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Japanese Corporate Restructuring and Tax Avoidance Claims in Recent Cases: Standard Articulated

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Corporate restructuring transactions are often motivated by tax planning, though there are usually other legitimate corporate needs to be achieved. The Corporations Tax Code of Japan contains provisions granting the government power to deny the effects of corporate restructuring for tax purposes—e.g., Article 132 (for family company group transactions) and Article 132-2 (for intra-group mergers and other reorganizations). In recent years, Japanese courts have been trying to clarify the standard for denying the tax effect of certain restructuring transactions.

Both of these statutory provisions discuss "actions/calculations leading to inappropriate decrease in corporate tax liability." The language is ambiguous and the transactional practitioners have sought clarification on how this language should be more meaningfully articulated.

The first relevant case involved an alleged "qualified non-cash merger" under the Corporate Tax Code, Article 2, Item 12-8(a) between the parent company and its subsidiary, purporting to satisfy the regulatory requirement of "overlapping executives" in the two companies. On that basis, the parent company, after merging the subsidiary, utilized the subsidiary's accumulated losses in the amount of approximately $500 million [at today's exchange rate] for deduction from the merged company's profits. The tax bureau challenged the effect of the deduction, and the company sued to challenge the bureau's decision. Supreme Court February 29, 2016, Minshu 70-2-242.

The language "action that is deemed to inappropriately reduce the corporate tax liability" under Article 132-2 of the Code is interpreted to mean any action that abuses corporate restructuring to achieve tax avoidance with respect to the following questions, which must be examined:

1. Whether the action in question is unnatural in that it is based on corporate restructuring procedures or methods not normally utilized or creates a form that is inconsistent with the reality; and

2. Whether such action is primarily motivated to reduce corporate tax liability by using a restructuring scheme that is inconsistent with the tenor or purpose of statutorily provided tax benefits.

The Supreme Court held that the overlapping executive position was created fictitiously for the purpose of tax reduction, as it only existed for a short period of time. The responsibility owed by the executive with the subsidiary was non-substantive. These circumstances rendered, among others, the restructuring ineffective for tax purposes.

Another important case appeared in Tokyo High Court about Article 132. The parent company in France held a Japanese Topco subsidiary, as well as other Japanese subsidiaries. After a restructuring scheme in 2008, the Japanese corporations were restructured under the Topco and received a large unsecured loan from a group finance company in France for approximately $800 million to purchase interests in the Japanese subsidiaries. The Japan Topco, after restructuring, deducted interest payments for the intra-group loan. The tax bureau challenged the deduction, and the Topco brought the lawsuit arguing validity. Tokyo High Court, June 24, 2020, Jurist 1554-10.

The High Court agreed to apply the Supreme Court standard for a large measure. The court argued that a different test proposed by the company would not be appropriate, because restructuring must be supported by some substantive non-tax related justifications. Thus, it is necessary to integrate all facts and circumstances in reviewing the Supreme Court standards, and the court should not be tilted in one way or the other in doing so. Applying the two-pronged standard, the High Court ruled in favor of the Japan Topco/appellee by pointing out numerous non-tax justifications achieved by this restructuring.

Admittedly, tax analysis is not corporate review of reasonableness. If we consider the business judgement rule with regard to tax analysis of restructuring, it would be too easy for aggressive attempts to be justified, which would be an extreme result. Practitioners view that this court's overall balancing between tax advantages and genuine corporate needs appears to be a reasonable middle ground to prevent tax abuse. Whether the Supreme Court test reasonably clarifies the ambiguity of the statutory language is still being debated. Practitioners feel it is better, but not clear yet.

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