

# Japan Tax Update

Monthly tax update



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As we all know, the only thing constant is change. And the only way to stay successful is to keep on top of changes - in the economy, the industry, and with regulation.

"Japan Tax Update" seeks to update you on the latest developments in Japanese tax law that affect Japanese and foreign multinationals having operations in Japan. In addition to providing information on Japanese tax issues, the purpose of this newsletter is to make management aware of changes in the regulatory environment that may have an impact on their business.

Included in this issue are the following articles:

1. Foreign M&As in Japan and Corporate Reorganizations: New Legislation Expected
2. Changes to Japanese Company Law: Impact on Foreign Investors
3. Recent National Tax Tribunal Decision Regarding the Classification of Director's Retirement Payment for Personal Tax Purposes

## 1. Foreign M&As in Japan and Corporate Reorganizations: New Legislation Expected

Proposed changes to the Japanese commercial code and the introduction of a new corporation law (which are expected to take effect in April 2006) may give a boost to M&As by foreign investors and make re-organizations in Japan easier. Currently, the following changes are being contemplated:

### *Cross-border M&As*

Cross-border M&As (i.e., mergers, spin-offs and share for share exchanges) where the shares of the foreign acquirer are used as consideration may become possible. A Japanese entity (a wholly owned subsidiary of a foreign acquirer) would need to be used as an intermediate acquisition vehicle (earlier plans which would have made direct cross border acquisition possible have been shelved).

#### *Cash buy-out M&As*

The shareholders of a Japanese target or the transferor corporation may be permitted to receive cash or other assets, rather than shares in the acquirer in case of mergers, spin-offs or share for share exchanges.

#### *Contributions in kind*

The current restrictions on contributions in kind may be eased, so that a court inspection or certification by attorney or accountant will no longer be necessary if the amount of contributed assets upon incorporation does not exceed JPY 5m.

#### *Post-establishment asset acquisitions*

The current court inspection or certification requirement upon acquisitions of assets within 2 years of establishment may be completely abolished.

#### *Reorganization by board approval*

A Japanese company which has 90% or more of its voting rights owned by another Japanese company may decide on reorganization steps (including mergers) without the approval of a shareholders' meeting. It would therefore become possible to eliminate minority interests with only board approval.

#### PwC Comment

Tax-qualified M&As currently require that consideration made to the shareholders is limited to the shares of the direct acquirer, the merging company or the transferee company upon the spin-off. The above proposals relate to the legislation of company law; whether cash mergers will also be treated as tax-qualified is presently unclear. Consequential reform of tax law can therefore be expected once the company law reform is complete. The current special treatment under the Corporate Revitalization Act that allows a triangular merger ("cross border merger with the use of shares of foreign parent) but it is not tax free.

## **2. Changes to Japanese Company Law: Impact on Foreign Investors**

A major overhaul of Japanese company law is being planned, with new legislation expected to be enacted in April 2006. The changes will do away with the Yugen Kaisha (YK) type of business entity and will introduce some new types of structure, as summarized below:

<b>CORPORATE STRUCTURES WITH SEPARATE LEGAL IDENTITIES (NOT PASS - THROUGH FOR JAPANESE TAX PURPOSES)</b>	<b>Pass-through for US tax purposes</b>	<b>NON - CORPORATE STRUCTURES WITHOUT SEPARATE LEGAL IDENTITIES (PASS - THROUGH FOR JAPANESE PURPOSES)</b>	<b>Pass-through for US tax purposes</b>
<b>Kabushiki Kaisha (KK)</b> Joint stock company, most commonly used entity	No	<b>Nin-i Kumiai (NK)</b> Civil code partnership or joint enterprise	Yes
<del><b>Yugen Kaisha (YK)</b></del> * <b>SCRAPPED</b> * Simplified limited company, designed for use by small businesses. Transitional rules may permit existing YKs to remain for a certain period	Yes	<b>Tokumei Kumiai (TK)</b> Anonymous association consisting of an operator and silent partners	Yes (but subject to 20% withholding tax in Japan)

<b>Godo Kaisha * NEW *</b> Commercial partnership company with only limited partners. Main difference to KK is that internal constitution may be determined by the agreement of partners rather than the statutes (e.g., profits do not need to be shared in proportion to investment)	Not yet determined	<b>LLP * NEW *</b> Limited liability partnership. Main differences to Godo Kaisha are lack of corporate identity (hence unable to enter separately into contracts) and <i>possible</i> Japanese tax treatment as pass-through.	Not yet determined
<b>Gomei Kaisha</b> Commercial partnership company with only unlimited partners	No		
<b>Goshi Kaisha</b> Commercial partnership company with both limited and unlimited partners	No		

Note that the Japanese tax treatment of Godo Kaisha has not yet been finally settled. There have been requests from pressure groups to make this pass-through, despite its corporate status.

As a result of the scrapping of the YK, the KK will also be reformed. There will now be 3 types of KK:

- 1) "Closed" (non-public) KK which may impose limitations on share transfers and may choose whether or not to create a board of directors (i.e. similar to the existing YK)
- 2) "Closed" KK with a board of directors and no limitations on share transfers
- 3) Public (non-closed) KK with a board of directors and no limitations on share transfers

Information on corporations (such as the amount of capital, names of directors, limitations on share transfers, etc) will be available to the public at registry offices.

PwC Comment

The new limited liability partnership structures – one corporate (Godo Kaisha) and one not (LLP) may well be of use to foreign investors in Japan, although it may yet take a while before their tax treatment (both in Japan and in the US) is determined.

On the other hand, the YK has never been a highly popular structure among foreign investors because of its "mom and pop" image. Nevertheless, some US investors have been using it because of its pass-through characteristics. It remains to be seen whether the new "closed" KK will be afforded similar pass-through treatment or will be deemed to be a *per se* corporation as the existing KK is.

### 3. Recent National Tax Tribunal Decision Regarding the Classification of Director's Retirement Payment for Personal Tax Purposes

With increasing numbers of corporate reorganizations, and the tax treatment of retirement payments by employers continuing to be a hot topic, a recent Tribunal decision helps to clarify the position in the case of a corporate reorganization when a director receives a retirement payment but then continues to provide services after it is paid.

Under Japanese tax law, payments must meet the following criteria to be classified as retirement income: (1) The payment must be received as a result of retirement or the termination of services; (2) The payment must be given as consideration for services provided to the employer; and (3) The payment must be a lump-sum.

In the case dealt with by the Tribunal decision, the taxpayer was a representative director of Company X, which was to merge with two other companies. Before the merger took place, it was decided that the

surviving company (Company X) would cease to provide a retirement payment scheme, and therefore the existing employees and directors were paid a lump sum for services up to the merger date. The taxpayer also retired as a director of Company X before the merger, although after the merger the taxpayer was subsequently re-appointed as a director of Company X.

The tax authorities (NTA) argued that as the taxpayer had been re-appointed as a director and had continued to provide services to Company X, he should not be treated as having retired prior to the merger. The NTA therefore viewed the lump-sum payment as salary income for the taxpayer's individual income tax purposes.

On the other hand, it was recognized from the fact-finding process that the taxpayer was not actually granted any decision-making power during his service after the merger, and when he retired as a director a few months after the merger, he did not receive any lump-sum payment.

Based on the facts, the Tribunal concluded that the services provided by the taxpayer as a representative director in the surviving company were only transitional and nominal. The decision reasoned that the difference between the director's services before and after the merger was sufficiently large enough to conclude that the retirement took place prior to the merger. Further, the judgment found that the lump-sum payment satisfied all three conditions in order to be treated as retirement income. The Tribunal therefore rejected the NTA's arguments and instead held for the taxpayer, agreeing that the lump-sum payment received prior to the merger should be characterized as a retirement payment for individual income tax purposes. The NTA was therefore ordered to revoke its assessment.

PwC comments

As the numbers of corporate reorganizations increase individuals may face similar issues to those in this case. The classification of income as salary or retirement income should be determined on case-by-case basis before accepting assessments by the tax authorities.

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 about our current issue or ideas for what you'd like to see covered in future issues.

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