March 2022

Follow @Paul_Hastings

International Corporate Restructuring and Tax-free Intra-group Transfer of Shares (Japan Perspective)

By Toshiyuki Arai

When a multinational company transfers shares within its global group via contribution-in-kind for purposes of international corporate restructuring, a key consideration is whether such transfer can be achieved tax-free. The applicable Japan tax rule has been clarified in a recent decision by Tokyo District Court.[1]

Underlying rule

Intra-group transfers of assets and liabilities taking place outside of Japan (i.e., from outside and to outside of Japan) can be made on a tax-free basis so long as the requirements for Qualified Contribution-in-Kind (*tekikaku genbutsu shusshi*) are satisfied. For example, the Japan parent company may transfer tax-free the shares of a wholly-owned U.S. subsidiary as contribution-in-kind to a wholly-owned sister subsidiary in the U.K. within the same corporate group. On the other hand, a similar transfer of "assets and liabilities that belong to a Japanese place of business" ("Domestic Assets") to a foreign intra-group entity is excluded from such tax-free transfer.[2]

Issue

How do we determine Domestic Assets (i.e., assets and liabilities that belong to a Japanese place of business)? The consequence of a Domestic Assets transfer to a foreign intra-group entity is that it can no longer be made tax-free.

The concept of Domestic Assets has two sub-parts: (a) what the underlying assets are; and (b) what place of business manages such assets.

Facts of this case

This case involved an intra-group transfer by the Japanese plaintiff (a pharma company, "Plaintiff") of its equity interest in a Cayman Island limited partnership to the Plaintiff's U.K. wholly-owned subsidiary (by contribution-in-kind). The transferred interest represented 49.99% of the Cayman Island LP. The Cayman Island LP was formed for the purpose of research and development of certain drugs as a joint venture with a non-Japanese pharma company. The issue disputed was whether such transferred equity interest constituted Domestic Assets and whether such transfer can be made on a tax-free basis.

The Japanese National Tax Agency (the "NTA") took the position that the LP interest constituted Domestic Assets and the transfer was subject to Japanese tax. The Plaintiff disputed such position.

Different theories advanced on "underlying assets" (Test 1)

The parties argued fundamentally different views on what the underlying assets are.

1. The NTA's view: the relevant underlying asset for this analysis should be the *LP interest itself*, i.e., bundled contractual rights and obligations that arose under the LP agreement without reference to the tangible underlying assets of the business.

2. The Plaintiff's view: the relevant asset is *the underlying business assets* that enabled the enterprise's business operations as an organic whole. Such assets are business assets necessary to conduct research and development for certain pharmaceutical products.

Different theories advanced on "place of business managing the assets" (Test 2)

The above difference in how to understand underlying assets will invariably impact the analysis of the place of business managing the assets.

1. Under the NTA's view, the LP interest was booked and administered at Plaintiff's Japan parent company, meaning that the place of business was in Japan.

2. Under the Plaintiff's view, the actual business assets were located overseas and the Japan parent company had little oversight for them.

Tokyo District Court's Holdings

The purpose of excluding Domestic Assets from the scope of Qualified Contribution-in-Kind is to ensure Japan's ability to tax appreciation in value in connection with the transferred asset when it is transferred overseas, thereby protecting Japan's tax authority.

1. The standard laid out in Basic Circular of Corporate Tax Code should be followed for the determination of Domestic Assets, i.e., (a) review what business location manages the relevant assets, and (b) in so doing, evaluate (i) the booking location of the assets and (ii) the location where routine management of the assets is performed.

2. The underlying asset in this instance is a Cayman Island LP interest, although such interest is integral with the business assets the enterprise owned and not just a bundle of contractual rights and obligations arising under the LP agreement.

3. Thus "the location that managed the assets" should be determined on the basis of the combined properties between the business assets and the contractual rights and obligations. Economically speaking, the core source of value for the LP is the ownership of the underlying business assets, which is of primary importance, and the contractual rights and obligations are of secondary importance.

4. Following that thinking, the court determined that the business assets are located in the U.S. and other non-Japanese territories and the managing location of such assets is also a non-Japanese territory that oversees such business assets. In conclusion, these assets do not constitute Domestic Assets, and thus are eligible for Qualified Contribution-in-Kind (i.e., tax-free transfer is granted).

Observation

The posed question can be analyzed from the perspective of form-over-substance or substance-over-form. The NTA's view is very much form-driven by focusing on the legal formality of where the LP interest was booked. The Plaintiff's approach was more substance-based, piercing the legal formality of the LP and giving more weight to the source value to generate profit. The government's view is understandably goal-oriented to tax the transaction. The Plaintiff's view was more economic in nature focusing on the center of gravity of business operations. This decision would be helpful for allowing future parties to go by economic reality of a legal interest rather than a legal formality. And such view is consistent with the traditional tax analysis based on substance-over-form.

✧ ✧ ✧

If you have any questions concerning these developing issues, please do not hesitate to contact the following Paul Hastings Tokyo lawyer:

Toshiyuki Arai
81.3.6229.6010
toshiyukiarai@paulhastings.com

[1] Tokyo District Court, March 11, 2020, Lex/Db 25570858.

[2] Corporate Tax Code, Articles 62-4; 2(14); Corporate Tax Code Enforcement Regulations, Article 4-3, Para. 10.