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Tax Avoidance or Not: Restructuring of Multinational Group Companies with Use of Intra-group Loan

Deductibility of Interest Challenged by Tax Bureau; Supreme Court Disagrees and Allows it

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Context

Transactions within a corporate group can sometimes achieve reduction of tax obligations, regardless of whether or how much such result was intended. One typical way observed is to extend an international intra-group loan by a group company to another group company and for the latter company to deduct interest from the corporate profit. Such attempt is sometimes referred to as base erosion and profit shifting ("BEPS"). Unlike other countries, Japan doesn't have a general rule disallowing such transactions. It does however have specific rules to set aside certain predesignated types of transactions that result in lowering tax liability with respect to family company group transactions and corporate group restructuring, among others. We wrote a client alert in October 2021 on a Supreme Court case that dealt with group restructuring with attempted lowering of tax.

The Supreme Court recently reviewed the tax deductibility of interest under an international intra-group loan that was challenged by the Tax Bureau. The court articulated certain rules by which to characterize unreasonable transactions that can be set aside. This is an appellate case of the case discussed in our 2021 alert, Tokyo High Court, June 24, 2020, Jurist 1554-10.

Underlying facts

For the plaintiff's corporate group, an international music conglomerate, the implemented transaction on its face was a result of its desire to achieve a simpler shareholding structure with a holding company and with fewer companies operating in each country. To that end, an acquisition of an operating company was planned in Japan with funds secured through restructuring.

X Co. (appellant/plaintiff) was incorporated in Japan with a paid-in capital of 2 million yen by its Dutch parent company, A Co. Then A Co. further contributed 29,500 million yen to X Co. X Co. then took out an intra-group loan from a French sister company B Co. in the amount of 86,600 million yen. X Co. acquired a Japanese operating company C Co., from a different Dutch sister company D Co., with the proceeds of capitalization and loan.

The loan was unsecured and X Co.'s balance sheet showed a deficit of capital after the loan. However, the borrowing was made on the condition that its proceeds be used for the acquisition of C Co. only. The purchase price was regarded as fair by the court. The interest rate and payment schedule were

based on the projected profit level of X Co. No circumstances were shown that X Co. had difficulty carrying the debt service.

X Co. claimed deduction of interest it paid to A Co. for Japanese corporate tax purposes. The Tax Bureau challenged the deductibility of interest under the Corporate Tax Code, Article 132, Para. 1.

Statutory standard for denial of an action under the Corporate Tax Code

The statutory standard for the Tax Bureau to set aside tax deductibility under Article 132 of the Code is as follows:

- An act or calculation made by the taxpayer corporation that, if accepted, will reduce tax liability of the taxpayer;
- The taxpayer corporation is a company within a family company group that, among others, enters into a transaction with another family company group member; and
- The tax position taken by the taxpayer corporation will unduly reduce corporate tax liability.

Court's standard of finding "an act that unduly reduces tax liability"

- "An act or calculation that, if accepted, will unduly reduce corporate tax liability" (Article 132 of the Corporate Tax Code) means a certain act taken which is unnatural and unreasonable from an economic and substantive perspective, i.e., which lacks economic reasonableness.
- Economic reasonableness should be reviewed in the totality of circumstances including the purpose of borrowing and the terms associated with the transaction. If the totality of the transaction lacks economic reasonableness, the purpose of the transaction will be deemed unreasonable. In reviewing the totality and reasonableness thereof, the court should review (a) whether there are unnatural attributes to the transaction, e.g., unconventional procedures or methods, or forms that are inconsistent with the substance, and (b) whether there are legitimate attributes other than the reduction of tax liability that are consistent with reasonable business purpose or other justifiable circumstances.

Factual application by court

- "The borrowing is not unnatural because it doesn't involve unconventional procedures, methods or forms that are inconsistent with the substance. We also find that there are circumstances consistent with achieving business purposes other than to achieve lower tax liability."
- "We observe however some unusual points that are unconventional in a non-affiliated and normal transaction. These circumstances however do not amount to rendering the borrowing unnatural and unreasonable from an economic and substantive perspective. In conclusion, we find that the borrowing does not qualify as unnatural and unreasonable. Deductibility allowed."

Discussion

1. This holding is in parallel with the 2016 Supreme Court[1] holding that we discussed in our October 2021 alert. On the face of it, the 2016 Supreme Court case discusses the alleged abuse of corporate restructuring under Article 132-2 of the Corporate Tax Code, where this case deals with a family company intra-group transaction under Article 132. In fact, the contemplated concern under Article 132 is identical to that under Article 132-2. It is unclear which provision should be applied if circumstances warrant application of both provisions.

2. Be that as it may, the standard articulated by the Supreme Court is indeed similar to the 2016 standard. Whether the standard articulated is the same as the arms' length rule is subject to discussion. Please refer to the discussion in the holding about unusual attributes in an unrelated normal transaction, which suggests a similar thinking. The reviewed elements may not be necessarily the same, but the spirit of this standard is closely related to the arms' length principle.

3. Many commentators agree that this decision is appropriate for holding that a purpose to reduce tax liability will not immediately result in denial of such act. It walks the reviewer through various elements they should consider and then decide on the totality of circumstances after integrating them. For clarity, the court mentioned (i) purpose, (ii) deal terms, (iii) process, (iv) method and (v) form that is inconsistent with substance. It would be hard to get into more specifics because at the end of the day, the test is one derived from fairness on the basis of the arms' length principle (or something similar to it).

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

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[1] Supreme Ct., February 29, 2016, Minshu 70-2-242.

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