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Japan's New Corporation Law (Part 1)

The new Corporation Law ("Law") was passed by the Japanese Diet on June 29, 2005 and promulgated by the government on July 26, 2005 (Law No. 86 of Japan) ("Kaisha ho"). The purpose for the Law is to modernize the overall corporate legislation in response to the changing societal and economic circumstances. The Law is designed to stimulate the formation of new companies and allow more flexible corporate management. Further, the Law eases restrictions on mergers and acquisitions (M&A) and provides new measures to defend companies against hostile takeover bids.

Key features of the Law are the following:

1. **Changes to the types of business entities that can be established;**
2. **Relaxation of the requirements for the establishment of companies;**
3. **Distribution of dividends; and**
4. **Relaxation of the requirements for corporate reorganizations.**

This issue provides a general overview of some of the provisions of the Law that relate to corporate taxes and reorganizations.

1. Changes to the types of business entities that can be established

a. Yugen Kaisha ("YK")

The Yugen Kaisha Law will be repealed when the Corporate Law becomes effective around April 2006. Until that time, it is possible to establish YKs.

On or after the effective date of the Law, existing YKs will continue to exist as a KK as stipulated in the Corporate Law while the registered name will still indicate "Yugen Kaisha". A YK that exists after the enactment of the Law is referred to as a Special YK ("Tokurei Yugen Kaisha") and will be governed by the Corporate Law sections governing KKs.

Therefore, although its legal form is a KK, it will retain the characteristics of a YK (e.g. its by-laws remain unchanged and registered name still indicates “Yugen Kaisha”).

At present, it is not clear how long Special YKs will be allowed to exist. The Special YK can be converted to a KK by changing its bylaws and registered name.

The repeal of the YK Law will have an impact for US inbound investment. The YK qualified as an eligible entity for U.S. “check-the-box” purposes, but a KK is a per se corporation. Therefore, the repeal of the YK Law could have an adverse impact on US taxpayers who previously elected “check-the-box” treatment for their YK.

b. Japanese LLC (“Godo Kaisha”)

The Law will introduce a new type of corporate entity called a “Godo Kaisha”, which is modeled after the U.S. LLC type of entity.

This entity will be a limited liability company whose members are only liable to the extent of their investment in the LLC, and will not be personally liable to third parties for the debts of the LLC. At present, it is not certain whether or not the Godo Kaisha is a pass-through entity such that tax would be imposed at the member level.

2. Relaxation of the requirements for the establishment of companies

a. Reduction of minimum capital requirement

The minimum capital requirements of JPY10 million and JPY3 million required to set up a KK and YK, respectively were eliminated under the Law.

Prior legislation that was enacted to encourage the formation of new enterprises permitted a company to be established with as little as JPY1 of capital, with the requirement that such company increase its capital to the required level within five years. The Law will permit companies to maintain an equity capital of JPY1 as long as they want.

Although a company can be formed with JPY1 of capital, the company should consider the perception issues (e.g. recruiting qualified employees, obtaining bank financing, customer concerns regarding dealing with a company with a low amount of capital) with respect to having a low amount of capital to determine whether a low amount of capital is beneficial from a business perspective.

b. Court inspections

Prior to the Law, the Japanese Commercial Code required that an inspector be appointed by the court to review specified in-kind contributions, a capital increase at post-incorporation, and purchases within two years after the establishment of the company. Certain in-kind contributions were exempt from such inspection requirement. Alternatively, a valuation certificate needed to be issued. This process took time and also cost money.

Under the Law, court inspection is no longer required for specified in-kind contributions to capital nor purchases of property within two years after establishment. This also applies to a company established by merger, spin-off, split-out or share-for-share exchange. Further, at the time of incorporation and for a capital increase at post-incorporation, the types of in-kind contributions which are not subject to the court inspection have been added, and the requirements for not being subject to the inspection were relaxed.

3. Distribution of dividends

Prior to the Law, a Japanese corporation could only legally pay dividends once a year, at the end of its accounting period. In addition to the year-end dividend, a KK whose business year was one year could stipulate in the Articles of Incorporation that it may distribute an interim dividend, only once per year, and within three months after a fixed date stipulated in the Articles of Incorporation.

Under the Law, corporations which do not have board of directors will be able to allocate retained earnings by offering dividends whenever and as many times during the fiscal year as they want. Therefore, some companies may opt to pay dividends on a quarterly basis according to their performance, taking advantage of the flexibility of the new rules.

However, the Law stipulates that regardless of the size of the capitalization, companies with net assets of less than JPY3 million cannot pay dividends to shareholders even if they have enough retained earnings to do so, in order to protect the interests of creditors.

4. Relaxation of the requirements for corporate reorganizations

In the area of corporate M&As, the Law will provide greater flexibility in reorganizing companies as well as the implementation of countermeasures against hostile takeover attempts.

For example, the Law relaxes the rules relating to the type of consideration that can be used for merger transactions as well as cross-border M&A transactions so that in-kind dividends of shares can be used to reorganize a company. In addition, cash as well as foreign shares can be used as consideration to be paid to shareholders of the nonsurviving company in a reorganization.

The Law also allows for simple corporate mergers that do not need shareholder approval. For example, under a simplified re-organization (e.g. merger, spin off, etc.), a surviving company of a merger is not required to obtain approval from its shareholders under certain circumstances.

In addition, the Law allows for a short form re-organization in which a Japanese controlling corporation which owns 90% or more of the voting rights of a controlled corporation may complete a reorganization (including mergers) without the approval of a shareholders meeting by a controlled corporation.

Further, in some cases, a loss can be recognized from a merger.

It should be noted that the portion of the Law relating to corporate reorganizations in which any assets other than shares of the reorganizing company are used will not go into effect until Spring 2007, due to concerns of a possible increase in foreign takeovers of Japanese companies. The delayed enforcement will give Japanese companies time to prepare countermeasures for possible hostile takeovers (e.g. poison pills).

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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