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Japan Tax Bulletin

Dissolution of an insolvent Japanese subsidiary

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When dissolving an insolvent Japanese subsidiary, an unexpected tax charge may arise unless the subsidiary's tax positions are reviewed and appropriate legal procedures are taken.

The most commonly utilized legal entity by foreign investors is the KK (Kabushiki Kaisha), which is a limited liability company whose interests are represented by share stocks. A KK can be dissolved by shareholders' approval at a meeting, with 2/3 or more of votes in support of the dissolution with 1/2 or more of the shareholders in attendance. A KK in the process of dissolution is managed by a liquidator. If a company in the dissolution process is insolvent, the liquidator is required to apply for special dissolution procedures to a court. Under the special dissolution procedures, legal actions and procedures proceed under the control of a court. As this be cumbersome, foreign investors prefer to utilize ordinary dissolution procedures where a court is not involved. In order to utilize ordinary dissolution procedures, it is necessary to get the subsidiary out of insolvency. An insolvent Japanese subsidiary usually has massive intercompany debts to foreign-affiliated companies. As such, planning to eliminate intercompany debts, with consideration of the tax impacts, is important.

1. *Tax years of a company in the process of dissolution*

The tax year of a company is the fiscal year stated in its Articles of Incorporation. When a shareholders' meeting resolves the dissolution of a company, the tax year of the company changes. The current year is treated as ending on the date of the meeting and new 12-month periods begin from the following day, until distributable residual assets are fixed and the dissolution procedures are completed.

2. *Discharging intercompany debts in a tax year before the dissolution of a company is decided*

When a Japanese subsidiary is discharged of intercompany debts, the debts discharged are recognized as revenue for the subsidiary for tax purposes. If the subsidiary holds tax losses, the tax losses can be offset against the revenue recognized when the debts are discharged. However, the availability of tax losses are restricted to 50% of the taxable income in a tax year unless the subsidiary is an SME[1] for tax purposes.
Therefore, if the subsidiary is an SME and holds sufficient tax losses, discharging intercompany debts would eliminate them without adverse tax impacts.

3. *Debt for Equity Swap in a tax year before the dissolution of a company is decided*

Foreign-affiliated companies can contribute intercompany monetary receivables to the subsidiary's capital in exchange for share stocks thus transferring intercompany debts to capital. However, the difference between the face value and the fair value of the intercompany debts is recognized as revenue for the subsidiary (debtor) for tax purposes[2]. As revenue is recognized for tax purposes, the same considerations as 2 above apply.

4. *Cash capital injection and debt payout before the dissolution of a company is decided*

Where foreign-affiliated companies make cash capital contributions out of which the subsidiary pays out the intercompany debts, the intercompany debts are transferred to capital. The economic effects are the same as in 3. In this arrangement, it is generally treated that no revenue is recognized for tax purposes but the foreign-affiliated company needs finance the funds temporarily to make capital contributions.

5. *Discharging intercompany debts in a tax year after the dissolution of a company is decided*

The tax losses discussed in 2 & 3 are stipulated in Article 57 of the Corporation Tax Law and available to a blue tax return status taxpayer[3]. A blue tax return taxpayer is allowed to carry forward a current year tax loss for the following 10 years under Article 57.
Where a corporate taxpayer is likely to have no distributable residual assets upon completion of the dissolution, the corporate taxpayer is allowed to utilize

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[1] An SME is a company whose stated capital is JPY100 million or less and which is not wholly-owned directly or indirectly of a company of which stated capital is JPY500 million or more.
[2] Where a 100% direct or indirect relationship exists between the creditor and the debtor and both are domestic companies, revenues are not recognized.
[3] A blue tax return status taxpayer is allowed utilize some tax benefits such as tax loss carry-over, special deductions etc. A blue tax return status taxpayer is required to (1) record transactions in accounting books with a double entry-bookkeeping and, maintain and reserve those books and records; and (2) submit an application form for approval to file a blue tax return with the tax office before the beginning of the tax year for which the blue tax return is to be filed. For newly incorporated companies wishing to file a blue tax return for their first tax year, the due date for the application is the earlier of the last day of the first tax year or the day after three months from the date of incorporation.

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Article 59 tax losses. Article 59 tax losses are generally tax losses on tax balance sheet (Schedule 5(1) of the Corporation Tax returns) minus Article 57 tax losses already utilized. Therefore, Article 59 tax losses includes expired Article 57 tax losses and tax losses that a white tax return status taxpayer[4] incurred. There is no 50% of taxable income restriction for Article 59 tax losses.

Therefore, in a tax year after the dissolution of a company is decided by the shareholders, both Article 57 tax losses and Article 59 tax losses are available, although Article 59 tax losses are only available where it is likely that there are no distributable residual assets upon completion of the dissolution.

[4] A white tax return status taxpayer is any taxpayer other than a blue tax return taxpayer.

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