

Japan Tax Update

Monthly tax update



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Tax reform in relation to corporate reorganizations (Series one)

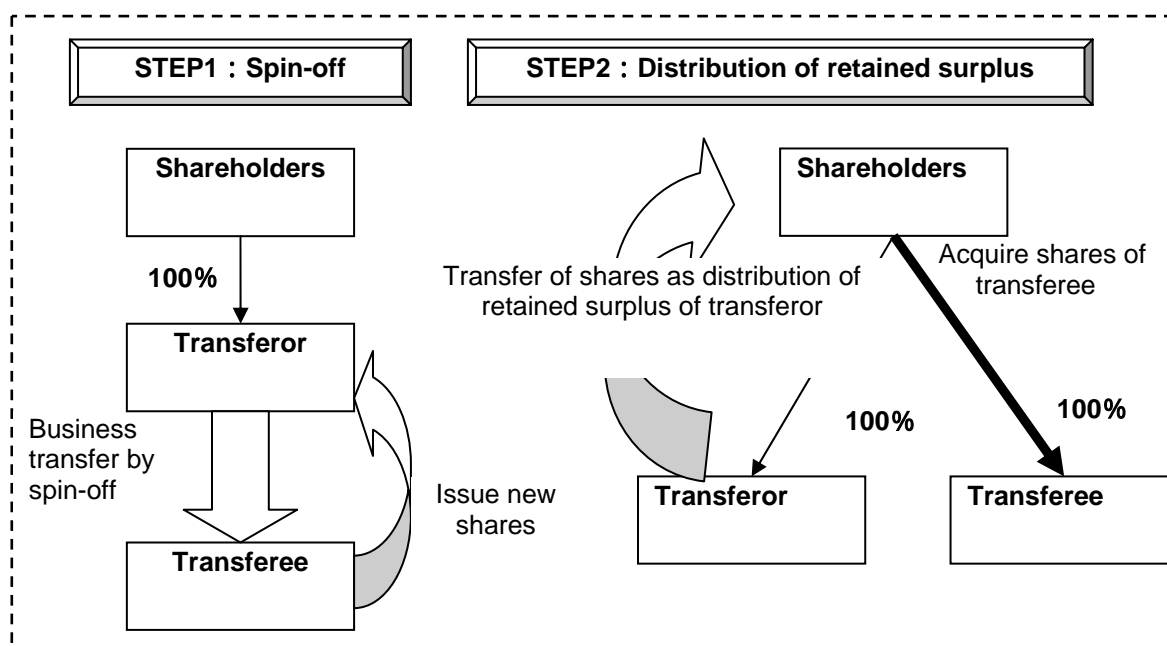
The new Corporation Law and its regulations were promulgated on June 26, 2005 and February 7, 2006 respectively and both became effective on May 1, 2006. In accordance with the new law and regulations, the tax law was also amended in the 2006 tax reform. The areas covered by these amendments include increase in capital amount and capital surplus upon the issue of new shares, distribution of retained surplus, directors' remuneration, stock option expenses, corporate split ups and corporate reorganizations.

As certain provisions of the Corporation Law relating to corporate reorganizations will become effective on May 1, 2007. It is expected that the 2007 Tax Reform will introduce further corresponding amendments in this regard.

This issue deals with the tax reform on the corporate split up, cash out merger triangular merger.

(1) Corporate split up

Under the new Corporation Law, a corporate split up is treated as a combination of two transactions - a corporate spin off (drop down) followed by a distribution of shares of the transferee company to the transferor company's shareholders. In the first step, the transferor company will acquire shares of the transferee company as consideration for transferring the relevant business assets/liabilities via the corporate spin off. In the second step, the transferor company is treated as having transferred the acquired shares to its shareholder(s) as a distribution of retained surplus. (Under the former Commercial Code, it was unclear whether a corporation was able to distribute a dividend with assets other than cash. The New Corporation clarifies that any non-monetary assets will be eligible for distribution as retained surplus. Accordingly, the second step under the corporate split up is now possible.)



Under normal circumstances, non-monetary assets are distributed as retained surplus to shareholders, any built-in gain or loss is realized at the time of distribution. Further, under the general tax treatment of corporate reorganizations, as the shares of the Transferee will not continue to be held by the Transferor, the spin off is treated as non-qualified and may trigger taxation for the transferor and shareholders. However, the amended tax law revises the definitions of corporate split out and tax qualified split out so as to treat such transactions as non-taxable under certain conditions. If a transaction meets such conditions, it will be treated as a qualified "split out".

Under the revised tax law, a corporate split out is defined as "consideration for spin off (ex, shares of the transferee company or other assets) which 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 a "corporate split out" under the tax law and may be subject to taxation as a non-qualified spin off followed by distribution of retained surplus. Other requirements for a tax qualified split out (i.e., intra-group or joint business split out) remain the same before and after the reform.

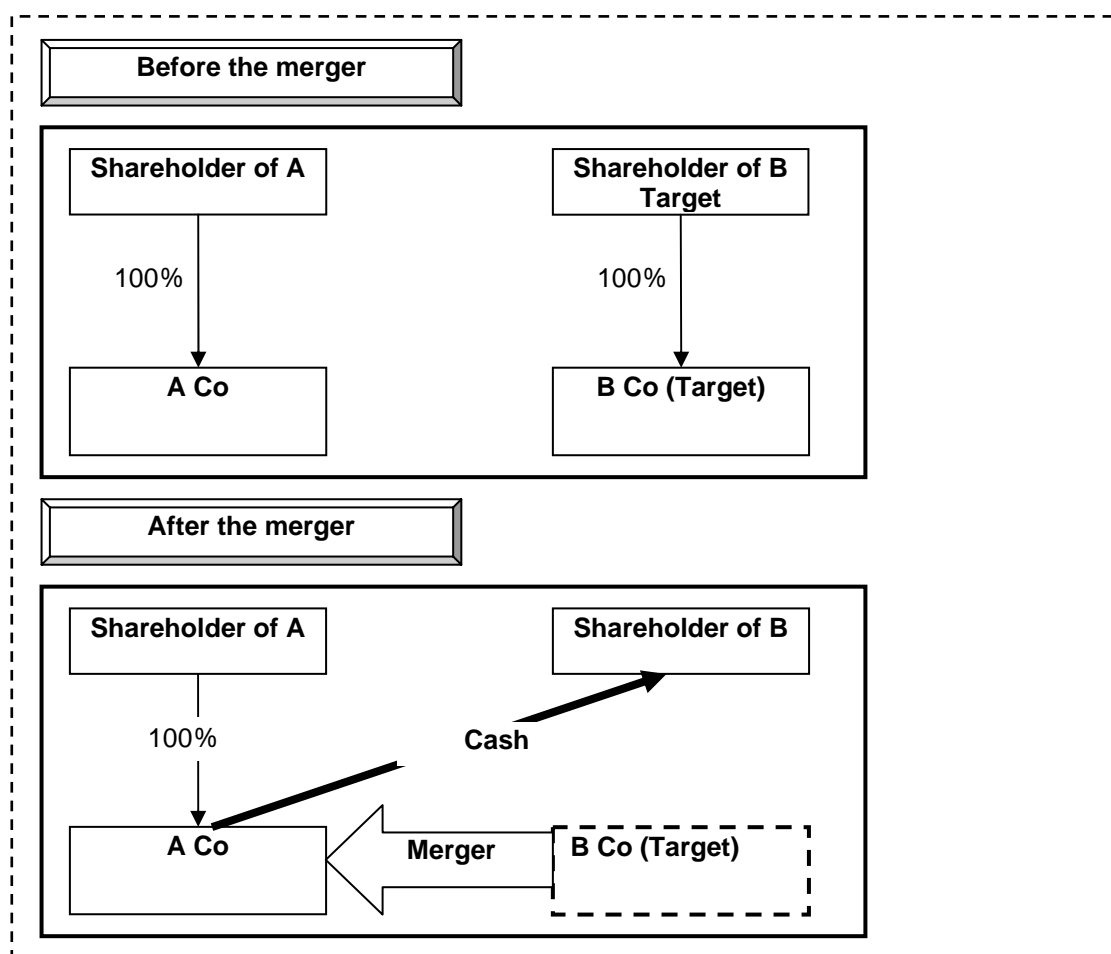
(2) Relaxation of consideration paid for corporate reorganizations

Cash-out merger

One of the major purposes of the new Corporation Law is to enable corporations to conduct reorganizations

in an easier and more flexible manner. Under the former Commercial Code, a corporation was not allowed to provide assets to shareholders of the target company other than shares of the acquiring company. Under the new Corporation Law, the acquiring company (A Co) is able to provide any assets to shareholders of the target company as consideration for the merger. This is called a “cash out merger”, in which an acquiring company can squeeze out shareholders of the target company after the merger.

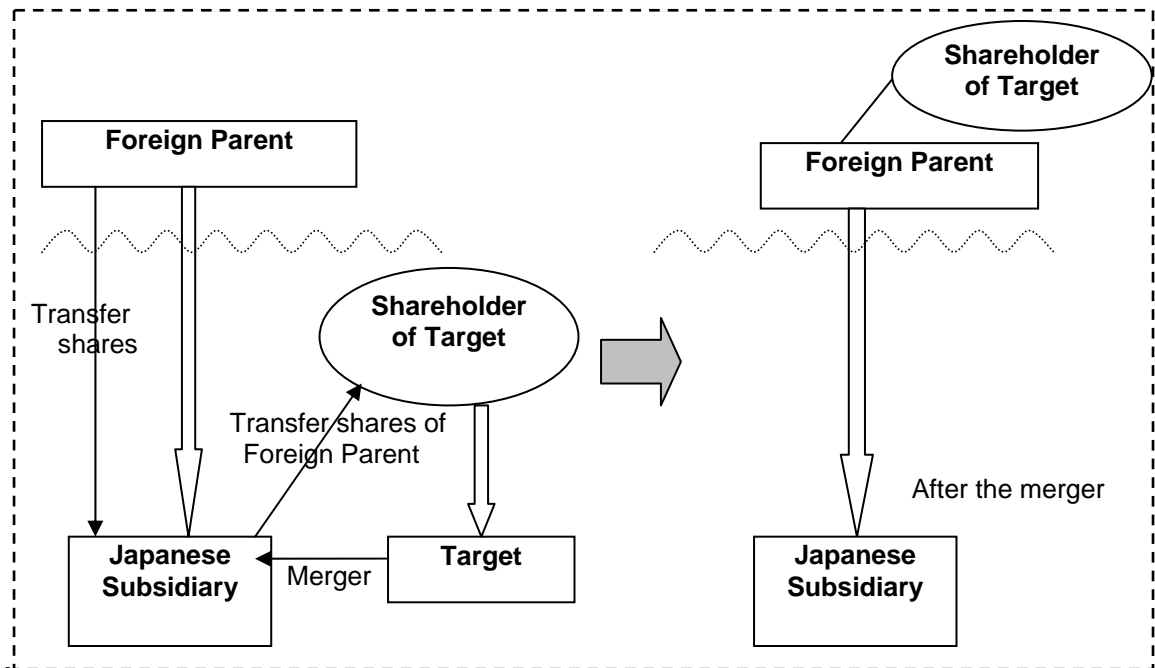
The above measures under the new Corporation Law is expected to take effect on May 1, 2007. Under the amended tax law, such cash out merger is treated as a tax disqualified merger that will trigger taxation on the target company as well as its shareholders. The 2007 Tax Reform may include amendments to address this issue.



Triangular merger (cross border merger and acquisition)

The relaxation in consideration paid for corporate reorganizations under the new Corporation Law is expected to provide greater opportunities for foreign corporations to acquire Japanese corporations. Currently, as a foreign corporation is unable to merge directly with a Japanese target, a foreign corporation will use its Japanese subsidiary to merge out the Japanese target. However, effective May 1, 2007, a subsidiary of a foreign corporation will be able to acquire a Japanese target by using shares of the foreign corporation as consideration (so called “triangular merger”).

However, under current tax law, a triangular merger is not treated as tax qualified and it is not certain whether any amendment will be provided under the 2007 Tax Reform.



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 or ideas for what you'd like to see covered in future issues.

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