Cross-Border Merger Taxation in Japan

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I. Introduction

As the world economy has become more integrated, global M&A has become an important strategic option for multinational corporations. Japan introduced qualified triangular mergers, qualified triangular stock exchanges and qualified triangular stock transfers ("qualified triangular mergers, etc.") in 2007 with anticipation of more investments into Japan by foreign corporations. The most well-known case is the 2008 Nikko Cordial Corporation and Citibank triangular stock transfer, where a US bank acquired a Japanese securities brokerage house without paying cash. After sub-prime issues and with excessive liquidity in China, Chinese companies acquired several Japanese companies using triangular mergers to make them wholly owned subsidiaries of Chinese-controlled companies. Today, with a strong yen exchange rate and weak domestic consumption, Japanese companies are considering cross-border M&A using qualified triangular mergers.

Under the Japanese Company Act, no direct merger is possible between Japanese corporations and non-Japanese corporations. Thus a merger exists where a Japanese operating corporation merges with a Japanese subsidiary of a foreign corporation in exchange for the shares in the foreign parent corporation, instead of shares in a Japanese subsidiary.

II. Qualified Merger of Corporation

Pursuant to Corporate Tax Law, in the case of a merger other than a qualified merger ("nonqualified merger"), a corporation that will cease to exist after the merger ("merged corporation") transfers its assets and liability at market price to a corporation that will exist after the merger ("surviving corporation"). Thus, capital gain or loss must be included in the last accounting year's income (i.e., the year that includes the day preceding the date of merger) of the merged corporation.[1] The merged corporation is treated as transferring to its shareholders new shares or other assets of the surviving corporation soon after it ceases to exist, having acquired such assets at market price from the corporation to be merged.[2] Therefore, in the case of a nonqualified merger, capital gain or loss accrues to the merged corporation and taxable constructive dividends are recognised by its shareholders.[3]

To be treated as a qualified merger under the Corporate Tax Law, assets other than shares of the transferee corporation or 100 percent parent company of the transferee corporation (boot) may not be distributed to the merged corporation,[4] and one of the following conditions must be satisfied:

- Either the merged corporation or the surviving corporation must hold 100 percent of the issued shares of the other corporation, directly or indirectly, or the two must be related in certain ways.

1. CTL, Art. 62(1) and (2).
2. CTL, Art. 62(1).
3. ITL, Art. 25(1), item 1.
4. CTL, Art. 2, item 12-8

- Either the merged corporation or the surviving corporation must hold more than 50 percent and less than 100 percent of the issued shares of the other corporation, directly or indirectly, or the two must be related in certain ways, and the following two additional requirements must be met: (a) approximately 80 percent or more of the employees of the merged corporation must continue working for the surviving corporation (if the merger is followed by another qualified merger, this requirement must also be met by the corporation surviving after the second qualified merger); and (b) the main business of the merged corporation is expected to continue by the surviving corporation (if the merger is followed by another qualified merger, this requirement must also be met by the corporation surviving the second qualified merger).

- Either the merged corporation or the surviving corporation must hold 50 percent or less of the issued shares of the other corporation and the purpose of the merger must be for the two corporations to conduct business jointly.

In the case of a qualified merger, the assets transferred from the merged corporation to the surviving corporation are deemed to be transferred at book value at the end of the merged corporation's last accounting year in calculating income after the merger.[5] Therefore, as the capital gain or loss of the merged corporation is not recognised at this stage, the taxation of capital gain or recognition of capital loss is deferred until the assets are transferred by the surviving corporation.

Tax on the shareholders of the merged corporation is deferred because the acquisition price of the shares distributed to the shareholders is equivalent to the book value of the shares in the merged corporation.[6] Constructive dividends on the shares distributed to the shareholders of the liquidating corporation are not taxed.[7]

In the case of a qualified merger, the following tax attributes are carried over from the liquidating corporation to the surviving corporation: profit reserves;[8] special accounts regarding governmental subsidies;[9] various allowance accounts;[10] various reserves;[11] and losses.[12]

III. Qualified Exchange of Stock

Under Corporate Tax Law, the shareholders involved in a qualified exchange of stock may defer the tax on capital gains realised on the exchange of stock until the shares are disposed of. An exchange of stock will qualify if the wholly owned subsidiary's shareholders only receive shares of the wholly owned parent corporation (no boot may be exchanged),[13] and the exchange of stock falls into one of the following categories:

- A single party holds 100 percent of the issued shares of the subsidiary or parent corporation, directly or indirectly.

- Either the subsidiary or parent corporation holds more than 50 percent and less than 100 percent of the issued shares of the other corporation, directly or indirectly, or holds a certain relationship therein and satisfies the following two requirements: (a) it is anticipated that approximately 80 percent or more of the employees of the subsidiary will continue working for the surviving corporation; and (b) it is anticipated that the main business of the subsidiary will be continued by the surviving corporation.

- Where the stock exchange is for the purpose of the joint enterprise of the subsidiary and parent corporation, and all of the following conditions are met: (a) a proximate relationship exists between the subsidiary and parent corporation, including with respect to the nature of their business; (b) the size of either the subsidiary or parent corporation with respect to sales proceeds, employee count, or related items does not exceed five times that of the other party or none of the officers of the subsidiary retires subsequent to the stock exchange; (c) it is anticipated that approximately 80 percent or more of the employees of the subsidiary will continue working for the subsidiary; (d) it is anticipated that the business of the subsidiary will be continued by the surviving corporation; (e) the shareholders of the subsidiary receiving the parent corporation's shares hold 80 percent or more of the subsidiary's shares (except when the number of the subsidiary's shareholders is greater than 50); and (f) it is anticipated that all of the outstanding shares of the subsidiary will be held by the parent subsequent to the stock exchange.

5. CTL, Art. 62-2(1).
6. CTL, Art. 61-2(2).
7. ITL, Art. 25(1), item 1.
8. CTL, Art. 2, item 18.
9. CTL, Art. 43(8), item 1.
10. CTL, Art. 52(8), item 1 and Art. 53(6), item 1.
11. 11 STML, Art. 52-3(15) and Art. 55(11).
12. 12 CTL, Art. 57(2).
13. 13 CTL, Art. 2, item 12-16; Art. 62-9.

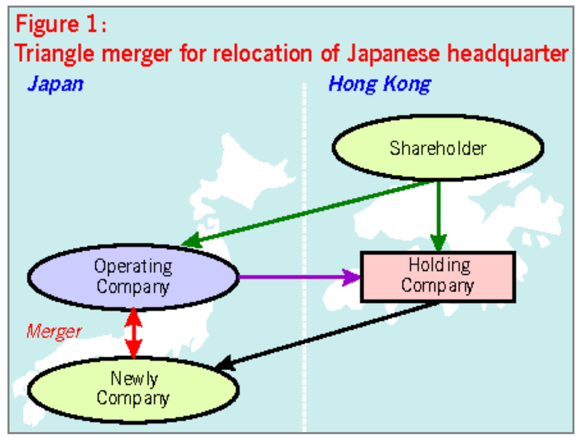
IV. Qualified Stock Transfer

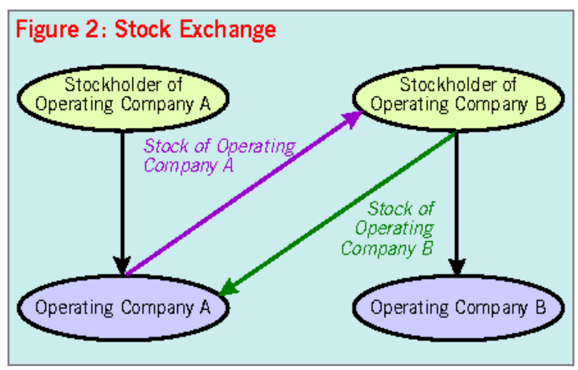
Under Corporate Tax Law, the shareholders involved in a qualified stock transfer may defer tax on capital gains realised until the shares are disposed of. For a stock transfer to qualify, the wholly owned subsidiary's shareholders must only receive shares of the wholly owned parent corporation (no boot may be transferred),[14] and the stock transfer must fall into one of the following categories:

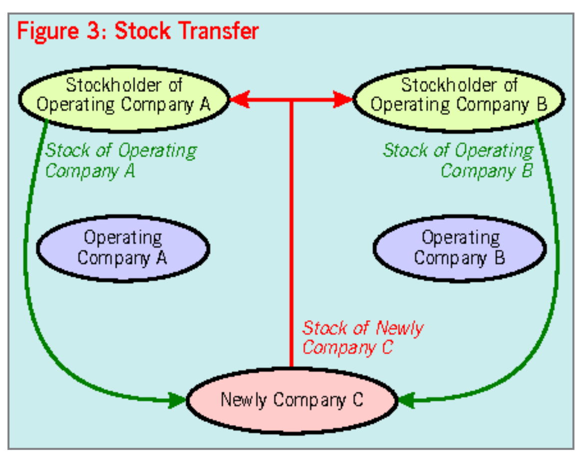
- A single party holds 100 percent of the issued shares of the transferee subsidiary and the other transferee subsidiaries, directly or indirectly, where one entity becomes the sole transferee subsequent to the transfer and it is anticipated that the transferor will become the wholly-owned parent of the transferee.
- Either the transferee subsidiary or the other transferee subsidiaries holds more than 50 percent and less than 100 percent of the issued shares of the other corporation, directly or indirectly, or holds a certain relationship therein, and satisfies the following two requirements: (a) it is anticipated that approximately 80 percent or more of the employees of the transferee will continue working for the transferee subsequent to the transfer; and (b) it is anticipated that the main business of the transferee will be continued by the transferee.
- Where the stock transfer is for the purpose of the joint enterprise of the transferor and transferee and all of the following conditions are met: (a) a proximate relationship exists between the transferor and transferee, including the nature of their business; (b) the size of either the transferor or transferee with respect to sales proceeds, employee count or related items does not exceed five times that of the other party, or none of the officers of the transferor or transferee retires subsequent to the stock transfer; (c) it is anticipated that approximately 80 percent or more of the employees of the subsidiary will continue working for the subsidiary; (d) it is anticipated that the business of the transferor and the transferee will be continued by the transferee; (e) the shareholders of the transferee receiving the transferor's shares hold 80 percent or more of the transferee's shares (except when the number of the subsidiary's shareholders is greater than 50); and (f) it is anticipated that all of the outstanding shares of the transferee will be held by the transferor subsequent to the stock transfer.

14. CTL, Art. 2, item 12-17; Art. 62-9

In practice, exchange of shares is more often used for both mergers and acquisitions than only mergers. In a merger, it is necessary to obtain administrative licenses owned by a merged company which has been merged into a new subsidiary. In an exchange of stock, an operating company *may* maintain administrative licenses.







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V. Cross-Border Merger

In the case of a merger, stock exchange and stock transfer, the new company or surviving company may distribute the parent company's shares instead of its own shares. If the parent company is located outside of Japan, the operating company will become a subsidiary of the foreign company and the shareholders will become the shareholders of the foreign company. Therefore, a triangular exchange of stock is an attractive option for Japanese companies and shareholders, who can expect:

- the importance of relocating headquarters of a Japanese company to a more tax friendly jurisdiction in order to reduce their global tax burden;
- the economy in Asia is still growing, especially the Chinese market and low cost manufacturing countries, such as Thailand and Indonesia, are important for a global strategy. However, Japan still remains the premium products and technology center of the group; and
- family companies or founders of listed companies who are concerned about individual income tax and inheritance tax will make it impossible to maintain ownership in the companies.

In order to complete a cross-border merger without taxation, certain additional conditions need to be satisfied:

- Headquarters should not be located in a tax haven where the effective tax rate is 20 percent or lower. UK, Netherlands and PRC are the countries with effective tax rates higher than 20 percent and will not be considered as tax havens for Japanese tax purposes. In the case of Hong Kong or Singapore, both effective tax rates are lower than 20 percent. Therefore, headquarters in such countries need to satisfy the "substantial presence" test. Alternatively, even if the headquarters are located in low-tax jurisdictions, it is possible to increase the effective tax rate.
- A shareholder who is a non-resident of Japan will realise capital gains from the exchange of shares from a Japanese corporation to non-Japanese shares if they are considered to be "controlling shares". Controlling shares mean 25 percent or more of the total shares in the Japanese company. In order to avoid such capital gains, the shareholder may maintain shares in non- Japanese headquarters under the management of permanent establishment in Japan. If a tax treaty exempts capital gains from shares from the Japanese government without respect to the percentage in the company, such as a Japan-Hong Kong tax treaty, the shareholder may acquire a non-Japanese headquarters' share without Japanese tax on the capital gain.
- Some Japanese customers have experienced issues with "treasury stock" in countries such as Singapore, which do not allow issuance of Singapore parent shares to a Japanese subsidiary, in order to make the Singapore-based company the new headquarters of the Japanese company group. However, such issues can be easily avoided by proper structuring of a Japanese subsidiary at the outset.

***Shimon Takagi** has been a licensed Japanese attorney-at-law (Bengoshi) since 1990; he is also admitted as a U.S. attorney in the State of New York. He handles matters in the areas of corporate and tax law, corporate transactions (acquisitions, joint ventures and strategic alliances), structured finance (bank, asset-based and project finance), securities, real estate and commercial and tax litigation for Japanese and non-Japanese clients. Prior to joining White & Case, Mr. Takagi was a local partner for another major international law firm from 1999-2002; he also served in varying roles at other law firms in Japan and the United States. From 1998-1999, he worked as the director of financial planning in the Private Banking Division at UBS Trust & Banking.*