Revisions to Anti-Tax Avoidance Rule requiring reduction in basis of subsidiary's shares after receiving dividends from subsidiary

August 2022

In brief

The Anti-Tax Avoidance Rule (or the 'Rule') was enacted as an anti-tax avoidance measure in 2020, under which a corporate taxpayer (Japanese parent company) is required to reduce its basis in its subsidiary's shares after receiving dividends from that subsidiary, to prevent the taxpayer from generating losses on the subsequent transfer of that subsidiary. Japan's tax reform for 2022 (the '2022 Tax Reform') increased the scope of certain exceptions to the application of the Rule; specifically, regarding (i) the calculation of retained earnings as of a specified control date and (ii) application of the '10-year holding period' exception to controlled subsidiaries that have received dividends from second- or lower-tier subsidiaries or that have carried out a merger or spin-off within intragroup subsidiaries.

The 2022 Tax Reform Act was approved in the Diet on March 22, 2022 and related Enforcement Orders and Regulations as well as the 2022 Tax Reform Act were promulgated on March 31, 2022. The revised statutes of the Anti-Tax Avoidance Rule (provided in the Corporate Tax Law Enforcement Order) entered into force on April 1, 2022 and apply retroactively with regard to dividends received by taxpayers in fiscal years commencing on or after April 1, 2020. Foreign companies with a Japanese affiliate should be aware of the Rule prior to undertaking a restructuring or to the Japanese affiliate receiving dividends from a lower-tier subsidiary.

In detail

1. Description of Anti-Tax Avoidance Rule before the 2022 Tax Reform and Background of the 2022 Amendment

Before the Rule came into effect in 2020, it was possible for a corporate taxpayer to acquire the shares of a company that had retained earnings, then to effectively strip out the earnings from that subsidiary via the receipt of dividends, which would be tax-exempt to the shareholder under Japanese dividend exclusion rules.[1] The distribution of dividends would result in the market value of the subsidiary being reduced. The Japanese parent company could then generate capital losses or

[1] A Japanese company can exclude from income 95% of dividends received from a foreign company in which it has a shareholding of 25% or more and if it has held those shares for a continuous period of six months or more, ending on the dividend declaration date. CTL 23(2)-1.

reduced capital gains by transferring the shares of the subsidiary or liquidating it after having received the dividends.

The Rule requires that, under certain conditions, the tax basis of shares held by a Japanese parent company must be reduced by the amount of dividends received from a subsidiary that were subject to dividend exclusion. In this way, capital losses or capital gains upon transfer of the shares are also adjusted (i.e., reduced capital losses or increased capital gains).

More specifically, under the Rule, where a Japanese parent company receives dividends from a related subsidiary, if the total amount of such dividend, plus all other dividends received by the shareholder in the fiscal year from other such related subsidiaries, exceeds an amount of 10% of the largest tax book value of shares among all the subsidiaries that the Japanese parent holds as of the dividend record date (the '10% book value test'), the Japanese parent company must reduce its basis in the shares of the subsidiary (or subsidiaries) by the amount of the tax-exempt dividends received, unless one of the exceptions to the Rule applies. A Japanese parent company can thus not reduce capital gain on the transfer of shares of a subsidiary by first stripping out value through the receipt of dividends.

Before the 2022 Tax Reform, a taxpayer was eligible for an exception to the Rule if one of the following applied:

a) Japanese companies or residents have owned 90% or more of the shares of a Japanese ‘related subsidiary’ from which the dividends are received since that Japanese subsidiary’s establishment (the ‘90% shareholder test’);
b) The total annual amount of dividends received is less than the net increase in the retained earnings of the subsidiary since the year in which a greater than 50% control relationship arose (the ‘retained earnings test’);[2]
c) The shareholder receives the dividends on or after 10 years have passed since the date that the greater than 50% control relationship arose (the ‘10-year holding period test’); **or**
d) The total annual amount of dividends received is JPY 20 million or less (the ‘de minimis test’).

The Rule included certain additional measures governing applicability where, for example, a Japanese-headed corporate group has undergone a corporate reorganization in which it seeks to interpose a subsidiary that would satisfy the conditions for one of the exceptions to the Rule between the Japanese parent and a subsidiary that would not. Under such rules, where a related subsidiary holds its own (second-tier) subsidiary,[3] the Rule may be triggered even if the requirements set out above for an exemption are otherwise satisfied by the first-tier subsidiary. More specifically, under the Rule, where a first-tier subsidiary satisfies either the de minimis test or the 10% book value test, the analysis stops there and the exemption should be satisfied with regard to dividends received from that first-tier subsidiary. If, however, the fist-tier subsidiary satisfies either the 10-year holding period test or (if it is a Japanese company) the 90% shareholder test, and such first-tier subsidiary has received in the past a material dividend[4] from a second- or lower-tier subsidiary, any second- or lower-tier subsidiaries of the first-tier subsidiary each must also satisfy the 10-year holding period test or (if such second- or lower-tier subsidiaries are Japanese companies) the 90% shareholder test in order for the first-tier subsidiary to be eligible for an exception from the Rule with respect to any dividends it issues to the Japanese parent.

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[2] A ‘related subsidiary’ is a subsidiary with which the corporate shareholder has a more than 50% control relationship (or is more than 50% controlled by a common third party) as of the date of the resolution approving the issuance of dividends (a ‘specified control relationship’).

[3] ‘Ownership’ as used here assumes that more than 50% of the first-tier subsidiary’s assets consist of shares in such second-tier subsidiary.

[4] A dividend exceeding the 10% book-value test and not satisfying the de minimis test (a ‘material dividend ’)

The Rule also applies where a first-tier or lower-tier subsidiary has undergone certain kinds of merger or demerger. More specifically, where a first- or lower-tier subsidiary is either (i) the surviving company in a merger or (ii) has been demerged from another related party (i.e., transferor company) under a reorganization without cash consideration, the requirements of the 10-year holding period test or (if it is a Japanese company) the 90% shareholder test must be satisfied by the merged company or the transferor company

After the Rule was introduced, taxpayers expressed concern that it may have unintended consequences, as Japanese entities regularly receive interim dividends, in addition to regular dividends, thus making it difficult to satisfy the requirements of the retained earnings test. Likewise, multinational corporations commonly restructure their foreign subsidiary groups, potentially making it difficult to satisfy the 10-year holding period test with respect to second- or lower-tier subsidiaries. After receiving comments from the business community, the Corporate Tax Law Enforcement Order was amended in line with the 2022 Tax Reform Proposal.

2. Amendments to the Rule under the 2022 Tax Reform

(1) Requirements for dividends sourced from retained earnings increased after the specified control relationship arose

The retained earnings test applies where the total annual amount of dividends the taxpayer receives from a related subsidiary is less than the net increase in the retained earnings of the subsidiary since the year in which the specified control relationship arose. Here, the ‘net increase in the retained earnings of the subsidiary since the year in which the specified control relationship arose’ is calculated based on (i) the amount of retained earnings on the balance sheet of the related subsidiary as of the end of the last fiscal year before the year in which the specified control relationship arose reduced by dividends received in the current year, and (ii) the amount of retained earnings on the balance sheet of the related subsidiary at the related subsidiary’s fiscal year end prior to the resolution date of the dividends.[5] The purpose of the retained earnings test exemption is ostensibly to exclude dividends sourced from retained earnings of the related subsidiary arising <u>after</u> the fiscal year in which the specified control relationship arose from the scope of the Rule. In the case of an interim dividend, however, the amount by which retained earnings have increased <u>in the current year</u> was not included in calculating the increased retained earnings amount. This does not appear consistent with the intention of the exemption.

Under the 2022 Tax Reform, the retained earnings test was amended to include the amount by which retained earnings of the subsidiary increased from the start of the fiscal year in which the interim dividends are issued up to the date of the receipt of such dividends, in calculating the ‘net increase in the retailed earnings of the subsidiary since the year in which the greater than 50% control relationship arose’. The Rule also considers, however, the amount by which retained earnings on the balance sheet of the related subsidiary increased from the end of the last fiscal year before the specified relationship arose until the date such specified control relationship arose. This should thus expand the scope of the exemption to more accurately reflect the circumstances where a taxpayer receives an interim dividend from a related subsidiary.

In seeking to apply this exemption, taxpayers should retain relevant transaction-related documents.

(2) Application of 10-year holding period test to first-tier subsidiary that has received material dividends from a lower-tier subsidiary

[5] Note that where the shareholder receives dividends from a related subsidiary prior to the year in which the greater than 50% relationship arose, the amount of such dividends can be deducted in calculating (i) the amount of retained earnings on the balance sheet of the related subsidiary as of the end of the last fiscal year before the year in which the greater than 50% control relationship arose.

As noted above, the Rule contains a provision to prevent a taxpayer from evading application of the Rule by interposing a subsidiary that satisfies the requirements of an exemption between it and another subsidiary that would not satisfy the requirements for an exemption. Specifically, the Rule requires that where a first-tier foreign subsidiary that has received a material dividend from a lower-tier subsidiary seeks to rely on the 10-year holding period test, the foreign holding company's own foreign subsidiary or subsidiaries must all also satisfy the 10-year holding period test, in order for the exemption to apply to dividends issued by the foreign holding company to the shareholder. As a result of this requirement, where a foreign holding company creates a new second-tier subsidiary, from which it receives a dividend within 10 years from the establishment, it causes the first-tier foreign holding company to no longer be eligible for an exemption to the Rule with regard to dividends issued to the parent, even if the first-tier foreign holding company satisfies the requirements of the 10-year holding period test with regard to the parent.[6]

Under the 2022 Tax Reform, an additional exemption was carved out with respect to a second- or lower-tier subsidiary, where the first-tier subsidiary is relying on the 90% shareholding test or the 10-year holding test. Specifically, where a newly established second-tier subsidiary has had a specified control relationship with the shareholder since the second-tier subsidiary's establishment until the date of the resolution of the dividend to the foreign holding company, and any third-tier or lower-tier subsidiaries have had a specified control relationship with the second-tier subsidiary from the date of such third- or lower-tier subsidiary's establishment until the date of the resolution of the dividend, the requirements for exemption to the Rule will be satisfied if the foreign holding company satisfies the 10-year holding period test with regard to the shareholder.

Additionally, where a first tier subsidiary, which make dividends to a Japanese parent, carries out a merger or demerger prior to the dividend distribution,[7] and the merged / transferor company has had a specified control relationship with the shareholder (that is, the Japanese parent or its lower-tier subsidiaries) for less than 10 years since such merged / transferor company's establishment, it will not taint the 10-year holding period qualification of the first-tier subsidiary

The above changes are relevant in cases where a foreign holding company that cannot otherwise satisfy the retained earnings test is relying on the 10-year holding test and has created a new second-tier subsidiary.

Note that, under the change, if the second-tier or the third-tier subsidiary is not newly established in the group but rather is acquired from a third party, it is still necessary for such second- or third-tier subsidiary to satisfy the 10-year holding test, in order for the first-tier subsidiary to be eligible for an exception to the Rule, even after changes made under the 2022 Tax Reform come into effect.

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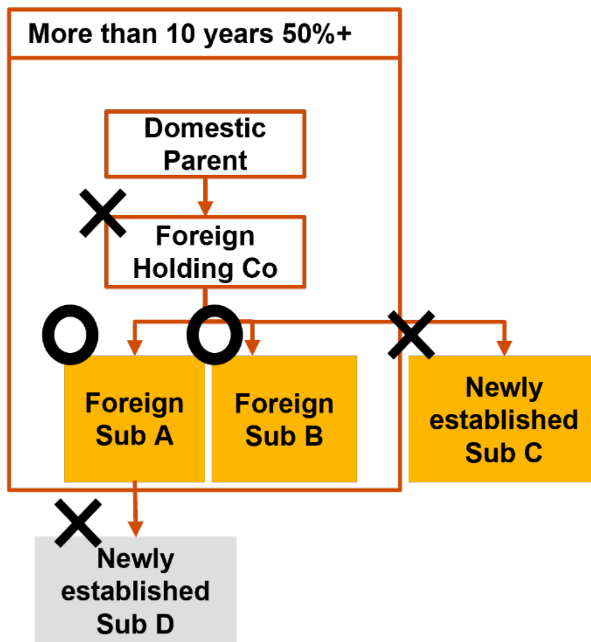
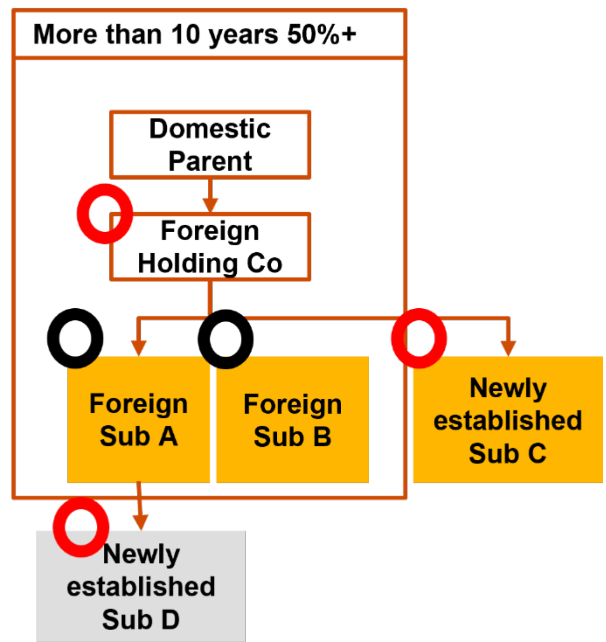
[6] Note that if the first-tier subsidiary can rely on the retained earnings test (rather than the 10-year holding test or the 90% shareholding test), **or** if the de minimis test is satisfied at the Japanese parent level, the requirements for the exception may be satisfied regardless of whether or not the lower-tier subsidiary can satisfy the 10-year holding test or the 90% shareholding test.

[7] While the details of the rules are beyond the scope of this Alert, a 'tax qualified' merger or demerger is a type of tax-deferred reorganization under Japanese tax law.





Before Amendment

- Where a foreign holding company that is relying on the 10-year holding period test has received dividends from a lower-tier subsidiary, any newly-established foreign subsidiaries of that foreign holding company must also satisfy the 10-year holding period test.
- Any second- or lower-tier subsidiaries failing the test will cause the first-tier foreign holding company to be ineligible for the exception.

2022 Amendment

- A newly established second- or third-tier foreign subsidiary that has had a specified control relationship (50%+) with the foreign holding corporation from such lower-tier company's establishment will be considered to be within the scope of its parent's (e.g., the foreign holding company's) 10-year holding period test.

Let’s talk

For a deeper discussion of how this issue might affect your business, please contact:

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