated for by a capital reduction etc., we request that reductions of capital carried out for loss compensation and other purposes be exempted from the taxation standard of the per capita residential tax on corporations.

**7. Lower valuation standards for fixed property tax under reorganization procedures**

We request that revaluation as a result of legal proceedings be added as a reduction-in-value event for taxation standards of the fixed property tax. The value adopted as book value, such as market value in a real estate appraisal -- with regard to corporations for which a reconstruction plan in legal proceedings under the Corporate Reorganization Law or Civil Rehabilitation Law is approved in due course -- should be treated as the value for taxation standards of the fixed property tax.

**8. Extension of special treatment measures with respect to the scale of capital of the Factor Based Tax**

One of the taxation standards of the Factor Based Tax is the size of capital plus additional paid-in capital (Capital etc), which basically includes an amount for compensating losses brought forward by a capital decrease or a reversal of capital reserves. Although special measures allow this amount to be subtracted from Capital etc., the application of these measures is limited to the fiscal period of April 1, 2004, to March 31, 2006. We therefore request that the period of this special measure should be extended..

**9. Wider scope of the guarantor's claim for indemnity with respect to special treatment of capital gain arising from performance of obligations of guarantee**

In connection with the special treatment of capital gain arising from the performance of obligations of guarantee prescribed in Article 64, Paragraph 2 of the Income Tax Law, we request clarification by Circular that the scope of the guarantor's claim for indemnity under the Income Tax Law include necessary expenses (legal fees etc.) for performance in a case where executive officers etc. of a corporation become unable to pay off the indemnificaton.

**10. Clarification of treatment of income arising from debt exemption of individual debtors.**

As for the treatment of income arising from debt exemption of individual debtors, a Circular notes that, when it becomes extremely difficult for a debtor to satisfy obligations, the income arising from a debt exemption shall not be included in taxable income. We request clarification of the extent of distress required to omit this income.

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### **For creditors**

#### **11. Procedures for bad debt loss when security is doubtful etc.**

In accounting for bad debt loss on secured monetary claims: Where nothing in effect will be left because a material security is pledged and a security right with an earlier order has been set up in excess of the price of its fair value etc., or where collection, in effect, is not expected to be made; and where a human guarantee is pledged (guarantor etc.) but the guarantor is either missing or identified as a debtor with multiple loans, it is understood that these material and human securities need not be taken into consideration. We request clarification of these treatments.

#### **12. Wider scope of credits subject to provisions for doubtful debts**

The requirements pertaining to monetary claims subject to provisions for doubtful accounts prescribed in Article 96, Paragraph 1, Item (2) of the Government Order of the Corporation Tax Law realistically stipulate that, for each debtor, liabilities should continuously exceed assets for a considerable period. We request, however, that assets be taken into consideration not for each debtor as a whole but for each debt in which different terms of recourse may apply.

In addition, in the Basic Circular of Corporation Tax Law 11-2-18, provisions for doubtful accounts prescribed in Article 52 of the CTL do not include bailed credits (deposits, caution money, guarantee money, or the like) among monetary claims. We therefore request that the above Circular be amended so that guarantee money for leasing -- excluding the part of caution money that is substantially close to monetary claims from the viewpoint of collectability -- become a subject credit.

#### **13. Provisions for doubtful debts with respect to the guarantor's claim for indemnity**

A guarantor's claim for indemnity may become subject to bad debt loss or provisions for doubtful accounts only after such guarantee obligations are performed. We therefore request an amendment to the Circular stipulating that when the guarantor receives a claim for performance from the creditor the claim for indemnity shall be included in the monetary claims subject to the provisions for doubtful debts.

#### **14. Clarification of provisions for doubtful debts based on actual assessment**

Transfer of provisions for doubtful accounts is allowed both under the effective standards based on actual assessment and the formal standards based on specified events, except where legal proceedings etc. have shelved repayment for a long time. With both standards, the calculation of a collectable amount exceeding collection of a material security and a human guarantee is not clear with respect to the effective standards. Although the scope of application (reason for transfer and amount of transfer) is said to have widened, application of the effective standards tends to be avoided. We therefore request that the calculation of the above collectable amount (including DCF method) according to the effective standards be clarified. This is important also from the viewpoint of promoting the disposal of non-performing loans.

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**15. Extension of the legal rate of provisions for doubtful debts based on specified events**

The transfer rate of provisions for doubtful accounts under the so-called formal standards (based on specified legal events) has remained at 50% since 1954 at the inception of the former Credit Write-off Provisions System. However, this rate has been estimated too low, as indicated by various surveys of actual data. We therefore request that the transfer rate be raised to about 80% ( or that the transfer rate be set up for proceedings particular to each reconstruction program, etc.

**16. Deduction of consumption tax where provisions for doubtful debts are accounted for**

Exemption from the consumption tax pertaining to bad debts corresponds to accounting for bad debt loss according to the Basic Circular under the Corporation Tax Law. We request that an earlier deduction of the consumption tax be allowed -- as the provisions for doubtful debts are accounted for.

**17. Clarification of the need for a reasonable reconstruction plan**

In accordance with the Basic Circular under the Corporation Tax Law 9-4-2, losses arising from support of subsidiary companies etc. should be accounted for as deductible business expenses instead of as charitable contributions, where they are based on a "reasonable reconstruction plan." We request further clarification of the need for this.

**For recovery funds and private equity investors**

**18. More flexibility in pricing new shares allocated to a third party**

When a capital increase takes place by means of a new-share allocation to a third party, the standard discount ratio of 10% prescribed in the Basic Circular under the Corporation Tax Law is not always reasonable. We therefore request that the standard be more flexible so as not to hinder raising capital.

**19. Procedures for accumulation accounting of receivables bought at discount**

We request clarification of treatment involving money claims acquired at a lower price than the principal amount, thus reflecting the credit risk of a debtor. Revenue should be recognized when the amount collected from the debtor exceeds the acquisition cost of the receivables, i.e., by cost recovery method instead of the accumulation method or the installment method.

**20. Clarification of how to treat collected receivables bought at discount**

With regard to receivables and claims in bankruptcy and rehabilitation etc. on which interest has not been paid for a considerable period, we request that the amount of such income not be recognized as a collected claim if the division between the interest and principal amounts is not clear, and that the collected amount be treated as the

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collection of the principal amount, i.e., by cost recovery method.

**21. Clarification of the scope of Permanent Establishment for foreign partners of LLPs and likes**

We request that the purport of the interpretation or standard be clarified in a Circular and Q&A with respect to the notion that a Limited Liability Partnership under the new Japanese LLP legislation is always regarded Item 1 P.E. It should also be clarified that foreign partners in other type of partnerships shall not always be regarded as possessing P.E. in principle according to such interpretation or standard.

**22. Deferment of capital gain arising from investment in kind in LLPs**

We request that investment in kind in an LLP under the new Japanese LLP legislation be deemed a transfer at book value, and that neither capital gain nor loss be recognized when contributed assets are returned to the initial contributor at the time of the LLP's dissolution. Capital gain or loss should not be recognized at the time of dissolution either.

**23. Clarification of taxation for foreign entities**

When a business entity organized under foreign legislation participates in a corporate reorganization in Japan, its income is treated immediately as belonging to the participants -- i.e., pass-through in its own jurisdiction -- the standard on whether to treat it as pass-through or not is not clear enough to enable an easy estimate in Japan. We therefore request clarification of the treatment of business entities operating under foreign legislation.

**24. Scope of financial income to be withheld from foreign partners of LLPs**

The withholding tax on distributions to partners of non-residents or foreign corporations of partnerships was newly stipulated in the 2005 tax reform. The distribution income of a partnership comprises business income from positive business activities as well as financial income arising mainly from passive investment. We therefore request that the Government Order under ITL be amended so that distribution income from passive investment not be subject to such withholding tax.

End.

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### **What is Japanese Association for Business Recovery?**

Japanese Association for Business Recovery (JABR), known as Jigyō Saisei Kenkyū Kiko in Japanese, was founded on March 16, 2002, to promote the study of proposals aimed at a practical approach to 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 of reconstruction techniques, reorganization security rights, reorganization credits and other issues involving 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 2004.
- (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 the future application of the Substantive Law on Bankruptcy, to which important revisions have been made. Since the "New Perspective in Business Recovery" symposium on May 27, 2004, six explanatory meetings for members have been held to discuss repudiation, corporate bonds, leaseholds and other significant issues related to the respective keynote report.

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- (3) 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 the body of bankruptcy legislation in general of the full amendment to the Corporate Law before it went into 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.
- (4) Trust and Business Recovery Committee (chaired by attorney Masaya Miyama) was set up to study possible impacts on business recovery of the overall revision to the Trust Law, which was to be proposed after an 80-year interval. Significant issues relevant to business recovery have been reported on and studied. As a result of these efforts, the committee will prepare comments for the released draft of the new Trust Law.
- (5) M&A Examination Committee (tentatively named) was set up to survey and analyze the practical application of M&A techniques on the business recovery scene. Among the broad issues in this perspective that the committee started to discuss were legal procedures, financial restructurings, business restructurings etc. It will report on these issues at a November 29, 2005 symposium.

**Inquiries should be made to:**

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