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Supreme Court rules in favor of taxpayer in “debt push down” case

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In brief

This article discusses a Supreme Court of Japan case decided on 21 April 2022 relating to “debt push down” arrangements. The court ruled that anti-abuse provisions in the tax law should not apply where a transaction has an economic rationale; however, the case also illuminates potential risks associated with such arrangements and provides some practical insight into the wide-reaching powers of the tax authority.

Background

The case involves a multinational group with a number of subsidiaries in Japan. The transaction at issue essentially involves a reorganization where the taxpayer, a newly established Japanese subsidiary, received a loan of approximately JPY 86.6 billion from a foreign related party in order to fund the acquisition of shares in other existing group companies in Japan. Following the acquisition of shares, one of the acquired companies was merged into the taxpayer, while the other acquired companies were consolidated in a separate merger into a subsidiary of the taxpayer, thereby reducing the number of group companies in Japan. As a result of the loan, the taxpayer reported approximately JPY 18.1 billion of interest deductions for Japanese corporate income tax purposes over a period of five years from 2008 through 2012.

The tax authority sought to apply the anti-abuse provisions under article 132(1) of the corporate income tax law (which applies to closely held corporations defined as a company controlled more than 50% by three or fewer shareholders and their related parties) to recalculate the taxable income of the taxpayer by disallowing the interest deductions, arguing that the loan arrangement was artificial and without a reasonable business purpose or economic rationale and had been entered into with a foreign related party in order to reduce the tax burden of the taxpayer. On this point, the tax authority noted that any economic benefit to the foreign related party as result of the acquisitions would be indirect and, at the time of the loan, was merely abstract and uncertain. As a result, the tax authority increased the taxpayer’s tax liability by approximately JPY 5.8 billion over the five-year period.

Upon appeal, the taxpayer argued that the transaction was made under arm’s length conditions and had a reasonable business purpose and economic rationale. Both the district court and high court ruled in favor of the taxpayer, finding that the transaction had economic rationale.

Supreme Court ruling

Similar to the district court and high court rulings, the Supreme Court ruled in favor of the taxpayer. The court acknowledged it was likely that one of the purposes of the transaction was to reduce the tax burden; however, there also were other reasons for the arrangement, such as enabling agile business operations and consolidating the group companies in Japan. Ultimately, the court concluded that, when viewing the transaction overall, the arrangement did not lack economic rationale and, therefore, the anti-abuse provisions of article 132(1) did not apply and the interest deductions should be allowed.

Deloitte Japan's View

Given the broad interpretation of the anti-abuse rules, it is welcome news for taxpayers that the courts have interpreted that the rules should not apply when there is economic rationale behind an intercompany financing arrangement. Nevertheless, it is still important for taxpayers to be able to demonstrate that an intercompany financing arrangement with a foreign related party has a reasonable business purpose or economic rationale. Using the current case as an example, if it can be argued that intercompany financing would enable a Japanese company to conduct business in a more efficient manner or there exists a commercial purpose for the transaction, such as a consolidation of entities, this could support the case for economic rationale in similar arrangements if they were to be challenged by the tax authority.

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