The Impact of Recent Tax Reform on the Structure of M&A Transactions

The recent Japanese tax reform was intended to reflect revisions to corporate law resulting from the implementation of the *Corporation Act* and to address tax issues during corporate reorganization. This reform includes some revisions relating to mergers and acquisitions (M&As) and will have an impact on the choice of structure for M&A transactions in Japan.

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When a company acquires shares in a company that has a net loss or holds property that includes unrealized capital losses, the net loss and/or the unrealized capital loss can be carried over beyond the acquisition and can be used to offset the future profits of the target company (formerly Article 57 of the *Corporation Tax Law*).

Companies can decrease the amount of taxable income by acquiring a company in debt and shifting its business to the acquired company. However, this method of avoiding tax was criticized as being inequitable with other methods of acquisition and possibly constituting tax evasion.

The ability of an acquiring company to carry over the net loss and/or unrealized capital losses of a target company is now limited when the acquiring company has directly or indirectly acquired a share in the target company of over 50% and under certain circumstances that might involve tax evasion.

More specifically, the carry-forward rule will not apply to tax losses incurred in fiscal years prior to the specified event or the losses from the sale of assets, incurred within three years from the beginning of the year of the specified event or within five years from the date of the share acquisition, and will not be deductible if the acquiring company has directly or indirectly acquired a share of over 50%. The rule will also not apply if:

(i) the acquired company was defunct prior to the acquisition but restarts business after the acquisition;

(ii) the acquired company is expected to cease all of its activities from before the acquisition and takes out loans that are over five times the size of its previous business;

(iii) the acquiring company or any of its affiliates have obtained receivables against the acquired company worth over 50% of the acquired company's liabilities for a price of less than 50% of face value, and the acquired company takes out loans worth over five times the size of the business before the acquisition;

(iv) in (i) through (iii) above, the acquired company is merged or demerged by a qualified exempted merger or demerger;

(v) all of the officers specified by law, and over 20% of the employees, resign because of the acquisition and the size of the new business (not including those who were employees before the acquisition) is over five times the size of the business before the acquisition, or in similar circumstances (Article 57-2 & Article 61 of the *Corporation Tax Law* of Japan).

Point (v) was designed as a catch-all provision to counter attempts at tax avoidance.

The former law was sometimes criticized as being comparable to qualified exempted corporation reorganizations, by which a target company's utilization of net loss is somewhat limited. The reform, therefore, integrated taxation in corporate reorganizations involving a company in net loss or a company with assets that included unrealized capital losses, and thus limited tax avoidance. The benefits of acquiring a company in losses are now somewhat reduced.

Share-for-Share Exchange and Share Transfer

In the case of a share-for-share exchange or a share transfer (that is, the establishment of a new company by transferring all shares in the target company to the new company in exchange for shares

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in the new company), there was no need to re-evaluate the target company's assets and the taxation of such assets. However, in other corporation reorganizations, the ownership of the target company's assets is alienated and formerly unrealized profit or loss is accounted for.

Because of this advantage, share-for-share exchanges or share transfers were utilized to squeeze out minority shareholders in the course of a managed buyout, for example, in either of the following ways:

(i) As an exceptional option in share-for-share exchanges, a company can acquire the entire shareholding of a target company by paying cash instead of shares issued by the company to the minority shareholders, when such acquisition qualifies under the *Industrial Revitalization Law* of Japan. If a company acquires a majority share in a target company and is qualified under the revitalization law, the majority shareholding company can squeeze out minority shareholders by completing this exceptional share-for-share exchange without taxation arising from the re-evaluation of the target company's assets, or

(ii) the majority shareholder of a target company can establish a parent company that is owned by the majority and minority shareholders through a share transfer without taxation arising from the re-evaluation of the target company's assets. The newly established parent company, controlled by the majority shareholder, can transfer its entire share of the target company to a company that is wholly owned by the majority shareholder. Finally, the major shareholder can squeeze out the minority shareholders by liquidating the established parent company.

Share-for-share exchanges and share transfers are also subject to taxation based on a re-evaluation of the target company's assets, unless the requirements for an exemption are met. Such exemption requires that only shares can be distributed under share-for-share exchanges and share transfers, and that the target company's share will be continuously owned by the newly established parent company in the future (Item 12-16 and Item 12-17 of Article 2 of the *Corporation Tax Law* of Japan).

This reform was a result of the criticism that the treatment of share-for-share exchanges and share transfers was not in line with taxation rules for other forms of company reorganizations.

As a result of the reform, schemes (i) and (ii) above are now subject to taxation based on a re-evaluation of the target company's assets.

Triangular Mergers

A triangular merger is a newly introduced transaction under the *Corporation Act* of Japan. Triangular mergers are mergers conducted by distributing the shares in the parent company of one of the parties to the merger to the other company's shareholder.

The implementation of triangular mergers has been suspended and is still under discussion; the taxation procedures for such mergers under the reform have still not been defined. Once the new taxation scheme is made public, it will likely significantly affect the attractiveness of this type of merger transaction.

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