

STRATEGIC M&A TAX ADVICE**The Source of Funds
Transferred from Foreign Subsidiary to Its Parent
Should Be Divided into Retained Earnings and Capital Surplus
- Approved by the Tokyo High Court.**

August 17, 2019

Facts

The Tokyo High Court recently revoked the original administrative disposition of the National Tax Agency (hereinafter, the “**Tax Agency**”) regarding the tax treatment by Kokusai Kogyo Kanri Co., Ltd., a Japanese company (formerly Kokusai Kogyo Co., Ltd.; hereinafter, “**Kokusai Kogyo**”), of funds received from its U.S. subsidiary. With respect to the funds of \$644,000,000 (JPY 51.2 billion¹) received from the U.S. subsidiary, Kokusai Kogyo filed its tax return under the following categories²:

- (1) \$544,000,000 (JPY 43.2 billion³) , the source of which is retained earnings of the subsidiary; and
- (2) \$100,000,000 (JPY 7.9 billion⁴), the source of which is capital surplus.

Japanese Tax Law Treatment

Japanese tax law treats the funds transferred from a foreign subsidiary to its parent (in Japan), differently according to its source (i.e. whether the source is retained earnings or capital surplus). When a Japanese corporation receives from its foreign subsidiary funds, the source of which is retained earnings (in this case, such funds will be called a dividend), 95% of such funds (dividend) will be allowed not to be calculated into gross revenue (in other words, allowed to be excluded from gross revenue to be qualified as tax free). This rule is designed to avoid double taxation in Japan and a foreign country including the U.S. Kokusai Kogyo, pursuant to this rule, subtracting 5% (JPY 2.1 billion) of the JPY 43.2 billion (set forth in (1) herein above), decided to exclude the remainder (JPY 4.1 billion) from gross revenue. With respect to the JPY 7.9 billion, the source of which is capital surplus, Kokusai Kogyo recognized the occurrence of a capital loss.

¹ Translated at the exchange rate then prevailing.

² Please refer to Exhibit A hereto.

³ Translated at the exchange rate then prevailing.

⁴ Translated at the exchange rate then prevailing.

Briefing

Argument of the Tax Agency

However, in 2014, the Tax Agency claimed that this treatment was wrong and made a disposition of correction. In detail, the Tax Agency argued that, because the effective date of the fund transfer (in the amount of JPY 43.2 billion) and that of the fund transfer (in the amount of JPY 7.9 billion) are the same, the relevant fund transfer of \$644,000,000, in whole, should be treated in the same way. This argument is consistent with the current practice by the Tax Agency that funds transferred from a foreign subsidiary to its parent (in Japan), the source of which is comprised of both retained earnings and capital surplus, are deemed, in its entirety, to have been derived from only capital surplus rather than retained earnings. Kokusai Kogyo sought the revocation of the disposition of correction by the Tax Agency at the Tokyo District Court. The Tokyo High Court affirmed the assertions by Kokusai Kogyo.

Judgment of the Court

The Tokyo High Court dismissed the argument from the Tax Agency, saying that “in the Corporation Tax Act, there is a general principle distinguishing the capital contributed by the shareholders and the profit gained by the corporations” and therefore, “funds transferred from a subsidiary, the source of which is retained earnings, and funds transferred from a subsidiary, the source of which is capital surplus, should be treated to be independent”. The Tax Agency further appealed to Japan’s Supreme Court, on June 11, 2019.

Comments

This Tokyo High Court’s ruling will have a material impact on the future practice of tax planning in M&A transactions and will influence future corporate dividend/capital return policies.

The responsible partner for this briefing is Akimitsu Kamori (Email: a-kamori@blakemore.gr.jp; Tel. (81-3) 3503-5591).

Akimitsu Kamori

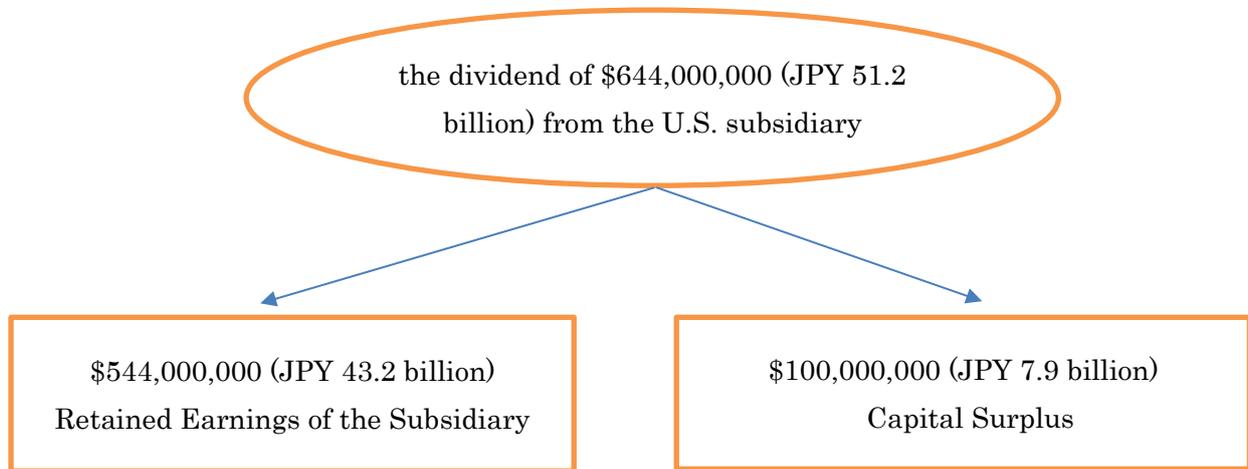
Partner
Blakemore & Mitsuki
Emai
(81-3) 3503-5591



Briefing

EXHIBIT A

Tax Treatment by Kokusai Kogyo (Approved by the Tokyo High Court)



Tax Treatment Argued by the Tax Agency

