

# Japan Tax & Legal Inbound Newsletter

## Opportunities for utilization of losses

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### In Brief

The effects of COVID-19 have caused significant decreases in revenue for a number of businesses, which may result in more businesses reporting loss positions for the current and upcoming years. To help combat decreasing revenues, businesses are looking to cut costs and implement tax planning measures to help reduce taxes and increase cash. One measure that may help businesses achieve these goals is ensuring that losses are used in an effective manner. In Japan there are a number of ways in which companies can utilize tax losses, such as the carryforward or carryback of net operating losses (NOLs) and the offsetting of group profits and losses through aggregation or reorganization. This newsletter discusses a number of methods available in Japan for utilization of losses and the potential impact each can have on a company's business.

### 1. Basics of NOLs in Japan

For companies filing blue form tax returns, NOLs incurred in fiscal years beginning on or after 1 April 2018 may be carried forward for 10 years (the carryforward period generally is 9 years for NOLs incurred in prior fiscal years). In addition, small and medium-sized enterprises (SMEs)<sup>1</sup> are allowed to carry back an NOL for one year to receive a refund of tax paid in the prior year. However, there are restrictions in place for certain companies that limit the amount of taxable income that can be offset by carried forward NOLs. A large company may use NOLs to offset only up to 50% of its taxable income in a fiscal year, while a company qualifying for SME status is allowed to use NOLs to fully offset income. Also, "newly established" companies (i.e., companies less than seven years old) may use NOLs to fully offset income unless they are wholly-owned by a large company, or by two or more large companies within a 100% affiliated group.

Additionally, NOL carryforwards may be restricted in certain situations, such as a change of ownership of more than 50% in connection with a discontinuance of an old business and commencement of a new business.

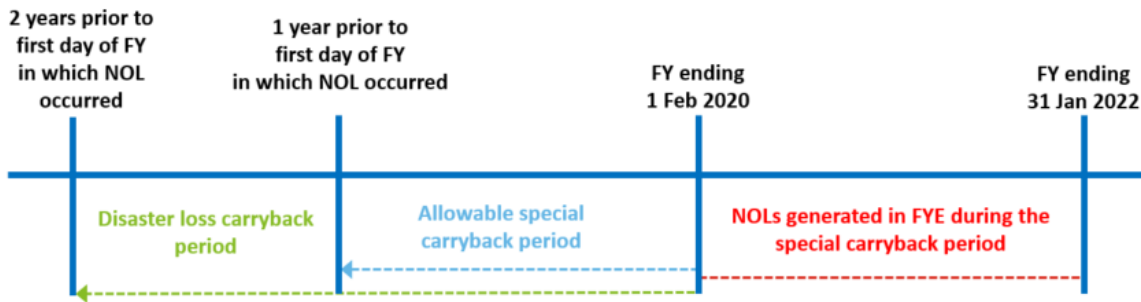
### 2. Expanded loss carryback under COVID-19 relief measures

In addition to the normal carryback rules for SMEs, special relief measures have been enacted in response to COVID-19 that expand the one-year NOL carryback to apply to certain companies with stated capital of JPY 1 billion or less. The special relief measures apply to NOLs generated in fiscal years ending on or after 1 February 2020 until 31 January 2022, and the 50% taxable income restriction on the use of carried forward NOLs that normally applies to non-SMEs does not apply to companies qualifying for the special carryback provision.

Companies also have the ability to carry back certain "disaster losses" to offset income in prior years. Disaster losses are losses that relate to certain damages caused to inventory or fixed assets, and include costs to take urgent measures to prevent the spread/occurrence of COVID-19 (e.g., losses on disposal of food by restaurants, and costs of purchasing masks, disinfectants, etc.). Unlike the standard NOL carryback, disaster losses may be carried back up to two years. The timeline below shows the relevant dates of the NOL relief provisions.

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<sup>1</sup> An SME is defined as a company with stated capital of JPY 100 million or less whose shares are not held, directly or indirectly, by a large company (i.e., a company with stated capital of JPY 500 million or more) or two or more large companies within a 100% affiliated group.

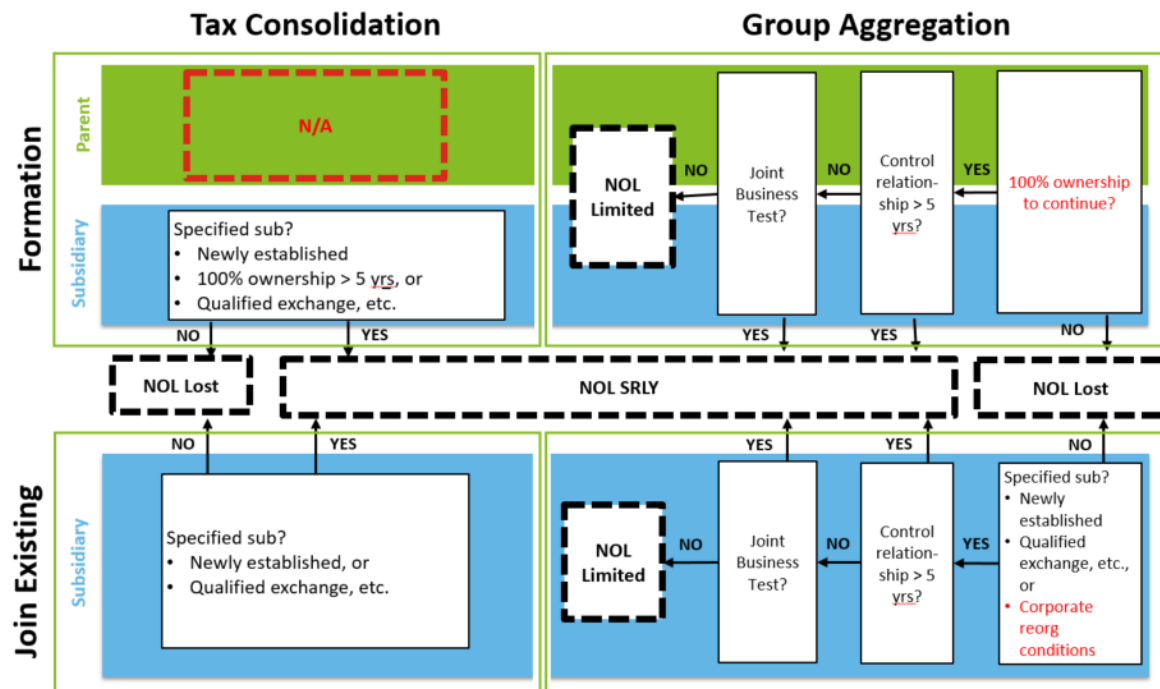


**3. Treatment of losses under tax consolidation/group aggregation rules**

Under the 2020 tax reform, Japan’s current tax consolidation system will be replaced with a group aggregation system for fiscal years beginning on or after 1 April 2022. Both the consolidation system and the group aggregation system allow losses of one company to offset profits of other companies within the same group; however, the group aggregation rules introduce a number of changes, including changes to the use of NOLs. (For more information on other differences between tax consolidation and group aggregation, see our [2020 tax reform newsletter](#).)

Under the current tax consolidation rules, pre-existing NOLs of a parent company carry over and are available to offset profits of any group member. However, under the group aggregation rules, NOLs of a parent company may be lost or subject to limitation under “separate return limitation year” (SRLY) rules, which effectively limit the offset of parent company NOLs to future profits of the parent, not profits of other group members. In addition, the current tax consolidation rules generally result in the loss of a subsidiary’s pre-existing NOLs if it elected to consolidate and was acquired in the last five years. Under group aggregation, however, such a subsidiary will not lose its NOLs (though its NOLs may be subject to limitation) provided it is expected to be continuously held 100% by the parent company at the time of forming the group.

For subsidiaries joining an existing group, there is an additional exception available under group aggregation. Acquired subsidiaries that would have forfeited pre-existing NOLs under the tax consolidation system may not have to forfeit their NOLs (though their NOLs may be subject to limitation) under group aggregation, provided conditions similar to those required for a qualified corporate reorganization are satisfied. The flowchart below illustrates the treatment of pre-existing NOLs under the tax consolidation and group aggregation systems.



**4. NOLs in group reorganizations**

In certain circumstances, Japan’s corporate reorganization rules also offer the ability to offset profits and losses within a corporate group via the merger of group companies. For example, if a profit making subsidiary is merged in a tax-

qualified manner with a loss making subsidiary within the group, and certain requirements are met (i.e., the ownership relationship has existed for five years, or deemed joint business requirements are met, etc.), the existing NOLs in the loss making subsidiary may be used to offset future income post-merger. However, it should be noted that where specific requirements are not met in a group reorganization, losses may be restricted or forfeited under rules similar to the new group aggregation rules highlighted above.

### Deloitte's View

As a result of COVID-19, many companies may be looking for ways to effectively utilize losses to generate tax savings to increase cash. With a number of different options available, companies should consult with their tax advisor to determine which option best suits their individual needs and circumstances. For example, a company with disaster losses, or that meets the conditions for expanded carryback, and that paid tax in prior years may be able to stimulate cash flow by receiving a refund of prior year taxes by carrying back their NOLs.

Companies with multiple profit and loss-making Japanese entities, on the other hand, may consider electing tax consolidation or implementing a group reorganization to allow offsetting of profit and loss between the various entities. However, companies considering consolidation also must analyze whether to consolidate under the current tax consolidation system or wait until the group aggregation system goes into effect, as such a decision could affect the treatment of parent and subsidiary NOLs. For example, corporate groups not currently in consolidation may prefer to wait to apply for group aggregation, especially if they have loss-making entities, as the hurdles (e.g., forfeiture of NOLs, etc.) upon entering the group will be reduced under group aggregation, while still maintaining some of the key benefits of tax consolidation. However, if the parent company of such a group has NOLs, electing to consolidate now may be more beneficial, as tax consolidation does not limit parent company NOLs upon entry, while SRLY limitations would apply under group aggregation. As such, companies should perform a detailed analysis to understand the specific implications for the group as a whole when considering tax consolidation or group aggregation.

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