Japan Tax Bulletin

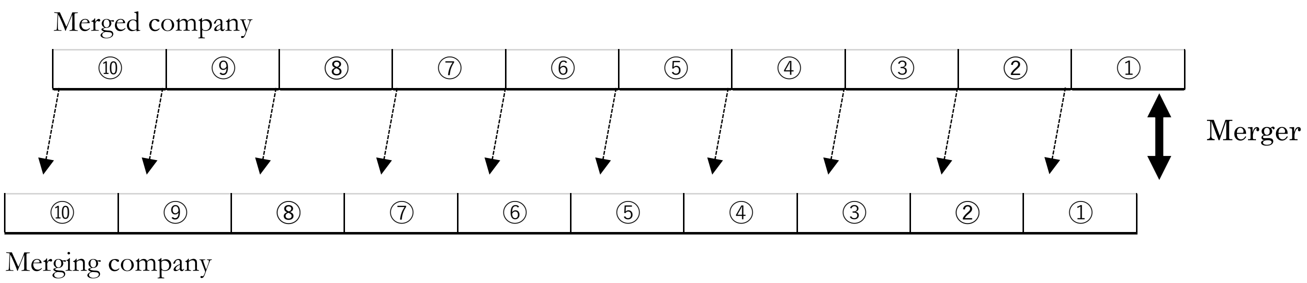
Succeeding tax losses of a merged company in a statutory merger

April 2023

A blue tax return status corporate taxpayer[1] is allowed to carry forward tax losses to the following 10 business years and carry back to the previous one business year, to offset against the following business years' income or claim a refund of the previous year's tax. When a company carrying forward tax losses (a "tax loss holding company") is merged into another company, the question is whether or not the tax losses of the merged company can survive in the merging company. Prior to the 2001 Tax Reform, the succession of tax losses of a merged company to a merging company was not allowed. In the 2001 Tax Reform, tax rules on corporate reorganizations were introduced into the Corporation Tax Law and the succession of tax losses of a merged company to a merging company in a qualified merger[2] became possible. As a merger involving a tax loss holding company may be used for tax avoidance, special anti-avoidance rules were implemented in the Corporation Tax Law.

1. *Succession of tax losses of a merged company to a merging company in a qualified merger*

A merged company's tax losses that arose in the business years commencing within 10 years prior to the date of the merger, are deemed to have arisen in the merging company in the business year in which the start date of a merged company's business year fell, as depicted below.



2. *Special Anti-Avoidance rules*

(1) General

Where a company acquires 100% of a tax loss holding company and thereafter merges the tax loss holding company and stops the underlying businesses, it could be viewed that the main motivation for the merger was to obtain the tax losses. The Special Anti-Avoidance rules restrict the utilization of a merged company's tax losses in a qualified merger unless the 5 years or more control relationship[3] continuation requirement or the joint business requirement is satisfied. Where the conditions are not satisfied, the following tax losses of both the merged company and the merging company are disregarded:

(i) Tax losses arising in business years before the business year when the control relationship was established, which are within 10 years from the beginning of the business year when the qualified merger occurred.

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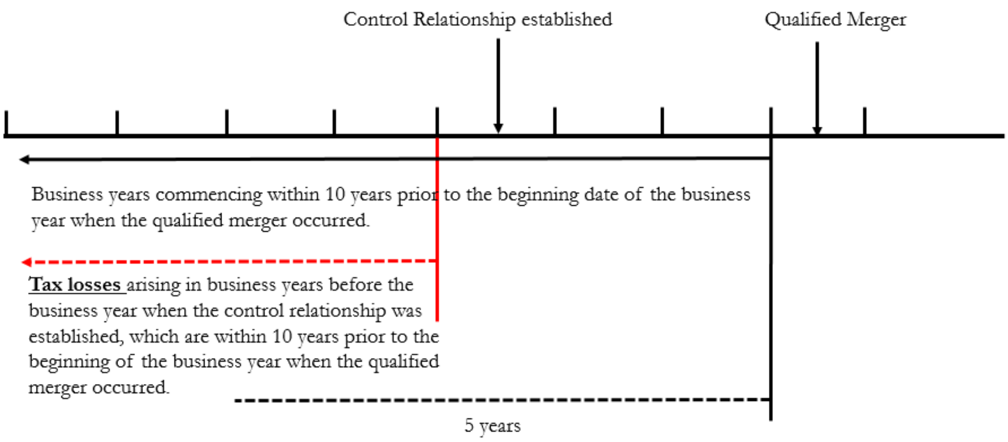
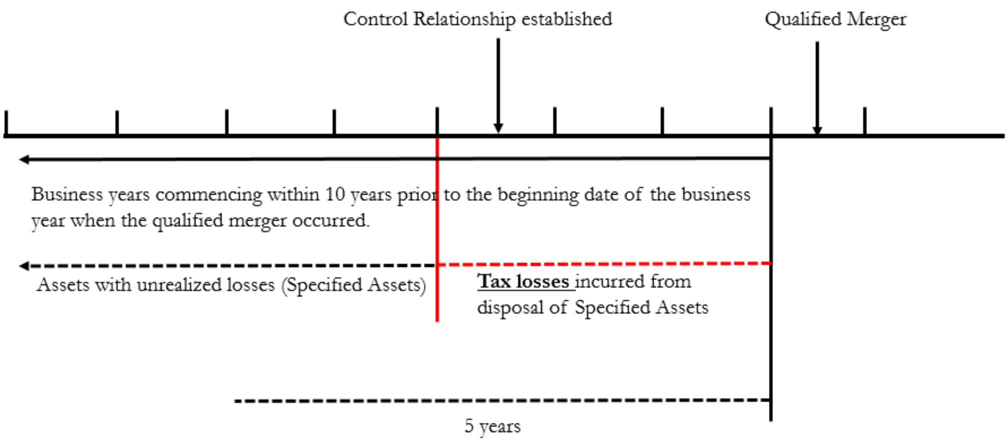
[1] A taxpayer who elects for blue tax return status and is required to maintain accounting ledgers and records as stipulated in the regulations.

[2] A qualified merger is a merger of companies in the same group or a merger of companies in the same or similar businesses to conduct a joint business. The detailed conditions need to be satisfied for a merger to be qualified.

[3] Either party of a merger own 50% or more of the other, or the same person owns 50% or more of both.



(ii) Tax losses arising from disposal of "Specified Assets" (assets with unrealized losses held in business years before the control relationship was established), from the beginning of the year during which the control relationship was established, to the end of the business year prior to the qualified merger.



(2) Joint Business Requirements

Where 5 years or more have passed from the date when the control relationship was established through the beginning of a business year when the qualified merger was completed, the special anti-avoidance rules are not applied (5-year control relationship continuation requirement). Even if the 5-year control relationship continuation requirement is not satisfied, the special anti-avoidance rules are not applied if the joint business requirements are satisfied. The joint business requirements are satisfied if (i), (ii),(iii) and (iv) or (i) and (v) below are satisfied.

(i) Business Relevance
The business of a merged company and that of a merging company are related to each other.

(ii) Business Scale
The business scale of either the merged business or the merging business (limited to businesses related to the merged business) in terms of the sales amounts, the number of employees, the amounts of stated capital, or the ratio of the scale of those equivalent to these does not exceed approximately 5 times that of the other.

(iii) Business Scale Continuation of the merged business
The merged business has continued from the time when the control relationship was established through immediately

before the qualified merger, and its business scale at one of those events, does not exceed approximately 5 times its scale at the other event.

(iv) Business Scale Continuation of the merging business
The merging business has continued from the time when the control relationship was established through immediately before the qualified merger, and its business scale at one of those events does not exceed approximately 5 times its scale at the other event.

(v) Continuation of Specific Officers
A specific officer (president, CEO, executive director etc., who is engaged in managing a company) of the merging company and that of the merged company are expected to be in office after the merger.

3. General Anti-Avoidance Rule

Even where an application of the specific anti-avoidance rule is avoided, if the burden of corporation taxes of parties involved in corporate reorganizations[4] are unreasonably reduced, the district director of the tax office is authorized to calculate the tax bases of the companies involved in corporate reorganizations, based on their own calculation without reference to the transactions or calculations actually employed. There have been court cases where the applicability of the general anti-avoidance rule was upheld.

[4] Merger, corporate division, capital contribution in kind, subsequent establishment (an agreement to acquire assets within 2 years from the incorporation of a company), share for share exchange or share transfer.