Grant Thornton

Japan Tax Bulletin

Update of Tax Losses under Japan Tax Law

January 2022

1. *Overview*

Tax losses of a corporation that files a blue tax return can be carried forward and will be able to offset against certain taxable income in the future financial years. However, a restriction may be applied in the case of a controlling interest acquisition, in a merger or group relief system.

2. *Tax losses carry forward / carry back*

2.1. *In principle*

When a corporation that files a blue tax return is in a loss position under corporate tax calculation, whose tax losses can be carried forward for 10 years and offset against up to 50% of each financial year's taxable income.

If the corporation is categorized as an SME (Small or Medium-Sized Enterprise[1]), it can offset carried forward tax losses against 100% of each financial year's taxable income. In case the SME had a profit in the previous year, it can carry back its tax loss one year and can offset the current year's tax loss against 100% of the previous year's taxable income. The remained tax loss can be carried forward to the next year onward.

2.2. *Exception for the relief of COVID-19*

As the relief of COVID-19, an exception on carrying back of tax losses can be elected to a corporation that files a blue tax return with paid-in capital up to JPY 1,000million excluding the corporation if it is owned 100% by a large company with its paid-in capital over JPY 1,000million.

When a corporation satisfies the requirements above, it can carry back the tax losses incurred during the financial years ended from 1st of February 2020 to 31st of January 2022 against 100% of the previous year's taxable income.

3. *Restriction of the utilization of tax losses where controlling interests are acquired*

Where a controlling ownership acquisition (more than 50% of shareholders capital in terms of the number of outstanding shares or invested amount) takes place in a corporation with tax losses, and one of the following events is triggered within 5 years from the acquisition, the tax losses incurred in the financial years before 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.

(i) In case, the loss corporation is not engaged in business just before the date of the acquisition of control (The mere holding of shares does not fall under the category of business)

- Commencement of business on or after the date of the acquisition of control (including the commencement of business through a merger)

(ii) In case, all the business of the loss corporation is abolished or is expected to be abolished just before the date of the acquisition of control

- Borrow funds with the amount that exceeds approx. 5 times of scale of the former business

(iii) In case, acquiring the claims of the loss corporation at a price less than 50% of the amount of the claims

- The amount of claims acquired exceeds 50% of the total amount of liabilities of the loss corporation

- Borrow funds with the amount that exceeds approx. 5 times of scale of the former business

(iv) In case, a loss corporation falls under any of the cases listed in (i) to (iii) above, and a loss corporation is merged by the other corporation as a qualified merger, or residual assets are determined of a loss corporation

(v) In case, all specified board members resign and approx. 20% of employees leave the loss corporation

- The size of the business of the non-employed business (the business in which employees of a loss corporation are not engaged) exceeds approx. 5 times the size of the business of the former business just before the date of the

4. *Tax losses in a merger*

4.1. *Tax-qualified merger*

In a tax-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 corporations from buying up loss-making corporation's to take advantage of their losses, there is an anti-avoidance rule.

(1) Tax losses of a merged corporation or a surviving corporation incurred in the financial years before the financial year when a

[1] A Small or Medium-Sized Enterprise is a corporation whose paid in capital is JPY 100million or less and the stated capital amount of the wholly owning parent corporation is less than JPY 500million.

Grant Thornton

controlling relationship (50% or more direct/indirect ownership) **was established and (2) tax losses incurred in the financial 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 unless a controlling relationship had existed continuously for 5 years or more on the first day of the financial year when a tax-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 corporation and the surviving corporation are related.
(ii) The sales amount, the number of employees or the stated capital of either the merged corporation or the surviving corporation does not exceed 5 times that of the other.
(iii) The business of the merged corporation has continued from the time when the controlling relationship was established until the tax-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 corporation has continued from the time when the controlling relationship was established until the tax-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 corporation will assume the same position in the surviving corporation after the merger.

4.2. Disqualified merger

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

5. Tax losses in Tax consolidation system / Group relief system

5.1. Tax consolidation system

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

5.2. Group relief system

Group relief system has been introduced in 2020 to replace Tax consolidation system and will apply to financial years beginning on or after April 1, 2022.

Domestic corporation groups which elect Tax consolidation system will move on to the Group relief system automatically unless submitting a cancellation notification of the elected Tax consolidation system. In this case, no tax issue will arise on tax losses.

When a domestic corporation group of 100% ownership that newly elect Group relief system, the treatment of the tax losses of a group parent and the tax losses group subsidiaries will be changed as follows:

-When the consolidation parent satisfies the condition a), the tax losses of consolidation parent incurred in the financial years before the financial year when the Group relief system is elected can be utilized to offset the taxable income of the consolidation parent after the Group relief system is elected. SRLY (Separate-Return-Limitation-Year) rule is applied to a group parent's loss while there was no restriction to a consolidation parent's loss under the tax consolidation.

-When group subsidiaries satisfy one of the following requirements a) to d), the tax losses of the group subsidiary incurred in the financial years before the financial year when the Group relief system is elected or the group subsidiary joins the group can be utilized to offset the taxable income of the group subsidiary after the Group relief system is elected or after the consolidated subsidiary joins to the corporate group. SRLY rule is applied to a group subsidiary's loss.

a) 100% ownership is existed by the consolidation parent and also meets the requirement a-1) or a-2)
  a-1) 50% or more shares had been owned by the consolidation parent for 5 years or longer
  a-2) satisfies the requirements of joint business conditions in section 4.1 above
b) Be consolidated subsidiaries by Tax-qualified share exchange, and also meets the requirement a-1) or a-2)
c) Incorporated as a 100% owned corporation of the group parent or the group subsidiaries
d) Satisfies the requirements of joint business conditions in section 4.1 above

The conditions for tax loss carry-over of a group subsidiary in Group relief are in line with those for a merged company's loss carry-over in a qualified merger.

-In otherwise, the tax losses incurred the financial year before the financial year when a controlling relationship is established and the tax losses incurred after the controlling relationship was established until electing Group relief system which corresponds to realizing built-in losses that existed before the controlling relationship was established will be discarded

© 2022 Grant Thornton Taiyo Tax Corporation. All rights reserved.
"Grant Thornton" refers to the brand under which the Grant Thornton member firms provide assurance, tax and advisory services to their clients and/or refers to one or more member firms, as the context requires. Grant Thornton Taiyo Human Capital Corporation is member firm of Grant Thornton International Ltd (GTIL). GTIL and the member firms are not a worldwide partnership. GTIL and each member firm is a separate legal entity. Services are delivered by the member firms. GTIL does not provide services to clients. GTIL and its member firms are not agents of, and do not obligate, one another and are not liable for one another's acts or omissions.