



## **JAPAN**

#### INTERNATIONAL DEVELOPMENTS

### 1. WHAT ARE RECENT TAX DEVELOPMENTS IN YOUR COUNTRY WHICH ARE RELEVANT FOR M&A DEALS AND PRIVATE EQUITY?

Spin-off, i.e. a corporation creates a spin-off by distributing 100% of its ownership interest in that business unit as a stock dividend to existing shareholders, has been actively implemented in the US and some other jurisdictions. However, it has not been implemented in Japan, due to the stringent requirements for the tax free spin-off. However, the 2017 tax reform revises the relevant rules and it is expected by the Ministry of Economy, Trade and Industry that the spin-off will activate the business reorganisations and consequently M&A. The tax free requirements under the new rule are described below.

- 1. Existing shareholders will receive shares in a spin-off company which numbers are in proportion to their numbers of shareholdings in the parent company and they will not receive anything else.
- 2. There is not any majority shareholder of the parent company and it is expected that there is not any majority shareholder of a spin-off company.
- **3.** Major assets and liabilities of a business unit will be transferred in connection with a transfer of that business unit.
- **4.** It is expected that approximately 80% or more of employees of that business unit be continuously employed by a spin-off company.
- 5. It is expected that a spin-off company will continue to engage in that business unit.
- **6.** It is expected that a director or an important employee of the parent company will become a specified director of a spin-off company.

(This rule will apply to transactions taking place on or after 1 April 2017.)

# 2. WHAT IS THE GENERAL APPROACH OF YOUR JURISDICTION REGARDING THE IMPLEMENTATION OF OECD BEPS ACTIONS (ACTION PLANS 6 AND 15 SPECIFICALLY) AND, IF APPLICABLE, THE AMENDMENTS TO THE EU PARENT-SUBSIDIARY DIRECTIVE AND ANTI-TAX AVOIDANCE DIRECTIVES?

As per BEPS Action 6, the Ministry of Finance expressed its intention on 26 May 2016 to cope with it by stating that since the conventional global standards such as the Model Tax convention and TP guideline are not properly responding to the business models of multinational enterprises in these days, efforts have been made to revise the global standards in order to properly impose taxation reflecting "Creation of Value". Japan has been revising double tax treaties with several jurisdictions in past a few years.

As per BEPS Action 15, Japan is one of many jurisdictions which have concluded negotiations on a multilateral instrument (MLI) that "will swiftly implement a series of tax treaty measures to update international tax rules and lessen the opportunities for tax avoidance by multinational enterprises." in the end of 2016.



#### **GENERAL**

### 3. WHAT ARE THE MAIN DIFFERENCES AMONG ACQUISITIONS MADE THROUGH A SHARE DEAL VERSUS AN ASSET DEAL IN YOUR COUNTRY?

#### A. Share deal

#### Tax advantages:

Net operating losses carryover continues with the acquired corporation, but there is an exceptional case described in "tax disadvantages" below.

#### Tax disadvantages:

- The basis in the underlying assets of the target company carries over and is not stepped up at the acquired corporation.
- # An intended carryover of net operating losses may be suspended in an example case described below.
  - 1) Target incurred tax losses in past years, thus it has a certain balance of carryover losses ("Subject tax loss carryover") as of the year end 2017.
  - 2) M&A takes place on 15 April 15 2018.
  - 3) If a certain specified event (typically, starting a business which is new for Target) would take place during the period between 15 April 2018 and 15 April 2013 (5 years), the Subject tax loss would be cancelled. Therefore, if the specified event would take place in January 2019, the Subject tax loss carryover will not be able to be used for FY 2019 and thereafter.

#### **B.** Asset deal

#### Tax advantages:

- The basis in the underlying assets of the target company can be stepped up and any further appreciation gain ("Goodwill") can be recognised and depreciated over 5 years.
- There will be no taxation at the level of shareholders of the target company (deemed dividends distributions and capital gain on shares), unless the target company will be liquidated.
- If shareholders in the target company wish to receive shares in the acquiring company (or its parent company which shares may be listed such as in Tokyo and NY Stock Exchange) as the consideration of a deal, a tax free merger (the joint venture type merger) between the target company and the acquiring company can be consummated.

#### Tax disadvantages:

- There will be two levels of taxation, if the target company will be liquidated after M&A, namely once at the target company's level and then at the shareholder's level.
- Net operating losses carryover of the target company will not be succeeded by the acquired corporation, except for certain cases where shares of the acquiring company rather than cash are given as the consideration.



#### **BUY-SIDE**

### 4. WHAT STRATEGIES ARE IN PLACE, IF ANY, TO STEP UP THE VALUE OF THE TANGIBLE AND INTANGIBLE ASSETS IN CASE OF SHARE DEALS?

In case of acquiring shares of the target company, the fiscal identity of the target company is not changed. As such, the tax basis of assets and liabilities will not be stepped up.

#### 5. WHAT ARE THE PARTICULAR RULES OF AMORTISATION OF GOODWILL IN YOUR COUNTRY?

In the asset deal in which the substance of a business is transferred, if the consideration paid would exceed the fair market value of net assets acquired, the excess portion (effectively "goodwill") would be amortised over the 5 years period. The same rule applies to taxable mergers, taxable de-mergers and taxable contributions in kind.

### 6. WHAT ARE THE LIMITATIONS TO THE DEDUCTIBILITY OF INTEREST ON BORROWINGS IN THE CASES OF ACQUISITION OF SHARES AND ASSETS?

In general, a deduction is allowed for interest paid or accrued on legally valid indebtedness of the taxpayer. However, some provisions may limit the deduction. Major limitations are highlighted below.

- **Transfer Pricing:** Very broadly, Interest expense paid or payable to a related foreign party over the arm's length basis is not deductible.
- **Thin Capitalisation:** Very broadly, in case where the debt / equity ratio exceeds 3 to 1, an excess portion of interest expense paid or payable to overseas related parties. The interest expense hereby includes guarantee fees and securities lending fees.
- **Earnings stripping:** In general, the rule prohibits a corporation from deducting the interest paid or payable to a related foreign party to the extent its "net interest expense" exceeds 50% of the corporation's "adjusted taxable income" as those terms are defined by the Corporate Tax Law. Interest in excess of this 50% limit can be carried forward the following 7 years.

#### 7. WHAT ARE USUAL STRATEGIES TO PUSH-DOWN THE DEBT ON ACQUISITIONS?

Typically, from a Japanese standpoint, in order to push down debt on an acquisition, a new local holding company is established to borrow a debt and carry out an acquisition of shares of the target company, and thereafter, the target company is merged into the holding company so that interest on the debt can be relieved against the target company's profits. Alternatively, a local holding company and the target company may jointly file a consolidated tax return.

#### 8. ARE THERE ANY TAX INCENTIVES FOR EQUITY FINANCING?

There is not any direct tax incentive for equity financing, but the Thin Capitalisation (mentioned in section 6 above) causes an indirect incentive.

#### 9. ARE LOSSES OF THE TARGET COMPANY(IES) AVAILABLE AFTER AN ACQUISITION IS MADE?

In case of share deals, net operating losses carryover should continue with the acquired corporation, but there is an exceptional case as a hypothetical example case described below, in which case, net operating losses carryover would be cancelled.

1) Target incurred tax losses in past years, thus it has a certain balance of carryover losses ("Subject tax loss carryover") as of the year end 2017.



- 2) M&A takes place on 15 April 2018.
- **3)** If a certain specified event (typically, starting a business which is new for Target) would take place during the period between 15 April 2018 and 15 April 2013 (5 years), the Subject tax loss would be cancelled. Therefore, if the specified event would take place in January 2019, the Subject tax loss carryover will not be able to be used for FY 2019 and thereafter.

In case of asset deals, net operating losses carryover of the target company would not be succeeded by the acquired corporation, but if shares of an acquiring corporation are offered as the consideration and the target is absorbed by the acquiring corporation by means of the merger for the purposes of joint venture business, net operating losses could be succeeded by the acquired corporation.

### 10. ARE THERE ANY ITEMS THAT SHOULD BE INCLUDED IN THE SCOPE OF A TAX DUE DILIGENCE THAT ARE VERY SPECIFIC TO YOUR COUNTRY?

- Review of the net operating loss carryover as it is subject to various limitations.
- Review of the withholding tax on license payments in order to confirm whether the payment is for use of the copyright (taxable) or for the use of copyrighted products (non-taxable).
- Review of entertainment expenses as they are subject to limitation on deduction.
- Review of director's remuneration as it is subject to limitation on deduction.
- Review of Consumption Tax (VAT) procedure, as the Japanese system is unique in comparison with the European system.

#### 11. IS THERE ANY INDIRECT TAX ON TRANSFER OF SHARES (STAMP DUTY, TRANSFER TAX, ETC.)?

There is neither stamp duty on a contract of transferring shares nor transfer tax on a transfer of shares.

### 12. ARE THERE ANY RESTRICTIONS ON THE CORPORATE TAX DEDUCTIBILITY OF ACQUISITION COSTS?

Generally, expenses incurred in connection with receiving services such as professional advisory services are tax deductible as services are completed. However, expenses related to the acquisition of an investment which are capital in nature are not tax deductible immediately. Costs in regard to failed acquisitions are in principle immediately deductible.

#### 13. CAN VAT (IF APPLICABLE) BE RECOVERED ON ACQUISITION COSTS?

In case of asset deal, transfer of assets is subject to VAT (i.e. Consumption Tax in Japan). Target charges VAT in invoicing to the acquirer corporation, but the acquirer corporation should be able to claim credits or otherwise refund of VAT paid. Transfer of shares in case of Share deal is not subject to VAT.

### 14. ARE THERE ANY PARTICULAR TAX ISSUES TO CONSIDER IN THE ACQUISITION BY FOREIGN COMPANIES?

Dividends distribution: Dividends are subject to the withholding tax at the rate of 20.42%. However, the tax may be exempted or reduced by virtue of a Double Tax Treaty (e.g. US and the Netherlands).

Transfer of shares: In principle, there is not capital gains taxation, unless foreign companies have Permanent Establishments (PE) in Japan. However, there will be capital gains taxation at the rate of 25.81% in the cases described below.



#### a) Quasi transfer of business

It is a case where (i) a shareholder (including its related parties) owns 25% or more shareholdings in a Target company at any time during a year in which a transfer of shares takes place and the two precedent years, and (ii) the said shareholder (including its related parties) transfers 5% or more shareholdings in the Target company during the year.

#### b) Quasi transfer of real estate

It is a case where a Target company owns real estate which amounts 50% or more of the amount of its total assets. However, the taxation may be exempted by virtue of a Double Tax Treaty (e.g. the Netherlands and Switzerland).

### 15. CAN THE GROUP REORGANISE AFTER THE ACQUISITION IN A TAX NEUTRAL ENVIRONMENT THROUGH MERGERS OR A TAX GROUP?

A group may reorganise after an acquisition in a tax free manner through mergers. However, operating loss carryovers may be forfeited upon a tax free merger, for example, in a case where after forming a domestic holding company which acquires shares in the target company, the target company is merged into the holding company. This would be an effective procedure to push-down the debt to the business of the target company, however, net operation loss carryovers of the target company, if any, would be forfeited.

### 16. IS THERE ANY PARTICULAR ISSUE TO CONSIDER IN CASE OF TARGET COMPANIES OF WHICH MAIN ASSETS ARE REAL ESTATE?

In principle, foreign companies are not taxed in Japan on gains from the sale of a corporation's stock, unless foreign companies have PE in Japan. However, there will be capital gain taxation at the rate of 25.81% in the case of the quasi transfer of real estate, i.e. the sale of a stock of corporation which owns real estate which amounts 50% or more of the amount of its total assets.

### 17. IS FISCAL UNITY/TAX GROUPING ALLOWED IN YOUR JURISDICTION AND IF SO, WHAT BENEFITS DOES IT GRANT?

The benefits the fiscal unity (the consolidated tax return) regime may grant are summarised below:

- Taxable profits of a group company and losses of another group company can be set off.
- Net operating loss of a parent company in a group can be used to set off against profits of subsidiary companies in the group.
- Dividend distributions are fully tax exempted within a group.
- Limitation of tax credits can be increased.

The benefits the tax grouping regime may grant are summarised below:

- Taxable gain and loss on transfer of certain assets such as fixed assets, land and marketable securities (not including Inventories) within a group are deferred.
- Dividends distributions are fully tax exempted within a group
- Bistribution in kinds and a transfer of shares to its issuing corporation are consummated on the tax free basis.

It should be noted that the tax grouping regime is mandatory while the fiscal unity (the consolidated tax return) regime applies by a taxpayer's election.



#### **SELL-SIDE**

#### 18. HOW ARE CAPITAL GAINS TAXED IN YOUR COUNTRY?

For a corporate taxpayer, capital gains are subject to the regular tax which maximum effective tax rate is 33.80%. For an individual taxpayer, capital gains on disposal of shares are subject to tax at the rate of 20.315%.

### 19. IS THERE ANY FISCAL ADVANTAGE IF THE PROCEEDS FROM THE SALE OF SHARES ARE REINVESTED?

There is no specific advantage, e.g. rollover relief, to reinvesting the proceeds of a sale of shares.

#### 20. ARE THERE ANY LOCAL SUBSTANCE REQUIREMENTS FOR HOLDING COMPANIES?

From a Double Tax Treaty standpoint, the tax treaties Japan has entered with US, UK, France, Australia, the Netherlands, Switzerland, New Zealand, Sweden and Germany contain the Limitation of Benefits clause and it effectively stipulates the substance requirement for the tax exemption on dividends as described below.

"Trade or business in country of residence is other than that of making or managing investments for the resident's own account" and "Income derived from Japan is the income which is derived in connection with or is incidental to that trade or business in country of residence."

From the CFC standpoint, the substance requirement is the capacity as the regional headquarters and it must have at least a fiscal office and its own management capacity.

#### 21. ARE THERE ANY SPECIAL TAX CONSIDERATIONS REGARDING MERGERS/SPIN-OFFS?

Upon a merger, a liquidating company and shareholders of a liquidating company are principally subject to tax on an appreciation gain realised by a merger.

For a tax-free merger, it would be relatively easy to consummate it within a group company, but not easy in case of a merger between unrelated parties.

A merger for the purpose of conducting joint venture activities would be an approach for a tax-free merger, which requirements are outlined below.

- 1) It is expected that 80% or more of the employees of a liquidated company will engage in a business of a surviving company.
- 2) It is expected that the main business of a liquidated company will be succeeded by a surviving company.
- 3) One of the businesses of a liquidated company is related to one of the businesses of a surviving company.
- **4)** (a) Sales, number of employees and capital amounts do not differ in more than five times between a liquidated company and a surviving company, or (b) it is expected that some of the management team members of a liquidated company and of a surviving company will remain after the merger.
- **5)** It is expected that 80% or more of the shareholders of a liquidated company will continuously own shares in a surviving company distributed at the merger (this requirement applies if the number of shareholders of a liquidating company is less than 50).

A tax free merger is not subject to VAT.

A spin-off in the true sense which is comparable with a spin-off in other jurisdictions such as the US has not been implemented in Japan, due to the stringent requirements for the tax free spin-off. However, the 2017 tax reform



revises the relevant rules and it is expected by the Ministry of Economy, Trade and Industry that the spin-off will activate business reorganisations and consequently M&A. The tax free requirements under the new rule are described below.

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- **4)** It is expected that approximately 80% or more of employees of that business unit be continuously employed by a spin-off company.
- 5) It is expected that a spin-off company will continue to engage in that business unit.
- 6) It is expected that a director or an important employee of the parent company will become a specified director of a spin-off company.

A tax free spin-off is not subject to VAT.

#### MANAGEMENT INCENTIVES

### 22. WHAT ARE THE TAX CONSIDERATIONS IN YOUR JURISDICTION FOR MANAGEMENT INCENTIVES?

The tax rules applicable to stock options granted to management are described below.

- **Grant of a stock option:** It is not a taxable event for management as well as for a corporation issuing the option.
- **Exercise of stock option:** Management is subject to tax as wage for a difference between the market value of shares and any amount contributed to a corporation. A corporation is able to deduct the cost of granting stock option.
- \$\cdot\text{Sale of shares:} Management is subject to tax on capital gains. It is not a taxable event for a corporation.

Taxation on management at the time of exercising the stock option may be deferred until the sale of such shares if the programme fulfills certain requirements provided by the Tax Law.

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