



# Financial Services Tax News

Financial Services Tax Group

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## **2007 tax reform relevant to enactment of corporation law provisions on triangular merger (substantial ownership transfer taxation on non-Japanese parties)**

The corporation law provisions allowing more flexible mergers and acquisition have been effectuated as of May 1, 2007 and have enabled an acquiring company to implement the so-called triangular merger, where such an acquiring company can use shares in its parent, instead of its own shares, as consideration for a merger (*gappei*), spin-off (*bunkatsu*) and share exchange (*kabushiki kokan*). There has been associated some tax reform to prepare for the enactment of these corporation law provisions.

This news letter provides an outline of taxation on non-Japanese parties receiving foreign shares in exchange for Japanese shares in connection with a triangular merger.

### **1. More flexible merger and taxation of capital gains on shareholders in merged company**

#### (1) Previous rules

Under the pre-tax reform rules, when shareholders in a merged company received shares in a merging company, the capital gain or loss would be deferred if no assets other than shares in the merging company (i.e., no "boot") was paid as consideration for the merger. In other words, if shares in the parent of the merging company are paid for, the shareholders in the merged company would be subject to any taxation on capital gains.

## (2) More flexible merger and deferral of taxation on capital gains

The corporation law provisions allowing more flexible merger and acquisition have been effective as of May 1, 2007, whereby an acquiring company can use shares in its parent as consideration for a merger. Under the 2007 tax reform, requirements for shareholders in a merged company to defer capital gains or loss from a merger transaction have been revised so that shares in a parent of a merging company, even if paid as consideration for the merger, will not trigger a taxation of capital gains for the shareholders in the merged company. The parent in this context means a company which directly owns the whole shares in the merging company immediately prior to the merger and is expected to continuously do so after the merger.

## 2. Taxation on non-Japanese parties receiving shares in foreign parent of merging company

### (1) Cross-border reorganization

In general, the deferral of taxation on capital gains to shareholders in a merged company as discussed above, applies to a cross-border reorganization where a Japanese company owned by a foreign parent merges with another targeted Japanese company using shares in the foreign parent.

### (2) Substantial ownership transfer

Under the substantial ownership transfer taxation rule which excludes the taxation rule on capital gains from sales of a real estate holding company, a foreign individual or company without a permanent establishment in Japan is subject to tax in Japan on capital gains from sales of shares in Japanese companies if:

- (a) it, together with specially related party, owns, or has owned, 25% or more of the shares in a Japanese company at any time during the year of sale or the prior two business years; and
- (b) it, together with specially related party, sells 5% or more of the shares in the Japanese company.

Under this rule, such a non-Japanese party would technically not be subject to taxation on capital gains in Japan from sales of foreign shares. In the cross-border reorganization as discussed above, if a non-Japanese party receives foreign shares in exchange for Japanese shares, now they are no longer subject to the taxation on substantial ownership transfer.

In this regard, therefore, there has been tax reform: if a foreign individual or company, having no permanent establishment in Japan, owns Japanese shares in a merged company which would be subject to the substantial ownership transfer taxation if sold, such a foreign party would not be able to apply for the deferral of taxation on capital gains even if only shares in a parent of a merging company are paid as consideration for the merger. Accordingly the foreign party would be subject to taxation on capital gains upon the merger.

### (3) Capital gains tax on non-Japanese party having permanent establishment in Japan

If a foreign individual or company with a permanent establishment in Japan owns Japanese shares in a merged company as assets which are associated with its business in Japan, such a foreign party would be entitled to the deferral of capital gains as discussed above. However, if the foreign party does not manage the shares in the parent of the merging company as assets associated with its business in Japan anymore, the foreign party would have to recognize taxable capital gains or loss as if it sold the shares at that time.

The tax reform as discussed above applies to corporate reorganization transactions taking place on or after May 1, 2007.

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