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Corporate Tax - Japan

Anti-avoidance rules for reorganisation transactions

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Introduction

Article 132-2 of the Corporate Tax Law was enacted in 2001, allowing the tax authorities to disregard certain manipulated reorganisation transactions for the purpose of determining the corporate income tax obligations of the relevant parties. However, the authorities appear not to have used this power until recently. It has been reported that in 2010 the authorities issued a correction determination that relied on this provision: it refused to allow a corporation which had merged with another corporation to carry forward the merged corporation's losses as a successor entity. This case is now pending before the Tokyo District Court.

Corporations should review the implications of Article 132-2. Since it has only recently been applied, there is no useful precedent on which to draw. Therefore, it may be helpful to refer to the lessons learned with respect to Article 132, which allows the authorities to disregard manipulated transactions between closely held corporations and their shareholders or related corporations - the authorities have applied Article 132 in nearly 100 publicly disclosed cases.

Article 132-2 allows the authorities to disregard a reorganisation transaction if it results in corporate income taxes being reduced "improperly".

Reorganisation transaction

A 'reorganisation transaction' includes:

- a merger;
- a corporate split;
- an in-kind capital contribution;
- an in-kind distribution;
- an acquisition of shares in a target using shares in the acquirer as consideration; or
- a transfer of shares by an existing shareholder to a newly established subsidiary holding company.

Article 132-2 applies to reorganisation transactions between independent parties if the transaction improperly reduces the amount of corporate income tax due from the parties.

Improper reduction of corporation tax

Article 132-2 provides that the authorities may disregard a reorganisation transaction if it results in an improper reduction of the corporation tax burden. In the absence of further clarifying regulations or rulings from the National Tax Agency, it is helpful to consider prior rulings by Japanese courts on actions by the tax authorities which interpret the term 'improper' with respect to Article 132. In these judgments, two tests have been used.

Characteristic transaction test
The first test of whether a transaction is improper for a closely held corporation is whether the transaction typically could not be conducted by a corporation that is not

closely held. For example, a court has previously decided that a transaction for the purchase of property for more than its fair value between a closely held corporation and a related corporation was improper.(1) This test has often been applied, but it is relatively vague and has been criticised because transactions that are driven by legitimate business purposes can nonetheless be deemed improper. It is unclear whether the courts will continue to uphold this test in future Article 132 cases. Practitioners indicate that recently the authorities have more often used a second, more conservative test.

Business purpose test and arm's-length transaction test
The second test provides that a transaction is improper if its economic terms and effect are economically unreasonable or unnatural. This test is applied by using one of two further tests: the business purpose test or the arm's-length transaction test.

Under the business purpose test, the authorities may deem a transaction improper if it does not serve sufficient legitimate business purposes (eg, making a profit or ensuring regulatory compliance). A transaction is improper if it is abnormal or irregular and has insufficient business purpose, but has the effect of reducing applicable corporate taxes (eg, a transaction that is expected to generate losses, with no expected profits). Where a transaction's purpose is purely to avoid tax, it will be deemed improper.

Under the arm's-length transaction test, the tax authorities compare the transaction against a similar transaction that would reasonably be conducted on equal terms between independent entities (ie, an arm's-length transaction) to see whether the terms of both transactions are consistent. This test is typically used where a comparable arm's-length transaction exists. However, it is sometimes difficult to find a sufficiently comparable transaction. Therefore, the focus is on the business purpose test.

Implications for Article 132-2
The structure of Article 132-2 is the same as Article 132. Therefore, it can be assumed that the meaning of 'improper' for the purposes of Article 132 will also apply to Article 132-2. However, it will generally be challenging for the tax authorities to find an improper reduction of taxes caused by a transaction if it can be demonstrated that independent parties would have conducted such a transaction at arm's length on similar terms, unless the transaction is clearly shown to have been conducted primarily as a tax reduction scheme.

Effect of rejection

Hypothetical transactions
If anti-tax avoidance provisions such as Article 132 are triggered, the authorities recompute the relevant tax obligation. In order to do so, they generally create hypothetical transactions with recharacterised terms based on the transactions at issue. The hypothetical transactions will have terms that are more natural and have an economically reasonable business purpose. The authorities then recalculate the relevant entities' tax obligations based on the hypothetical transactions. For instance, a non-interest-bearing loan from a closely held corporation to its shareholder (who was a director) was deemed not to be economically reasonable for the corporation, because the loan did not generate a profit and was regarded as having improperly reduced its corporate tax liability. The tax authority recalculated the company's tax obligation figures after determining an economically reasonable amount of interest as income from the loan; it deemed that the corporation had paid the amount of interest to the director as a bonus, which was not deductible from the corporation's taxable income.(2)

Article 132 grants the authorities power to recharacterise transactions for the purposes of calculating the relevant entities' tax obligations; however, it does not change the legal obligations between parties to a contract. In the above example, regardless of whether the closely held corporation had earned or had a right to receive interest, the tax authority could calculate its tax obligation as if the closely held corporation had earned a reasonable amount of interest on its taxable income, even though the corporation did not have a legal right to claim interest from the director.

Although Article 132 does not require the authorities to create a reasonable hypothetical transaction in order to recalculate applicable tax obligations with respect to a disregarded transaction, in practice the authorities have adopted a policy of doing so in order to avoid criticism for applying Article 132 excessively or inappropriately.

Implications for Article 132-2
The structure of Article 132-2 is the same as Article 132. Therefore, it can generally be assumed that the authorities will prefer to apply hypothetical transactions with respect to disregarded transactions under Article 132-2. It may be more challenging to determine economically reasonable terms for hypothetical reorganisation transactions (compared with transactions among closely held corporations that are disregarded under Article 132), since reorganisation transactions are typically much more complex. Thus, the authorities may find it more challenging to recharacterise improper reorganisation transactions under Article 132-2 because it will be difficult for them to

determine which aspects of an improper reorganisation should be disregarded, and to determine the correct hypothetical transaction to apply when recalculating applicable corporate taxes.

Comment

It has been 10 years since the introduction of Article 132-2, but there have recently been increased reports of abusive reorganisation transactions seeking improper tax reductions. The authorities are likely to increase their tax audits of such transactions, and tax practitioners can expect to see an increased application of Article 132-2.

For further information on this topic please contact Toshinori Uneki *or* Nathan Schmidt *at Nishimura & Asahi by telephone (+81 3 5562 8500), fax (+81 3 5561 9711) or email (* t_uneki@jurists.co.jp *or* n_schmidt@jurists.co.jp*).*

Endnotes

(1) July 31 1969, Fukuoka District Court.

(2) February 27 1961, Tokyo High Court.

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