# Comparative Analysis of the U.S. and Japanese Consolidated Tax Return Systems

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## Introduction

Japan introduced the consolidated tax return system in 2001 one year after corporate reorganization regime was created following the revision of commercial law. The aim of the consolidated tax return system is that "a corporate group which operates and is substantially deemed as one corporation should be treated as one taxable entity"[1]. Our system is so new that it should be examined carefully from a comparative perspective to implement or improve the system.

On the other hand, the U.S. consolidated tax regime dates back to 1917[2], only a few years after the adoption of the U.S. income tax system itself. The first provisions for consolidation were designed to prevent the evasion of surtax implemented by the government. However, consolidated return filing was also expected to reflect "the principal of taxing as a business unit what is in reality a business unit.[3]" Over the years, the consolidated return rules have evolved into a complex but sophisticated system[4]. As an object of comparative analysis, this is the best.

This paper compares the Japanese consolidated tax return system with the U.S. consolidated tax return system. First is an overview focusing on three main issues; stock ownership requirement rules, loss limitation rules, and investment basis adjustment rules under both systems. Second is analysis of those issues comparing the Japanese consolidated tax return system with the U.S. consolidated tax return system.

In this article, "P" shall mean a common parent corporation, "S" shall mean a subsidiary of P eligible under both the U.S. and Japanese systems to file a consolidated return with P, and, unless other stated, it is assumed P and S file a consolidated return (in the case of a U.S. corporate group under Section 1501 of the Internal Revenue Code of 1986, as amended (the "I.R.C.", or the "Code") and in the case of a Japanese corporate group under Japanese Corporate Tax Law ("JCTL") ). In the context of intercompany transaction, a selling member is "S", and a buying member is "B".

1. Stock Ownership Requirements and General Rule

(1) In General

In the U.S., Section1501 permits an affiliated group of corporations to file a consolidated income tax return. The term "affiliated group" means (A) 1 or more chains of includible corporations (generally being all U.S.-organized corporations with certain exceptions) connected through stock ownership with a common parent corporation which is an includible corporation, but only if (B)(i) the common parent owns directly stock meeting the requirements of paragraph (2) in at least 1 of the other includible corporations, and (ii) stock meeting the requirements of paragraph (2) in each of the includible corporations (except the common parent) is owned directly by 1 or more of the other includible corporations[5]. Paragraph (2) requires possession of at least 80 percent of the total voting power of the stock of such corporation, and at least 80 percent of the total value of the stock of such corporation(the 80% value test). Thus, generally speaking, the U.S. adopts an 80% ownership test. Once these criteria are met, a consolidated return may be filed at the election of the group without permission from the Internal Revenue Service (the "IRS").

On the other hand, in Japan, a corporate group may file a consolidated tax return instead of a single tax return only by getting permission from Commissioner of the National Tax Agency (the "NTA")[6]. In order to get permission, the corporate group has to file an application three months before the group files the first consolidated tax return to Commissioner[7]. At this point, all members of the corporate group are supposed to agree to consolidated tax return filing. The corporate group has to consist of at least a common parent corporation (P) and one or more subsidiaries that are wholly owned by P and other members of P group. This would mean that Japan consolidated tax return system adopts a 100% stock ownership test[8].

Japan adopted a 100% ownership test to avoid problems caused by the existence of minority shareholders[9]. The 100% ownership requirement also best theoretically matches to the underlying economic notion of all consolidated filing system, namely that the group in question effectively constitutes one economic unit.

However, the 100 % ownership requirement is hard to use. If only one share of the member's stock is sold outside the group, the group won't be a consolidated group any more[10]. So, the 100% ownership requirement has been rarely adopted in OECD countries-- only in Japan and Denmark[11].

(2) Minority Shareholder Problem

It is clear that minority shareholders may exist under the U.S. consolidated tax return system. This part briefly discusses the problems thereby created under the U.S. consolidated tax return system.

P is treated as an agent to pay tax for the consolidated group (and for other procedural tax purposes), but each member is fully liable for 100% of the group's tax liability on a joint and several basis[12]. But how tax liability is allocable among the members is not provided by either statute or Regulation other than a default rule for calculating earnings and profits ("E&P")[13]. Accordingly, members often enter into tax sharing agreements, which specify the allocation to each member of the group's tax liability. Minority shareholders can be negatively or positively impacted depending on the allocation of tax liability to the corporation in which they hold stock[14].

In Japan also, P is treated as an agent for the payment of consolidated tax liability on behalf of the members of the group[15], and, like the U.S., each member is jointly and severally liable for 100% of the group tax if not fully paid by P[16]. However, how to calculate the share of each member's tax liability is provided by law. There is no room for a private contractual allocation agreement among the members.

Comments by lawmakers recently have indicated that in Japan the ownership requirement may be reduced from 100% to 50%[17]. If so, Japan will have to consider what kind of problems might be triggered by using such a reduced ownership requirement. If the stock ownership requirement is reduced from 100% to 50%, it will be necessary for the Japanese government to consider how the satisfaction of the stock requirement is decided; i.e., by just the number of the outstanding shares, by vote, and/or by stock value? To avoid abuse, Japan should probably adopt the value test. If it does, it will probably have to address the effect of options, as the U.S. did in 1984 when the U. S. Congress introduced the 80% value test[18].

(3) Tax Treatment of Options

One of the financial techniques which may reduce or increment the value of stock held by a particular person is such person's holding of put or call options on the stock. In addition, under normal stock exchange rules, a person may borrow stock of a particular issuer from a broker, which would raise the question of whether such borrowed stock should be taken into account in determining satisfaction of ownership requirement.

In Japan, there is no rule for stock options (or borrowed stock) in regard to stock ownership. However, tax treatment of stock options and/or borrowed stock in determining whether a controlled group is an affiliated group has become a big issue in the U.S.[19]. The facts of a recent U.S. letter ruling[20], which triggered a number of newspaper articles, exemplify this issue.

S was a member of P's consolidated group. But after a public offering, S left P's group. Thereafter, P had accumulated a large net operating loss[21] ("NOL") and wanted to use S's anticipated profits to offset P's NOL by filing consolidated tax returns with S again. Unfortunately for P, P could not afford to buy enough S stock to re-establish 80% control and thus satisfy the stock ownership requirement. Instead, P borrowed S stock from the affiliate of P's principal bank. Taking into account the borrowed shares, P then owned enough shares to satisfy the affiliation requirement. Accordingly, after getting permission from the IRS to reconsolidate under Section 1504(a)(3)[22], P was able to file a consolidated tax return with S and achieve substantial tax savings.

An author in special report on Tax Notes named this transaction a "synthetic consolidation"[23]. An article in the New York Times described "synthetic consolidations" as a new type of tax avoidance scheme[24]. Synthetic consolidation is not stopped by the usual loss limitation rules under Treasury Regulations such as Separate Return Limitation Year ("SRLY") rule[25], overlap rule[26], and United Loss Rule ("ULR")[27]. Thus, whether synthetic consolidation is abusive and how (or if) it should be limited or prohibited entirely must be considered. In this regard, there are three issues to be pointed out[28];

First, since synthetic consolidation is obviously intended to avoid tax, is it consistent with cases such as Elko Realty v. Commissioner[29], in which the court ruled that if a corporation acquires another corporation solely to make use of the acquired corporation's tax attributes on a consolidated return, the requisite affiliation may be found lacking on business purpose grounds despite compliance with the literal terms of the statute[30]?

In the Elko Realty case[31], the court held that two subsidiaries acquired for the purpose of using losses to offset income of the profitable acquiring corporation were not properly includible on a consolidated return. The court indicated that if ownership of a subsidiary's stock serves no business purpose other than a tax reduction purpose, the subsidiary should not be treated as an "affiliate" for purposes of the consolidated return provisions. It put forth as an alternative holding that it was disallowing loss deductions under the predecessor to Section 269.

Second, it should be asked if P secured true ownership of S stock. In the consolidated tax return area, what is "stock ownership" is an important issue, since a certain stock ownership gives an affiliated group the right to offset a member's income against other member's loss. Especially the effect of options has to be considered. Options are treated as exercised in certain conditions under Treas. Reg. § 1.1504-4.

Third, it should be asked why the 5 year period limitation of reconsolidation ("5 year rule") under Section 1503(a)(3)(A) was waived by the service[32]. In the synthetic consolidation situation described in the ruling, reconsolidation was allowed one year after S left the group. Japan has 5 year period reconsolidation rule without any waiver rule[33]. Thus, the Japanese system would stop benefit of the synthetic transaction at least for 5 years after deconsolidation.

As mentioned, synthetic consolidation was permitted by a private letter ruling[34]. However, a recent article indicated that this transaction had been reported to IRS whistleblower office[35]. Due to the statute of limitations, the taxpayer in question may be safe from challenge. The IRS may prohibit synthetic consolidation on a prospective basis.

### (4) Computation of Taxable Income and Tax Liability

#### i. Taxable Income

Under both the U.S. and Japanese consolidated tax return system, the amount of consolidated taxable income is calculated by combining the members'separate taxable incomes and making various consolidating adjustments[36]. The adjustments to consolidated taxable income mainly include adjustments related to intercompany distributions, intercompany contributions, and intercompany transactions such as sales. The last issue is separately discussed since it is the most important item in this area.

#### (a) Intercompany Distributions

In Japan, generally dividend on stock of a related corporation[37] other than a member of a consolidated group and a 100% group member are excluded from income after reducing certain amount of the recipient's interest expense allocated to the dividend[38]. The reason for the reduction of certain interest is that an expense for an exempt income should not be deductible for tax purposes. Dividends on stock of a member of a consolidated group and a 100% group member are excluded from consolidated taxable income without reduction for interest deemed attributable to the cost of the stock[39]. The main reason for not reducing the interest deduction of the recipient member is to promote the smooth circulation of capital resources within the groups.

Inside the consolidated group, the amount of the dividend reduces the accumulated profits of the dividend-paying corporation ("D") which, in turn, will reduce the receiving corporation's basis of D stock later when D is sold[40].

In the U.S., dividends received from members of the consolidated group are likewise excluded from consolidated taxable income[41]. The corporation receiving the dividends must reduce its basis of the dividend-paying corporation under the investment basis adjustment rules ("IBA") described below, and the resulting basis may be negative[42].

(b) Intercompany Contributions

In Japan, contributions made by one corporation to another corporation outside the consolidated group context can virtually result in income to both corporations. For this purpose, contributions include the contribution of money or other property or benefits (valued at their respective fair market values) conferred gratuitously, but do not include advertising, entertainment or welfare expenses incurred by one corporation on behalf of another[43] and does not include investment by one corporation in another corporation in exchange for its equity. Generally, the corporate recipient is generally required to include the fair market value of the contribution in income[44]. In addition, the corporate contributor is required to take into income any difference between the fair market value and the cost basis of asset and service donated, though it may be able to take a deduction for the donation, subject to limitations[45].

In contrast, intercompany contributions within a Japanese consolidated group are ignored for the purpose of current tax examination - they are neither added to group gross income nor deducted from group gross income[46].

In the U.S. this kind of contribution may be treated as contribution or distribution depending on the facts and may affect the basis of the stock of the members, depending on the factual characterization[47]. For example, P transfers cash of $100,000 to S as a contribution. In Japan, this will not give rise taxable income or deductions to either P or S, nor will it result in any change to P's basis in P's S stock. But in the U.S., P will increase its basis of its stock in S.

ii. Intercompany Transactions

(a) U.S. Consolidated Tax Return System

The intercompany transaction rules in the U.S. consolidated return regulations are very broad and intricate[48]. These rules were issued in 1995[49] and provide a set of uniform rules of general application based on general principles that will govern the treatment of all types of intercompany transactions[50].

"Intercompany transactions" include not only property transactions but also nonproperty transactions such as S's performance of services, licensing of technology, rentals of property, loans of money to B, and B's payments or accrual of its expenditure for such items[51].

The Treasury Regulations describe the basic purpose of the intercompany transaction rule: to provide rules to clearly reflect the taxable income (and tax liability) of the group as a whole by preventing intercompany transactions from creating ,accelerating, avoiding, or deferring consolidated taxable income (or consolidated tax liability)[52].

The core of the rule is a matching rule[53] and acceleration rule[54]. Under the rules, the timing, and the character, source, and other attributes of S's intercompany items and B's corresponding items are determined as if S and B were divisions of a single corporation. However, in determining the amount and location of intercompany items, S and B are treated as separate corporations.

Additionally, the regulations include "anti-abuse" rules[55]. The regulation states that if a transaction is structured with "a principle purpose to avoid the purpose of this Section", then "adjustments must be made to carry out the purposes of this Section." This language suggests that new type of Section 269 is available for IRS in this area[56].

(b) Japanese Consolidated Tax Return System

Compared with the U.S. intercompany transaction rule, the Japanese rules are simpler and more limited. In Japan, intercompany transactions may include transfers only of listed properties such as fixed assets, land, marketable securities (other than securities held for trading), monetary claims and deferred assets[57], and only if such assets have a book value of more than $100,000. Gains or losses on transfers within a consolidated group are deferred until the assets are transferred outside the group or written off[58]. Transfers of other assets are simply treated as normal sales to unrelated parties. Limiting applicable assets and setting a threshold are considered to effectively contribute to cut administrative burden for both companies and tax officials.

Under Japanese system, B does not take carryover basis for intercompany transactions. For example, S sells a land with cost basis 60x to B for 90x. B takes 90x as cost basis for the land but S defers the recognition of the 30x of gain in computing its income. In a later year B sells the land to an unrelated party for 130x. S recognized the 30x to its income and B recognized the 40x in gain.

Moreover, it ought to be noted that in 2010 the Japanese government introduced a new rule called as group tax system (GTS)[59]. GTS is required for all corporate groups which have wholly owned stock relationship ("special corporate group") even if they have not elected to file a consolidated return. Special corporate groups include corporate groups which can elect to file a consolidated tax return as well as corporations which are wholly owned by an individual or related parties[60]. Thus, the coverage of GTS extends beyond that of the consolidated return system.

Example (1) A parent company (P) owns 100 % of the stock of a subsidiary (S). P and S are a special corporate group and also can file a consolidated tax return. But even if they do not, they are subject to GTS.

Example (2) A parent company (P) owns 80% of the stock of subsidiaries S1 and S2, S1 owns 20% stock of S2, and S2 owns 20% of the stock of S1. P, S1, and S2 are a special corporate group and can also file a consolidated tax return.

Example (3) An individual ("I") owns 100 % of the stock of two corporations G1 and G2. G1 and G2 are a special corporate group subject to GTS, but they can't file a consolidated tax return. Note that, since I is not a corporation, transactions between I and either G1 or G2 will not be subject to GTS, although transactions between G1 and G2 will be subject to GTS.

Example (4) An individual (I) owns 100 % of the stocks of two corporations G1 and G2. I's son owns 100 % of the stocks of two corporations G3 and G4. I's grandson owns 100 % of the stock in each of two corporations G5 and G6. Corporations G1 through G6 comprise one special corporate group, but they can't file a consolidated tax return.

GTS requires special corporate groups to apply the same intercompany transaction, intercompany distribution, and intercompany contribution rules, as are applied to corporate groups that elect to file a consolidated tax return[61] (described above), with some exceptions. One of the important exceptions is that intercompany transaction rule is applied only once for a specified asset to avoid administrative burden[62].

(c) Comparative Analysis

The U.S. and Japanese intercompany transaction rules are so different that it is difficult to compare. First of all, ideas of coverage of the rule are different. Current U.S. intercompany transaction rule are vast and flexible enough to apply to all asset and service transfers among consolidated group members. In contrast, the Japanese intercompany transaction rule is limited in two ways; (i) it only applies to "applicable assets" and (ii) it only applies over a set threshold. To simplify rules, introducing the threshold seems to be essential and not so hard to introduce. Second, there are differences outside of a consolidated group. The U.S. has Section 267 and Japan has GTS. The former is supposed to disallow losses transferred among certain related groups. The latter is supposed to increase the fairness of the tax treatment of wholly owned groups and to encourage corporate groups to file consolidated tax returns.

iii Tax Liability

In the U.S, the consolidated tax is determined applying the rates of Section 11 and other relevant provisions of the Code, to the consolidated taxable income of the group.

In Japan, The consolidated tax is calculated by multiplying the consolidated taxable income by the applicable rate[63] (The applicable consolidated rates are based on the status of P[64]. If P is an ordinary corporation, the corporate tax rate on consolidated taxable income is 30% (25% after 2012). If P is a medium- or small-sized company (generally a company with capital stock or invested capital of not more than ¥100 million)[65], the corporate tax rate is reduced to 22% on the first ¥800 million of taxable income[66]. If P is a cooperative association, the rate is 26% on above ¥1 billion of the consolidated income and 23% on less than ¥1 billion of the consolidated income.)

2. Loss Limitation Rules

This part provides a discussion of the Japanese tax treatment of corporate losses in comparison to the American treatment. Here, corporate losses include net losses (net operating losses ("NOL") in American usage) and capital losses. This article considers only net losses (realized losses) for ease of explanation[67].

The Japanese government enacted new rules on the use of corporate losses related to corporate reorganizations in 2000 and introduced a consolidated tax return system with new rules for consolidated corporate losses in 2001, basically following the U.S. system. In 2006 the Japanese government enacted new limitation rules on the use of corporate losses after corporate ownership and business changes.

(1) Basic Rules

Under Japanese corporate tax law, the term "net losses" means the excess amount of costs, expenses, and capital losses over gross income in a business period[68]. In other words, a net loss is the amount of negative income in a business period. In Japan, if a corporation which files a blue tax return[69] has net losses, it may be allowed to carry over those losses for 9 years[70] and carry them back for 1 year[71]. After 2012, large companies (i.e., those with over ¥100 million in capital) can use only 80% of their current income to offset net losses. No distinction is made between operating losses and capital losses.

In contrast, in the United States, there are two kinds of carryover losses; NOL and capital loss carryovers and carryback. NOLs which have been generated in the ordinary course of business carry over for 20 years and carry back for 2 years[72]. Capital losses which occur due to sale of capital assets carry over for 5 years and carry back for 3 years[73]. Capital losses may only be used to offset capital gains[74].

The main purpose of the loss carryforward and carryback rule is generally "averaging" between profit years and loss years. Only a taxpayer who earns income within a certain period after or before they have losses is able to benefit from the loss carryforward and carryback rule. Accordingly, a fundamental idea for tax attributes is that a tax attribute clings to a taxpayer which created it and only the taxpayer can use it. This idea is called as the 'corporate entity approach'.

However, the corporate entity approach causes an incentive for trafficking losses. A profit company has a chance to use another company's NOL though merging with it or acquiring it and filing consolidated returns. Accordingly, some limitation is needed to deal with these perceived abuses. In the U.S., there is a long history of loss carryover and limitation rules from 1920's[75].

Currently there are three statutory sections (in addition to Section 172) dealing with NOL carryovers in the Internal Revenue Code; (i) Section 381(which affirmatively permits carryovers in certain asset transfers), (ii) Section 269, and (iii) Section 382 (each of the latter two providing for limitations on the use of carryovers and certain built-in deductions).

Section 381 provides for carryover of certain of a corporation's tax attributes (ex. NOLs, E&P and other tax attributes) to a successor corporation when (i) P liquidate S under Section 332, (ii) P transfers assts in a reorganization under any of Section 368(a)(1)(A), (C), (F), and (D) (in the latter case, only non-divisive transactions). The common point of both (i) and (ii) is permitting loss carryover in situations where there is a continuity of investment in situations where, as a policy matter, it is appropriate to carry over the relevant tax attributes (such as the tax-deferral referenced above). And these carry-overs are subject to the limitations in Sections 269 and 382, below.

Section 269 provides for the disallowance of deductions and other tax benefits when tax avoidance is the principle purpose for the acquisition of control of a corporation by another.

Section 382 provides that if a pre-change loss corporation has more than a 50% ownership change (Section 382 ownership change)[76], the post-change loss corporation can use the pre-change NOLs only up to the Section 382 limitation amount (the value of the pre-change loss corporation's stock times a Federal Treasury-specified debt interest rate)[77]. As described below, Section 382 applies to a new-entry loss member, instead of the SRLY rule, in case where both 382 and SRLY would otherwise apply[78]. A Section 382 ownership change is a more than 50 % point increase in the ownership by an acquiring party of the loss corporation's stock within 3 years. Such a change triggers application of Section 382. The underlying policy is that new shareholders should not obtain an indirect benefit from losses which were incurred during the period former shareholders owned the loss company's stock[79]. Thus, whenever a more than 50% ownership change of a loss corporation occurs, its NOL must be limited. This policy is called as the "ownership change approach".

Section 382 is much more important than Section 269. While Section 269 continues to apply, its roll has been greatly diminished after 1986 when Section 392 was revised.

### (2) Backgrounds and Rules Related to Corporate Acquisitions and Reorganizations

i. Prior to 2001--- relying on corporate entity approach

Prior to 2001, under the Japanese tax system, many opportunities existed to traffic in net losses because the survival of net loss carryforwards solely depended on the continuation of the corporate entity. In a stock acquisition-whether for cash or stock of the acquirer, even where the ownership and business were fully or mostly changed, net loss carryforwards and built-in losses could be used in full.

In the case of the merger of two corporations, even though the Japanese commercial law provides that a surviving corporation inherits all attributes from a merged corporation[80], the Japanese Supreme court[81] held that though the net loss carryforwards of the surviving corporation generally continued after the merger, the net loss carryforwards of the merged corporation could not be carried over into the surviving corporation[82]. These rules obtained regardless of whether the shareholders of surviving corporation and its business were changed.

These conditions were similar to the U.S. rules in existence before the initial enactment of the Section 382 in 1954[83]. Specifically, the U.S. Tax Court in Alprosa Watch Co. v. Commissioner[84] indicated a similar concern. In the Alprosa case, a partnership acquired for cash all the stock of a loss company (L) who was engaged with producing and selling globes and changed L's original business, location and name. It sought to use the income from the new business to offset L's NOL. The issue was whether L could use L's carryover losses after the acquisition. Tax Court held that L could use its losses regardless of its business, location, and name change because L was the same taxpayer before and after the acquisition. In this case, the carryover of NOL depends on continuation of a corporate shell.

As the carryover of attributes depended on continuation of a corporate shell, a loss corporation could merger with a profit corporation instead of vice versa in order to keep its NOL.

ii. 2000 to 2006 ---relying on business continuity approach

In 2000, introducing corporate reorganization rule[85], Japan also promulgated new rules limiting the liberal net losses carryover regime outlined above. These rules continue in effect today. Essentially these rules apply only to "qualified", i.e., tax free mergers (qualified merger). Otherwise, the pre-2002 rules were left intact. The rules effectively prohibit the use by the combined entity of even the surviving corporation's losses if both (i) the "affiliation" of the two corporations occurred within 5 years before the merger and (ii) the merger fails to meet the requirements of a "deemed joint business". "Affiliation" for this purpose is the ownership by the surviving corporation of 50% or more of the total number of the stock of the merged corporation.

A "deemed joint business" exists when the merged companies satisfy either (I) all of (a) through (d), or (II) (a) and (e) of the following paragraph[86].

(a) After a merger, there is a relationship between a substantial business of a merged corporation and a substantial business of the surviving corporation, (b) difference of the business scales (described below) of the two businesses is within 5 times, (c) the business of a merged corporation has been continued since the affiliation, and difference of the business scale of a merged corporation is within twice between the business on the beginning of the affiliation and the business right before the merger, (d) the same requirement as (c) for the business of a surviving corporation, (e) the persons who have been certain board members of a merged corporation before the beginning of the affiliation are expected to be board members in a surviving corporation. "Business scale" is determined mainly by gross amount of sales, number of employees, amount of capital.

Accordingly, the rules would be applied as in the examples immediately following:

(i) Assume tax free merger of Corp B into Corp A where Corp A has owned 55% of Corp B voting stock for 6 years. Both Corp. A and B can carry over their net losses regardless of whether deemed joint business is satisfied or not.

(ii) Assume tax free merger of Corp B into Corp A where Corp A has owned 55% of Corp B voting stock for 4 years, but no stock before then. Unless there was a deemed joint business, neither Corp. A nor B can carry over their net losses.

(iii) Assume tax free merger of Corp B into Corp A where Corp A has owned 45% of Corp B voting stock for 6 years, and in addition the AB combined corp. satisfies a deemed joint business test. ......Both Corp. A and B can carry over their net losses.

(iv) Same as (iii), but no deemed joint business. ......Neither Corp. A nor B can carry over their net losses.

(v) Same as any of (i), (ii), or (iii), except the merger is taxable. ......Neither Corp. A nor B can carry over their net losses.

After 2001, in a qualified merger, the surviving corporation is permitted to use the net loss forwards of the merged corporation. However, to prevent mergers for the purpose of using net loss carryforwards, new loss limitation rules were enacted that are applicable solely to mergers. This rule does not apply to taxable acquisitions. The rules put both a surviving corporation and a merged corporation under the same rules, so effectuating a reverse merger is no longer useful. But if the merger is not eligible as a non-taxable reorganization, survival of net losses carryforwards still depended on the continuation of the corporate entity. And also in a taxable acquisition or non-taxable acquisition like an U.S. B reorganization where the ownership and business is fully or mostly changed, net loss carryforwards and built-in losses were still allowed to be used in full.

The new loss limitation rules prohibit the surviving corporation to use net loss carryforwards of the loss corporation when the affiliation was made in 5 years before the merger. But if the merger meets the requirements of a deemed joint business, the rule can't be applied. In the other words, even though ownership totally changes in a reorganization, once it meet the business continuity requirement, the new loss limitation rule still allows a loss corporation to carryover its losses. In essence, the rule implicitly values the business continuity approach more than the ownership change approach.

The rule reflects the business continuity approach. In contrast in the U.S., the business continuity approach ended up with support in case law.

The business continuity approach was adopted in Libson Shop Co. v. Koehler in the U.S.[87]. In this case, the petitioner was a surviving company which merged with 17 companies. Those companies stocks were wholly owned by the same individuals in the same proportions. One was engaged with management under which the others were retailers of women's cloths. Three of those 17 companies had pre-merger NOL and continued those businesses after the merger. The issue was whether the pre-merger NOL offset post-merger income.

Adopting the business continuity approach, Supreme Court examined the loss carryforward rule's purpose and concluded that Congress was primarily concerned with the fluctuating income of a single business. It held that[88];

> The purpose of these provisions (loss carryforward rule) is not to give a merged taxpayer a tax advantage over others who have not merged. We conclude that petitioner is not entitled to a carry-over since the income against which the offset is claimed was not produced by substantially the same businesses which incurred the losses.

However, the Supreme Court did not define what "substantially the same businesses" was. This ambiguity caused controversy, since at least three approaches are possible to understand the meaning of "substantially the same businesses" is.

The first approach is that "substantially the same businesses" means the continuity of the same type of business. This approach is the most understandable one. Providing a surviving company continue a merged company's business after a merger, it would mean that the merger satisfy the "substantially the same businesses" and pre-merger NOL would be used to offset post-merger income. However, in Libson Shops case, Supreme Court did not allow the taxpayer to carryover NOL even though it had continued the pre-merger business.

The second approach is that "substantially the same businesses" means most of the assets used by merged companies in its course of business should be used by the surviving company. This test has been adopted by the IRS.

The third approach is that merged companies are required still to survive and operate their original businesses inside of the surviving company and to offset pre-merger NOL against post-income of each merged companies. This approach is based on the part of the Supreme Court opinion that indicated that, since the three companies continued to create NOLs after the merger, those companies could not have offset its pre-merger NOL but for the merger. Thus, this approach is more similar to the SRLY rule than the business continuity approach.

Former Section 382 which was enacted in 1954 took account of a business continuity requirement especially in a taxable corporate acquisition. The business continuity requirement also caused ambiguity and many cases have shaped its regulations[89]. Tax Reform Act of 1986 revised Section 382 and current Section 382(c) provides the business continuity requirement under which the surviving company must keep the acquired loss company's original business for only 2 years[90].

iii. After 2006 ---relying on ownership change approach?

In 2006, Japan enacted a completely new loss limitation rule. Under Art. 57-2, "loss corporations" are not allowed to use a carryover net loss or "certain recognized built-in loss" if they experience one of a list of "certain events" within 5 years after having a "specified control relation"[91]. In a taxable merger, a qualified merger, taxable acquisition, or tax free acquisition like the U.S. B reorganization, if a loss corporation experiences a "certain event" such as a change of business and the specified control relation described below, its net loss carryforwards and recognized built-in losses are disallowed. This is applicable to consolidated groups, too[92].

A. Loss Corporations

For purposes of the statute, "loss corporations" are corporations which have either carry-over net losses and/or built-in loss assets. Built-in loss assets are assets that loss corporations own on the date of the ownership change and that have built-in loss greater than the lesser of (a) 50% of the amount of the equity of the corporation on the date of the ownership change or (b) ¥10,000,000 (approx. $100,000)[93]. For purposes of the statute, assets are tangible assets, land, securities, receivables, and capitalized costs. Recognized built-in losses are those generated when the built-in loss assets are sold, written down, or abandoned.

B. Specified Control Relation

For purposes of the statute, "specified control relation" means the effectuation by one corporation or single individual of the acquisition over 50% of the total number or total amount of outstanding shares of stock (excluding treasury stocks or self-investments) directly or indirectly (including by way of a qualified merger), apparently regardless of the period over which acquired.

Accordingly the simultaneous acquisitions by two unrelated persons each of 49% the outstanding shares of stock a corporation would not be the specified control relation. If an individual who owns 49% stock of a loss corporation purchase 2% more of the stock, it would be the specified control relation. Thus, only the taking of corporate control by one person or entity triggers the loss limitation.

Compared with this rule, Section 382(g)(1) requires a change of significant magnitude (i.e., more than 50 percentage points) during 3 years before it is activated.

C. Certain Events

For purposes of the statute, "certain events" means[94];

a. if the loss corporation does not operate any business on the date of having specified control relation, it gets a business by virtue of the change,

b. if the loss corporation does operate a business on the date of the specified control relation, either (a) it ceases operating such business or (b) it receives by way of equity capital contribution or the issuance of debt, cash or other property with a value equal to 5 times the "scale" of its business on the date of having the specified control relation. For purposes of the statute, scale is determined by the total amount of gross income from main business and financial income in certain periods.

c. if the new shareholder buys the loss corporation's "bad debt" whose face amount is equal to or greater than 5 times the scale of the business on the date of the specified control relation. For purposes of the statute, a new shareholder means a shareholder which causes specified control relation. For purposes of the statute, loss corporation's "bad debt" means debt previously issued by the loss corporation but bought by the new shareholder at a price 50% less than the original issue price, but if and only if the face amount of such acquired debt is over 50% of the total face amount of the debt of the loss corporation[95].

d. in connection with Sections a. b. and c., the loss corporation is merged into a corporation in a transaction, which is a qualified reorganization,

e. if both (a) all of the loss corporation's board members and over 20% of its employees resign from the loss corporation, and (b) the business that it operates on the specified control relation in which the employees on the date of having the specified control relation were not engaged increases 5 times as the size of its business scale on the date of the specified control relation. Then if only one board member is left in a loss corporation, it will be able to avoid an application of this rule. For purposes of the statute, "board member" is different from the comparable U.S. term. It means president, vice president, chief of the executive officers, a representative director, a senior executive managing director, a managing director, and other personnel who work for the management of the loss corporation[96]. Accordingly, a person can be a "board member" without actually being a member of the board of directors of the loss corporation.

In addition, when GTS was introduced, tax regime on corporate liquidation was repealed and liquidating distributions among special corporate group associate with carryover of net losses under JTCL Art. 57(2).

(3) SRLY Rule

The most important benefit afforded affiliated groups when they file consolidated returns is the reduction in tax burden permitted by offsetting one member's losses against another member's income during the consolidated periods. This offsetting is allowed because the members are economically deemed as one taxable entity and its taxable income or losses occurred within the entity should be calculated as a whole. But carryover losses and built-in losses from separate tax return period should be treated differently.

i. SRLY Rule or Section 382

In the U.S., before specific limitations were written into the regulations, courts ruled that when a new S enters into a consolidated group with an NOL and built-in losses, the acquiring consolidated group can't offset S's losses from separate return years against the group's income[97]. Clearly, a court said that[98];

> The right of deduction of a net loss computed under Section 206 (former Section 172) is restricted to the computation of the net income of the taxpayer. But a corporation of the affiliated group remains a taxpayer, and the deduction must be confined to the computation of the net income of the corporate entity.

Thus, the court originally has set the limitation of pre-consolidated loss of a subsidiary like current SRLY rule does. Another court made the reason clearer, noticing that[99];

> Doubt, if there can be any, is not likely to survive a consideration of the mischiefs certain to be engendered by any other ruling. A different ruling would mean that a prosperous corporation could buy the shares of one that had suffered heavy losses and wipe out thereby its own liability for taxes. The mind rebels against the notion that Congress in permitting a consolidated return was willing to foster an opportunity for juggling so facile and so obvious.

The first SRLY rule was put into place by Treasury Regulations in 1929[100] and has been a feature of the Treasury Regulation since that time.

The original purpose of the SRLY rule is to prevent the use of the consolidated return system for tax avoidance purposes. But in 1986 Section 382 was revised, after which it could apply in the same situations to which SRLY applied. More recently, SRLY has been limited to those cases where consolidation occurs without a change in control that would trigger a limitation under Section 382[101]. This is called the "overlap rule".

The acronym "SRLY" signifies "separate return limitation year", which is any year in which a current member of the consolidated group in question filed a separate return. The SRLY rule provides that the deduction of a SRLY loss by a consolidated group in any taxable year is limited to the taxable income contributed to the group by the member with SRLY loss[102]. A SRLY loss is the loss generated in a SRLY.

Three kinds of separate return years (SRY)[103] are excluded from the reach of the SRLY limitation; one for common parent corporation, the second one for a member of an affiliated group during each of the loss year, and the third one for successor corporations[104]. Accordingly, the parent company and affiliated but unconsolidated corporations are out of SRLY rule.

ii. Japanese Version

(a) Basic Rule--- Prior to 2010

Consolidated groups are allowed to the carryforward and back consolidated net losses like separate corporations carryforward and back their own losses[105]. The definition of consolidated net loss is the negative amount of the consolidated taxable income[106]. When a corporation with losses join in a consolidated group, some limitation like the SRLY rule or Section 382 rules was needed.

Accordingly, the consolidated tax return system introduced by the Japanese government has a loss limitation rule so strict that it discards all net losses of the new subsidiary[107]. The discarded net losses are not recovered even if or when the subsidiary leaves the consolidated group later[108]. Moreover, the built-in gains or losses of the subsidiary are valued and after offsetting, the leftover of the gains or losses would be taxed (in the case of gain) or discarded (in the case of losses). Essentially this system was like a mandatory Section 338(b)(10) election for S immediately prior to consolidation. It was said that those strict limitations have discouraged corporate groups from filing consolidated tax returns. Though some amendments made in 2010 have mitigated the limitation as described below, they substantially remain in effect.

There are three exceptions to this harsh limitation scheme. First, any common parent company is excepted from the basic rule[109]. Second, "special consolidated subsidiaries" are excepted from the valuation rule (i.e., the built-in gain/loss deemed recognition)[110]. The special consolidated subsidiaries are supposed to have no chance to engage in tax avoidance by using losses occurred during years when separate return was filed and are thus treated as favorably as the common parent company in this regard. Third, the valuation rule is applied only to certain assets (fixed assets, land, marketable securities (other than securities held for trading), monetary claims and deferred assets) with over the lesser of 50% of its capital amount or ?10,000,000 ($100,000) value[111].

The "special consolidated subsidiaries" excepted from the limitation rule are listed below[112];

First, a corporation that became a wholly owned subsidiary through a share transfer after the group started to file a consolidated tax return. Share transfer means that shareholders of one or more existing corporations contribute shares to a new holding company in exchange for share in the new holding company.

Second, a corporation that has been wholly held directly or indirectly by its common parent corporation for 5 years or more periods to the date of consolidation.

Third, a corporation that was founded by its common parent corporation and has continued to be wholly held directly or indirectly by the corporation.

Fourth, a corporation that was founded by another corporation which in turn is wholly held by its common parent corporation and has been so held directly or indirectly by the parent corporation since the foundation of the other corporation.

Fifth, a corporation which was acquired by its common parent corporation through qualified share exchange or qualified triangular merger. Share exchange means that two existing corporations become parent and subsidiary via a share exchange.

Sixth, a corporation that has been wholly held for more than 5 years by another corporation which in turn was founded by their common parent corporation through a qualified merger, qualified stock transfer, or qualified equity transfer.

Seventh, a corporation that was acquired and wholly owned subsidiary of consolidated group under the order of the statutes.

(b) Current Rule

In 2010, the loss limitation rule was mitigated. The rule was changed to allow separate-return year net loss of a special consolidated subsidiary to offset its own separate post-consolidated income after any consolidated years. In other words, a kind of SRLY rule applies only to special consolidated subsidiaries. Such mitigation has been expected to encourage corporate groups to elect to file a consolidated tax return.

However, there might be a lack of consistency to be pointed out. For special consolidated subsidiaries, built-in losses are not limited, but the amount of special consolidated net loss is limited by its own separate post-consolidated income, although built-in loss will be limited another rule connected to reorganization rule.

(4) Comparative Analysis

There are three approaches to limit using losses ; (i) a carryover and limitation rule, (ii) a an "all discard" rule, and (iii) a valuation rule. These approaches classify the loss limitation rules showing below;

・Carryover and then limitation; I.R.C. Section 382, SRLY rule.

・Discard everything rule; I.R.C. Section 269, JCTL Art.57(9)(iii), 57-2.

・Valuation rule; JCTL Art.61-11(1), 61-12(1).

Section 382 is the leading rule for loss carryover limitation in the U.S. As described before, this rule applies to consolidated groups, too. The main idea of this section is based on the ownership approach rather than the business continuity approach. Section 382 ownership automatically triggers Section 382 application. The Section 382 limitation amount is generally too small to attract an acquiring corporation. Thus, it has been criticized on the basis that the limitation of Section 382 is too harsh since it might destroy the chance to revive the loss corporation in case that there is no intent to abuse the loss carryover and the acquiring company's manager has an administrative ability to recover the loss business.

On the other hand, the Japanese loss limitation rule is aimed at abusive schemes. However, there are two points to be considered.

First, roughly speaking, Japanese loss limitation rules rely on the business continuity approach. Indeed, this approach is familiar with the original idea of carryover net losses, but it would be uneconomic to keep unprofitable business of the loss corporation only for using the loss. As mentioned in considering the Libson Shop case, business continuity is so ambiguous that it might cause some controversy in the future.

Second, though over 50% stock ownership triggering application of Art. 57-2 has been recognized as adopting the ownership change approach in a sense, only acquiring 2% to have more than 50% stock ownership with certain events triggers Art. 57-2, namely disallowance of using all losses which was incurred before the certain event. Thus Art. 57-2 may have a harsh effect for the continuing shareholder.

## 3. Investment Basis Adjustment and Sale of Subsidiaries

### (1) In General

Investment Basis Adjustment ("IBA") is basically an adjustment to P's basis in S stock and is needed to avoid double taxation or double deduction at the time when P sells S's stock. The notion is simply illustrated. For example, if S's income is taxed as a part of P group's consolidated taxable income, with such income being retained by S, and P's tax basis in S's stock remained the same, later, if P were to sell S's stock, the increase in value implied by the taxed income would be taxed a second time to the P group. In this case, under IBA rule, P's basis in S stock is increased by the S's taxable income. Thus, later, when P sells S's stock, the gain would not include S's taxed income in P's consolidated return. Correspondingly, if S's NOL is used to reduce the P group's taxable income, and, later, P sells S's stock at loss without any adjustment to P's basis in S's stock, the loss would be deducted twice by one taxable entity. Accordingly, under the IBA rule, P's basis in S's stock is decreased by the amount of S's NOL used to reduce P group's taxable income and thereby the economic loss is used once by P group, one taxable unit.

In the U.S., the IBA rule had a long history beginning in the 1920's[113]. The most important case in this area is Charles Ilfeld Co. v. Hernandez[114]. In the Ilfeld case, plaintiff claimed the second loss deduction when S was disposed of, which was occurred before 1929 regulations imposed the IBA regime. Supreme Court reasoned that;

The allowance claimed would permit petitioner twice to use the subsidiaries' losses for the reduction of its taxable income. By means of the consolidated returns in earlier years it was enabled to deduct them. And now it claims for 1929 deductions for diminution of assets resulting from the same losses. If allowed, this would be the practical equivalent of double deduction. In the absence of a provision of the Act definitely requiring it, a purpose so opposed to precedent and equality of treatment of taxpayers will not be attributed to lawmakers.

In short, this decision made it clear that economic loss should not be deducted twice by one taxable entity, or by a consolidated group, regardless of whether regulation provide for a basis adjustment[115]. The 1929 rules were repealed. In 1966, new regulations were issued, and providing that E&P was used as rod for the IBA.

Between 1966 and 1994, E&P was used to adjust stock basis[116]. Under Section 312(k), generally E&P are higher than taxable income due to a number of adjustments including less favorable depreciation adjustment. The higher E&P resulted in IBA that made P's basis in S's stock higher, which in turn increased the loss or reduce a gain of P on any sale of S's stock.

In the Wood Investment case[117], using E&P as a rod for IBA was thought unsuitable. Accordingly, in 1994, Treasury changed the rule to use taxable income instead of E&P for IBA[118].

The current IBA mainly consists of two parts[119]; basic IBA and an excess loss account ("ELA").

・Basic IBA[120]; there are four types of investment adjustments to P's S stock basis; stock basis increased by S's taxable income and reduced by S's taxable loss, increased by S's tax-exempt income, decreased by S's noncapital, nondeductible expenses (including expired loss carryover), decreased by S's distribution to P, and increased by P's computed contributions to S.

・ELA[121]; When negative investment adjustments exceed the owing member's stock basis, they create negative stock basis, called an excess loss account, in which P has an ELA. When P disposes of its S stock, P is required to recapture the amount of the ELA as capital gain.

The pertinent application of IBA traditionally caused two kinds of abusive transactions; the so-called son-of-mirror transaction and the loss duplication transaction. Those transactions were initially attacked by the loss disallowance rule (LDR) in the U.S[122]. The parts below will describe why the transactions were problematic, how LDR worked and finally why and with what LDR was replaced. Finally, the response to those transactions in Japan will be considered.

(2) Son-of-Mirror Transaction

In the son-of-mirror transaction, the pertinent application of IBA prevented recognized built-in gain from being taxed. For example, a new S has a built-in gain asset with $40 basis and $ 100 fair market value and P buys all of S stock for $100 and takes $100 for S stock's basis during Year 1. Then P files a consolidated tax return with S. During Year 2, S sells the built-in asset for $ 100 and records a $60 gain. P's basis in S stock increases by the gain under IBA to $160. Later, P sells all of S stock for $100 and gets $60 loss ($100-$60). In the taxable year, the P group can offset $ 60 gain against $60 loss in the consolidated tax return. P's $60 loss is artificial; it does not reflect an economic loss. Without any adjustment P's selling the build-in gain asset out of the group could be tax free.

Son-of-mirror transactions became a problem especially after 1986 when Tax Reform Act of 1986 repealed General Utilities doctrine[123]. The General Utilities doctrine derived from General Utilities & Operating Co. v. Hervering[124]. In General Utilities, the taxpayer distributed the appreciated stock to its shareholder instead of directly selling them to the buyer. The shareholder then sold the distributed stock to a third party buyer to avoid corporate income tax. The issue was whether the built-in gain of the stock on the distribution would be taxed. However, Supreme Court just followed the regulation and the case[125]. Then, General Utilities principle was codified in 1954 tax reform with some exceptions[126]. Congress has made contiguous attempt to shrunken until the principle was applied[127].

As a result, son-of-mirror transaction received significant attention because consolidated groups were able to avoid tax on recognized built-in gain by way of such a transaction. IRS declared the need to attack son of mirror transactions and assure the imposition of a corporate-level tax on the subsidiary's recognized built-in gains in Notice 87-14[128]. Following this Notice, Treasury issued Proposed Regulation 1.1502-20T which adopted LDR as a tool of eliminating son of mirror transactions[129]. The preamble of the Prop. Reg. recognized the most accurate method to tax the recognized built-in gain due to the increased amount of basis in S stock would be "tracing". Tracing is a method to eliminate positive basis adjustments under IBA when those adjustments are from earnings attributable to the recognition of built-in gain and to reduce stock basis if a distribution of current earnings and profits is attributable to such gain. However, tracing was viewed as too hard to operate for both taxpayers and IRS. Consequently, LDR was adopted as a second best. The preamble of the final regulation said;

Because it is not administratively feasible to differentiate between loss attributable to built-in gain and duplicated loss, the final regulations disallow loss with respect to subsidiary stock that is duplicated by the subsidiary's operating losses or built-in losses with respect to its assets.

The purpose of LDR was not only to attack son-of-mirror transaction but also to prevent losses of subsidiaries from being duplicated as investment losses of P when or if P disposed of the subsidiary's stock (i.e. loss duplication).

Regulation § 1.1502-20(c) allows loss to the extent it exceeds an amount determined by the following items: (i) E&P from extraordinary gain dispositions (extraordinary gain factor); (ii) positive investment adjustments in excess of the amount described in (i)(positive investment factor); and (iii) duplicated loss (loss duplication factor). The former two items are for the son-of-mirror transaction, and the last one is for loss duplication. As it shows, LDR is the rule that determines the deductible amount. It was pointed that when extraordinary gain factor and positive investment adjustment were applied to recognized built-in gain from appreciation of the assets value after entering the group, LDR would disallow real economic loss[130].

When LDR was repealed after the Rite Aid case described below, Treasury and the IRS adopted tracing[131] and suggested a basis disconformity rule as an alternative method in case it is too hard for the taxpayer to use tracing because of a lack of records[132]. The basis disconformity rule was also criticized due to the fact that it was both overinclusive and underinclusive[133].

The son-of-mirror transactions are inconsistent with GU repeal and validity of the rule for the transaction depends on whether it violates GU repeal. While tracing is the best method to attack son-of mirror transaction, it put too much burden on taxpayers and the IRS. But as described above, LDR and basis disconformity rule may violate GU repeal.

(3) Loss Duplication

i. LDR and the Rite Aid Case

As described before, LDR was intended to prevent loss duplication, too. Again, a simple illustration is useful. For example, assume P forms S with a capital contribution of $100k cash and S buys an asset for $100k. P has a $100k basis in S stock. Then, the value of the asset owned by S decreases to $ 60k. P is going to think of selling S. How? First S sells its asset for $60 to a third unrelated party and gets $40k loss. P's basis in S stock is decreased by the loss under IBA. Then P sells S stock for $60k and gets no gain or loss. So this time P can get $40k loss only once. But when P sells S stock first and then S sells the asset to a third unrelated party, P can get $40k loss and S also get $40k loss. A deduction of single economic loss which is incurred inside of the consolidated tax return is used twice even though those deductions are taken the different entities. Thus, LDR disallowed the deduction of loss when P sold S stock in order to assure only one deduction. But if this built-in loss is a built-in gain, there will be gain duplication. And no rule eliminates it[134]. The problem here is loss selectivity; namely taxpayers tend to organize in transactions creating loss duplication while avoiding gain duplication[135].

Especially as it applies to loss duplication, LDR has been criticized because it was not based on the repeal of General Utilities and overrode Section 165(g)[136]. Noticing such opposition, preamble of the proposed regulation said;

> Although it can be argued that it is inappropriate to address the problem of loss duplication only as it related to consolidated returns because the problem also occurs in the context of separate returns, this argument ignores the fact that the consolidated return regulations adopt a comprehensive approach to gain and loss duplication that represents a fundamental departure from separate return treatment.

But there are pro and con opinions that loss duplication is supported by the repeal of GU[137]. If the repeal of GU reaches loss duplication, LDR should be sustained. There are two arguments supporting this idea. First, violation of GU repeal covers whenever taxation for built-in gain is impaired. In that sense, loss duplication is also within violation of GU repeal. Second, GU repeal is also aimed at loss selectivity. In that sense, LDR for loss duplication is also needed to effectuate the GU repeal policy. If it is concluded that LDR violates to the repeal of GU, it is difficult to support LDR as it applies loss duplication.

To mitigate harshness of LDR, Treasury and IRS indicated two ways[138]; first, a taxpayer could make a Section 338(h)(10)election, which allows the parties to treat a sale of stock as if it were a sale of assets, since in such a case any built in loss in the stock would be ignored, and, second, by permitting a "reattribution" rule which allows P to keep a leaving S's NOL to the extent of the disallowed loss on the stock sale[139].

Finally in the Rite Aid case[140], LDR was challenged. In this case, the taxpayer did not use either Section 338(h)(10) or reattribution rule and the taxpayer's loss on the sale of S stock was disallowed under LDR.

The Court of Federal Claims held for the IRS[141], but Federal Circuit Court held for the taxpayer, reasoning that;

> Section 1502 does not authorize the Secretary to choose a method that imposes a tax on income that would not otherwise be taxed. Income tax liability is not imposed by the Secretary's regulations, but by the Internal Revenue Code. Therefore, in the absence of a problem created from the filing of consolidated returns, the Secretary is without authority to change the application of other tax code provisions to a group of affiliated corporations filing a consolidated return. ...Realization of the loss does not stem from the filing of a consolidated return, and the

> denial of the deduction imposes a tax on income that would otherwise not be taxed[142].

And also the court mentioned that "with Sections 382 and 383, Congress has addressed this situation by limiting the subsidiary's potential future deduction, not the parent's loss on the sale of stock under Section 165"[143]. After all, the court repealed the LDR for loss duplication by concluding that "the regulation is manifestly contrary to the statute"[144].

IRS announced that it accepted the result of this case in the interest of sound tax administration and the Treasury discarded LDR .

ii. After the Rite Aid Case ------The United Loss Rule ("ULR")

While after the Rite Aid case, the proposed regulation about introducing the "united loss rule" ("ULR") was issued in January, 2007 and finalized in September, 2008. ULR got a good reception, in that it simplified the complicated rules into one united rule. This had been a 20 year process after LDR was issued[146]. ULR is the rule which unites the rules for son-of mirror transactions under Reg. 1.337(d)-2, loss duplication by a single entity under Reg.1.1502-35, and loss duplication by two entities under duplicated loss factor under Reg. 1.1502-20.

The two principle purposes of ULR are indicated in the Treasury Regulations; first is to prevent the consolidated return provisions from reducing a group's consolidated taxable income through the creation and recognition of noneconomic loss on S stock. Second is to prevent members (including former members) of the group from collectively obtaining more than one tax benefit from a single economic loss[147].

The essence of ULR is practically the same as LDR[148]. However, there are a couple of big differences between LDR and ULR. First, ULR apply only to loss share[149]. Second, the effects of ULR application mean not disallowance of loss deduction on the seller, but reduction of the attributes on the buyer[150].

(5) Comparative Analysis

IBA was introduced at close to the same time when the consolidated tax return system was created in Japan. However, the way to operate IBA has been largely simplified. First, S's accumulated profit is used to adjust P's basis in S stock[151]. Second, the adjustment to the basis is made not annually, but only once when S stock is disposed of[152]. Accumulated profit is usually determined by adding taxable income and received dividend, and subtracting net losses, corporate income taxes and undeducted items[153]. In this calculation, since net losses are subtracting regardless of whether they offset against taxable income or not, the accumulated profit could be negative. In this case, how it affects the stock basis is arguable. Though accumulated profit is similar to E&P, since it is calculated based on taxable income, the problem in the Wood Investment case thus does not appear under Japan consolidated tax return system.

In Japan, when a company distributes or sells built-in assets to a shareholder, the gains are are recognized and taxed[154]. The rule is the same as the U.S. rule post its repeal of GU. And we also have rules similar to IBA. However, it is unnecessary to cope with son-of-mirror transaction because corporate-level tax on the pre-consolidated built-in gain is taxable under the valuation rule noted above. For example, if a new S has any net built-in gain, the gains will be taxed before entering the consolidated group. But an application of the valuation rule limits this to only some listed assets (real estate, land, securities, pecuniary claim, and deferred assets) with $ 10,000 or greater fair market value[155]. In fact, to the extent beyond this limitation there is a son-of-mirror transaction problem.

In Japan, there is no anti-loss duplication rule. But in corporate taxation other than the consolidated tax area, loss duplication has drawn attention, and some professors have stated that we would need some limitation like Section 362(e)(2).

In full pursuit of simplification under the consolidated tax return system, one option might be uniform adoption of LDR without variation. It would mean that there would be no need to have an IBA and no possibility of son-of-mirror transaction and loss duplication.

One distinctive rule under Japanese statutes is a comprehensive prohibition of tax avoidance ("CPTA") which is similar to a sort of anti-avoidance rule under the U.S. law. CPTA is originally aimed at tax avoidance by closely-held corporations[156] and generally its ambiguity has been criticized. However, on introducing the corporate reorganization and consolidated tax return system, CPTA was considered to be necessary to prevent corporations from avoiding tax by abusing each system, so that those were added to the statute[157].

CPTA for consolidated groups provides that if a transaction associated with a consolidated tax return is recognized to have improperly reduced corporation tax or other taxes, the director of the competent the NTA office may calculate the amount of taxes as appropriate[158].

As it is uncertain when a transaction associated with consolidated tax return is recognized to have "improperly' reduced tax, courts as well as NTA will have to work hard to find what we need to add to the statute.

## Conclusion and Outlook

This paper has compared the U.S. and Japanese consolidated tax return systems, focusing mainly on three issues; stock ownership, loss limitation and IBA rules. Based on those considerations, the principal advantages (i-iv) and disadvantages (v-viii) of consolidation could be summarized as below[159];

i) A member of a consolidated group can offset its losses which incurred during consolidation.

ii) A member of a consolidated group can defer taking into account gain on intercompany transaction.

iii) A member of a consolidated group can increase the basis in subsidiaries' stock under IBA.

iv) A member of a consolidated group can make a distribution to its parent without taxation.

v) A parent in a consolidated group must reduce its basis in its subsidiaries' stock under IBA.

vi) Certain losses of a new member during the separate return year might be disallowed.

vii) Loss on the disposition of a consolidated subsidiary is disallowed under ULR (only in the U.S.).

viii) The consolidated tax return rules are so complicated that companies have to be well advised by tax experts.

In the U.S., it should be more advantageous for affiliated groups to file a consolidated return. Actually, it is said that virtually all publicly owned United States corporations elect to report their income on a consolidated tax return as a member of a consolidated group[160]. This would mean not only that there are competent tax advisers, but also mean that the complicated rules work well.

As opposed to this, it is reported that only few corporation file a consolidated tax returns in Japan. The advantages of filing a consolidated tax return may be outweighed by the disadvantageous once the intercompany contribution items, valuation rule, and certain other rules are taken into account. However, after the mitigation of the all discard rule for special consolidated subsidiaries, some in Japan expected that more corporate groups would elect to file a consolidated tax return. Moreover, GTS might in any case be an intermediate step between a separate tax return and a consolidated tax return. More importantly, the operating rules under the consolidated tax return system itself should be effectively developed without destroying Japanese economy in the process[161].

NOTES

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1 The Tax Commission of Japan, A report about the tax reform of 2001, (Dec. 2001).

2 *See* Reg. 33, Arts. 207, 208 (1918). This was without statutory authorization. In 1918, consolidated returns were required by statute. Rev. Act of 1918, §240(a).

3 *See* S. Rep. No. 617. 65th Cong., 3d Sess. 8-9 (1918).

4 *See e.g.,* Andrew Dubroff and John Broadbent, Consolidated Return: Evolving Single and Separate Entity Themes, 72 Taxes 743 (1994).

5 I.R.C. Section 1504(a)(1). Certain preferred stocks are excluded under I.R.C. Section 1504(a)(5) in determining whether the ownership requirement is satisfied.

6 JCTLArt. 4-2.

7 JCTL Art. 4-3. Commissioner can decline to permit it if he/she find the fact that the group can't determine its tax liability appropriately by using a consolidated tax return. JCTL Art. 4-3(2).

8 JCTL Art. 2. There is an exception of the 5% S's stock options owned by directors and employees. JCTL-Enforcement Order ("EO") Art. 4-2(2). A group shall not include foreign subsiduaries.

9 Probably, the ownership requirement is reduced from 100% to 50% at some point, according to a recent lawmaker's comment. We have to consider what kind of problems might happen by using such a reduced ownership

requirement. Actually, in the U.S., lawmaker's declined to accept 50% ownership because the group would lack a reality as a taxable unit.

10 For example, this would cause recognition of deferred built-in gains and/or losses under intercompany transaction rule (as described below) and adjustment of P's basis in S stock. JTCL-EOArt. 9(2)(iii).

11 *See* Malcom Gammie QC et. al., Achieving a Common Consolidated Corporate Tax Base in the EU, 45(2005).

12 Treas. Reg. § 1.1502-77.

13 I.R.S. Section 1552(a).

14 *See* Arnold C. Johnson, *Minority Stockholders in Affiliated and Related Corporations,* 23rd N.Y.U. Inst. 321, 329 (1965). *See e.g.,* In re All Product, Co., 32 B.R. 811(1983).

15 JCTLArt. 81-22(1), 81-27.

16 JTCLArt. 81-28(1).

17 Hideki Tomonaga et. al., Perfect Manual of Group Tax System, Zeiri Vol. 53, No. 12, p.34 (2010).

18 P.L. 98-369, § 60(a).

19 BU1, New York Times (May 31, 2009).

20 Prt. Ltr. Rul. 200506013 (Feb. 11, 2005), 2005 WL 328128.

21 I.R.S. Section 172.

22 This was required because the re-affiliation took place within five years of the earlier dis-affiliation.

23 Robert Willens, *Synthetic Consolidation; The Next Big Thing?*, 114 TAX NOTES 1013 (2009). *See also* William Garhan, *ICP Responds to Fairfax*, 123 TAX NOTES 1603 (2009).

24 BU1, New York Times (March 10, 2012).

25 Treas. Reg. § 1.1502-21(c)(1).

26 Treas. Reg. § 1.1502-21(g)(1).

27 Treas. Reg. § 1.1502-36.

28 *See* Takako Sakai, *Synthetic Consolidation and Stock Ownership Requirement,* 566 Tax Jurisprudence 183 (2011).

29 29 T.C. 1012 (1958), *aff'd per curiam* 260 F.2d 949 (3rd Cir. 1958).

30 *See also* BITTKER & EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS, ¶13.41[3].

31 *Supra* note 29.

32 I.R.C. Section1504(a)(3)(B).

33 JTCLArt. 4-2, JTCL-EOArt. 14-6(1), (3).

34 *But see* I.R.C. Section 6011(k)(3).

35 BU1, New York Times (March 10, 2012).

36 JCTLArt. 81-3.

37 A related corporation means a corporation owned at least 25% by the recipient corporation. JCTL Art. 23(6). Dividend on stock of a corporation other than member of a consolidated group, a 100% owned corporation or a related corporation are excluded from income to the extent of 50% of the amount of the dividend after reducing the amount of the recipient's interest expense allocated to the dividend. JCTLArt. 23(1).

38 JCTLArt. 23(1), 23(4)(ii).

39 JCTLArt. 23(1), Art. 81-4(1).

40 JCTL-EO Art. 9(1)(v).

41 Treas. Reg. §1.1502-13(f)(2)(ii).

42 Treas. Reg. §1.1502-32.

43 JCTLArt. 37(7).

44 JCTLArt. 22(2).

45 JCTLArt. 37.

46 JCTL Art. 37(2), Art. 81-6(2). Actually, this legislative is effective for the contribution on and after 1 October, 2010.

47 Treas. Reg. §1.1552-1(b)(2).

48 Treas. Reg. §1.1502-13. This revised 1966 Regulation.

49 Final Regulations were adopted in TD 8597 in 1995.

50 *See* Bittker & Eustice, supra note 30, at ¶13.43[1]. Sec. 267 specially applies to loss property. Under intercompany transaction context, application of sec. 267 heavily relies on intercompany transaction rule. *See* Treas. Reg. § 1.267(f)-1.

51 Treas. Reg. §1.1502-13(b)(1)(i).

52 Treas. Reg. §1.1502-13(a)(1).

53 Treas. Reg. §1.1502-13(c).

54 Treas. Reg. §1.1502-13(d).

55 Treas. Reg. §1.1502-13(f).

56 Bittker & Eustice, supra note 30, at ¶13.43[1], 13.43[5][a].

57 JCTL-EO Art. 122-14(1).

58 JCTLArt. 81-10.

59 For the details of GTS, Yoshimi Nakamura, Corporate Group Taxation, (Okurazaimukyokai, 2011).

60 JTCL-EO Art. 4 .

61 JCTLArt. 61-13.

62 JTCL Art. 61-13(2), JCTL-EO 122-14(4). And the other is that intercompany contribution under GTS do affect the accumulated profits and the tax basis of members in the stock of the donee or donor. JCTL-EO Art. 9(1)(vii), 119-3(6), 119-4(1).

63 JCTLArt. 81-12(2).

64 For consolidated tax years beginning during the period from 1 April 2002 to 31 March 2004, the regular consolidated tax rates were each increased by 2% (temporary 2% surtax). For tax years beginning on 1 April 2004 or later the temporary surtax does not apply. The 2% surtax was added because some revenue decrease was expected after the consolidated return system was introduced.

65 JCTLArt. 66(1).

66 JCTL Art. 66. A company may not be treated as a medium-or small-sized company if it is wholly owned by a large-sized company with capital stock or invested capital of ¥500 million or more. JCTLArt. 66(6)(ii).

67 As to built-in losses, there are more intricate rules. Indeed since built-in losses have no expiring date unlike net losses carryforward, they are more useful and should be limited more strictly than net losses. But in order to limit deduction of recognized built-in losses, it is necessary to value the amount of the assets and that put a lot of administrative burden on both taxpayer and tax agency. That is why some thresholds are needed, again. Generally, built-in gains and losses are transferred to an acquiring company by way of qualified mergers by which it takes transferred basis for the assets. The built-in losses are limited under statute. This legislation is consistent with the limitation rule for net losses carryforward under both the U.S. and Japan rule. *See* JTCLArt. 62-7.

68 JCTLArt. 2(19).

69 In Japan, corporations can file either a blue tax return or a white tax return. Though a corporation has to comply with certain documentary requirements, nearly all corporations file a blue tax return because they can get many tax preferences by filing it and accordingly only a few small corporations select

the simpler white tax return. Corporations filing white returns are not allowed net loss carryovers and carrybacks, although they can use the losses from natural disasters and the losses under a special plan of insolvency. *See* JCTLArt.58, 59

70 JCTLArt. 57. The period of carryover of net losses is extended from 5 years to 7 years in 2004 and from 7 years to 9 years in 2012.

71 JCTL Art. 80. But carryback of net losses owned by large companies has been suspended except for cases of corporate dissolution. Japanese Special Tax Measures Law (JSTML) Art. 66-13.

72 I.R.C. Section 172(b)(1)(A).

73 I.R.C. Section 1212(a)(1).

74 I.R.C. Section 1211(a).

75 See e.g., Loken, Loss Carryovers and Corporate Alterations: Toward a Uniform Approach, 52 Minn. L. Review 571 (1968). Daniel Simmons, Net Operating Losses and Section 382: Searching for a Limitation on Loss Carryovers, 63 Tul. L. Rev. 1045 (1989).

76 I.R.C. Section 382(g).

77 I.R.C. Section 382(b)(1).

78 Treas. Reg. § 1.1502-13(a)(1).

79 American Law Institute, Federal Income, Estate and Gift Tax Project, Income Tax Problems of Corporations and Shareholders: Report of Working Views, 337, 347 (1958).

80 Old Japanese commercial law art. 103. Japanese corporation law Art. 2 (27), (28).

81 Japanese Supreme Court decision 1968. 5. 2., Minsyu 22(5) p. 1067.

82 However, the Hiroshima local court held that net loss carryforwards of a surviving corporation could not be used in the case of a "reverse merger", i.e., a merger of a profitable and substantially larger corporation into a surviving loss corporation. The court reasoned that in substance the profitable corporation was the surviving corporation. *See* Hiroshima local court 1990.2.25 Gyousyu vol. 41, no.1, p. 42.

83 I.R.C. Sections 382(a), (b) (1954).

84 11 T.C. 240 (1948).

85 *See* Tetsuya Watanabe, *Tax-Free Treatment for Corporate Reorganizations in Japan,* available at http://www.law.berkeley.edu/files/sho_sato_tax_conf_web_paper--

watanabe.pdf (last visited Sep. 29, 2012).

86 JCTL-EO Art. 112(3).

87 353 U.S. 382 (1957).

88 Id., at 389-390.

89 *See e.g.,* Commissioner v. Goodwyn Crockery Co., 315 F2d 110 (6th Cir. 1963). *And see* Treas. Reg. §1.382-(a)-1(b)(7) (1962).

90 Treas. Reg. §1.368-1(d)(1).

91 JCTLArt. 57-2(1).

92 JCTLArt. 81-9-2.

93 JTCLArt. 60-3(1).

94 JTCLArt. 57-2(1).

95 JCTL-EO Art. 113-2(17).

96 JCTL-EO Art. 113-2(19).

97 Other than cited below, *see e.g.* Commissioner v. Trustees of lumber invest. Ass'n, 100 F.2d 18 (7th Cir. 1938) (carryover case). Frelbro Corp. v. Commissiner, 36 T.C. 864 (1961), *rev'd on other grounds,* 315 F.2d 784 (2d Cir. 1963) (carryback case).

98 Commissioner v. Ben Ginsburg Co., Inc., 54 F.2d 238 (1931).

99 Woolford Realty Co., Inc. v. Rose, 286 U.S. 319, 329-330 (1932).

100 Treas. Reg. 75, Art. 41(c)(1929). *See also* Treas. Reg. 102 Art. 31 (1938) and Treas. Reg. § 1.1502-21A(c) (1966).

101 T.D. 8823, 1999-2 C.B. 34. *See* Richard Yate, et. al., *Final SRLY/Consolidated Section 382 Regs. Remove SRLY Limitation for Most Groups as of 1999,* 91 J.Tax'n 325 (1991). SRLY rule was about to be eliminated. *See e.g.,* John Broadbent and Andrew Dubroff, *Whither SRLY? Can the Simplified Regulation be simplified?*, 58th N.Y.U. Ins't ch. 8, §8.02 (2000).

102 Treas. Reg. §1.1502-21(c).

103 Treas. Reg. §1.1502-21(e).

104 Treas. Reg. §1.1502-21(f)(2).

105 JCTLArt. 81-9(1), Art. 81-3(1). *But see also* JSTMLArt. 68-98.

106 JCTLArt. 2(19-2)

107 JCTLArt. 57(9)3.

108 JCTL Art. 57(9)3, 58(4)3. *But see* after revision of 2010, JCTL-EO Art. 122-12(1)7.

109 JCTLArt. 81-9(2)1.

110 JCTLArt. 61-11(1), 61-12(1).

111 Id. JTCL-EO Art. 122-12(1).

112 JCTLArt. 61-11(1)1~6, 61-12(1)4.

113 *See* Jerome R. Hellerstein, *Loss Availed of in Consolidated Returns,* 2 Tax L. Rev. 391 (1947) (It argued only basis decreasing adjustment to prevent a consolidated group from double deduction prior to the issuance of Regulation).

114 292 U.S. 62 (1934).

115 *See* Fred W. Peel, Consolidated Tax Return: A Treatise on the Law of Consolidation Federal Income Tax Returns, 204-205 (1959).

116 Treas. Reg. § 1.1502-32(a) (1966).

117 85 T.C. 274 (1985)(It was arqued that depreciation to calculate E&P should be determined either straight-line method or accelerated method).

118 *See also* I.R.C. Section 1503(e)(1)(A). H.R. Rep. No. 100-391, at 1087-91.

119 *See also* a circular basis adjustment rule under Reg. §1.1502-11(b)(1), (2).

120 Treas. Reg. §1.1502-32(b)(2).

121 Treas. Reg. §1.1502-19(a)(2).

122 Treas. Reg. §1.1502-20 (1991).

123 Tax Reform Act of 1986 Pub. L. No. 99-514, §631, 100 Stat. 2085, 2269-2275. *See also* Joint Committee on Taxation, General Explanation of the Tax Reform Act of 1986, 328-331 (1987). *And also see e.g.,* George Yin, *General Utilities Repeal: Is Tax Reform Really Going to Pass it by,* 31 Tax Notes 1111 (1986).

124 296 U.S. 200 (1935).

125 296 U.S. at 204.

126 Internal Revenue Code of 1954, Pub. L. No. 83-591, § § 311(a), 336(a), 68A Stat. 95, 106. S. Rep. No. 1622, 83ed Cong., 2nd Sess. 1954.

127 For example, I.R.C. Section 311(d)(i) was enacted for non-liquidating distribution in kind in 1984.

128 1987-1 C.B. 445.

129 T.D. 8294, 55 Fed. Reg. 9426.

130 Christian M. McBurney, *The Consolidated Return Regs' Loss Disallowance Rule-When is it Vulunerable?*, 90 J. Tax'n 20, 24 (1999).

131 Treas. Reg. §1.337(d)-2.

132 Notice 2004-58, 2004-2 C.B. 520.

133 Christopher J. Nelson and Brian A. Peaboy, *New Interpretations of LDR Regime;*

*The Basis Disconformity and Presumption Models,* 104 Tax Notes 943, 956 (2004). *See also* Lee A. Sheppard, *IRS Defends Loss Disallowance Replacement,* 104 Tax Notes 154, 155 (2004). Basis disconformity rule was not adopted in Final Regulation of Section 337(d). *See* T.D. 9187, at 10320.

134 Gain duplication is readily avoided by selling S's built-in asset first or selling it after S's liquidation. Dubroff, at §72.01[5].

135 T.D. 8294, at 9428. And see Don Leatherman, *Why Rite Aid Is Wrong?*, 52 Am. U.L. Rev. 811, 862-877 (2003).

136 *See e.g.*, Bryan Collins, *et. al.*, *Friday the 13th, Part III: The Final Loss Disallowance Rules,* 52 Tax Notes 1627, 1631 (1991).

137 T.D. 8294, at 9428. Dubroff, §§ 72.01 [5],[9]. Micheal Schler, Consolidated Return Loss Disallowance: Conceptual Issue, 95 Tax Notes 899, 901 (2002). Letherman, *supra* note 135, at 901.

138 T.D. 8294, at 9429-9430.

139 Treas. Reg. §1.1502-20(g)(1).

140 Rite Aid Corp. v. United States, 46 Fed. Cl. 500 (2000), 255 F.3d 1357 (Fed. Cir. 2001).

141 46 Fed. Cl. 500 (2000). *See* Brian P. Collins, et.al., *Court of Claims Upholds Validity of Loss Disallowance Rules,* 28 J. Corp. Tax'n 29 (2001).

142 255 F.3d at 1359-1360.

143 Id., 1360.

144 Id.

145 2002-7 I.R.B. 526. *See* Mark Silverman and Lisa Zarlenga, *Rite Aid: A Tough Pill for the Government to Swallow,* 94 Tax Notes 1343 (2002).

146 *See e.g.*, Amy S. Elliott, *IRS Finalizes Complex Unified Stock Loss Disallowance Regs,* 120 Tax Notes 1030 (2008).

147 Treas. Reg. §1.1502-36(a)(2).

148 Patricia W. Pellervo and Darin A. Siders, *The Newest Loss Disallowance Rule For Consolidated Groups- Let the Buyer Beware,* 109 J. Tax'n 334 (2008).

149 *See* Treas. Reg.§1.1502-36(d)(2), (3).

150 Burt Stratton and Arthur Sewall, *Buyer and Seller Considerations under New Unified Loss Rules,* 36 Corp. Tax'n 3 (2009).

151 JCTL- EO Art. 119(1).

152 Id

153 JCTL Art. 9(1).

154 JCTLArt. 22(2),(3). In built-in loss asset cases, the losses are also supposed to be deducted.

155 And also the valuation rule is not applicable to some subsidiaries which have status as P and then no way to avoid tax like wholly owned subsidiaries 5 years before consolidation. JCTLArt.61-11.

156 JTCL Art. 132.

157 JCTL Art. 132-2, 132-3.

158 JCTL Art. 132-3.

159 *See e.g.,* James C. Warner, Practical Guide to Consolidated Returns 2nd ed., ¶225 (CCH, 2007).

160 Martin J. McMahon, Jr., *Understanding Consolidated Returns,* 12 Florida Tax Review 125 (2012).

161 As a Japanese treatise in this area, Takako Sakai, Corporate Tax Attributes, (Seibundo, 2011).