

New corporation law and its impact on the tax law

The new corporation law and its regulation were promulgated on June 26, 2005 and February 7, 2006 respectively, and both of which took effect on May 1, 2006. In accordance with the new legislation of the corporation law and regulation, the tax law was also amended in the 2006 tax reform. Major amendments include the following items:

- The capital amount
- Directors' remuneration
- Stock option expenses
- Corporate spin off
- Distribution of retained surplus
- Relaxation of consideration in the corporate reorganization

Since measures for relaxation of consideration in the corporate reorganization will become effective on May 1, 2007, it is expected that the 2007 tax reform will include some legislation in this regard.

I Capital amount and capital surplus upon issuance of new shares

Before the 2006 tax reform, upon the issuance of new shares, the aggregate of capital and capital surplus of the issuing company increases by the amount of the total issue price of the new shares pursuant to the provision of the old Commercial Code. The amount of increase in capital or capital surplus is changed in the new Corporation Law as (i) the amount of cash contribution, or (ii) in the case of a contribution in kind, the fair market value of the contributed assets. In compliance with the provision under the new Corporation Law, the tax law was also amended. This amendment will apply to the issuance of new shares resolved on or after May 1, 2006.

Debt-equity swap (DES)

The above amendment raises an issue in relation to how much capital and capital surplus should increase in the case of a debt-equity swap where a loan with a face value lower than its fair market value is contributed to the debtor company. If capital and capital surplus increases

by the amount of the fair market value, the difference between the face value and the fair market value may be treated as debt forgiveness income. However, under the tax law, the definition of the fair market value of the loan is not clearly defined. Under Japanese GAAP, a reasonably appraised value such as the net present value of the future cash flow from the loan is used as the value which is used on the books of the creditor to record the value of shares received upon the debt-equity swap. It could be argued that such value should be considered the fair market value for tax purposes.

On the other hand, it is arguable that from the perspective of the debtor (the issuer of the shares), the value of the debt should be the face value of the loan. This position appears to be supported by the new Corporation Law, which provides that where the face value of the loan is used as the value of the contribution, a valuation of the contributed assets by a court appointed inspector is exempted. This suggests that for the purposes of the new Corporation Law, the fair market value is the face value. In any case, debt forgiveness income has not been recognized in most debt-equity swaps made by financial institutions and the amendment may affect this practice.

II Distribution of retained surplus

Distribution of retained surplus

Under the new Corporation Law, any form of repatriation, including not only dividends but also capital repayments, repurchase of shares, etc., are required to be made as a distribution of retained surplus. For example, if a cash distribution is made by way of a capital repayment, the transaction would consist of two steps: (i) a decrease in capital or capital reserve with a corresponding increase in retained surplus; and (ii) a distribution of retained surplus in cash. The retained surplus consists of earnings surplus and capital surplus (that is made out of reduction in capital or capital reserve).

While the distribution of retained surplus is made in accordance with the procedures for the declaration of a dividend, the tax treatment of the distribution will be determined based on the source of the retained surplus from which it was made. Thus, any distribution out of retained earnings will be treated entirely as a dividend whereas a distribution out of capital or capital reserve will be treated as a capital repayment resulting in shareholders taxation for dividend income and capital gain/loss. Before the reform, if a company distributed a dividend by decreasing the capital reserve, the distribution is treated entirely as dividend. After the reform, the amount of deemed dividend in case of distribution of retained surplus accompanied by the

reduction in capital reserve will be calculated in the same manner as a capital repayment (i.e., distribution of retained surplus accompanied by the reduction in capital).

The above amendment will apply to the distribution of earning surplus on or after May 1, 2006. Note that if the base period for the distribution ends before May 1, 2006, while the distribution is made on or after May 1, 2006, such distribution is governed by the old tax law.

Deemed dividend on treasury shares repurchased by corporation issuing different classes of shares

Before the reform, where a corporation repurchases its treasury shares, the amount of the repurchase price in excess of the capital attributable to the repurchased shares is deemed to be a dividend. The capital attributable to the repurchased shares is computed in accordance with the following formula:

$$\frac{\text{Capital and capital surplus}}{\text{Total shares issued}} \quad \times \quad \text{Number of shares repurchased}$$

In the above formula, even where a company has different classes of outstanding shares, the deemed dividend would be computed based on the total number of the issued shares including all classes of shares. The amended tax law provides that the capital attributable to the repurchased shares will be computed separately for each class of shares.

The above amendment will apply to share purchase made on or after April 1, 2006. With respect to a company which has issued different classes of shares as of April 1, 2006, a transitional measure will apply.(i.e., capital amount per each class of share should be computed by certain formula such as issue price basis, fair market value basis or etc.)

III Repurchase of treasury stock

Before the 2006 tax reform, treasury stock is considered an asset for tax purposes while it is debited to the capital account under the Japanese GAAP. The amended tax law provides that when treasury stock is repurchased, capital and/or capital surplus will be reduced by an amount equal to the repurchase price (less the amount of deemed dividend, if any), so that the tax treatment is consistent with the accounting treatment.

The above amendment will apply to treasury stock purchased on or after April 1, 2006, although a transitional measure will apply to treasury stock held as of March 31, 2006, i.e., the balance of capital surplus is required debited to the capital surplus account for tax purposes (the balance of capital surplus is reduced) in the tax return filed on or after April 1, 2006.

IV Issue of class of share

Allotment of new shares or rights to subscribe for new shares without additional contribution by shareholders

Under the new Corporation Law, a company can allot new shares or rights to subscribe for new shares without receiving additional contributions from existing shareholders. Under the old Commercial Code, a company can split its shares to achieve, economically, the same result. However, under the new Corporation Law, a different class of shares or rights can be allotted to existing shareholders (e.g., distribution of poison pill right). The amended tax law provides that the allotment of new shares/rights to existing shareholders will not be a taxable event for those shareholders to the extent such allotment will not be disfavor certain shareholders.

The above amendment will apply to the allotment made on or after May 1, 2006.

Exercise of right to request repurchase of shares/share subscription rights

Under the new Corporation Law, where a company has issued shares/share subscription rights with a right to request repurchase of the shares/share subscription rights upon request of the holders, the company may repurchase the in exchange for cash, share subscription rights or another class of shares.

The amended tax law provides that if the holders of the shares/share subscription rights receive only a different class of shares/share subscription rights as a consideration for the repurchase, the exchange will be made on a no gain / no loss basis to the extent that the value of the transferred shares/share subscription rights is equivalent to that of received.

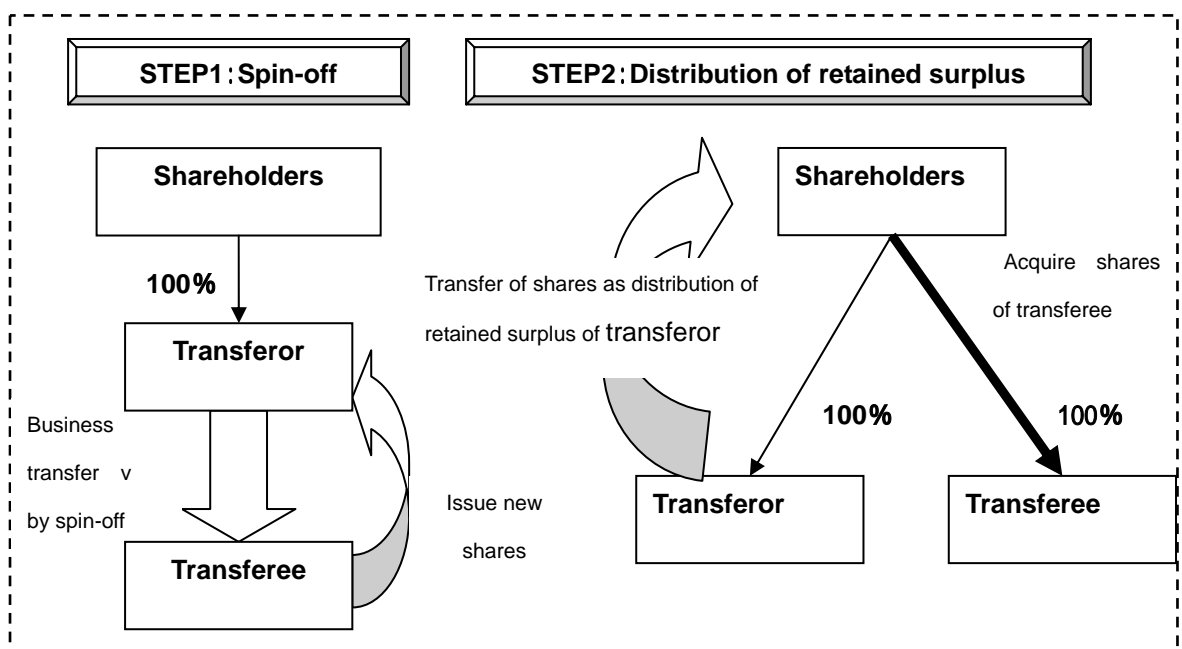
The above amendment will apply to requests for repurchases made on or after April 1, 2006.

V Tax reform in relation to the corporate reorganization

(1) Corporate split up

Under the new Corporation Law, the corporate split up is treated as a combination of two

transactions, i.e., a corporate spin off (drop down) followed by a distribution of shares of the transferee company to the transferor company's shareholders. In the corporate spin off, the transferor company will acquire shares of the transferee company as a consideration for transferring business or assets/liabilities via corporate spin off. Then, the transferor company will transfer the acquired shares to its shareholders as a distribution of retained surplus. In the old Commercial Code, it was unclear whether or not a corporation is able to distribute dividend with the assets other than cash. The New Corporation clarifies that any non-monetary assets will be eligible for distribution as retained surplus. This new form of distribution under the Corporation Law provides theoretical basis for considering the corporate split up.



Where non-monetary asset is distributed as retained surplus to the shareholders, any built-in gain or loss is realized at the time of distribution. Further, under the general tax treatment of the corporate reorganization, since the shares of the transferor will not be kept by the transferor, the spin off becomes disqualified and may trigger taxation for the transferor and shareholders. In order to avoid such taxation, the amended tax law revised the definition of both the corporate split out and tax qualified split out.

In the revised tax law, the corporate split out is defined as "consideration for spin off (ex, shares of the transferee company or other assets) is entirely transferred to the shareholders on the date of the spin off". Thus any transaction that does not satisfy this definition is not treated as "corporate split out" under the tax law, any may be subject to the taxation as a transaction of disqualified spin off followed by distribution of retained surplus. Any other requirements for tax

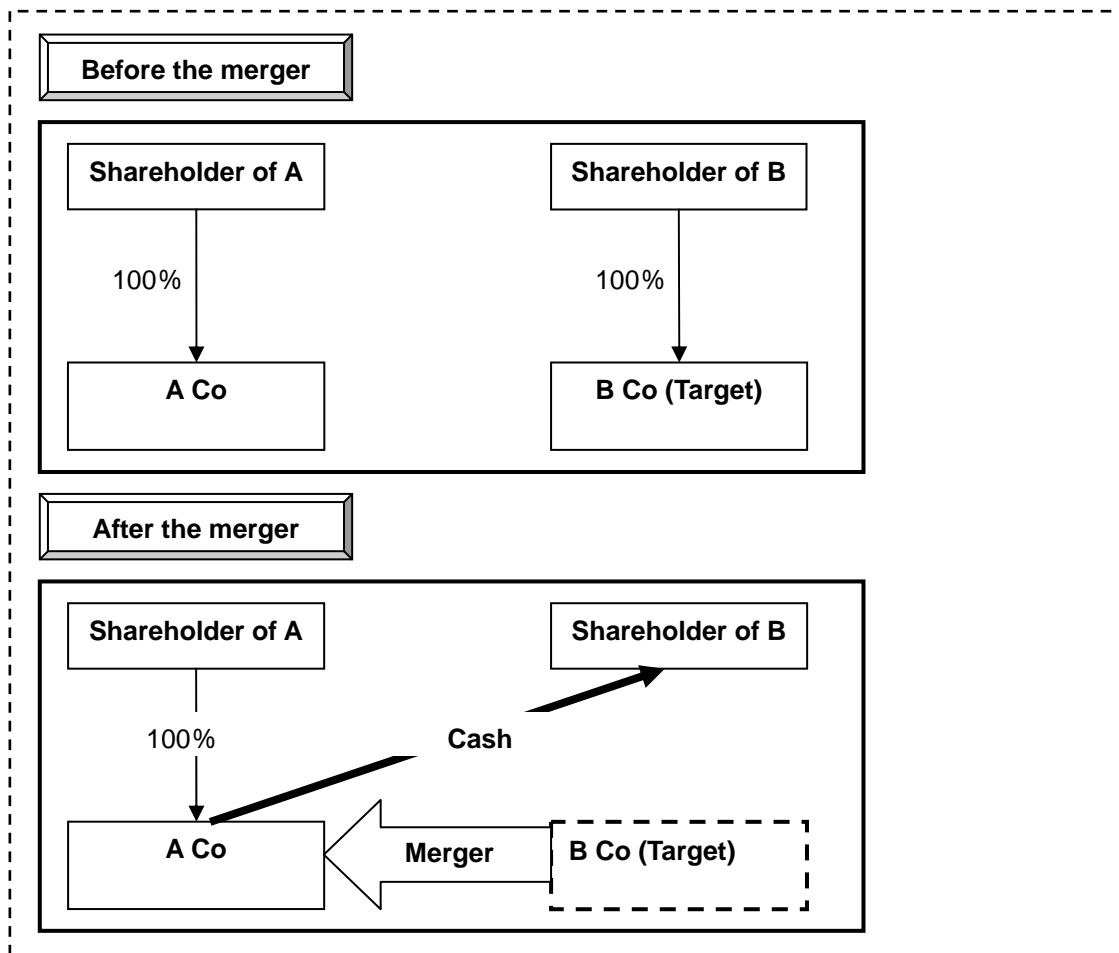
qualified split out (i.e., intra-group or joint business split out) remain the same before and after the reform.

(2) Relaxation in consideration paid for the corporate reorganization

Cash-out merger

One of the major purposes of the new Corporation Law is to enable corporation carries out corporate reorganization easier and in more flexible manner. Under the old Commercial Code, a corporation is not allowed to give assets to the shareholders of the target company instead of the shares of the acquiring company. Under the new Corporation Law, the acquiring company (A Co) is able to give any assets to the shareholders of target as consideration for the merger. This is called a “cash out merger”, in which an acquiring company can squeeze out shareholders of target after the merger.

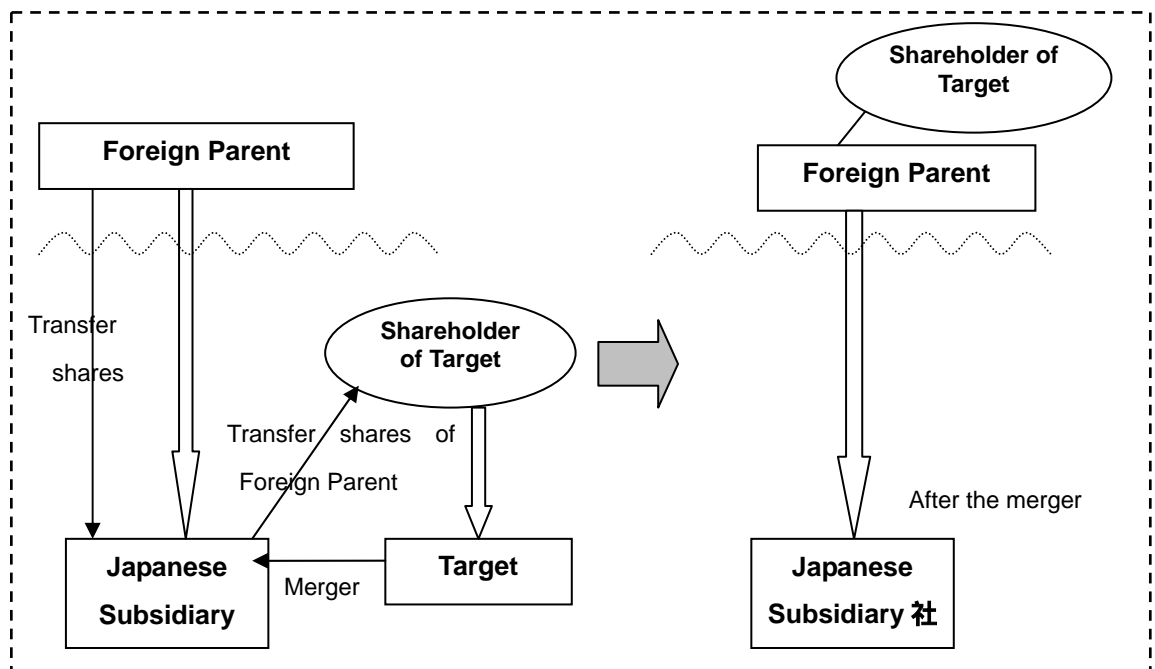
The above measures under the new Corporation Law is expected to take effect on May 1, 2007. Under the amended tax law, such cash out merger is treated as tax disqualified merger that will trigger taxation on the target company as well as its shareholders. It is necessary to keep an eye on the 2007 tax reform.



Triangular merger (cross border merger and acquisition)

Relaxation in consideration paid for the corporate reorganization under the new Corporation Law is considered to provide much opportunity for foreign corporations to acquire Japanese corporation. Since a foreign corporation is not able to merge directly with the Japanese target, a foreign corporation will have its subsidiary to merge out the Japanese target. After the provision for a relaxation in consideration paid for the corporate reorganization become effective (possibly May 1, 2007), shareholders of a target will be able to become those of a foreign parent.

Under the amended tax law, the triangular merger is not treated as tax qualified, however, it is not certain whether or not any amendment will be provided under the 2007 tax reform.



DES

As a result of the DES that is carried on or after May 1, 2006 pursuant to the New Corporation Law, the debtor company may recognize taxable gain equal to the difference of face value of the loan and increased capital / capital surplus. Before the tax reform, where a debtor company has filed an application for corporate rehabilitation proceeding or similar events provided under the tax law, the deduction of expired tax losses is allowed up to a certain amount including the debt forgiven gain. The amended tax law provides that the deduction of expired tax losses will also be used for offsetting gain arising from debt-equity swap (i.e., gain from the extinguished debt by converting into capital).

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