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Tax Losses Under Japan Tax Law

This issue covers the treatment of tax losses under Japan Tax Law.

1. Tax loss carry forward/carry back

Tax losses can be carried forward for 9 years and offset against up to 80% of each year's taxable income for a blue tax return filer[1]. The 80%limit will be reduced to 65% for fiscal years beginning between April 1, 2015 and March 31, 2017 and 50% for years beginning after March 31, 2017.

An SME (Small or Medium Sized Enterprise) can offset carried forward tax losses against 100% of current year taxable income. An SME is a corporation whose stated capital is JPY 100 million or less, unless 100% owned directly or indirectly by a corporation of which stated capital is JPY 500 million or more.

Tax losses can be carried back to the previous fiscal year. However, this carry back is currently suspended for corporations apart from those which are SMEs or in liquidation.

2. Restriction of utilization of tax losses where controlling interests are acquired

Where a controlling ownership acquisition[2] takes place in a company with tax losses, and one of the following events is triggered within 5 years from the acquisition, the tax losses incurred in business years prior to the year when the acquisition took place are disallowed and cannot be carried forward to the year when the events discussed below are triggered or thereafter[3]:

(i) (a) Where a tax loss holding company conducts no business before the acquisition, (b) it commences businesses after the acquisition,

(ii) (a) Where a tax loss holding company discontinued the business conducted before the acquisition or is expected to discontinue, (b) it finances through loan or equity, funds of more than 5 times the business scale as defined by regulations,

(iii) (a) Where a person acquired a tax loss company or its related persons acquired monetary claims against the tax loss holding company at a discount value, (b) the tax loss holding company receives funds of more than 5 times of the scale of the business conducted before acquisition,

(iv) (a) Where (a) in (i), (ii) or (iii) above is satisfied, (b) a tax loss holding company is engaged in a tax-free qualified merger as a merged company or the residual asset value in liquidation of the tax loss holding company is determined,

(v) (a) Where all directors and more than 20%of employees resign as a result of the acquisition, (b) the scale of the new business ommenced after the acquisition is more than 5 times that of the business conducted before the acquisition,

(vi) Other comparable events as defined by the regulations.

3. Tax losses in a merger

3.1 Tax free qualified merger[4]

[1] A blue tax return filer is a taxpayer who has filed an election as such and is required to maintain books and records to calculate taxable income correctly.

[2] More than 50% of shareholders capital in terms of the number of outstanding shares or invested amount

[3] Article 57-2 of Corporation Tax Law(CTL)

[4] In order for a merger to be treated as a tax-free qualified merger, only shares in the merged company or the 100% parent of the merged company may be distributed. Further, one of the following conditions must be satisfied[4].

(i) Either the merged company or the surviving company must hold 100% of the issued shares of the other corporation, directly or indirectly, or the two corporations must be related in certain ways; or

(ii) Either the merged company or the surviving company must hold more than 50% and less than 100% of the issued shares of the other corporation, directly or indirectly, or the two corporations must be related in certain ways, and the following two additional requirements must be met:

(a) Approximately 80% or more of the employees of the liquidating corporation must be expected to continue working for the surviving corporation (if the merger is followed by another qualified merger, this requirement must also be met by the corporation surviving after the second qualified merger); and

(b) The main business of the merged company must be expected to be continued by the surviving company (if the merger is followed by another qualified merger, this requirement must also be met by the corporation surviving after the second qualified merger); or

(iii) Either the merged company or the surviving company must hold 50% or less of the issued shares of the other corporation and the purpose of the merger must be for the two corporations to conduct business jointly.

In a tax-free qualified merger, the tax losses of the merged corporation can be succeeded by the merging corporation and the tax losses of the merging corporation can be carried forward. However, to discourage companies from buying up loss-making company's in order take advantage of their losses, there is an anti avoidance rule.

(1) Tax losses of a merged company or a surviving company incurred in business years prior to the business year when a controlling relationship[5] was established and (2) tax losses incurred in the business year when a controlling relationship was established or thereafter created out of realizing built-in losses that existed before the controlling relationship was established are ignored[6] unless a controlling relationship had existed continuously for 5 years or more on the first day of the business year when a tax-free qualified merger took place, or deemed joint business conditions are satisfied.

Deemed joint business conditions can be satisfied where conditions (i)~(iv) are satisfied or (i) and (v) are satisfied:

(i) The businesses of the merged company and the surviving company are related.
(ii) The sales amount, the number of employees or the stated capital of either the merged company or the surviving company does not exceed 5 times that of the other.
(iii) The business of the merged company has continued from the time when the controlling relationship was established until the tax-free qualified merger and the business scale (described in (ii) above) measured at either of those times does not exceed twice the scale at the other time.
(iv) The business of the surviving company has continued from the time when the controlling relationship was established until the tax free qualified merger and the business scale (described in (ii) above) measured at either of those times does not exceed twice the scale at the other time.
(v) It is expected that an executive director of each company will assume the same position in the surviving company after the merger.

3.2 Disqualified merger

In a disqualified merger, the tax losses of the merged corporation cannot be succeeded by the merging corporation. There is, however, no restriction about using the tax losses of the merging corporation.

4. Tax losses in a consolidated tax return

A domestic company ("consolidation parent") and its domestic 100%-owned subsidiaries (consolidated subsidiaries) are allowed to file a consolidated tax return. The tax loss of the consolidated parent can be utilized to offset taxable income of the consolidated subsidiaries. The tax losses of a consolidated subsidiary can be utilized to offset the taxable income of the consolidated subsidiary after a consolidated tax return is elected as long as the consolidated parent owns 100% of the consolidated subsidiary continuously for more than 5 years before the election is made.

[5] 50% or more direct ownership or 50% or more owned by common person, Article 2, 12-7-5
[6] Article 57(3), (4) of CTL