

Japan Tax Update

Monthly tax update



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As we all know, the only thing constant is change. And the only way to stay successful is to keep on top of changes — in the economy, the industry, and with regulation.

The "Japan Tax Update" seeks to update you on the latest developments in Japanese tax law that affect Japanese and foreign multinationals having operations in Japan. In addition to providing information on Japanese tax issues, the purpose of this newsletter is to make management aware of changes in the regulatory environment that may have an impact on their business.

Tax Implications of Subscription Warrants Granted as Part of Poison Pill Scheme to Ward off Hostile Takeover Bids

Since October 2004, a specialist panel of legal specialists and company executives established by the Ministry of Economy, Trade and Industry ("METI") has been examining whether Japanese companies can adopt US-style defensive measures against hostile takeover bids. In particular, the panel has been investigating whether Japan can introduce the so-called "poison pill" under its current legal framework.

On May 27, 2005, METI released the report prepared by this panel. The report proposes several poison pill schemes to defend against a hostile takeover. One of the schemes is a rights plan under which a company will grant subscription warrants to its shareholders when a hostile bidder appears in the market. The plan involves issuing a large number of new shares to dilute the hostile bidder's stake since only shareholders other than the hostile bidder will be able to exercise the warrants. In anticipation of the report, taxation guidelines were previously issued by the Japanese National Tax Administrative Agency ("NTA") on April 28, 2005 and these guidelines include the tax implications arising from the grant and exercise of subscription warrants. The following is an outline of these guidelines.

Tax implications for shareholders

A poison pill scheme is classified into three types: (1) warning in advance, (2) trust arrangement, and (3) special purpose company (“SPC”) with trust arrangement. Under the “warning in advance” plan, the company makes a warning in advance to its shareholders and prospective shareholders advising them that the company will grant warrants to all shareholders when a hostile bidder appears. Under the “trust arrangement” plan, the warrants are kept in a trust account and transferred to shareholders when a hostile bidder appears.

Under all types, a corporate shareholder will be subject to taxation pursuant to Article 22 of the Corporate Tax Law at the time the subscription warrants are granted by the issuing company directly or via a SPC. The taxable value is fair market value (“FMV”) of the subscription warrants.

An individual shareholder will be subject to taxation at the time the subscription warrants are exercised [in the case of types (1) and (2)¹] or at the time the subscription warrants are transferred by the SPC [in the case of type (3)²]. In the case of types (1) and (2), the taxable value will be the difference between the FMV of the shares acquired less the exercise price, if any. In the case of type (3), the taxable value is the FMV of the subscription warrants.

As noted above, in the case of a corporate shareholder, under all types, the taxable value is the FMV of the subscription warrants. In the case of an individual shareholder, under type (3), the taxable value is the also the FMV of the subscription warrants. Existing tax laws and regulations are silent regarding the calculation of the FMV of the subscription warrants. It is likely that the FMV will be calculated in accordance with the Fischer Black and Myron Scholes (B&M model) formula used for option pricing.

Under type (3), the subscription warrants are first issued to the SPC, which will retain the warrants until a hostile bidder appears. The SPC may be subject to the taxation at the time the subscription warrants are issued by the company to it, depending upon the restrictions placed on the subscription warrants or other factors. If the warrant agreement is prepared in a manner such that the value of the warrants are close to zero (for example, a non-transferability clause except in certain limited cases), it may be possible for no taxable income to arise from the issue of the warrants.

Summary of taxation in case of types (1) and (2) plans

Timing	Issuing company	Trust bank [in type (2)]	Corporate shareholder	Individual shareholder
Issue of subscription warrants/ Trust agreement	-	-	-	-
Grant to shareholder	-	-	Subject to taxation on FMV of subscription warrants	-
Exercise of subscription warrants	-	-	-	Subject to taxation on difference between FMV of shares acquired less exercise price

¹ Article 84 (Income benefit from grant of subscription warrants) of the Income Tax Law Enforcement Order.

² If the subscription warrants are first granted to the SPC and then transferred to individual shareholders, the economic benefit from the transfer of the subscription warrants is taxed pursuant to the general principle of income taxation as embodied in Article 36 of the Income Tax Law.

Summary of taxation in case of type (3) plan

Timing	Issuing company	SPC	Corporate shareholder	Individual shareholder
Issue of subscription warrants to SPC	-	Subject to taxation on FMV of subscription warrants depending upon agreement	-	-
Creation of trust	-	-	-	-
Transfer of subscription warrants to shareholder	-	Deduction of FMV of subscription warrants depending on agreement	Subject to taxation on FMV of subscription warrants	Subject to taxation on FMV of subscription warrants
Exercise of subscription warrants	-	-	-	-

You have a vision. PricewaterhouseCoopers helps bring that vision to reality. We hope you enjoy the current issue of Japan Tax Update and appreciate your comments or ideas for what you'd like to see covered in future issues.

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