



# Financial Services Tax News

Financial Services Tax Group

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## The New Corporation Law and its Restrictions on Para-foreign Corporations (Article 821)

The new Corporation Law ("New Law") was passed by the Japanese Diet on June 29, 2005 and proclaimed by the government on July 26, 2005 (Law No. 86 of Japan) ("*Kaisha ho*"). During Diet sessions enacting the New Law, the Diet focused on the impact of Article 821 of the New Law on "para-foreign corporations," or certain foreign corporations that operate in Japan in branch form, and on concerns raised by the foreign business community in Japan that Article 821 could produce unfair and severe tax burdens unintended by the Diet. This issue focuses on the debate that occurred over Article 821 during the Diet session enacting the new law and the supplemental resolution of the Diet regarding Article 821.

### 1. Article 821 places restrictions on para-foreign corporations

Under Article 821, a para-foreign corporation is defined as a foreign corporation (a corporation incorporated under the laws of a foreign jurisdiction) doing business in Japan in branch form if: 1) the foreign corporation has its substantial head office in Japan; or 2) the main purpose of the foreign corporation is to conduct business in Japan. Article 821 imposes joint and several legal liabilities on individuals who transact on behalf of or in the name of the para-foreign corporation (e.g. the representatives or directors of the para-foreign corporation) and thereby hampers the ability of para-foreign corporations to operate in Japan.

Broadly, Article 821 appears to be targeted at corporations that avoid the governance provisions of Japanese laws by incorporating under foreign laws, even though their true purpose is to conduct business in Japan. However, during the Diet session, many members of the foreign business community raised concerns that the language of Article 821 as written was overly broad and would affect foreign companies operating legitimately in Japan in branch format.

These concerns were crystallized and presented to the Japanese government by various chambers of commerce.

In response to the outcry from the foreign business community, the Ministry of Justice explained in the Diet session enacting Article 821 that the then current Commercial Code contained even harsher restrictions against para-foreign corporations (although it is unclear whether those restrictions had ever been enforced in reality), as under those provisions the para-foreign corporation's juridical personality was disregarded unless the para-foreign corporation was reincorporated under the Japanese law. The denial of the para-foreign corporation's juridical personality adversely affected the ability of creditors of the para-foreign corporation to press their claims against the para-foreign corporation. Under the Ministry of Justice's stance, the New Law resolves the prior issue of a para-foreign corporation not having juridical personality by not disallowing such personality, protects creditors of the para-foreign corporation through imposition of joint and several legal liabilities on the representatives of the para-foreign corporation for transactions made by the para-foreign corporation, and does not create any additional adverse impact to the foreign corporation.

## **2. Supplemental Diet Resolution on Article 821**

To address the foreign business community's concerns, the House of Councilors (Upper House of the Diet) passed a supplemental resolution on June 29, 2005 that specifically addressed Article 821 as follows:

1. – 14. (omitted, as doesn't directly address Article 821)
15. In view of the important role of investments from foreign corporations into Japan to date and the expectation of the continuing necessity of those investments in the future, the following measures shall be made in connection with the Article 821 so that legal certainty will be secured:
  - (1) The purpose of Article 821 is to prohibit evasion of the corporate governance provisions of the Japanese commercial code by using foreign corporations. Therefore, it should be announced broadly that existing foreign corporations and future investments from foreign corporations should not be adversely affected by Article 821.
  - (2) It should be announced broadly that Article 821 does not restrict or require any specific corporate form for business entities from foreign jurisdictions.
16. In consideration of the effect of the enactment of the New Law against the foreign corporation, amendment of Article 821 should be considered in the future as necessary.

\* \* \* \* \*

The legal effect of Article 821 and Supplemental Resolution and how it will be interpreted on a going forward basis is unclear. For foreign corporations operating currently in Japan in branch format but who are considering incorporating the branch into a Japanese corporation, various Japanese tax ramifications need to be considered, such as the potential for taxable goodwill being created by a transfer of business, triggering payment of retirement allowances to employees, etc. Accordingly, we recommend that foreign taxpayers considering such changes consult with their professional tax advisor.

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