Japan

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Introduction

In Japan, it is customary for the tax system to be amended annually. This year there have been several important updates, including those related to corporate tax.

Among the wide range of amendments, some relate to corporate tax and may be of interest to companies located in foreign countries that have capital ties with companies in Japan. This chapter focuses on such amendments under the 2022 tax reform.

Revision of the calculation of the amount of capital corresponding to the return of capital and the deemed dividend in the case of a return of capital

On March 11, 2021, in a case involving the taxation of dividends received by a domestic corporation from a foreign corporation established under the laws of the State of Delaware, U.S., the Supreme Court ruled that with regard to a mixed dividend whose underlying assets are capital surplus and retained earnings, the provisions of Article 23, Paragraph 1, Item 3 (now Item 4) of the Enforcement Order of the Corporate Tax Act are partially invalid. In response to this ruling, the National Tax Agency implemented certain provisional measures. Subsequently, with this year's tax reform, the law was revised in line with the Supreme Court ruling.

Before amendment

Dividend taxation on capital surplus was imposed by deeming the amount calculated as follows as the amount of deemed dividend (X) under Article 23, Paragraph 1, Item 1 of the Corporate Tax Act:

$$X = P - S$$

$$A = C \times [P \div Q \text{ (if } P \leq Q) \text{ or } 1 \text{ (if } P > Q)]$$

$$S = A \times R$$

A: Amount of Capital, etc., corresponding to the amount of refunded capital immediately before the capital refund ("Capital, etc., Corresponding to the Immediately Preceding Refund").

S: Amount of the portion of the capital amount corresponding to the shares held by the corporation that was the basis for receiving the assets ("Share Corresponding Portion Amount").

C: Amount of capital, etc., of the refunding corporation immediately before the capital refund ("Capital, etc.").

R: Shareholders' Percentage. This is the ratio of the number of shares of capital return held by the domestic corporation (and the foreign corporation with Permanent

Establishment in Japan) immediately before the capital refund to the total number of shares of capital refund.

P: Amount of capital surplus of the refunding corporation reduced by the refund of capital ("Reduced Capital Surplus").

Q: Book Value of Net Assets. This is the amount obtained by subtracting the book value of liabilities from the book value of assets as of the end of the previous fiscal year of the refunding corporation. However, if the amount of capital has increased or decreased between the end of the previous fiscal year and the time immediately prior to such capital refund, the amount of such increase or decrease shall be added or subtracted.

However, if the amount of profit reserve is negative, the amount of Capital, etc., Corresponding to the Immediately Preceding Refund exceeds the amount of Reduced Capital Surplus. For example, consider the case where a company with Capital, etc., of 100 and a profit reserve of minus 20 pays 32 dividends funded by capital surplus and 25 dividends funded by retained earnings and the Shareholders' Percentage is 100%. In this case, the Book Value of Net Assets is 80 (=100-20) and the Capital, etc., Corresponding to the Immediately Preceding Refund (=Share Corresponding Portion Amount) is 100×32/80=40, which exceeds the Reduced Capital Surplus (32). If this Share Corresponding Portion Amount (=Share Corresponding Portion Amount) (40) was treated as dividends from capital surplus, part of the amount of dividends from retained earnings (8 of 25) would correspond to and overlap with the amount of the Capital, etc., Corresponding to the Immediately Preceding Refund (=Share Corresponding Portion Amount), and the provisions of Article 23, Paragraph 1, Item 3 of the Enforcement Order of the Corporate Tax Act was designed so that dividends from retained earnings could also be included in the refund of capital. This point became a point of dispute, and the Japanese Supreme Court ruled that such provisions were partially invalid.

Judgment by the Supreme Court

The Supreme Court held that a dividend of surplus funded from both capital surplus and retained earnings (mixed dividend) constituted a refund of capital under Article 24, Paragraph 1, Item 3 (now Item 4; the same shall apply hereinafter in (2) and (3)) of the Corporate Tax Act. The Supreme Court then declared, in summary, as follows:

(i) The provisions relating to dividends in the Corporate Tax Act are based on the basic premise that a distinction should be made between the capital portion and the profit portion, and that there is a difference between Article 23, Paragraph 1, Item 1 of the Corporate Tax Act (dividends of surplus excluding those involving a decrease in the amount of capital surplus) and Article 24, Paragraph 1, Item 3 (as at the time of the Supreme Court's ruling) of the Corporate Tax Act (dividends of surplus limited to those involving a decrease in the amount of capital surplus) in the resources of paying property of the corporation. A refund that is funded solely from retained earnings is uniformly treated as a distribution of the profit portion, regardless of whether or not the capital portion is included, and all or part of the refund is not included in the amount of gross income. On the other hand, pursuant to Article 24, Paragraph 1, Item 3 of the Corporate Tax Act, a refund that is made solely from capital surplus is divided into a refund of the capital portion and a distribution of the profit portion, and the amount of the profit portion distribution is deemed a dividend of surplus under Article 23, Paragraph 1, Item 1 of the Corporate Tax Act.

(ii) Given these provisions of the Corporate Tax Act, Article 24, Paragraph 1, Item 3 of said Act contemplates that, in the case of a distribution of surplus funded from both retained earnings and capital surplus, the portion funded from retained earnings shall be treated

as a distribution of the profit portion in its entirety, while the portion funded from capital surplus shall be divided into a refund of the capital portion and a distribution of the profit portion. On the other hand, Article 24, Paragraph 1, Item 3 of the Corporate Tax Act does not treat a distribution from retained earnings as a refund of the capital portion.

(iii) Article 23, Paragraph 1, Item 3 of the Enforcement Order of the Corporate Tax Act (as at the time of the Supreme Court's ruling), which regulates the calculation method of the Share Corresponding Portion Amount under Article 24, Paragraph 3 of said Act, attempts to calculate the Share Corresponding Portion Amount by treating a refund of corporate assets as a proportional distribution from both the capital portion and the profit portion in accordance with their respective ratios to the net assets. This calculation framework is basically consistent with the aforementioned basic premise of the Corporate Tax Act. However, only in the case where the Book Value of Net Assets is less than the Capital, etc., the above calculation method would result in the amount of Capital, etc., Corresponding to the Immediately Preceding Refund being in excess of the amount of Reduced Capital Surplus. Therefore, in the case of a dividend of surplus funded from both retained earnings and capital surplus, if the amount of Capital, etc., Corresponding to the Immediately Preceding Refund is calculated as described above, the portion funded by retained earnings will be treated as a refund of the capital portion. Therefore, Article 23, Paragraph 1, Item 3 of the Enforcement Order of the Corporate Tax Act (as at the time of the Supreme Court's ruling), which stipulates the calculation method of the amount of Capital, etc., Corresponding to the Immediately Preceding Refund, would not be in accordance with the intention of the Corporate Tax Act to the extent that the amount of Capital, etc., Corresponding to the Immediately Preceding Refund exceeds the amount of Reduced Capital Surplus with respect to dividends from surplus funded from both retained earnings and capital surplus.

Tentative action by the National Tax Agency after the Supreme Court judgment

As mentioned above, this judgment declared the calculation method of the amount of the Share Corresponding Portion Amount for mixed dividends to be illegal and invalid to the extent that it results in the amount of Capital, etc., Corresponding to the Immediately Preceding Refund being in excess of the amount of Reduced Capital Surplus. In response to this judgment, on October 25, 2021, the National Tax Agency announced that, with respect to Article 23, Paragraph 1, Item 4 of the Enforcement Order of the Corporate Tax Act and Article 61, Paragraph 2, Item 4 of the Enforcement Order of the Income Tax Act, which are similar provisions, the amount of Capital, etc., Corresponding to the Immediately Preceding Refund calculated in the case of mixed dividends shall be up to the Reduced Capital Surplus in accordance with this judgment.

This treatment was applied retroactively. Shareholders whose past tax returns have changed as a result of the recalculation of the amount of the Capital, etc., Corresponding to the Immediately Preceding Refund may file requests for correction with the competent tax office in accordance with the provisions of the Act on General Rules for National Taxes; provided, however, that such request shall be filed only if five years have not passed since the statutory filing due date.

Revision of laws

While the National Tax Agency took the aforementioned actions, the calculation method of the Share Corresponding Portion Amount for mixed dividends was revised under the 2022 tax reform.

First, Capital, etc., Corresponding to the Immediately Preceding Refund, which is the basis for calculating the amount of deemed dividends related to the refund of capital and Reduced Capital Surplus, which in turn is the basis for calculating Capital, etc., will be limited to Reduced Capital Surplus by the refund of capital, under both the Corporate Tax Act and Income Tax Act. The same applies to the calculation of the amount of deemed dividends for distribution of capital reduction and the amount to be subtracted from the Capital, etc.

In addition, in the case where a corporation issuing class shares makes a return of capital, the capital corresponding to the Capital, etc., Corresponding to the Immediately Preceding Refund, which is the basis for the calculation of the amount of deemed dividends, and the Reduced Capital Surplus, which is the basis for the calculation of the Capital, etc., shall be calculated based on each class capital amount pertaining to such return of capital.

Revision of the Group Tax Relief System

The previous Consolidated Taxation System was abolished, and the Group Tax Relief System has started to be applied to fiscal years beginning on or after April 1, 2022. However, several amendments to the law have been made in conjunction with the implementation of the Group Tax Relief System. Among these revisions, those related to investment book value adjustments and foreign tax credits seem to be important.

Amendments to the Investment Book Value Adjustment

The Investment Book Value Adjustment is a method of adjusting the amount of the book value of shares of the totalising subsidiary corporation held by the totalising corporation to the amount equivalent to the Book Value of Net Assets of the totalising subsidiary corporation, and increasing or decreasing the totalising corporation's own revenue reserve amount according to the adjustment of the book value of the shares, in the case where an approval of the Group Tax Relief System granted to the totalising subsidiary corporation becomes invalid due to certain events such as its withdrawal from the group.

Before the 2022 tax reform, under the Group Tax Relief System, the amount of the book value of the shares of the totalising subsidiary corporation that was withdrawing from its group was, in general, the amount equivalent to the net asset value of the withdrawing totalising subsidiary corporation immediately prior to the withdrawal from the group. Because of this, if the shares of the totalising subsidiary corporation were acquired at a price over the net asset value, i.e., with an acquisition premium, the acquisition premium was not allowed to be included in the costs as the transfer cost of the shares of such totalising subsidiary corporation. This point made companies reluctant to conduct mergers and acquisitions because of the risk of taxation on the transfer of shares.

The 2022 tax reform maintains the use of the calculation method mentioned above. On the other hand, each totalising corporation of the group that owned shares of the withdrawing subsidiary corporation at the time of the withdrawal is allowed to add, to the amount of the book value of the withdrawing totalising subsidiary corporation, the amount of the "Amount Corresponding to the Asset Adjustment Account, etc." if the totalising corporation has attached a detailed statement of such calculation to its tax return, etc., for the business year in which the withdrawal occurred and kept documents containing the basis for such calculation. The "Amount Corresponding to the Asset Adjustment Account, etc." means the amount of the equivalent amount calculated as the asset adjustment account or the liability adjustment account in the case where a non-qualified merger is implemented with the totalising subsidiary corporation as an acquired corporation at the time of acquisition thereof with the shares of the totalising subsidiary corporation as the consideration for the merger.

It should be noted that this amendment will not apply to the totalising subsidiary corporations that will not be subject to the fair market valuation system in respect of the assets when withdrawing from the Group Tax Relief System because they will not continue their main business.

Revision of the foreign tax credit system

Under the Group Tax Relief System, if each totalising corporation pays foreign corporate tax for each fiscal year, the amount of such foreign corporate tax shall be credited against the amount of corporate tax on income for that fiscal year up to the upper limit on the tax credit amount (Article 69, Paragraphs 1 and 14 of the Corporate Tax Act and Article 148, Paragraph 1 of the Enforcement Order of the Corporate Tax Act). The maximum amount of tax credit is calculated using the total amount of income, foreign income, and corporate tax of each totalising corporation. Therefore, if an error in calculation for a prior year is discovered in another corporation within the group, it is likely to affect the other group companies to which the foreign tax credit is applied, which may result in the filing of multiple amended returns or requests for correction for the prior year. Therefore, even if there is an excess or deficiency between the tax credit amount in the timely filed return and the recalculated tax credit amount, the tax credit amount for the past fiscal year is fixed at the amount calculated according to the timely filed return (Article 69, Paragraph 15 of the Corporate Tax Act), and there is no need to file an amended return in relation to the excess or deficiency (hereinafter referred to as the "Fixing"). The excess or deficient amount shall be adjusted in the subject fiscal year (the "progressive fiscal year", or the fiscal year that includes the date of correction or amendment in principle) (hereinafter referred to as the "Progressive Fiscal Year Adjustment").

Since this Progressive Fiscal Year Adjustment is expected to be applied voluntarily by taxpayers, there have been some problems. First, even if the tax authorities find that the Progressive Fiscal Year Adjustment should be applied as a result of a tax audit, there is no legal basis for the tax authorities to inform the taxpayer of the details of the findings. Second, if the taxpayer does not appropriately apply the Progressive Fiscal Year Adjustment due to reasons such as not being satisfied with the results of the investigation by the tax authorities, the Fixing cannot be cancelled unless, for example, the resulting decrease in the amount of corporate tax can be assessed as unreasonable. Therefore, the tax authorities generally did not have any authority to cancel the Fixing and demand the taxpayer to correct their tax return (Article 69, Paragraphs 19 and 20 of the Corporate Tax Act).

In order to solve this problem, the following amendments were made under the 2022 tax reform:

(i) If the relevant tax authority finds that the Progressive Fiscal Year Adjustment should be applied as a result of its investigation, the tax authority shall explain to the totalising corporation the details of the investigation results (including the amount for which the Progressive Fiscal Year Adjustment is found to be applied and the reasons thereof).

(ii) If the amount indicated as the amount of the tax credit deficiency or the tax credit excess after the Progressive Fiscal Year Adjustment in the documents attached to the timely filed return for the business year that includes the date when the explanation in (i) above is given differs from the explanation given in (i) above by the tax authority, then the Fixing to the amount equivalent to the tax credit deficiency or excess for the year shall not be applied.

(iii) If a taxpayer files an amended return or the tax authorities make a correction to its tax return for the business year in which the Fixing is not applied with respect to the amount

of tax credit, the amount of tax credit deficiency or the amount of tax credit excess (the "Tax Credit, etc."), the Fixing shall, in principle, be reapplied to the amount stated as the Tax Credit, etc., in the amended return or notice of correction for that Fixing.

Revision of withholding at source for dividends on shares, etc., of wholly owned subsidiaries and affiliated corporations

Before the revision, dividends from domestic corporations were, in principle, subject to withholding at source. For example, when a parent corporation receives dividends from a wholly owned subsidiary corporation in a group or from an affiliated corporation of which more than one-third of its total number of outstanding shares is held by the parent corporation, withholding is still imposed at the time of payment of such dividends. The income tax withheld at source is deducted from the parent corporation's income tax return and a refund is paid. On the other hand, the entire amount of dividends received from a wholly owned subsidiary is excluded from the gross income in the calculation of the parent corporation's corporate income tax.

However, the heavy administrative burden on taxpayers and tax authorities caused by withholding at source were criticised. Therefore, under the 2022 tax reform, it was decided that the following dividends, etc., paid by certain domestic corporations will not be subject to income tax, that no income tax withholding will be imposed on such dividends, etc., and that other necessary measures will be taken in connection with this change:

(i) Dividends, etc., on shares, etc., of a wholly owned subsidiary corporation (100% shareholding ratio).

(ii) Dividends, etc., regarding shares, etc., of another domestic corporation in the case where, as of the record date for the payment of the dividends, etc., a domestic corporation directly holds shares, etc., of another domestic corporation that accounts for more than one-third of the total number of issued shares, etc., of the latter domestic corporation.

Please note, however, that this provision shall apply only to dividends, etc., to be received by a domestic corporation, and does not apply to dividends, etc., received by a foreign corporation from a domestic corporation.

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