Deloitte.
デロイト トーマツ

Japan Inbound Tax & Legal Newsletter

Anti-dividend stripping rules under 2020 tax reform

April 2020, No. 56

In Brief

Under Japanese tax law, capital gains are fully taxable at the corporate shareholder level, while certain qualified dividends are tax-exempt. To mitigate potential double taxation, corporate shareholders often choose to "strip" the retained earnings of subsidiaries by paying tax-exempt dividends prior to share transfers to reduce the share value and capital gain. However, as a result of new anti-dividend stripping rules introduced as part of Japan's 2020 tax reform, such dividend stripping may no longer be feasible. Under certain conditions, the tax basis of the shares in the hands of the corporate shareholders must be reduced by the tax-exempt portion of dividends paid, thus nullifying the benefit of paying the dividends.

This newsletter provides an overview of the newly introduced anti-dividend stripping rules and their potential impact on inbound M&A transactions.

1. Dividend exemption rules

A corporate shareholder can exclude from its taxable income dividends received from a Japanese corporation, with the excluded amount determined based on the length and percentage of ownership of the Japanese corporation paying the dividend. In the case of dividends received from a foreign corporation, a company generally can exclude 95% of the dividend amount from its taxable income, if applicable ownership period and ownership percentage requirements are met.

Japanese tax law also contains anti-dividend stripping rules meant to prevent companies from realizing capital losses by turning off the dividend exemption. Prior to the 2020 tax reform, however, the rules only applied in limited situations where a corporate shareholder acquired shares of a Japanese corporation within two months prior to the record date of the dividends and transferred the shares within one month following the record date. Thus, to the extent companies were not subject to these provisions, fully taxable capital gains could be recharacterized as tax-exempt dividends.

2. Overview of new anti-dividend stripping rules

For fiscal years beginning on or after 1 April 2020, if a corporate shareholder receives dividends from a Specified Subsidiary[1] and the Specified Dividend Amount[2] exceeds 10% of the tax basis in the Specified Subsidiary's shares, the tax basis is reduced by the portion of the Specified Dividend Amount that is excluded from the taxable income of the corporate shareholder under rules such as the dividend exclusion provisions outlined above.

---

[1] "Specified Subsidiary" refers to a corporation in which the corporate shareholder directly and/or indirectly owns more than 50% of the shares (or owns certain voting interests in another corporation) on the date the payment of the dividends is declared by the Specified Subsidiary.

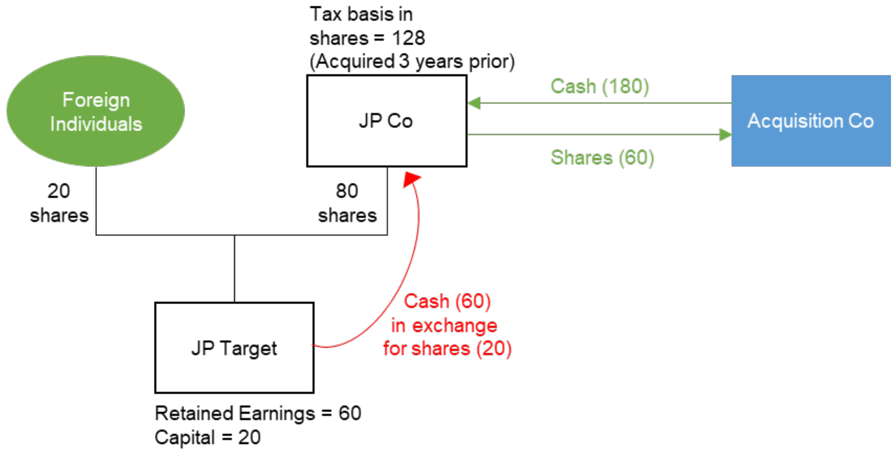
[2] "Specified Dividend Amount" refers to the aggregate amount of dividends received by the corporate shareholder from certain subsidiaries during the same fiscal year. The Specified Dividend Amount also includes deemed dividends to the extent not received from wholly-owned corporations.

However, there are exceptions for dividends that are:

- Paid from Japanese corporations that have been continuously owned at least 90% by Japanese persons (e.g., Japanese corporations, Japanese individuals, etc.) from incorporation to the date a Controlling Relationship[3] began;
- Sourced from retained earnings generated after a Controlling Relationship began; or
- Paid after 10 years from the date a Controlling Relationship began.

In addition, under a deminimus provision, the anti-dividend stripping rules will not apply if the Specified Dividend Amount is less than JPY 20 million.

Below is an abbreviated illustration of how these new rules impact a common acquisition scenario where a Japanese target company (JP Target) buys back its own shares before the Japanese corporate shareholder (JP Co) sells its shares in JP Target.



JP Co		
	Pre-2020 reform	**Post-2020 reform**
Share buyback:		
Deemed dividend [A]	56 [60 cash - (20 capital x 20/100 shares]	56
Return of capital [B]	4 [60 – [A]]	4
Tax basis associated with return of capital [C]	32 [128 tax basis x 20/80 shares held by JP Co]	32
Capital loss	(28) [[B] – [C]]	(28)
Sale:		
Tax basis in JP Target shares [D]	96 [128 tax basis – [C]]	40 [128 tax basis – [C] – [A]]
Capital gain	84 [180 cash – [D]]	140 [180 cash – [D]
Taxable income:		
Taxable deemed dividend	0	0
Share buy-back capital loss	(28)	(28)
Sale capital gain	84	140
Total taxable income	56	112
Cash tax (30%)	**16.8**	**33.6**

[3] "Controlling Relationship" refers to a relationship in which one party (together with certain related parties) directly and/or indirectly owns more than 50% of the shares or certain voting interests in another corporation.

Deloitte's View

Japan's new anti-dividend stripping rules could impact inbound M&A transactions, as acquirers often propose target companies buy back shares from Japanese corporate shareholders as part of the acquisition process to reduce taxable capital gains. However, after the 2020 tax reform, such tax saving benefits may no longer be available for Japanese corporate shareholders owning a majority interest in a target, unless an exemption applies. Accordingly, buyers should obtain information such as tax basis in the target, shareholder history, historical retained earnings, etc. in the course of due diligence to analyze whether the new rules will be triggered, and if so, whether any exemptions may apply.

The new rules apply even in cases where tax avoidance is not intended and also apply to deemed dividends for Japanese tax purposes in certain reorganization transactions (e.g., share buy-backs, capital redemptions, liquidations, etc.).

As the new anti-dividend stripping rules are complex, taxpayers should consider consulting with a tax professional to assess the impact the rules may have on their company.

Newsletter Archives

To see past newsletters, please visit our website. www.deloitte.com/jp/inboundtaxnewsletter

Subscribe to Japan: Inbound Tax Alert and tax@hand

To automatically receive future newsletters, please email deloitte-tokyo.newsletter@tohmatsu.co.jp and register by providing your name, company, position, and email address.
Click here to download our tax@hand app to view inbound tax alerts and other content on your mobile device.

Contacts

Deloitte Tohmatsu Tax & Legal Inbound Group

Not all facts and circumstances are covered in this alert. If you have any questions regarding your specific situation, please contact one of the tax professionals at our Deloitte office in Tokyo or visit our website www.deloitte.com/jp/inbound-tax-and-legal-services

Jun Sawada, Inbound Group Leader		**jun.sawada@tohmatsu.co.jp**
Business Tax Services	**Sunie Oue, Partner**	**sunie.oue@tohmatsu.co.jp**
	David Bickle, Partner	**david.bickle@tohmatsu.co.jp**
Indirect Tax Services	**Fumiko Mizoguchi, Partner**	**fumiko.mizoguchi@tohmatsu.co.jp**
Global Employer Services	**Russell Bird, Partner**	**russell.bird@tohmatsu.co.jp**
Transfer Pricing	**Timothy O'Brien, Partner**	**timothy.obrien@tohmatsu.co.jp**
	Samuel Gordon, Partner	**samuel.gordon@tohmatsu.co.jp**
Tax Management Consulting	**Sreeni Menon, Director**	**sreeni.menon@tohmatsu.co.jp**
Global Tax Services	**Koichi Hattori, Partner**	**koichi.hattori@tohmatsu.co.jp**
Financial Service Industry	**Yang Ho Kim, Partner**	**yangho.kim@tohmatsu.co.jp**
	Kai Hielscher, Partner	**kai.hielscher@tohmatsu.co.jp**
Tax Controversy	**Yutaka Kitamura, Director**	**yutaka.kitamura@tohmatsu.co.jp**
Legal	**Kaori Oka, Partner**	**kaori.oka@tohmatsu.co.jp**
Immigration	**Yoshito Kijima, Partner**	**yoshito.kijima@tohmatsu.co.jp**
Payroll and Social Benefits Processing	**John Dorff, Partner**	**john.dorff@tohmatsu.co.jp**

Issued by

Deloitte Tohmatsu Tax Co.
Tokyo Office
Marunouchi-Nijubashi Building, 3-2-3 Marunouchi, Chiyoda-ku, Tokyo 100-8362, Japan
Tel: +81 3 6213 3800
email: tax.cs@tohmatsu.co.jp
Corporate Info: www.deloitte.com/jp/en/tax

MAKING AN IMPACT THAT MATTERS since 1845

IS 669126 / ISO 27001