

# Japan Tax Update

Monthly tax update

April 2007, Issue 28



PricewaterhouseCoopers Tax (Zeirishi-Hojin PricewaterhouseCoopers) is the largest professional tax corporation in Japan with more than 480 staff. PricewaterhouseCoopers ([www.pwc.com](http://www.pwc.com)) provides industry-focused assurance, tax and advisory services to build public trust and enhance value for its clients and their stakeholders. More than 140,000 people in 149 countries across our network share their thinking, experience and solutions to develop fresh perspectives and practical advice.

This Update is provided for general guidance only, and does not constitute the provision of legal advice, accounting services, investment advice, or professional consulting of any kind. Before making any decision or taking any action, you should consult a professional adviser who has been provided with all pertinent facts relevant to your particular situation.

Zeirishi-Hojin PricewaterhouseCoopers  
 Kasumigaseki Bldg., 15F  
 2-5 Kasumigaseki 3-chome  
 Chiyoda-ku, Tokyo 100-6015  
 Telephone: 03-5251-2400  
<http://www.pwc.com/jp/tax>

\*connectedthinking

© 2007 Zeirishi-Hojin PricewaterhouseCoopers. All rights reserved. "PricewaterhouseCoopers" refers to Zeirishi-Hojin PricewaterhouseCoopers or, as the context requires, the PricewaterhouseCoopers global network or other member firms of the network, each of which is a separate and independent legal entity.

## Tax Issues Regarding Triangular Mergers

**The new Corporation Law rules relating to corporate reorganizations effective are effective as of May 1, 2007**

The new Corporation Law rules relating to corporate reorganizations became effective on May 1, 2007. Before the effective date, an acquiring company is required to issue its shares to the shareholders of the acquired company (i.e., a target company) in a corporate merger, a corporate spin off or a share exchange. Under the new rules, consideration paid to a target' shareholders is not limited to the shares of the acquiring company but can include any assets including corporate bonds, stock subscription rights, warrants, cash or shares of the group company of the acquirer. If target' shareholders receive only cash as a consideration of the reorganization, such acquisition is called a "cash out merger". If target' shareholders receive shares of the parent of the acquiring company, such acquisition is called a "triangular merger" (although in fact, the transaction could be in the form of a triangular spin-off or triangular share for share swap).

It should be noted that the new Corporate Law rule is slightly different in the case of the corporate reorganization to establish a new entity. In such a reorganization, the consideration paid by the newly established corporation is limited to stock, corporate bonds, stock subscription rights and warrants of the newly established corporation.

The rules are illustrated in the table below:

	<b>Corporate reorganization between the existing corporations (merger, spin off, or share exchange)</b>	<b>Corporate reorganization to establish a new corporation (merger, spin off, or share transfer)</b>
<b>Consideration for the reorganization</b>	Any assets that have value (cash, other assets, acquirers' shares, the shares of the acquirer's group company, bond, stock subscription rights, warrants, etc.)	Shares of the newly established corporation plus bond, stock subscription rights, or warrants
<b>Effective date of the reorganization</b>	Date specified in the reorganization agreement	The registered date of the newly established corporation

From a Corporate Law perspective, the new rules should enable corporate investors to carry out mergers and acquisitions in Japan more efficiently. First, the rules allow an acquiring company to purchase 100% of the shares of a target company using assets other than shares of the acquiring company. Second, in the tender offer context where the target is a public company, the acquiring company may be able to use publicly traded shares of its parent company in the acquisition where such shares may be attractive to the existing shareholders of the target.

## **2007 Tax Reform in relation to the above new rules**

### **(1) Consideration for the reorganization**

As discussed above, under the new Corporate Law rules, the acquiring company is able to transfer any type of asset to the target's shareholders as a consideration of the reorganization. However, for tax purposes a deferral of income tax for the acquired corporation and its shareholders is allowed only in the case when the reorganization is solely for the shares of the acquiring company or its 100% parent<sup>1</sup> and all other tax requirements for the tax qualified reorganization are met.

### **(2) Business relevancy test in case of the joint business reorganization**

As a part of the 2007 Tax Reform, there was a much controversy regarding the business relevancy test that should be met if a corporate reorganization does not fall in the category of the intra-group reorganization (i.e., the acquiring corporation and the target have more than 50% equity relationship). Under the Japanese reorganization tax rules, where a 50% or less equity relationship exists between two companies, a merger or other reorganization can only be tax free if, among other conditions, the two businesses of the parties to the reorganization are related in some sense. If a foreign acquirer does not have an existing relevant operation in Japan, this condition made it difficult to use an SPC to acquire a Japanese target because the SPC, which is a party to the reorganization, would not have the relevant business. Therefore, compared to domestic companies, foreign acquirers were at a disadvantage.

In the 2007 Tax Reform, the definition of the "business relevancy" was amended to include any preparatory activities such as market research, solicitation for offering or conclusion of contract, and etc. According to the amended Corporation Tax Law Enforcement Order, the "business relevancy test" is met if the requirements of both 1) and 2) are met.

- 1) Both the target corporation and the acquiring corporation must meet all of the following conditions immediately before the merger:
  - i) Owning or renting office, store, plant or other fixed facilities<sup>2</sup>;

<sup>1</sup> The parent directly owns, and will continue to own, 100% of the shares of the Japanese acquiring corporation prior to, and after, the reorganization.

<sup>2</sup> "Fixed facilities" means facilities which are placed in a country or an area where the head office or principal office is located.

- ii) Having employees (or a director who exclusively engages in the business for the corporation);
- iii) Engaging in any one of the following activities in its own name and its own account:
  - (a) Sales of goods or other business<sup>3</sup>;
  - (b) Solicitation for offering or conclusion of contract regarding sales of goods or other business through advertisement or promotion;
  - (c) Market research to obtain materials necessary to engage in sales of goods or other business;
  - (d) Application for a license to a governmental organization which is required by law to engage in the sales of goods or other business, or holding rights of such license;
  - (e) (1) Application for acquisition of intellectual property rights<sup>4</sup> or request, application or similar procedures for registration (except for registration of transfer of the rights) of intellectual property rights; (2) request, application or similar procedures for registration of transfer of intellectual property rights and other similar rights<sup>5</sup> (including registration of rights to apply or rights to use the intellectual property rights); or (3) holding intellectual property rights or holding intellectual property rights and other similar rights;
  - (f) Possession or lease of assets (except for fixed facilities) necessary to engage in sales of goods or other business; and
  - (g) Similar activities mentioned (a) to (f) above

2) The Business of Target Corporation and the Business of Acquiring Corporation meet any one of the following conditions:

- i) The Business of Target Corporation and the Business of Acquiring Corporation are the same kind of business;
- ii) Goods, assets, services (limited to those which are for sales, for lending or for providing) or management resources<sup>6</sup> of the Business of Target Corporation and those of the Business of the Acquiring Corporation are the same or similar; or
- iii) The Business of Target Corporation and the Business of Acquiring Corporation are expected to be engaged in business by utilizing the goods, assets, services or management resources of the Business of Target Corporation and the Business of Acquiring Corporation after the merger.

The Business of Target Corporation and the Business of Acquiring Corporation are presumed to meet the requirements of above 2) where the Business of Target Corporation and the Business of Acquiring Corporation are actually engaged in business as one body by utilizing the goods, assets, services or business resources of the Business of Target

### **(3) Taxation on the shareholders of the target corporation**

Even if the reorganization is carried out on a tax-free basis, if shares of a foreign parent are issued to a non-resident shareholder of the target Japanese corporation, the non-resident shareholder upon receiving the new shares will be subject to capital gains taxation based on the application of Japanese tax laws and any relevant income tax treaty. In general, subject to treaty override, transfer of shares in a Japanese company by a foreign person is subject to tax in Japan if the foreign person (including related parties) owns 25% or more of a Japanese company and transfers 5% or more of the shares within one taxable year. In addition, under certain conditions a foreign person is subject to tax in Japan on transfer of shares in a real estate holding company.

---

<sup>3</sup> "Sales of goods or other business" means sales of goods, lease of assets or providing services continuously executed for the purpose of receiving consideration, including development or production of goods, or development of services.

<sup>4</sup> "Intellectual property rights" means rights related to the intellectual property rights prescribed by the laws or the rights related to benefit which is protected by the laws such as patent, utility model right, breeder's right, design right, copyright or trademark.

<sup>5</sup> "Intellectual property rights and other similar rights" means intellectual property rights, including rights to apply or rights to use the intellectual property rights, which are limited to those necessary for sales of goods and other business.

<sup>6</sup> "Management resources" means equipment used in business, intellectual property rights and other similar rights related to business, production technology, skill or knowledge of employee, know-how of production or sales of goods related to business, know-how of providing services and other resources similar to them.

The above treatment is not applicable if such shares are attributable to a permanent establishment (PE) in Japan of such non-resident shareholders. In such a case, the capital gain is deferred until such time when the shares are no longer maintained by the PE in Japan in which case there is a deemed transfer of shares by the non-resident shareholder which is subject to taxation.

#### **(4) Taxation on the deemed transfer of shares by the SPCC of the parent corporation**

In a triangular merger, typically the SPC will transfer parent company shares to the shareholders of the target. If such parent company shares were acquired before the contract date, the difference in value between when these shares were acquired and the contract date will create a taxable gain as of the contract date.

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.

If you have any questions, please contact:

Jack Bird	813-5251-2577	jack.bird@jp.pwc.com
Alfred Zencak	813-5251-2431	alfred.zencak@jp.pwc.com
Ken Leong	813-5251-2945	ken.leong@jp.pwc.com
Takuro Tagai	813-5251-2413	takuro.tagai@jp.pwc.com
Yumiko Arai	813-5251-2475	yumiko.arai@jp.pwc.com