# Tax developments challenge Japanese taxpayers

**Eiki Kawakami of Kojima Law Offices looks back at a busy few months for the Japanese tax system. Politics and disputes have been keeping taxpayers busier than ever with a number of important decisions making many think twice about how they structure their work.**

The Democratic Party of Japan suffered a crushing defeat in the House of Councilors Election on July 11 2010. During the election campaign, particularly when the campaign was heating up towards the end of June, Prime Minister Naoto Kan (member of the Democratic Party of Japan), who returned from the G8 meeting held in Toronto, abruptly proposed to double the consumption tax rate from 5% to 10% and reduce the corporate tax rate to 25%. Although it was apparent that Japan must adopt these tax measures to meet the fiscal challenges faced by the country, such as promoting economic growth and restoring government finances, his approval ratings declined as soon as he began campaigning. As a result, the ruling party suffered a crushing defeat in the election. Judging from the sentiment of the people, it seems that Kan's proposals were considered handouts to large corporations at the expense of the general public.

The Japanese corporate tax rate of 41% is significantly higher than tax rates in other countries. Since the opportunity to reduce the tax rate effectively vanished in the wake of the election defeat, tax directors of multinational companies will likely continue their efforts to minimise their effective tax rate in Japan. Amid the political developments described above, two significant tax disputes were recently reported and are summarised below.

## Yahoo Japan

The taxpayer in this dispute was Yahoo Japan. Softbank, a leading telecommunications company, held 40.95% of Yahoo Japan's outstanding shares and Yahoo Inc. (the US parent of Yahoo Japan) held 34.79% of the outstanding shares.

In February 2009 Yahoo Japan purchased from Softbank 100% of the outstanding shares in a subsidiary of Softbank which operated a data centre. Then, Yahoo Japan took over the subsidiary's business operations by merging the purchased subsidiary into Yahoo Japan. Through the merger, Yahoo Japan acquired the purchased subsidiary's tax loss carry-forward which amounted to ¥21 billion ($230 million). However, the Japanese tax authorities found that Yahoo Japan could not acquire the tax loss carry-forward and issued a Tax Reassessment Notice on June 30 2010.

By virtue of the 2001 tax reforms which changed the tax rules relating to mergers and other reorganisations, the tax loss carry-forward of a predecessor company in a merger can be acquired by the merged company, provided that a transaction will not fall foul of the anti-tax avoidance provisions that the law specifically prescribes for the succession of a tax loss carry-forward in a merger. There are two requirements to acquire the tax loss carry-forward in a merger. Firstly, the merger must create synergy. Secondly, certain members of management of the predecessor company must be retained as members of the management of the merged company.

Yahoo Japan maintained that both requirements were met because the purpose of the merger was to utilise the data center capabilities of the purchased subsidiary for Yahoo Japan's cloud computing business. and that the president of Yahoo Japan had also been a vice president of the purchased subsidiary since 2007.

However, the tax authorities asserted that for the first requirement, Softbank's cash funding needs was an essential reason for the transfer of shares. Further, the tax authorities asserted that it would not be possible to treat the merger as a transaction that was conducted proactively to meet a business necessity. For the second requirement, although the tax authorities stated that the requirement might be fulfilled in form, they found that the requirement was not fulfilled in substance. The tax authorities also stated that in the determination of the price of the shares of the purchase subsidiary, the expected amount of tax savings that Yahoo Japan would be able to obtain by the acquisition of the tax loss carry-forward was factored into the price of the shares.

This dispute indicates that the tax authorities are not reluctant to take the concept of substance over form and apply it broadly in their determination of whether the two requirements have been met. However, as it seems likely that the case will be appealed through the courts, time will tell whether such a broad application of the concept of substance over form is warranted.

## IBM Japan

The taxpayer in this dispute was IBM Japan. The tax authorities recently issued a Tax Reassessment Notice on the grounds that the company's reported taxable income in 2008 (and in subsequent years) was understated by ¥400 billion ($4.4 billion). The structure of the transaction is described below:

1) The seller owns 10 shares issued by the target (all of the outstanding shares of the target);
2) The target has capital of 100 and retained earnings of 900;
3) The seller will sell the 10 shares of the target to the buyer and the sale price of the 10 shares will be equal to the sum of the capital and retained earnings, such as 1000. The sales price per share will therefore be 100; The seller's cost basis of the shares is equal to the capital of the target or 100. Therefore, the seller will recognise a taxable gain of 900 in the sale of the shares. Since the appreciation of the shares has been created by the earnings of the target, there would be double taxation on the earnings such as the taxation on the target on its earned profits and taxation on the sale of the target's shares;
4) After acquiring the shares of the target, the buyer will have the target buyback nine shares that were originally owned by the target (the target will pay 900 to the buyer and acquire nine treasury shares). For tax purposes, the 900 that the buyer will receive will be deemed to consist of a dividend distribution of 810 and consideration of 90 for the transfer of the shares. The dividend distribution is exempted from taxation as it is paid out from profits that have already been taxed. For the consideration of 90 for the transfer of the shares, the corresponding cost of the shares is allowed to be offset. Therefore the buyer is allowed to report a taxable loss of 810. (The taxable loss of 810 should be regarded as the recovery of the 90% portion of the double taxation noted above);
5) If the buyer is a holding company and

does not have taxable profit, the buyer and target can file consolidated tax returns. By doing so, it becomes possible to offset the taxable loss of 810 against the taxable profits of the target.

Presumably, the structure described above is the structure that IBM implemented which is the focus of the Tax Reassessment Notice. This means that the target is IBM Japan (an operating company in Japan), the seller is IBM Corporation (the parent company of IBM Japan in New York), and the buyer is IBM AP Holdings (a holding company established in Japan by IBM Corporation).

It should be noted that because the structure implemented would ordinarily cause taxes to be imposed at an initial stage, the implementation of the structure would usually not generate any tax savings. However, if the seller is a qualified resident of the US for the purposes of the double tax treaty between Japan and the US, the above-mentioned Japanese taxation of the capital gain of 900 will be exempt from Japanese taxation and would create significant tax savings in Japan.

## 2010 Tax Reforms

For Japanese tax reforms in 2010, what is most interesting is that certain sections of the tax law (and related regulations which are relevant to the above-mentioned taxable loss of 810) were reformed. As a result, under similar circumstances, the tax deduction of the loss of 810 will no longer be allowed when the new law takes effect on October 1 2010.

The new law provides that: if a domestic corporation transfers shares to the corporation that issued the shares and if the transferor and transferee are wholly-owned affiliates within a corporate group, any gain or loss realised by the transfer will not be recognised for tax purposes; and if a domestic corporation acquires shares intending to subsequently have the shares acquired as the treasury shares of the corporation that issued such shares and if the shares are acquired as a treasury share by the corporation which issued the shares, the tax exemption of the dividend distribution received will not apply.

Given the nature of these reforms, it would seem that the tax deduction of losses (as was done in the IBM structure mentioned above) were in compliance with applicable tax laws and regulations then in effect. However, the tax authorities seem to be taking the position that general principles of anti-tax avoidance will apply even before a specific anti-tax avoidance rule is enacted.

## Tax litigation

In the field of tax litigation, on December 3 2009, the Supreme Court rendered a significant judgment involving the constitutional principle that no taxes can be assessed without a law requiring such assessment. The court case concerned a dispute over whether or not a tax payment to the government in Guernsey qualified as a foreign tax payment under the Japanese controlled-foreign company (CFC) rules. The tax laws in Guernsey allow a taxpayer to choose the tax rate which would apply to a taxpayer and a captive insurance company in Guernsey that is a member of a Japan-based corporate group. The company selected the tax rate of 25.5% which was slightly higher than the threshold tax rate of 25% under the Japanese CFC rules.

Although the tax authorities asserted that a payment in Guernsey would not qualify as a foreign tax payment under Japanese tax laws, the Supreme Court held that the payment constituted the payment of a tax because it satisfied the requirements of a payment of tax established in previous court precedents. Further the Supreme Court found that it was a foreign corporate tax as it satisfied the requirements of the foreign corporate tax prescribed in the corporate income tax law. Consequently, the taxpayer prevailed.

In the lower court, the tax authorities pointed out that "when a legislator legislates, the legislator will envision certain situations (which will be covered by such legislation), but will not be able to envision every situation (that should be covered by legislation). Therefore, it is inevitable that written laws will become general and abstract". The tax authorities also asserted that, "a court must assume the authority and responsibility to establish concrete rules applicable to a dispute based on such general and abstract laws in order to settle disputes.", and therefore, "when a court interprets a law, the interpretation should inevitably include the function of creating law". This assertion by the tax authorities seemed to be the authorities' basis of the above-mentioned tax reassessment directed against Yahoo Japan.

The tax authorities also asserted that "some may argue that tax avoidance can be prevented by legislation. However, in the area of international tax avoidance, legislation based on prior experience has limitations in preventing tax avoidance and thus we can not solely rely on the legislature to solve tax avoidance problems and maintain the principle of equal taxation". This assertion by the tax authorities seemed to be the authorities' basis of the above-mentioned tax reassessment on IBM Japan. However, the Supreme Court rejected these assertions, at least in the Guernsey case.

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