

STRATEGIC M&A TAX ADVICE**The Ace of Diamonds is Now in Trouble**

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Introduction

Article 132 of the Corporation Tax Act of Japan provides:

When it is found that any acts conducted or calculations made by the corporation would, if allowed, unreasonably reduce the burden of corporation tax, Tax Agencies may calculate (a) the tax base of corporation tax related to the corporation, (b) the net operating loss, or (c) the amount of corporation tax, based on their own recognition, notwithstanding the acts or calculations.

This application of Article 132, which Tax Agencies have relied upon over the years to deal with international corporations' tax avoidances is now in doubt.

What the Case is about

This June, Tokyo district court narrowly interpreted Article 132, which benefits corporations. Some say the judgment reflects today's global corporate activities. Others say it endangers current practices of Tax Agencies. Either way, everyone is waiting for the next judgment by the court of appeals.

The case is about a tax position taken by the record company, Universal Music. As part of a restructuring, Universal conducted an absorption-type merger with its related company. For this, Universal borrowed JPY 86,600,000,000 from foreign group companies and paid interest thereon thus reducing its taxable income.

Tokyo Tax Agency pointed out that the tax treatment of Universal is unreasonable and strange because its music business within Japan has not been changed by the restructure. It also argued that the treatment is the kind of conduct that only group companies are capable of. Tokyo Tax Agency then applied Article 132 of Corporation Tax Act, arguing that the treatment unreasonably reduced the corporate tax burden. Tokyo Tax Agency also taxed Universal an amount of JPY 5,800,000,000, pointing out that JPY

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18,100,000,000 in net income for the last 5 years was not declared. Universal brought the case to court.

Interpretations of Article 132 of Corporation Tax Act

The issue was in which circumstances Article 132 can be applied. In the recent case of Japan IBM, the court already showed an interpretation of Article 132, holding that if a conduct does not fall within usual transactions between independent parties and results in reducing a tax burden, then the conduct will be considered unreasonable (therefore Article 132 can be applied). In that case, a holding company of Japan IBM, based on the Consolidated Tax Return Filing System, offset a loss arising from its sales of subsidiary stock trading. Although the judgment was in favor of Japan IBM, the interpretation itself was beneficial to Tax Agencies.

However, with Universal, the court appears to have changed its interpretation, saying that “the fact that the conduct is something that only group companies are capable of does not necessarily mean that the principle of fair tax burden is infringed”. Under this interpretation, even a slight business reason can be a defense for corporations. In other words, in the future, Article 132 will be applied only when there exists no benefit for corporations other than reducing tax burden. This judgment was appealed and now in the court of appeals.

Article 132 can be a huge concern for corporations and interpretation of the same has significant impacts on tax practices.

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