JAPAN

Country M&A Team

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1. General Introduction

1.1 General Comments on M&A in Japan

This chapter details the main issues relevant to purchasers and sellers of the transfer of ownership in a Japanese company or business.

Non-tax considerations normally play a major role in determining the form taken by Japanese M&A transactions (e.g. regulatory or licensing issues, employment laws,etc.). Some of these considerations are noted where appropriate in this chapter.

1.2 Corporate Tax

1.2.1 General Tax Regime

The Japanese corporate income tax generally consists of a national tax, prefectural and inhabitants taxes, and an enterprise tax.

The corporate tax rates are as follows:

- corporations with paid-in capital of over JPY100 million: 30%
- corporations with paid-in capital of JPY100 million or less:
  - first JPY8 million of taxable income 22%
  - over JPY8 million of taxable income 30%

The inhabitants' tax is a local tax consisting of prefectural and municipal taxes. It is levied on a corporation in each prefecture in which the corporation has an office to carry on its activities and is computed as a percentage of the corporation tax. The allocation to each local jurisdiction is based on the number of employees. In addition, each local Government levies an equalisation per capita tax on each corporation that has an office or business place in its jurisdiction. This equalisation tax varies depending on the amount of paid-in capital, plus capital surplus, and the number of employees.

The enterprise tax is a prefectural tax levied on a corporation in each prefecture in which the corporation has offices to carry on its activities. For a corporation with paid-in capital of JPY100 million or less, the enterprise tax liability will be calculated simply by multiplying the taxable income that is allocated to each prefecture by the appropriate tax rate. The allocation is generally made on the bases of the number of employees. The rates vary depending on the amount of the corporation's taxable income. For a corporation with paid-in capital exceeding JPY100 million, the enterprise tax liability will be the sum of three different factors (i.e. an income-based factor, a capital factor and a value-added factor), each with its own tax rate and calculation rules.

The effective tax rate (including local enterprise and inhabitants' tax) is generally around 42% for businesses with income exceeding JPY8 million since the enterprise tax is deductible in computing the taxable income. However, the effective corporate tax rate may differ depending on the amount of corporate taxable income and the way the enterprise tax is calculated.

1.2.2 Tax Losses

Tax losses may be carried forward in Japan for seven years for losses incurred in fiscal years beginning on or after 1st April 2001. Currently, the tax loss carry back provision is suspended for tax losses arising in years ending through 31st March 2006. However, tax losses may currently be carried back for tax losses incurred by small and medium sized corporations (i.e. a corporation whose capital is JPY100 million or less and 50% or more of its stock is not held by a "large company", including foreign company) in their first five years of operation. Such losses may be carried back one year upon application by the taxpayer.

A change in the ownership of shares in a company, or a change in the nature of a company's business, does not give rise to the expiration or limitations on the use of tax losses in Japan. "Latent" tax losses (e.g. the difference between the Japanese tax book value of assets and their actual market value) are generally not realised until a taxable event (e.g. a sale of the assets or a transfer of assets pursuant to a merger).

1.2.3 Taxation of Dividends

Dividends, net of attributable financing costs, which are received by a Japanese company (ParentKK) from another Japanese company (SubKK), may be excluded from the taxable income of ParentKK provided that ParentKK owns 25% or more of SubKK. If ParentKK owns less than 25% of SubKK, only 50% of the dividends from SubKK, net of attributable financing costs, may be excluded from the taxable income of ParentKK. There are also special rules relating to minority shareholding and investment trusts and certain types of interest that may be excluded from the above definition of financing costs that should be considered.

However, exclusion from taxable income is not permitted for dividends on shares that were acquired within one month prior to the year-end of the company paying the dividends concerned and sold within two months after the same year-end.

The Japanese income tax (at 20%) that is withheld by the Japanese dividend-paying company is generally recoverable by the recipient either as a credit against its tax liability or a refund, if the recipient is in a tax loss position. There may be situations where the credit is not available and the recipient may only report the withheld tax as a deduction against income.

1.3 Withholding Taxes

Japanese-sourced dividends, interest, royalties, service fees, and rent received by a foreign corporation are generally subject to withholding tax at the rate of 20% under Japanese domestic law. Service fees that are not sourced in Japan and remittances of branch profits are not subject to withholding tax.

Japan has a comprehensive network of double tax agreements, which operate to reduce withholding tax and exempt business profits derived by a company resident in a treaty country that does not have a permanent establishment in Japan.

Where a non-resident entity conducts its operations in Japan through a permanent establishment (e.g. a branch), the above mentioned Japan-sourced income would be subject to tax under the same procedure as that applicable to a resident entity.

Under the new Japan-U.S. Tax Treaty (Treaty) which was ratified on 30th March 2004, withholding taxes on payments between the two countries were significantly reduced. Beginning from 1st July 2004, all royalties paid by residents of one contracting State to residents of the other may be paid without being subject to withholding tax at source. The Treaty also eliminates withholding tax at source on dividends where the shareholder owns more than 50% of the dividend-paying company. The withholding tax rate on dividends is reduced to 5% where the beneficial ownership is between 10% and 50% and the rate is reduced to 10% where the beneficial ownership is less than 10%. However, complex rules and detailed tests in order to substantiate treaty entitlements have been included in the Treaty. These tests, in the form of a comprehensive limitation of benefits test, anti-conduit rules for certain income, and the legal concept of beneficial ownership, must be fully complied with by taxpayers when submitting their treaty relief forms.

The payment of a royalty and interest to foreign related parties will be subject to the Japanese transfer pricing regulations (and thin capitalisation rules for interest).

1.4 Consumption Tax (GST/VAT)

Japanese consumption tax (currently 5%) applies to goods sold and services rendered in Japan (excluding shares or securities but including goodwill). Export and certain services invoiced to non-residents are zero-rated. Such tax may be recoverable by the payers depending on their consumption tax recovery position. Typically it would not be recoverable for an individual who is not registered for consumption tax purposes. It may only be partially recoverable for a company in the financial sector and fully recoverable for manufacturing or other service companies.

1.5 Stamp Tax

Stamp tax ranging from JPY200 to JPY600,000 is payable on documents which require formal stamping to have legal effect. This includes agreements for the sale of certain assets. Stamp tax is generally payable by the purchaser, unless otherwise stated in the agreement.

1.6 Other Relevant Taxes

Where compulsory registration of real property applies, there is an imposition of registration and licence tax. This also applies on the registration of a company or branch. The rate varies depending on the type of property.

2. Acquisition

2.1 The Preference of Purchasers: Stock vs. Asset Deal

In many situations, the purchaser and seller could have conflicting interests regarding whether to structure the transaction as a sale of shares or assets.

For purposes of corporate taxation, there is no distinction between the taxation of capital gains on the sale of shares or assets. However, in some cases, purchasers may want to purchase only selected assets or businesses to avoid issues such as acquiring contingent or unrecorded liabilities, or incurring a substantial amount of time and expense in completing a due diligence if shares are acquired. The purchase of a business may also enable the purchaser to report and deduct amortisable goodwill.

Further, a purchaser may prefer to acquire assets, for example, where the target does not have attractive tax attributes, such as tax operating loss carryovers or there is an intention to integrate those assets into its existing business.

2.2 Stock Acquisition

Generally, an acquisition of a Japanese company is achieved through a direct acquisition by a foreign investor of the shares in the Japanese company. Where a purchaser intends to exit in subsequent years, it may wish to use an appropriate holding company in the U.S., Netherlands, Switzerland or Germany as the Japanese tax treaties with these countries provide exemptions from Japanese tax on gains from the sale of shares in a Japanese corporation.

An acquisition of the target's shares will permit the survival of any Japanese corporate tax attributes of the target, including tax net operating loss carry forwards. However, where a premium is paid to acquire shares, the goodwill arising from the purchase of shares is not amortisable to the purchaser for Japanese tax purposes.

The target's tax basis in its assets remains unchanged in connection with a share purchase, as there is no change in the tax attributes of the target. Further, there would not necessarily be any costs from the transfer of employees, which tend to be normal features of asset purchases. On the other hand, subsequent decisions made by the purchaser regarding personnel issues may be constrained by the target's existing work rules, severance and retirement plans.

Currently, Japanese accounting principles do not require extensive financial statement disclosures and permit, in certain situations, the recording of assets and liabilities off balance sheet in the financial statements of non-consolidated subsidiaries. It is expected that several new accounting rules, including an accounting policy for stock options, will be introduced to improve the level of disclosures in the financial statements.

2.3 Asset Acquisition

If a purchaser does not have a presence in Japan, it could form a domestic corporation (e.g. a KK) that would purchase the assets and take over the business operation of the Target Company.

Any accumulated tax net operating losses of the target will remain with the target under an asset acquisition.

An asset acquisition will generally allow the purchaser to avoid exposure to contingent or unrecorded liabilities. These liabilities will remain with the seller unless they are contractually assumed by the purchaser under the sale and purchase agreement.

However, asset acquisitions are more likely to encounter regulatory difficulties. Many industry sectors are subject to one or more forms of regulation or licensing. Obtaining consent to transfer licences (or perhaps more accurately, obtaining a new licence) can be a long process.

Employment law can also be a key issue, as the transfer of employees in an asset (or business) transfer requires each transferring employee's individual consent.

From a tax perspective, an asset purchase at above historic tax basis will allow a step-up of its tax basis. Goodwill, in particular, may generally be amortised on a straight-line basis over a five-year period, provided it has also been recognised for financial accounting purposes. A valuation to support any goodwill paid should be considered to avoid any issues being raised at a later tax audit.

One point of detail to note in the case of an asset acquisition relates to provisions for retirement benefits. Japanese companies often operate unfunded pension arrangements, where provisions are simply set up on the companies' own balance sheets. These provisions are generally non-tax deductible. In the event of a business disposal by means of an asset transfer, the purchaser may be paid by the seller to take over these pension liabilities. This amount would be taxable income to the purchaser in the period in which it is received. However, the purchaser would not receive an immediate tax deduction for setting up a corresponding provision on its own balance sheet. Thus, the failure to plan in advance may result in an unexpected "up-front" tax liability to a purchaser.

2.4 Transaction Costs to Purchasers

2.4.1 Consumption Tax (GST/VAT)

- Stock Deal

  Consumption tax does not apply to the sale of stock.

- Asset Deal

  Consumption tax is imposed on the transfer of assets, including goodwill. Consumption tax is neither imposed on the transfer of monetary assets, such as cash or receivables, nor land. Consumption tax that is paid by the purchaser may be recovered, depending on the purchaser's consumption tax position.

2.4.2 Stamp Tax

- Stock Deal

  No stamp tax is payable on an agreement for the sale of stock.

- Asset Deal

  Stamp tax is payable on documents which require formal stamping to have legal effect. This includes agreements for the sale of real property, intangible assets, or businesses, agreements for corporate reorganisations, and stock certificates. Stamp tax is generally payable by the purchaser, unless otherwise stated in the agreement.

2.4.3 Registration and Licence Tax

- Stock Deal

  Registration and licence duties are not applicable to stock acquisitions.

- Asset Deal

  Registration and licence duties are imposed on the registration of real property or intangible assets, a company's commercial registration, as well as other transactions. For example, where title to real estate is transferred and the new owner is registered, tax may be imposed on the value of the real estate that is transferred.

  A registration and licence tax will also be imposed when new share capital is issued (e.g. when an acquisition company is incorporated and funded in order to complete an asset acquisition). The current tax rate is 0.7% of the amount of capital that is allocated to the paid-in capital account (or 0.15% in the case of capital increase in the course of a merger to the extent of the former share capital of the disappearing company).

2.4.4 Assets Transfer Tax (Real Property Acquisition Tax)

The acquisition of real property (e.g. land, building and factory) is subject to a real property acquisition tax at the rate of 3% or 4% of the asset value. The tax rate that will apply depends on the date of acquisition.

2.4.5 Concessions Relating to M&As

No consumption tax is imposed in the case of a merger or a spin-off. In the case of a contribution in-kind, consumption tax is imposed. It is, however, calculated based on the value of the shares issued in exchange for the transferred assets and liabilities (i.e. upon the net value of the assets and liabilities. (See section 5 for more detailed information regarding M&As.)

The consent of each employee who will be transferred to the transferor is required in the case of a business transfer, although this is not required in the case of a spin-off and merger.

2.4.6 Tax Deductibility of Transaction Costs

- Stock Deal

  Acquisition costs incurred by a Japanese company with respect to the acquisition of shares in another Japanese company are not deductible. Such costs may be capitalised and deductible for tax purposes when the shares are sold.

- Asset Deal

  For asset acquisitions, the cost of the acquisition (including professional fees, taxes, and charges) should, to the extent identifiable, be added to the cost of the relevant assets that are acquired. The tax treatment of these costs should then correspond with the tax treatment of the underlying assets (i.e. depreciable, amortisable or tax deductible when the assets are finally sold).

3. Basis of Taxation Following Stock or Asset Acquisition

3.1 Stock Acquisition

The purchase price generally constitutes the purchaser's tax basis in the purchased stock. The tax basis in the underlying assets does not change. Therefore, a stock acquisition would not allow the purchaser to maximise the tax benefits which are generally available in an asset deal.

3.2 Asset Acquisition

The purchaser's basis in the target's assets, for Japanese tax purposes, will determine the amount of allowable depreciation and the cost of goods sold that may be deducted for purposes of determining the purchaser's taxable income after the acquisition. The purchaser will take a cost basis in an asset acquisition and will be required to allocate the purchase price among the assets acquired for purposes of calculating future depreciation deductions to be reported.

If the target's fair market value (including any goodwill arising from the asset acquisition) exceeds the adjusted tax basis of its assets, an asset acquisition allows the purchaser to record the assets at their respective fair market values and obtain tax deductions for depreciation and amortisation.

4. Financing of Acquisitions

4.1 Thin Capitalisation

The Japanese thin capitalisation rules provide for a 3 to 1 debt:equity ratio and apply to all companies having interest-bearing debt due to foreign related parties. The portion of interest expense that exceeds this ratio is permanently disallowed as a deduction. This excess interest may still be subject to withholding tax.

The rules state that interest expense will be permanently disallowed to the extent that the average balance of interest-bearing indebtedness to a foreign-controlling shareholder (who owns at least a 50% direct or indirect ownership interest) exceeds three times the net equity of the foreign-controlling shareholder in the debtor company. However, if the total interest-bearing debt of the debtor company is less than three times its net assets, then the thin capitalisation rules do not apply.

Net assets will not be less than the capital account (i.e. paid-in capital and capital surplus). Therefore, if there is a deficit in retained earnings, then the capital account is deemed to be the net assets of the company.

Third-party loans guaranteed by a related foreign party will not be subjected to the thin capitalisation rules.

The thin capitalisation rules provide a comparable company ratio exception, which is determined based on standards similar to those that should be used under a transfer-pricing context. Under this exception, it is permissible to use a ratio that is higher than 3:1, if such ratio is also used by a specific Japanese company of similar size conducting similar business activities. It should be noted, however, that the tax authorities take a very strict position on the comparability exception.

4.2 Deductibility of Interest

4.2.1 Stock Acquisition

Interest incurred by a Japanese company on funds used to acquire shares in another Japanese corporation is not tax deductible in the year that the company receives a dividend from a Japanese corporation since the dividend from a Japanese subsidiary to a Japanese shareholder is generally tax-free.

4.2.2 Asset Acquisition

The debt to equity ratio of the Japanese company could be structured so that it is within the scope of the conditions stated under the thin capitalisation rules (see section 4.1) to maximise the interest deduction.

Since the Japanese national and local tax rates are relatively high, the use of debt financing could reduce the Japanese company's overall tax liability.

5. Reorganisations and Share-for-Share Transactions

5.1 Corporate Reorganisations

Under the corporate reorganisation rules, assets and liabilities may be transferred at their tax basis such that no taxable gain or loss would be recognised, provided that certain conditions are met. As a result, the capital gain or loss that would be realised on the transfer will be deferred.

Currently, if cash or assets (other than shares) are paid to the transferor, the merged company or shareholders of the transferor/merged company as consideration, the assets must be transferred at their fair market value (i.e. the transaction will be a taxable reorganisation).

The corporate reorganisation rules apply to the following types of corporate reorganisations:

- qualified corporate spin-offs and split-ups;
- qualified investment (contribution) in-kind;
- qualified post-establishment transfers; and
- qualified mergers.

5.1.1 100% Ownership in Subsidiary

A transfer of a business unit to a new or existing wholly-owned subsidiary in return solely for shares/stock in the subsidiary may be accomplished on a tax-free basis. No other tests need to be satisfied.

5.1.2 More than 50% Ownership in Transferee Corporation

Tax-free transfers of a business unit to a less than 100% owned subsidiary may be accomplished if the transferor owns more than 50%, directly or indirectly, in the transferee corporation and the following conditions are satisfied:

- transfer of business unit – it is expected that about 80% or more of the employees in the transferred business unit will continue to be engaged in the transferred business at the transferee corporation;

- continuing business requirement – the business that is transferred will continue to be operated by the transferee corporation after the transfer;
- the principal part of the business assets and liabilities used in the transferred business unit will be transferred to the transferee corporation; and
- in case of spin-offs and split-ups, more than 50% of the existing ownership is expected to continue after the spin-off or split-up.

5.1.3 Joint Business Reorganisation (50% or Less Ownership)

In the case of a reorganisation between two companies that share a group relationship of less than 50% (i.e. a joint business reorganisation), the reorganisation may still be treated as a qualified reorganisation if the following conditions are satisfied:

- the conditions for a tax-free transfer applicable to a more than 50%-owned subsidiary as stated above are satisfied;
- continuing shareholding requirement (this is not required for a corporation with the number of shareholders exceeding 50) – in general, more than 80% of the former shareholders of the transferor corporation must continue to hold the shares of the transferee corporation;
- business relevancy requirement – the business transferred by the transferor and one of the businesses of the transferee must be relevant to each other; and
- comparable business size requirement – either of the following must be satisfied:
  - the ratio of either sales, number of employees, or other appropriate measure, of the transferred business unit and the transferee's relevant business must be no greater than 5:1; or
  - if the above cannot be met, this condition will still be satisfied if the transferor corporation sends at least one of its management-level persons to the management of the transferee corporation.

5.1.4 Investment In-Kind

An investment in-kind, or contribution to capital, which generally meets the above conditions may be accomplished on a tax-free basis. Under this scenario, an entire business unit need not be transferred, but single assets may be transferred as a contribution to capital on a tax-free basis if it is made to a wholly-owned subsidiary. Transfers to less than 100% affiliated companies may be made tax-free if the transfer is of a business unit, and the requirements discussed above are met. (See sections 5.1.2 and 5.1.3.)

5.1.5 Post-Establishment Transfer

Under a post-establishment transfer, the transferor corporation first incorporates a new corporation (transferee corporation) via a cash contribution and the transferee corporation then uses the cash to purchase the transferred assets. This transaction may be accomplished tax-free if the following conditions are satisfied:

- the transferor company held all of the outstanding shares of the transferee company throughout the period up to and including the asset transfer;
- the transferor company expects to continue to hold all of the outstanding shares of the transferee company;

- the assignment of assets was planned at the time of the establishment of the subsidiary, and the assets were actually transferred within six months from the establishment of the subsidiary; and
- the amount of cash paid to the transferor company is approximately the same as the amount contributed by the transferor company to the transferee company.

5.1.6 Merger

In general, a tax-free merger may be accomplished if the above-mentioned conditions are satisfied. All assets and liabilities of the merged company are transferred to the surviving company at the tax basis (tax book value). Thus, no taxable gain or loss will be incurred with respect to the merger. There will be no deemed dividend payment with respect to the liquidation of the merged company. Note that a cancellation loss on the merged corporation shares held by a merging corporation at the time of the merger will not be tax deductible.

Thus, the merger will be tax-free if:

- the merger of 100% affiliated group companies is solely for stock;
- the merger of more than 50%, but less than 100% affiliated companies, meets the conditions in section 5.1.2; or
- the merger of less than 50% affiliated companies meets the conditions in section 5.1.3.

5.1.7 Restriction on Using Carried Over Losses

In a tax-free merger, the tax losses of the merged company will be carried over to the surviving company if certain conditions are satisfied. In general, tax net operating losses that arose while both companies were owned by the same interests (group years), may be carried forward in a tax-free merger. There are limits placed on tax net operating losses carried over from pre-group years as well as limits on built-in losses.

The limitations on the use and carry over of tax losses apply equally to both the merged company and the surviving company.

In the case of spin-offs, split-ups (except for split-ups which may be regarded as merger equivalent), or contributions in kind, the tax losses will remain with the transferor corporation.

5.2 Stock-for-Stock Exchanges and Transfers

Under a stock-for-stock exchange (Kabushiki Kokan), the issued and outstanding shares that are held by shareholders of a company that will become a 100%-owned subsidiary (Company B) will be transferred to a company that will become the 100% parent company of Company B (Company A). Company A will issue new shares to Company B's shareholders in exchange for the shares in Company B.

Under a stock-for-stock transfer (Kabushiki Iten), shares of a company that will become a 100%-owned subsidiary (Company B) which are held by Company B's shareholders will be transferred to another newly established company (Company A). Company A will issue new shares to Company B's shareholders so that Company A will become the 100% parent company of Company B.

The recognition of the capital gain that would be realised by the shareholders of Company B on the transfer of Company B's shares pursuant to a stock-for-stock exchange or transfer for tax purposes is deferred, provided the following conditions are satisfied:

- Company A reports the shares obtained from the former Company B shareholders at an amount that is equal to or less than the total book value (or tax basis) of the shares that were held by the Company B's shareholders prior to the stock-for-stock exchange or transfer; and

- the total amount of shares that the Company B's shareholders should receive as a result of the stock-for-stock exchange or transfer should be at least 95% of the consideration that is received.

  If the number of shareholders in Company B is 50 or more, the book value of the Company B shares that must be recorded by Company A is the net asset book value (for tax purposes) of Company B immediately before the stock-for-stock exchange or transfer.

  When cash or other assets are granted to the Company B shareholders at the time of the stock-for-stock exchange or transfer, gain or loss must be recognised. The amount of the gain or loss is equal to the amount of the cash or other property (at their fair market value) received less the book value of the shares transferred that is allocable to the cash or other property received.

5.3 New Corporation Law

A new Corporation Law (Law) was passed by the Japanese Diet on 29th June 2005 and promulgated by the government on 26th July 2005 (to be effective in May 2006 although the exact timing has not been determined). The purpose for the Law is to modernise 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.

In the area of corporate M&A, the Law provides greater flexibility in reorganising companies as well as the implementation of counter measures against hostile takeover attempts. For example, the Law relaxes the rules relating to the type of consideration that may be used for merger transactions as well as cross-border M&A transactions so that in-kind dividends of shares may be used to reorganise a company. In addition, cash as well as foreign shares may be used as consideration to be paid to shareholders of the non-surviving company in a reorganisation (i.e. a so called triangular merger will become possible, although it will be a taxable merger unless the Japanese corporate tax law is changed to allow for such merger to be tax-free).

The Law also allows for simple corporate mergers that do not need shareholders' approval. For example, under a simplified reorganisation (e.g. merger and spin-off), 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 reorganisation in which a Japanese controlling corporation which owns 90% or more of the voting rights of a controlled corporation may complete a reorganisation (including merger) without approval of a shareholders' meeting by a controlled corporation.

Further, it allows for a reorganisation (i.e. merger, spin-off and share exchange), even if it may result in a capital deficit to the surviving company or transferor company. Such capital deficit may be recognised from a merger where the acquired entity has a capital deficit or the consideration to be paid for the merger is greater than the net assets of the acquired entity. Under the current Japanese Commercial Code, such merger or other reorganisation that would result in a capital deficit is not permitted.

The portion of the Law relating to the relaxation of the type of consideration that may be used for mergers and other types of reorganisation 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 counter measures for possible hostile takeovers (e.g. poison pills).

6. Other Structuring and Post-Deal Issues

6.1 Repatriation of Profits

The payment of royalty and interest will be subject to the Japanese transfer pricing regulations (and thin capitalisation rules for interest). See sections 1.2.3 and 1.3 for a discussion of the withholding tax implications relating to the payment of dividends, royalties, and interest paid to Japanese shareholders and foreign shareholders.

6.2 Losses Carried Forward and Unutilised Tax Depreciation Carried Forward

Please refer to sections 2.2 and 2.3.

6.3 Tax Incentives

Tax incentives enjoyed by a target are generally preserved through a stock deal.

Where the target enjoys any tax incentives, these would generally be lost when the business is transferred through an asset deal.

6.4 Group Relief

Japanese tax law allows for the filing of consolidated tax returns by a Japanese company and its 100% owned Japanese subsidiaries. Adoption of the consolidated tax system is optional but it has to be continuously applied once elected, and all of the 100% subsidiaries are subject to consolidation without exception.

Parent companies should file tax returns and pay taxes on the consolidated corporate income. The system applies only to the national corporation tax. The local inhabitants taxes and local enterprise tax will continue to be imposed on each member company.

The parent company and its subsidiaries will be jointly and severally liable for tax liability. Tax allocation will be made according (and limited) to each company's taxable income or tax liability. The parent company will pay the tax on behalf of the entire group and later seek tax reimbursement from its subsidiaries, or record it as a credit on its books until receipt of payment from the subsidiaries.

The recognition of profits or losses from intra-group transactions will be deferred until the assets are transferred to a party outside the consolidated group when the consolidated group dissolves, or when a member company withdraws. However, this rule will not apply to transfers of inventory (i.e. no deferral of profits or losses is allowed).

With very limited exceptions, the only tax losses incurred pre-consolidation which may be utilised against consolidated profits are those of the parent company of the consolidated group.

Immediately before consolidating (or after joining a group), subsidiary companies will generally be required to separately recognise gains/losses and pay tax on the built-in gains. This rule will not apply to the parent company or to subsidiaries that have been associated with the parent for a certain period. This rule will not apply to companies joining the group under a tax-qualified reorganisation, excluding a Kabushiki Iten transaction.

7. Disposal

7.1 Preference of Sellers: Stock vs. Asset Deal

A seller of a profitable business is more likely to be interested in selling shares since this may mitigate the consequences of possible double taxation on gains at both the corporate and shareholder levels.

However, where the seller has operating loss carry forwards which are available to shelter gains on appreciated assets, a seller may be willing to dispose of its assets.

There is no distinction under Japanese corporate tax law between capital gains and ordinary income. In most cases, the tax and accounting basis in the assets should be the same since there is a close degree of book and tax conformity (e.g. in the case of depreciable assets).

7.2 Stock Sale

7.2.1 Profit on Sale of Stock

Gains realised by a Japanese seller company from the sale of stock are included as income to the seller and taxed at the normal tax rates.

Under Japanese domestic tax law, a disposal of shares by a non-resident will be subject to Japanese law if the non-resident seller owns 25% or more of the shares in a Japanese company and sells 5% or more of the shares during the taxable year.

Gains derived by a foreign seller on the disposition of shares of a Japanese company may not be subject to Japanese tax, if the seller is a resident of a country with which Japan has a treaty and the treaty exempts profit from the sale of shares in a Japanese company from Japanese tax.

Capital gains derived by an individual seller from the sale of stock are taxed separately from other income. There is no distinction between short-term and long-term gains.

In principle, net capital gains are subject to a flat 15% national tax and an additional (non-deductible) local tax of 5%, for a total of 20%.

However, for the period from 1st January 2003 to 31st December 2007, an individual shareholder will be subject to tax at the rate of 10% (7% national tax and 3% local tax) for transfers of listed shares under certain circumstances. Individual sellers who have losses in the same income category may deduct such losses against share gains in the same year. Individual sellers may not generally carry forward losses.

7.2.2 Distribution of Profits

Capital gains may be distributed as dividends to the shareholders without any restrictions. See sections 1.2.3 and 1.3 for a discussion of the withholding tax implications relating to the payment of dividends to Japanese shareholders and foreign shareholders. Please see also section 6.1 on repatriation of profits.

7.3 Asset Sale

7.3.1 Profit on Sale of Assets

A business may be transferred from one entity in Japan to another by way of a sale of the assets and liabilities of the business (Business Transfer) at fair market value for Japanese tax purposes. The seller will record profit or loss for Japanese tax purposes based on the difference between the proceeds received for the transfer and the book value of the business that is transferred.

The difference between the transfer price and the fair market value of the assets and liabilities in the Business Transfer will generally be treated as goodwill for Japanese tax purposes. A payment received by the seller for goodwill will be included in its taxable profit, but any carried forward tax net operating losses of the seller may be used to offset against such taxable profit.

In the absence of real estate or marketable securities or goodwill, it may be possible to structure the Business Transfer so that most of the business assets are transferred at net book value without the recognition of taxable gain.

In the case of asset disposals by non-resident companies, both national and local corporate income taxes will arise if the asset is held through a Japanese permanent establishment. If the assets are not held through a Japanese permanent establishment, taxation will be limited to national corporate income tax on profits from the disposal of Japanese shares or Japanese real estate. Some, though not all, Japanese double tax treaties exempt capital gains on certain categories of asset.

7.3.2 Distribution of Profits

Capital gains may be distributed as dividends to the shareholders without any restrictions. See sections 1.2.3 and 1.3 for a discussion on the withholding tax implications relating to the payment of dividends paid to Japanese shareholders and foreign shareholders. Please see also section 6.1 on repatriation of profits.

8. Transaction Costs for Sellers

8.1 Consumption Tax (GST/VAT)

The seller of assets is required to collect Japanese consumption tax (current rate is 5%) from the purchaser in connection with a sale of assets that are located in Japan. Depending on the seller's consumption tax position, it may be required to remit to the tax authorities the excess of consumption tax collected over consumption tax paid.

8.2 Stamp Tax

As stated previously, stamp tax is generally payable by the purchaser, unless otherwise stated in the agreement.

8.3 Concessions Relating to M&As

No consumption tax is imposed in the case of a merger or a spin-off. In the case of a contribution in-kind, consumption tax is imposed, however it is calculated based on the value of the shares issued in exchange for the transferred assets and liabilities (i.e. upon the net value of the assets and liabilities). Please see section 5 for more detailed information regarding M&As.

The consent of each employee who will be transferred to the transferor is required in the case of a business transfer, although this is not required in the case of a spin-off and merger.

8.4 Tax Deductibility of Transaction Costs

Transaction costs may generally include legal fees, any costs required to conclude the sale agreement, arrangement fees, etc. Such costs should generally be deductible to the seller.

9. Preparation of Target for Sale

9.1 Distribution of Surplus Cash

Dividends paid from a Japanese subsidiary to a Japanese corporate shareholder (a corporation) may be partly or wholly non-taxable, subject to certain conditions. There may be an incentive for a seller to extract the maximum possible value from a subsidiary by way of a dividend prior to its disposal.

The Japanese Commercial Code provides the following rules to the payment of dividends:

- dividends may be paid on an annual basis after approval at the annual general shareholder's meeting; a Japanese company whose business year is one year may stipulate in the Articles of Incorporation that it may distribute an "interim dividend" by resolution of the Board of Directors, only once per year, and within three months after a fixed date stipulated in the Articles of Incorporation.

  Under the new Corporation Law (to be effective in May 2006 although the exact effective date has not been determined), Japanese companies will be able to pay dividends whenever and as many times during the fiscal year as they want, subject to a shareholders resolution (under the current Law, only at an annual general shareholders meeting) unless the Articles of Incorporation stipulate that a dividend may be paid by a board member's resolution where the Board of Directors as well as an independent auditor exists. Interim dividends as described above will remain. However, the Law stipulates that regardless of the size of the capitalisation, companies with net assets of less than JPY3 million may not pay dividends to shareholders even if they have enough retained earnings to do so, in order to protect the interests of creditors.

  Please refer also to section 6.1 on repatriation of profits.

9.2 Transfer Assets to be Retained to Another Affiliate

For assets that will be retained, the seller may want to transfer (e.g. via spin-off and split-off) the target's assets (that will not be sold to the purchaser) to another Japanese affiliate and then sell the shares in the target to the purchaser. Alternatively, the seller may want to transfer the assets to be sold to another Japanese Company and then sell the shares of that Japanese company.

10. De-mergers

A de-merger usually takes place through the sale of assets or a business. The implications of a de-merger should be the same as an asset deal as discussed in sections 2.3 and 7.3.

11. Listing/Initial Public Offer (IPO)

After acquiring a target, a financial buyer generally looks for an exit route either through a sale or an IPO. Since the objectives of a financial buyer are to maximise its return on investment and optimise its exit multiples, any profits derived from the exit route through an asset or stock sale are generally regarded as income subject to tax. To realise profits in a tax efficient manner, an appropriate structure should be put in place to effect the acquisition.

For a non-Japanese resident, there are no special tax laws or regulations applicable to capital gains arising from an IPO in Japan (preferential tax treatment exists for an individual resident investor). Therefore, profits derived from an IPO by a financial buyer may be subject to tax in Japan, as the gains will be regarded as income, unless the shares are held through a company that is resident in a treaty country that exempts such gains.