Japan Tax Bulletin

The use of expired tax losses

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In some cases, after a company has been dissolved the disposal of its assets or the discharge of its debts result in gains and so a large gain can arise in the financial year during liquidation. The use of tax losses is therefore of key importance. If the carried forward blue tax return losses do not cover the gain on debt forgiveness, the use of expired losses is permitted under certain requirements. Further, where the dissolved company is a large company for tax purposes, use of blue tax return losses is limited 50% of taxable income. It is important to note that if residual assets remain in the last business year, the use of expired losses is not possible. Therefore, from the stage of dissolution, tax planning should be carefully carried out and the timing of asset disposal and debt forgiveness should be considered.

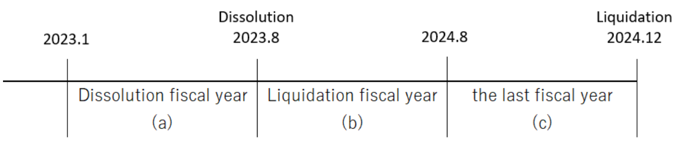
1. When the use of expired losses due to dissolution is permitted

1.1 Deemed fiscal year due to dissolution[i]

(a) When a company is dissolved, the period from the start of the financial year to the date of dissolution is regarded as a single financial year (dissolution fiscal year) and a tax return for this period must be submitted. The deadline for submission is within two months from the day after the date of dissolution, with a special exception for a one-month extension.

(b) Each one-year period commencing on the day following the date of dissolution is a 'liquidation fiscal year'. A tax return must be filed within two months from the day after the end of each financial year in liquidation, with a special one-month deadline extension.

(c) When the residual assets of a company in liquidation are determined, a final return must be filed within one month from the day after the end of the fiscal year (the last fiscal year) that includes the date of determination of the residual assets (or, if the last distribution is made, by the day before the date of such distribution). No special one-month extension is granted.



1.2 Requirements[ii]

If a company is dissolved and is expected to have no remaining assets, the "expired loss" is deductible from income in liquidation fiscal years and the last fiscal year. This is an amount calculated in a prescribed way based of the amount of losses incurred in each financial year prior to the financial year during which the company is being liquidated (the applicable year). In this case, the use of the expired loss is not limited to amounts equivalent to gains on debt forgiveness, gains on valuation of assets in liquidation, etc., as described below in section 4, and there are no restrictions on the use of the expired loss. The inclusion of expired losses in deduction is applicable as long as a detailed statement is included in the corporate tax return (attachment of Schedule 7(3)) and a document is attached explaining that the company is expected to have no residual assets.

1.3 "Substantial Balance Sheet[iii]*"*

In order to explain that a company is expected to have no residual assets, the Substantial Balance Sheet must be prepared to reasonably show that net equity will be negative. When the net equity are exactly zero, it also falls under 'no residual assets are expected' and the expired loss can be used. A Substantial Balance Sheet is prepared on the assumption that the company is to be liquidated, with assets and liabilities valued at disposal value (market value). As a rule, deferred assets and provisions are not recorded as opposed to a company in going concern, and liabilities are recorded on the basis of legal liabilities. Under the Companies Act, a Balance Sheet must be prepared at the date of dissolution and in each financial year during liquidation and requires a resolution of the general meeting of shareholders. The Substantial Balance Sheet is substantially the same as the balance sheet prepared at that time.

In order to be allowed to deduct the expired losses, it must be shown for each financial year during liquidation that, according to the current status at the end of each financial year, there are 'expected to be no residual assets'.

2. How to calculate the expired loss

[Formula]

Deductible amount of expired losses[iv] $= \{A - (\triangle B)\} - C - D$

A) Total amount of losses carried forward from the previous financial year or earlier (total amount of tax purpose earnings & profits (rieki tumitate kin) at the beginning of the period as per Schedule 5(1) I, absolute value if the said amount is negative)

B) If the total amount of capital and capital surplus is less than or equal to zero, add the absolute value of the amount (Schedule 5(1) II).

* This allows a negative amount of capital and capital surplus to be included in deduction even if the company is insolvent.

C) Blue tax return losses carried forward (Schedule 7(1))

D) Disaster losses carried forward (Schedule 7(1))

3. Enterprise tax deductible in the last fiscal year[v]

The amount of enterprise tax (including the amount of local corporate special tax) for the last fiscal year that includes the date of the determination of the residual assets of the corporation, is to be included in the amount of deductible expenses for that fiscal year. Enterprise tax is included in deductible expenses at the time of filing (payment) in an ordinary fiscal year, but if it is not included in deductible expenses in the last fiscal year, the company loses the opportunity to include it in deductible expenses.

In other words, the amount of the expired losses can be deductible after deduction of 'C' blue losses and 'D' disaster losses and, for the last fiscal year, up to the amount of income before deducting enterprise tax losses for the last fiscal year.

4. Deductible losses in the event of debt forgiveness, etc. due to corporate reorganization, etc.

Notwithstanding the dissolution of a company, a reassessment under the provisions of the Corporate Reorganisation Act or the Civil Rehabilitation Act or a decision to initiate rehabilitation proceedings might be made during one of the ordinary fiscal years. In such a case if any of the facts listed in (i) to (iii) below occurs, the total of the amounts falling under (i) to (iii) may be included in deduction if the expired loss is based on the loss incurred in each financial year before the applicable year.

(i) When debt is discharged from a creditor:

Gain on debt forgiveness

(ii) When a gift is received from a director or officer:

Gain on donation of private property

(iii) When an asset is revalued:

Gain on revaluation

The amount of loss carried forward is the amount after deducting 'C' blue tax return losses and 'D' disaster losses. Therefore, by giving priority to the deduction of expired losses, blue tax return losses[vi] can be carried forward for further years.

** For information on deductibility of tax losses carried forward, refer Japan Tax Bulletin no. 22-01.*

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[i] *Article 13 and 14(1)(i)and (v) of the Corporate Tax Law*

[ii] *Article 59(1)(iv) of the Corporate Tax Law*

[iii] *Corporate Tax Basic Circular 12-3-7~9*

[iv] *Article 117-5, Order for Enforcement of the Corporate Tax Law, Corporate Tax Basic Circular 12-3-2*

[v] *Article 62-5(5) of the Corporate Tax Law*

[vi] *Article 57(1) of the Corporate Tax Law*