

**A Study from the Accounting Point of View on
the Adoption Tendency of the Consolidated Income Tax System
— From a Research of Listed Companies
on the First Section Market of the Tokyo Stock Exchange —**

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For companies listed on the First Section Market of the Tokyo Stock Exchange, we conducted a research for the tendency that companies adopt a consolidated income tax system introduced to Japan starting from a financial year ending on or after March 31, 2003. This article clarifies the current situation and problems on the basis of the result of the research.

Firstly, we inquired about the tendency of introducing the consolidated income tax, and approximately 40 percent of all the companies expected to introduce it.

Secondly, because the income sum approach and profit and loss transfer approach of the consolidated income tax system were not sufficiently understood, it was solely focused to be used to offset the loss carried forward by a parent company and its subsidiary company against profit with a whole group.

Thirdly, approximately half of the companies said that it was not desirable to adopt a market value basis for assets of their subsidiary companies when the consolidated income tax system was applied.

Fourth, 86 percent of the companies complained that the loss carried forward by their subsidiary company before the financial year of the consolidated income tax system was not allowed to be taken over at all, which means that the economic single entity approach is stronger than the economic separate entity approach in Japan.

Fifth, 65 percent of the companies said that it was not desirable that no general contribution with the consolidated group was qualifying for deduction. It means that they are worried that there will be a difficulty in calculating fair value.

Sixth, approximately 33 percent of the companies are considering having a spin-off system or a holding company in relation to the consolidated income tax system.

Seventh, it seems that companies do not feel an urgent necessity to create the consolidated income tax system or the tax allocation system.

Keywords: consolidated income tax system, Japan Economic Organization, income sum approach, profit and loss transfer approach, tax allocation system, consolidated income tax system, prevention of tax avoidance, losses of consolidated subsidiary corporations, and market value basis for assets of subsidiary companies

Introduction

Because more companies are restructured by stock transfer, stock-for-stock, establishment of a new holding company, split-up of shares, and mergers, the consolidated income tax system started to be introduced in 2002 from the viewpoint with the aim of strengthening international competition power and neutrality of taxation. Thus, we conducted research by means of a questionnaire for 1,474 companies listed on the First Section Market of the Tokyo Stock Exchange by post for a period of one month between September 12 and October 12, 2002, and received valid answers from 213 companies with a 14.5 percent answer rate. In this paper, we discuss the tendency of the introduction of the consolidated income tax system by companies and how the system should be on the basis of the result of the answers from the companies.

I Result of research

Firstly, we will clarify the tendency of the research result. Next, as 48 companies which were the members of the Tax System Committee of the Economic Legal Headquarter in the Japan Economic Organization (its answer rate was 36.9 percent) were included in the valid answers, we will discuss how we will handle the system in future by showing the result of cross analyses that we conducted, where necessary, to determine whether there was a difference in answers between members of the Tax System Committee (48 companies) and non-members (165 companies).

1 Change in the tendency of introducing the consolidated income tax system

We inquired about the tendency of introducing the consolidated income tax, and found that approximately 40 percent of the companies were going to introduce.

- ① Planning an early introduction regardless of abolition of surtax: 16 companies (7.5%)
- ② Planning to introduce when the surtax is abolished: 8 companies (3.8%)
- ③ Planning to introduce when we decide appropriate: 62 companies (29.1%)
- ④ Still not determined whether to introduce or not: 33 companies (15.5%)
- ⑤ No plan to introduce: 93 companies (43.7%)

In comparison with research conducted by the Research Room of Daiwa Research Institute¹ before introducing the consolidated income tax system, only 19.4 percent answered that it was not decided but it is highly possible to introduce in the future including introduction in the initial year, 2002. However, in research this time, approximately 40 percent (86 companies) were showing a positive attitude toward introducing the system.

In addition, 56 percent of the members of the Tax System Committee of the Economic Legal Headquarter in the Japan Economic Organization (called "members" hereinafter) and 36 percent of the non-members (called "non-members" hereinafter) were planning to introduce the consolidated income tax system whereas 25 percent of the members and 50 percent of the non-members were not going to introduce it. It indicates that there is a major difference between members and non-members.

2 How to file the consolidated income tax return

Firstly, we inquired about adoption of the consolidated income tax system by income sum approach, and approximately 30 percent said it was desirable, approximately 10 percent said it was not desirable, and the remaining 60 percent or so were undecided.

- ① Not desirable at all: 6 companies (2.8%)
- ② Not desirable to a certain extent: 18 companies (8.5%)
- ③ Undecided: 121 companies (56.8%)
- ④ Desirable: 57 companies (26.8%)
- ⑤ Very desirable: 6 companies (2.8%)

The income sum approach this time is said to be a type between the French² and American types. Japan took the income sum approach this time, in which there were 52 percent of the members and 58 percent of the non-members, but it is regardless of the type of the consolidated income tax system that they were going to introduce. It indicates that members and non-members exceed the majority respectively.

Secondly, approximately 65 percent of the companies were undecided when we inquired whether the profit and loss sum approach (which is the same as the profit and loss transfer approach) should be adopted for the consolidated income tax system.

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| <ul style="list-style-type: none">① Prefer profit and loss transfer approach: 29 companies (13.6%)② Undecided: 140 companies (65.7%)③ Prefer income sum approach this time: 39 companies (18.3%) |
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There are the group relief system by the U.K. and the institution system by Germany in the profit and loss transfer approach. The institution system is as follows. "It is located in a country where a corporation or a limited joint stock company implementing an operation is responsible for an obligation of making a payment of the total profit to another company as an institutional company by making a profit payment agreement (Gewinnabfuhrungsvertrag)³ stipulated in Article 291 of Stock Law. A representative of the institutional company adds income (zurechnen) produced by others (Einkommen) when the condition is met". 60 to 80 percent of the companies were undecided on whether the profit and loss transfer approach should be adopted for the consolidated income tax regardless of the type of the consolidated income tax system that they were going to introduce, wherein 58 percent were the members of the Tax System Committee and 68 percent were the non-members. It shows that there is no major difference.

3 Scope of consolidation

Firstly, in introducing the consolidated income tax system, we inquired whether it was desirable that the system was applied only to 100 percent owned subsidiary companies, and more than 40 percent of the answers

were undecided. Then, we inquired 100 percent owned subsidiary companies, and 25 percent were undecided.

- ① Undecided: 94 companies (44.1%)
- ② Desirable by less than 80%: 14 companies (6.6%)
- ③ Desirable by more than 80%: 26 companies (12.2%)
- ④ Desirable by more than 90%: 21 companies (9.9%)
- ⑤ Very desirable: 54 companies (25.4%)

Approximately 30 percent of the members and 50 percent of the non-members said that they were undecided about the scope of consolidation. The percentage in which a consolidated subsidiary corporation should be held by country is as follows; the United States is 80 percent or more, France is 95 percent or more⁴, England is 75 percent or more, and Germany is 50 percent or more. Owning 95 percent or more by France means that the stock has a voting right and a right of receiving dividend, and the remaining 5 percent are stock options. It is therefore effectively 100 percent, which is the same as Japan. Originally, neutrality of the taxation in the consolidated income tax system means that there is no difference in tax amount between where internal organizations such as branch or a department system are used and where the subsidiary company system is used, and thus it should be reasonable for its original meaning that a 100 percent owned subsidiary company is defined as a consolidated subsidiary corporation.

Next, approximately 70 percent of the companies were affirmative about the enforcement of the consolidated income tax system on all 100 percent owned subsidiary companies, and a greater number of the companies said that they must accept the enforcement about the scope of consolidation regardless of the type of the consolidated income tax system that they were going to introduce.

- ① Not desirable at all: 30 companies (14.1%)
- ② Not desirable to a certain extent: 35 companies (16.3%)
- ③ Must accept: 110 companies (51.6%)
- ④ Desirable: 24 companies (11.3%)
- ⑤ Very desirable: 11 companies (5.2%)

Regarding the enforcement of selection of the scope of consolidation, 65 percent of the members and 68 percent of the non-members had an affirmative opinion, saying it was desirable or they had to accept, which means that there is hardly a difference.

The United States adopts the enforcement and France adopts the voluntary selection⁵. The enforcement of the scope of consolidation needs to exist for the neutrality of the taxation and exclusion of arbitrariness.

4 Taking over the loss carried forward of a subsidiary company

86 percent (183 companies) said that it was not desirable that the loss carried forward of the subsidiary company before the financial year in which the consolidated income tax system was introduced is not allowed to be taken over at all.

- ① Not desirable at all: 142 companies (66.7%)
- ② Not desirable to a certain extent: 41 companies (19.2%)
- ③ Must accept: 26 companies (12.2%)
- ④ Desirable: 0 company (0%)
- ⑤ Very desirable: 1 company (0.5%)

The loss of a consolidated subsidiary corporation produced on a non-consolidated basis, that is, before starting to introduce or participate in the consolidated income tax system cannot be deducted by carrying forward in the consolidated income tax return. 96 percent of the members and 83 percent of the non-members said that it was not desirable to take over the loss carried forward of the subsidiary company, which means there is a 13 percent difference between them. The loss of the consolidated subsidiary corporation produced on a non-consolidated basis, that is, before starting to introduce or participate in the consolidated income tax system cannot be deducted by carrying forward in the consolidated income tax return.

5 Market value basis for assets of subsidiary companies

45 percent of the companies said that it was not desirable to adopt a market value basis for assets of the subsidiary company when the consolidated income tax system was applied, whereas 46 percent of the companies, which is almost the same percentage, were undecided.

- ① Not desirable at all: 60 companies (28.2%)
- ② Not desirable to a certain extent: 35 companies (16.4%)
- ③ Undecided: 100 companies (46.9%)
- ④ Desirable: 14 companies (6.6%)
- ⑤ Very desirable: 2 companies (0.9%)

48 percent of the members and 22 percent of the non-members said that it was not desirable at all, which means there is a difference of more than double between them.

6 Contribution

In response to an inquiry that the amount of general contributions within the consolidated group is not tax-deductible at all, 65 percent of the companies said that it was not desirable, whereas 7 percent of the companies said that it was desirable, which means there is a major difference.

- ① Not desirable at all: 98 companies (46.0%)
- ② Not desirable to a certain extent: 41 companies (19.3%)
- ③ Undecided: 59 companies (27.7%)
- ④ Desirable: 12 companies (5.6%)
- ⑤ Very desirable: 1 company (0.5%)

Article 81-6 ② of Corporation Tax Law stipulates that "the total contribution that the consolidated corporation paid to another consolidated corporation between which there is a relationship of complete control by consolidation is not tax-deductible," which means that the contribution is not allowed to be offset against a loss. Regarding the fact that the total contribution in the consolidated group is not tax-deductible, approximately 70 percent of the members and 40 percent of the non-members said that it was not desirable at all, which means there is a 30 percent difference between them.

7 Entertainment expenses

We inquired about consolidated parent corporations carrying out tax adjustment where entertainment expenses are arranged not to be deductible in a lump sum, and in a simple survey, 50 percent said that it was not

desirable.

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| <ul style="list-style-type: none"> ① Not desirable at all: 68 companies (31.9%) ② Not desirable to a certain extent: 41 companies (19.2%) ③ Must accept: 92 companies (43.2%) ④ Desirable: 9 companies (4.2%) ⑤ Very desirable: 0 companies (0%) |
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When we inquired about entertainment expenses being made non-tax-deductible in a lump sum in consolidated parent companies, 46 percent of the members and 43 percent of the non-members said they must accept it, which means there is hardly a difference between them.

The background of this answer includes the following reasons. Entertainment expenses are tax-deductible for parent companies, but a non-tax-deductible amount of entertainment expenses of small- and medium-sized companies (the maximum capital being 50 million Yen) could be used, and there is no need for entertainment expenses in cases of a spin-off by separating from a division of a major company. The percentages of negative and positive answers are almost in balance.

8 Treatment of elimination of internal transactions — fixed assets

Firstly, we inquired about fixed asset being made a subject to eliminate internal transactions, and 43 percent of the companies said that it was desirable, whereas 18 percent of the companies said that it was not desirable, which means that the former is more than double.

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| <ul style="list-style-type: none"> ① Not desirable at all: 20 companies (9.4%) ② Not desirable to a certain extent: 17 companies (8.0%) ③ Undecided: 82 companies (38.5%) ④ Desirable: 74 companies (34.7%) ⑤ Very desirable: 17 companies (8.0%) |
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The total of the 52 percent of the members and 40 percent of the non-members said that it was desirable that the fixed asset is made a subject to eliminate internal transactions, which means that there is a 10 percent difference between them.

Secondly, we inquired about financial obligations being made a subject

to eliminate internal transactions, and 44 percent of the companies said that it was desirable and 11 percent of the companies said that it was not desirable in the simple survey, which means that the former is more than 4 times greater than the latter.

- ① Not desirable at all: 11 companies (5.2%)
- ② Not desirable to a certain extent: 13 companies (6.1%)
- ③ Undecided: 93 companies (43.7%)
- ④ Desirable: 79 companies (37.1%)
- ⑤ Very desirable: 14 companies (6.6%)

The total of 44 percent of the members and 44 percent of the non-members had an affirmative opinion, saying that it was desirable, which means that there is no difference between them.

Thirdly, we inquired about inventory being not made a subject to eliminate internal transactions, and 37 percent of the companies said it was desirable and 25 percent of the companies said it was not desirable in the simple survey, which means that the former is larger than the latter.

- ① Not desirable at all: 19 companies (8.9%)
- ② Not desirable to a certain extent: 33 companies (15.5%)
- ③ Undecided: 79 companies (73.1%)
- ④ Desirable: 59 companies (27.7%)
- ⑤ Very desirable: 19 companies (8.9%)

We inquired about inventories being made a subject to eliminate internal transactions, and total of 50 percent of the members and 33 percent of the non-members said that it was desirable, which means that there is a 7 percent difference between them.

9 Restructure of companies

We inquired whether the companies were considering to use a corporation spin-off system or having a holding company, and approximately 33 percent of the companies said that they were considering it because the corporation is originally restructured before the consolidated income tax system is adopted.

- ① Already have the system: 46 companies (22.0%)
- ② Considering to have the system: 25 companies (12.0%)
- ③ Unknown: 18 companies (8.7%)
- ④ Not considering to have the system: 113 companies (54.3%)
- ⑤ No intention to have the system in the future: 6 companies (2.9%)

10 Practicability of the consolidated income tax system

Firstly, we inquired whether the consolidated income tax system was simplified enough to be useable, and as high as about 80 percent of the companies said that it was complicated to use.

- ① Very complicated: 74 companies (34.9%)
- ② Complicated: 97 companies (45.8%)
- ③ Undecided: 37 companies (17.5%)
- ④ Simplified: 4 companies (1.9%)
- ⑤ Very simplified: 0 company (0%)

Secondly, regarding whether they were going to adopt a new consolidated income tax system on the introduction of the consolidated income tax system, the reason why only 35 percent of the companies say that they will adopt a new consolidated income tax is that they don't feel an urgent necessity, although as high a proportion as approximately 80 percent of the companies said that the system was complicated in the previous question.

- ① Adopt a very complicated system: 10 companies (4.7%)
- ② Adopt a complicated system: 26 companies (12.1%)
- ③ Undecided: 140 companies (65.7%)
- ④ Adopt a simplified system: 34 companies (16.0%)
- ⑤ Adopt a very simplified system: 3 companies (1.4%)

Thirdly, although introduction of a consolidated income tax will have a major effect on the tax allocation system, as low a proportion as approximately 20 percent of the companies need a creation of a new tax allocation

system. This indicates that it has not been discussed yet, and they do not feel an urgent necessity of introducing the system.

- ① Adopt a very complicated system: 6 companies (2.8%)
- ② Adopt a complicated system: 10 companies (4.7%)
- ③ Undecided: 163 companies (76.9%)
- ④ Adopt a simplified system: 28 companies (13.0%)
- ⑤ Adopt a very simplified system: 5 companies (2.4%)

11 Prevention of tax avoidance in the consolidated income tax

We inquired about the fact that a regulation for negating action or calculation of the consolidated corporation to prevent tax avoidance by using the consolidated income tax system was made, and the answer was as follows.

- ① Not desirable at all: 25 companies (11.7%)
- ② Not desirable to a certain extent: 23 companies (10.8%)
- ③ Undecided: 108 companies (50.7%)
- ④ Desirable: 50 companies (23.5%)
- ⑤ Very desirable: 1 company (0.5%)

Regarding the creation of the regulation for negating the action or calculation, 24 percent of the companies said that it was desirable and 23 percent of the companies said that it was undesirable, which indicates that they are almost the same. Unless there is a detailed regulation for tax avoidance, an action of avoidance can be judged comprehensively under this regulation where facts are authorized to be judged case by case.

Regarding the creation of the regulation for negating the action or calculation of the consolidated corporation to prevent tax avoidance of the consolidated income tax, 58 percent of the members and 49 percent of the non-members were undecided, which means that both exceed the majority or are close to it.

II A study from viewpoints of accounting theories of consolidated income tax for internal transactions

1 The amount of losses of consolidated subsidiary corporations

In Japan the losses carried forward that a subsidiary company owned before the participation in the consolidated income tax group may not be offset by the amount of the consolidated income as a consolidated deduction, because the total amount of the loss carried forward must be deducted except for exceptions at the time of participation in the consolidated group. (Article 81-9 ② of Corporation tax law)

In the USA, losses carried forward are succeeded in cases where a certain company has acquired assets of another company. "(a) a legal merger, (b) an acquisition by an exchange of shares with voting rights of one's own company and shares of another company in order to control that other company after the acquisition, (c) an acquisition by an exchange of assets of another company and shares with voting rights of one's own company, (d) if the transferee company becomes under the control of a company to which its assets are transferred, a transfer where part or the whole of the assets of one's own company will be made to another company by exchanging with the shareholders of that other company, (e) an exchange of shares and corporate bonds under a restructure, and distribution of shares and corporate bonds of the controlled company, (f) capital restructure, and (g) mere change in the name, type or address of a company⁶" "Losses carried forward before the inclusion in the consolidated income tax group may be deducted up to the separate amount of taxable income of that subsidiary company for each fiscal year⁷."

As such, in the USA, consolidated income cannot succeed the losses carried forward before the participation in the consolidated income tax group, but the losses carried forward before the participation in the consolidated income tax group may be deducted up to the separate amount of taxable income of that subsidiary company for each fiscal year. It can be said that the method of the USA is a concept of an economic single entity approach, and that of Japan is a concept of a single entity approach.

2 Valuation at market of assets of a subsidiary company before the start of the consolidated income tax system

This way of thinking of profit or loss on valuation at market in respect of assets accompanied by the start of the consolidated income tax system is that unrealized profit or loss must be recognized by valuing latent profit or loss of assets that has arisen on the non-consolidated basis, that is, the tax relationship must be settled once at the time of the transfer from taxation on a non-consolidated basis to that on a consolidated basis, and continuity is not allowed between taxation on a non-consolidated basis and that on a consolidated basis.

Firstly, its aims are said to be (1) to prevent a tax avoidance action to reduce its taxable income by bringing about latent profit or loss of a consolidated subsidiary corporation that has arisen before the application of consolidated income tax into the amount of consolidated income tax after the start of consolidated income tax, and (2) not to have an effect on adjustment of book values of shares of consolidated subsidiary corporations by making restriction on bringing about latent profit or loss into consolidated income tax⁸.

Secondly, the Japanese rule does not allow losses carried forward before the participation in the consolidated group to be succeeded at all. Japanese companies must be greatly dissatisfied with this point. This shows that the Japanese way has a stronger concept of the economic single entity approach than that of the economic separate entity approach. Accordingly, in line with the principle of Separate Return Limitation Year (called "SRLY" hereinafter) in the USA, "built-in loss shall not be allowed in the consolidated income tax return, but deduction shall be allowed only from the members' income."⁹ will become a future issue. In other words, a controversy will be raised regarding the rule that capital losses or losses carried forward incurred at the time of the separate return before the participation in the consolidated group shall not be offset by consolidated income tax of another consolidated corporation, but can be offset within the income of the corporation making that loss.

Thirdly, let's look at the effect of loss carried forward on the tax allocation system. (1) Because losses carried forward of a consolidated corporation are offset by the consolidated income tax group for that year, the amount of these losses will be smaller than the amount of deferred tax assets accounted for in the individual separate financial statements. For

example, that is the reason why the amount of deferred tax assets accounted for in the consolidated financial statements in the UK, where profit and loss transfer approach is adopted, will become smaller. (2) As regards losses carried forward of the parent company and its subsidiary companies, in cases where consolidated income tax is adopted, the possibility of the collection of the deferred tax assets will be examined in the whole consolidated income tax group under the corporation tax law, and it is therefore considered that the possibility of collection will generally become greater than in the case of the separate return.

(3) The consolidated income tax system cannot be applied to regional taxes. Tax allocation system will therefore be examined for the parent company and its subsidiary companies separately. It is estimated that examination will be carried out as to whether the adoption of consolidated income tax may be made as to the corporation levies in respect of business tax and residential tax from the viewpoints of the principle of neutrality and simplicity of taxes.

3 The relationship between transactions at market value of internal transactions and contributions

Offset is not allowed as a penalty of tax avoidance by saying, "The amount of contributions that a consolidated corporation has paid to another consolidated corporation between which there is a relationship of the complete consolidated control may not be tax-deductible." (Article 81-6 ② of Corporation Tax Law) Because of this rule, as regards transactions within a consolidated group, under the consolidated income tax system, transactions of domestic subsidiary companies will be made on the market value basis, but on the other hand the transfer pricing tax system will become an issue in cases of transactions of overseas subsidiary companies. We will therefore examine whether the transfer pricing theory may be invoked.

Firstly, regarding the provision of human services, and, in particular, salaries paid to a temporarily transferred person physically staying at a corporation to which the temporary transfer is made (a subsidiary company) by a corporation from which the temporary transfer is made (a parent company), supplementation of the gap between the salaries under the wage systems between the corporation to which the temporary transfer is made and that from which the temporary transfer is made will originally be a

deduction of the corporation from which the temporary transfer is made. However, in that case, where salaries by type of occupation and age in the wage census are applied and a major gap arises, the standard whether the parent company unreasonably supports the subsidiary company in the matter of wage supplementation or not, in other words, whether it will be deemed to be a contribution or not, will become an issue.

Secondly, many Japanese subsidiary companies are regional production companies created by a spin-off separated from a manufacturing division or an accounting, general affairs or computer company made by a spin-off from an administrative division. Calculation of market prices at the time of transfer of intangible assets of manufacturing knowhow in the manufacturing processes to a production company and calculation of market values by the arms length standards in respect of commissioned processing expenses at the time of delivery of inventories at the inventory cost will be necessary.

Thirdly, where a parent company has let its subsidiary company use its brand (trade mark), "for example, a subsidiary company, Ciba(us) pays royalties to its parent company, Geigy-Basle (a tax haven, Switzerland), at 10 percent, but the IRS asserted that the rate should be reduced by 6 percent. On the grounds that DuPont has paid similar royalties in the comparable price method in the range of 10 percent to 12.5 percent, a court decided in favour of the taxpayer."¹⁰. Nevertheless, in case where a parent company in Japan lets its wholly owned subsidiary use its brands, there will be an issue of whether or not a problem of accreditation of a contribution similarly to transfer pricing will be raised.

As above, how the comparable price method, resale price method, cost plus method and comparable profit method which incorporates financial analysis in this, or profit split method under the principle corresponding to income will be applied to market prices in accrediting contribution will become an issue as a method to determined arms length prices.

Fourthly, in cases of domestic subsidiary companies, there will be a problem of accrediting contribution in relation to market price (fair value) transactions, but in cases of overseas subsidiary companies transfer pricing will become a major problem, so consideration must be made in combination with these. "More than two organizations directly or indirectly owned or controlled in the same proportion, commercial transactions or business (in all cases of whether it is a legal corporation or not, whether it is orga-

nized in the US or not, or whether it is a related company or not) cases, if such distribution, allocation or application is required to prevent tax avoidance, or if it is decided that some income of such organizations, commercial transactions or businesses will be clearly reflected, the director shall distribute, allot and apply gross income, deduction, credit or allowance between organizations, commercial trades or businesses”¹¹. This means the following: (1) The Internal Revenue Agency authorizes relevant taxpayers to allocate gross income, deduction, credit or allowance. (2) It is based on the principle that it should be valued on the basis of the arms length standards for transactions between relevant parties — in other words, a method of transactions where separate parties must have formed in independent transactions¹². Accordingly, while income is allocated under the transfer pricing system in the USA, the negation of contribution to another consolidated corporation in Japan means double taxation in cases of consolidated income tax group. That will be the same thing as taxation on the non-consolidated basis.

4 Internal transactions of fixed assets

Firstly, unrealized profit or loss is eliminated as the elimination of internal profit or loss by stipulating that “all the amounts of unrealized profit or loss included in inventory assets, fixed assets and other assets acquired by transactions between consolidated companies must be eliminated” in preparation of consolidated financial statements; “provided, however, that part of the book values on the seller’s side that is deemed to be irrecoverable shall not be eliminated” (Article 5-3 of the Principles of Consolidation). Internal transactions of fixed assets in consolidated income tax returns in Japan are realized at the time of resale not only outside the consolidated group but also within the consolidated group.

Secondly, controlled groups owned by more than 80 percent¹³ are dealt with in the consolidated income tax return also in the USA where a loss arising from a sale or an exchange between controlled group members tends to be deferred rather than negated. In this respect unrealized profit or loss arising from transactions between consolidated companies within a corporate group will be deferred in the consolidated income tax return also in Japan as internal transactions on the basis of the economic single entity approach.

Thirdly, in cases of losses arising from a sale or exchange between

members of the same controlled group, 267 (a) (1) and (d) shall not be applied to losses in similar cases, but losses in similar cases shall be deferred until the assets are transferred outside the controlled group, and will remain recognized as losses under the standards of the consolidated return or until the time mentioned in the regulation¹⁴. The difference is that its realization is recognized at the time of resale within a consolidated group in Japan, but it will continue to be deferred until it is transferred outside the group in the USA.

5 Corporate restructure and consolidated income tax return

Firstly, the following cases are considered to be fully used as an exception of market price valuation at the start of consolidated income tax: ① a parent company pertaining to stock transfer due to corporate restructure and similarly its wholly owned subsidiary, ② a 100 percent owned subsidiary established by the parent company or its 100 percent owned subsidiary (including 100 percent owned subsidiaries by an eligible spin off by separating from a division, an eligible contribution in kind, an eligible ex post facto establishment), ③ in cases where there is a 100 percent owned subsidiary company as a non-merger corporation, or the like among eligible mergers or the like, and ④ a wholly owned subsidiary company by means of a share exchange that has a certain condition such as continuous holding, etc.

Secondly, I would refer to a split other than in the form of a spin-off by separating from a division and the consolidated income tax. For example, where a split other than in the form of a spin-off by separating from a division is made, a difficult practical problem will arise in considering the consolidated income tax system. The introduction of the consolidated income tax system is therefore usually made in consideration of the relationship with corporate restructuring. In concrete terms, the consolidated business year means, in principle, a period from a day on which the business year of the consolidated parent corporation pertaining to the consolidated corporation starts to the day on which it terminates. However, Article 57 ⑦ of Law stipulates that "where a corporation has made a split other than in the form of a spin-off by separating from a division in a split in which the corporation itself is a corporation which split up in the middle of the consolidated business year, a period from a day on which it started to the day prior to the day of the split shall not be included in the consolidated busi-

ness year". In this case, discontinuity occurs in that the period from a day on which the consolidated business year starts to the day prior to the day of the split will be excluded from the consolidated business year (that is the separate business year) because part or the whole of the businesses will be transferred from the corporation that splits up to a corporation which succeeds the split. Losses carried forward in the business year to which the regulation is applied will be treated as follows: Although 9 ⑤ II of Article 81 stipulates "in a case where a split is made in a form other than in a spin-off by separating from a division in a split where a domestic corporation made this corporation a corporation that splits up, and where there is an amount separately attributable belonging to the consolidated losses of the said consolidated corporation having arisen for each of the consolidated business years which started within five years from the day on which the business years started to which a day prior to the day of the said split belongs, the amount separately attributable to the said consolidated losses for each of the business years in or after the consolidated business year to which the day prior to the day of the said split belongs shall be deemed to be an amount of losses having arisen for the business year of the said domestic corporation to which the day on which the consolidated business year started belongs in which the said amount separately attributable to the said consolidated losses have arisen.", this corporation that split shall file a separate return for the amount of loss for each separate year for the amount separately attributable to the consolidated loss. However, the amount separately attributable to the consolidated loss carried forward and deducted will reduce the amount of the consolidated loss.

III Matters which promote introduction of the consolidated income tax system

There are six matters to which attention should be drawn in the introduction of the consolidated income tax.

Firstly, the proportion of loss-making corporations in Japan has increased from 49.6 percent in 1988 to 69.6 percent in 1999¹⁵, increasing by about 20 percent over the last 10 years. According to the National Tax Administration Agency, its use was made for the period ending March 2003 onwards by 164 corporate groups which include NEC, Fujitsu and NTT, but from the period ending March 2003 these companies plus

Mitsubishi Electric and Toshiba are loss making corporate groups which have introduced the consolidated income tax system in order to eliminate losses carried forward at the parent companies by the whole corporate groups.

Secondly, where a corporation owns financial, insurance, and music businesses other than an electronics business such as Sony as a new movement, 8-10 percent (10-12 percent for the initial three years) of the total R & D expenses may be credited against tax under the R & D tax system, and 10 percent of the acquired prices of IT investment may also be credited against tax. However, the maximum amount of tax credit is 20 percent of the total amount of the corporation tax, which will therefore become greater than that on a non-consolidated basis. As a result, because the effect of tax reduction increases, introduction by corporation groups in the black will be promoted. In this way, in line with the increase in understanding the income sum approach of the consolidated income tax system, management strategies taking advantage of its merit will be created.

Thirdly, in cases of most of the Japanese international corporations such as Sumitomo Electric Industries, their 100 percent owned subsidiaries have become parent companies, and they have actual experiences in consolidated income tax on their wholly owned subsidiaries. Top management is therefore very much familiar with the consolidated income tax system. In the USA, consolidated income tax returns correspond to 1.3 percent of the number of corporation tax returns, 57.8 percent of net income (the amount after losses), and 85.9 percent of the amount of corporation taxes before tax credit respectively¹⁶.

Fourth, Matsushita Electric Industries made Matsushita Telecommunications Industries, Kyushu Matsushita Electric, Matsushita Seiko, Matsushita Denso System, and Matsushita Kotobuki Electronic Industries its wholly owned subsidiaries by share exchange on 1st October 2002. The movement of the restructuring of these corporations was made in consideration of the relationship with the negation of taking over losses carried forward and valuation at market value when transferred to assets of subsidiary companies under the consolidated income tax system. This will mean that they are linked to consolidated income tax in the future.

Fifth, provision of development software has been prepared for the consolidated income tax system and the consolidated tax allocation system relating to that for the practicability of the consolidated income tax sys-

tem¹⁷.

Sixth, because 100 percent owned subsidiary companies having existed before 1st January 2002 are not subject to valuation at market value in effect for the consolidated business year beginning on or before 31st December 2006, it is possible that this will be used from the time of the introduction of the consolidated income tax system.

Conclusion

We reported separately (see reference bibliography) the answer results by the **Riccarto** method in the simple totalization, cross totalization results, and cross totalization in respect of the part of the consolidated income tax system out of "Research of the adoption tendency of the consolidated accounting and the consolidated income tax" financed by the subsidy of scientific research expenses for the fiscal year of 2002. In this paper we presented the result of the whole research concerning the consolidated income tax for fiscal 2002 and further the result of the analysis by dividing the subject of research into two groups, that is, members and non-members of the Tax System Committee of the Economic Legal Headquarter in the Japan Economic Organization, and clarified that the necessity of deepening the understanding of the consolidated income tax system through short training courses or advising and spreading its education is requested upon the essential application of the consolidated income tax system. We also try to find the direction of research study for fiscal 2003.

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Notes

- 1 "The result of research of the corporate tendency accompanied by the introduction of the consolidated income tax system" by the Research Room of the Daiwa General Research System: "Shojihomu (Legal affairs of commercial matters)" No.1626 (15th April 2002).
- 2 Code General des Impots (called "CGI" hereinafter) Art 381.
- 3 Article 14 of KstG (Article 14 of German corporation tax law).
- 4 CGI Art 223A alinea.l.
- 5 CGI Art 223 alinea 5.
- 6 Internal Revenue Code Sec 381 (c).

- 7 USA Regulation 1. 1502-21 (b) (2) (i).
- 8 Sai Yonetani, "Valuation at market value in the consolidated income tax system", *Zeimukoho (Tax Information)*, Vol.5 No.7 2003, Pages 7-46.
- 9 USA Regulation 1. 1502-15.
- 10 Richard T Ainsworth, *Text note of 12 case studies of judicial precedent in regard to Transfer Pricing*. Ritsumeikan University 2003, from Judicial precedent 9 Ciba-Geigy Corporation 85 T.C 172 (1985).
- 11 Internal Revenue Code Sec 482.
- 12 George L. White, *Computation of Consolidated tax Liability*, US Income Series, Tax Management Inc., 2002, P149.
- 13 IRC Sec 267 (f) (1).
- 14 IRC Sec 267 (f) (2).
- 15 "The actual situation of corporations seen from the tax affairs statistics 3 and the numbers of corporations in profit and loss-making corporations for fiscal 1999", the National Tax Administration Agency.
- 16 The author calculated with the use of Internal Revenue Service, *Statistics of Income Corporation Income tax Returns*, 1998.
- 17 Hitachi Ltd. and TKC have developed and their products have been for sale for major companies and offices of licensed tax accountants respectively.

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