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Japanese Court Invokes Antiavoidance Clause for First Time in Denying NOL Deduction

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Summary by taxanalysts®

The Tokyo District Court on March 18 in *Yahoo Japan v. Government* issued the first decision to apply section 132-2 of Japan's Corporation Tax Act, an antiavoidance clause aimed at tax avoidance schemes involving organizational restructuring; the court used the provision to deny the deduction of net operating losses of an acquired related company.

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The Tokyo District Court on March 18 in *Yahoo Japan v. Government* issued the first decision[1] to apply section 132-2 of Japan's Corporation Tax Act (the Act), an antiavoidance clause aimed at tax avoidance schemes involving organizational restructuring. The court used the provision to deny the taxpayer's deduction of net operating losses of a related company acquired in a merger.

The court also adopted more liberal definitions of the conditions that trigger the section than those established by recent Supreme Court decisions for purposes of applying its sister provision (section 132). If the decision becomes final without material changes, it may pose a challenge to tax planning involving organizational restructuring.

Background

The issue of the case was whether, upon a merger between related corporations, the deductible NOLs could be transferred from the acquired corporation to the surviving corporation. Three corporations belonging to the group were engaged in the transaction: the plaintiff-taxpayer corporation (the Plaintiff), which is a corporation providing Internet search services; a corporation that operates information and telecommunication facilities (Target); and the holding company of the group (Holding).

Initially, Holding held 100 percent of shares in Target and approximately 42 percent of interest in the Plaintiff. Target had NOLs of approximately JPY 54.2 billion (about $522 million). On December 26, 2008, the CEO of the Plaintiff was appointed as the vice CEO of Target. On February 24, 2009, the Plaintiff acquired from Holding all shares of Target. The Plaintiff then merged with Target on March 30, 2009.

After the restructuring, the Plaintiff deducted on its tax return Target's NOLs from its income for the tax year ending on March 31, 2009. The tax office disallowed the deduction by invoking section 132-2.

Legislation

According to section 57, paragraph 2 of the Act, the merging corporation can be the successor to the target corporation's NOLs that accrued in a period of seven years before the merger took place if the merger is classified as a "qualified merger."[2] However, section 57, paragraph 3 provides that if the merger is between affiliated corporations, the succession of NOLs is contingent on the following additional conditions:

- the "specified capital relationship" (basically meaning an affiliate relationship whereby one party controls, is controlled by, or is under the common control of the other party) began more than five years before the beginning of the tax year in which the merger takes place; or
- the "deemed joint business" conditions are met.

The deemed joint business conditions consist of five elements, two of which were relevant to this case:

- **Relevancy of businesses:** One of the major businesses of the merging corporation is related to one of the businesses of the target corporation.
- **Continued appointment of specified board members:** At least one "specified board member" (who is a person engaged in management) of the target corporation and at least one specified board member of the merging corporation will become specified board members of the merging corporation after the merger.

Had both these elements been met, the deemed joint business conditions would have been fulfilled and the Plaintiff could have been the successor to the NOLs of Target.

However, the Act contains an antiavoidance rule applicable to corporate restructuring (section 132-2) providing that if it is found that any acts conducted or calculations made by the corporation will, if allowed, unreasonably reduce the corporate tax burden, the tax office "may calculate . . . the amount of loss . . . based on his/her own determination."

The tax office applied this section to calculate the tax liabilities of the Plaintiff as if it were not the successor to the NOLs and to ignore the Plaintiff's act to fulfill the condition of "continued appointment of specified board members."

Decision of the Court

There was no question that the merger of the Plaintiff and Target was a qualified merger. Further, there was no controversy about whether the two elements of the deemed joint business conditions applicable to the case (that is, the relevancy of businesses and the continued appointment of specified board members) were present.

Thus, the issue boiled down to the applicability of the antiavoidance rule of section 132-2, which was broken down into two aspects: whether the Plaintiff's acquisition of the NOL "unreasonably reduce[d] the burden of corporation tax," and whether appointing the CEO of the Plaintiff as the vice CEO of Target fell under "any acts conducted . . . by the corporation."

Unreasonable Reduction of the Burden of Corporation Tax

Within the meaning of section 132 of the Act, which is an antiavoidance clause applicable to schemes involving closely held corporations, the term "unreasonableness" has been interpreted as a lack of economic reasonableness other than tax benefit. In this context, the issue was whether the same interpretation should be given to the term as used in section 132-2 of the Act. Had this interpretation been used, the court might have found the Plaintiff's acquisition of NOLs reasonable. That is because the appointment of the vice CEO of Target before the acquisition of shares can be justified from an economic perspective for business purposes, or at least can be authorized at the management's discretion.

However, the court decided that a corporation's act can be regarded as "unreasonably reduc[ing] the burden of corporation tax" if it is found that "allowing reduction of the tax burden as a result of such act clearly conflicts with the underlying policy of the taxation regime applicable to organizational restructuring or the specific clause" allowing the reduction of the tax burden. The court further noted that an act can be found to be unreasonable because of conflict with the underlying policy even if there was a business purpose for each step of the restructuring in question. The court noted that the tax-deferral rule and succession of NOLs applicable to organizational restructuring were introduced to enable the continuation of ongoing business without incurring a tax burden. The court said that section 132-2 of the Act was introduced concurrently with the purpose of preventing tax avoidance inconsistent with the underlying policy of the rule -- that is, attempting to take advantage of tax benefits without the continuation of ongoing business.

Applying the standard to decide "unreasonableness" in the present case, the court examined the underlying policy of the tax regime regarding organizational restructuring (that is, section 57, paragraphs 2 and 3 of the Act) and the specific clause allowing the reduction of the tax burden (that is, section 112, paragraph 7 of the order). The court then said that "in the case where a specified board member of the target corporation, as well as that of the merging corporation, is going to be appointed to that [of the merging corporation] even after the merger, it can be regarded that the control over the transferred assets lasts through the merger and the business is jointly operated after the merger." According to the court, this reasoning explains the allowance of succession of NOLs under section 57, paragraphs 2 and 3 of the Act and section 112, paragraph 7 of the order.

Based on its findings, the court concluded that allowing the NOLs to be acquired conflicted with the underlying policy of section 57, paragraphs 2 and 3 of the Act and section 112, paragraph 7 of the order. First, the court decided that there was no control over the transferred assets lasting through the merger with the appointment of the vice CEO of Target, even though the element of appointment of specified board members was present. Second, the court found that the merger at issue was in substance to sell and purchase Target's assets (most of which was the tax benefit of the NOLs) rather than to jointly operate Target's business after the merger. Finally, the court noted that the Plaintiff and Holding were aware of the substantive possibility of disallowance of acquisition of the losses. In light of these facts, the court concluded that the Plaintiff's acquisition of the NOLs was to "unreasonably reduce the burden of corporation tax" under the definition given by the court.

Acts Conducted by the Corporation

The second issue is a rather technical interpretation of the text of the provision that read "any acts conducted . . . by the corporation." The court decided that the act in question was not necessarily required to be conducted by the taxpayer corporation, but it can be an act of any entity involved in the organizational restructuring transaction. Under this interpretation, the fact that the appointment of the vice CEO of Target was made by Holding rather than by an act of the Plaintiff did not prevent the application of section 132-2 of the Act.

The court concluded that section 132-2 of the Act authorized the tax office to disallow the Plaintiff's deduction of the succeeded NOLs from its income. Thus, the court upheld the tax office's denial.

Remarks

This is the first judicial decision on section 132-2 of the Act since the provision was introduced in 2003 along with the rule providing tax deferral and succession of NOL in organizational restructuring. For the past 10 years, the tax authority has not applied the antiavoidance rule, which has led to widespread aggressive tax planning in this area.

The case marks an attack by the tax authority on this aggressive tax planning. The case has received much attention since it is regarded as a test of how narrowly or broadly section 132-2 of the Act would be applied to attack tax planning involving organizational restructuring. As explained above, the court issued a decision in favor of the government that goes beyond this particular case by broadly defining the scope of the antiavoidance rule. Thus, the decision may encourage the tax authority to make more stringent assessments in tax investigations regarding mergers and other organizational restructuring transactions.

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FOOTNOTES

[1] Tokyo Chiho Saibansho, Tokyo Dist. Ct., Case No. Hei 23 (gyo-u) No. 228,. Note that on the same day, the same court issued another decision applying the same tax provision to a related transaction.

[2] Note that the current rule, effective from April 2, 2014, sets the period at nine years.

END OF FOOTNOTES

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