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Japan Tax Bulletin

Anti-tax avoidance rule for intercompany dividend exemption and transfer of a foreign subsidiary shares

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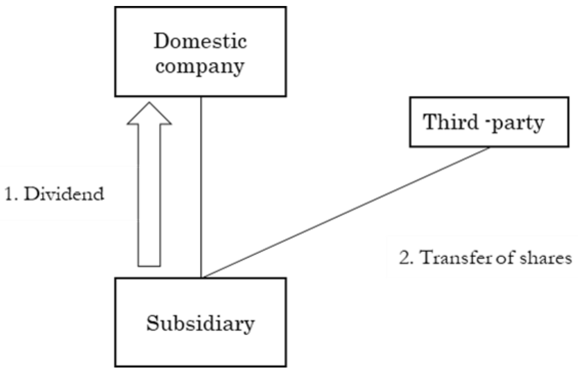
New anti-avoidance rule to prevent the pre-sale dividend stripping of foreign subsidiary investments.

Under current domestic tax law, 95% of dividend income received from a foreign subsidiary is exempt from corporate income tax. For dividends received from other domestic companies, the amount exempt from corporate income tax depends on the shareholding percentage in the domestic company. The table below shows the relationship between the exempt amount and shareholding percentage.

Shareholding percentage	Exempt amount
100%	100%
More than 33% but less than 100%	Dividends received – interest expense on debt to acquire the shares
More than 5% or more to 33%	50%
5% or less	20%

In the past, it was possible for a domestic company to extract profits from a foreign subsidiary and then sell the foreign subsidiary's shares to a third-party buyer, thereby creating tax-exempt dividend income and a tax-deductible loss on the sale of the shares. The 2020 tax reform introduced an anti-avoidance rule aimed at reducing the tax lost in these kinds of transactions.



1. *The new rule*

If a domestic company receives dividends from other companies, in which the domestic company has a "special control relationship", and the amount of the dividends exceeds 10% of the book value of the shares held, the book value of the shares is reduced by the amount of the dividends. A "special control relationship" is a relationship where 50% or more of outstanding shares, voting rights for declaring dividends or appointing directors of a company, are held directly or indirectly by a domestic company.

2. *Exceptions*

If the following conditions are satisfied, the new rule above is not applicable:

2.1 Domestic shareholder rule
This condition is met if 90% or more of a domestic company's shareholders, for the period from the date of incorporation to the day when a special control relationship is established, are domestic corporations or residents (domestic shareholders).
In order to satisfy the domestic shareholder rule, a domestic company which pays dividends is required to maintain documents to verify that 90% or more of its shareholders are domestic shareholders for the period from the incorporation to the day when a special control relationship is established

2.2 Profit surplus rule
The new rule is not applicable if ①−②≧③, where:

① is the amount of profit surplus on the balance sheet of a special controlled subsidiary at the end of the business year prior to the one in which the dividends were declared;

② is the total amount of dividends that the shareholders of a special controlled subsidiary receive from the day following the business year end in ①, to the day when shareholders receive the dividends; and

③ is the amount of profit surplus on the balance sheet of a special controlled subsidiary, at the end of the business year that ended prior to the date when the special control relationship was established.

2.3 10-year rule

The new rule only applies for the first 10 years after the date the special control relationship was established. Dividends received after this period are exempt from the rule.

2.4 De minimis rule

If the amount of dividends received in a business year does not exceed JPY20 million, the new rule is not applicable.