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Japan Tax Newsletter

2010 Tax Reform and the Restructuring of Group Companies

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Under the 2010 reforms to the Corporate Tax Act of Japan (the "Tax Reforms"), the concept of a "Group Taxation Regime" has been adopted, and the relevant regulatory provisions took effect as of October 1, 2010. In the Group Taxation Regime, gain or loss realized by a Japanese corporation arising from the sale of most types of assets to another Japanese corporation will not be recognized, provided that such acquiring corporation is in a "100% Control Relationship" (as explained below) with such selling corporation.

These Tax Reforms will affect the way the planning and carrying out of restructuring of group companies in Japan. We will, therefore, outline the Group Taxation Regime and the affects thereof on restructuring efforts.

(1) 100% Control Relationships

A Group Taxation Regime will apply to transactions between Japanese corporations that are party to the same 100% Control Relationship. A "100% Control Relationship" is:

① The relationship in which one party (including, but not limited to, an individual or a foreign corporation) directly or indirectly holds all of the shares in the other party (i.e., a parent and subsidiary relationship); or

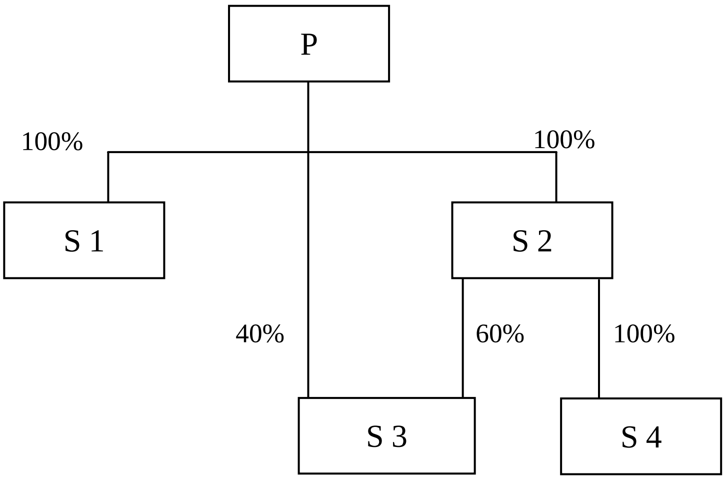
② The relationship between the parties where all of the shares of such parties are held by the same person (e.g., the relationship between brother and sister corporations in a group company structure wherein there is the same ultimate parent) (Article 2, Item 12-7-6 of the Corporate Tax Act).

For example, if all of the entities shown on Chart 1 below (i.e., P and S1 through S4) are Japanese corporations, then (a) P is in a 100% Control Relationship with each of S1 through S4 by virtue of the parent/subsidiary relationship described in ① above, and (b) entities S1 through S4 are all in a 100% Control Relationship with each other by virtue of the brother/sister relationship explained in ② above (as well, S2 and S4 are in a 100% Control Relationship by virtue of the parent/subsidiary relationship).

In the event that P is a foreign corporation or an individual, all of the above-described relationships exist; however, if P is a party to an applicable asset sale, the non-recognition treatment under the Tax

Reforms will not apply because P is not a Japanese corporation.

Chart 1



(2) Transfer of Business/Assets Between Corporations in 100% Control Relationships

(a) Non- Recognition of Capital Gain

According to the Tax Reforms, gain or loss from the transfer of most types of assets (the "Applicable Assets") between Japanese corporations which are parties to the same 100% Control Relationship will generally not be recognized by the transferring corporation. The Applicable Assets are: (i) fixed assets, (ii) land, (iii) monetary claims, (iv) securities, and (v) deferred assets. By contrast, gain or loss from the sale of inventory will continue to be recognized even after the Tax Reform. Additionally, securities which are held for the purpose of trading, and assets that have a book value of less than JPY 10 million will not be subject to the treatment under the Tax Reforms (Article 61-13, Paragraph 1 of the Corporate Tax Act, and Article 122-14, Paragraph 1 of the Order for Enforcement of the Corporate Tax Act). Therefore, the gain or loss from the sales of these assets (i.e., inventory, securities held for trading, and assets with a low book value) has to be recognized even if such sales and purchase are conducted within group companies in a 100% Control Relationship.

In relation to the Applicable Assets, although the transferor generally will not recognize gain or loss thereon at the time of transfer, such gain or loss must be recognized by the transferor if certain events occur. Such events are when (i) the transferor or the transferee exits from the 100% Control Relationship, (ii) the transferee further transfers the Applicable Assets, (iii) the Applicable Assets are depreciated, amortized, revalued, or written-off or (iv) the Applicable Assets of the transferee corporation are revalued at fair market value due to the commencement of the group filing a consolidated tax return (Article 61-13, Paragraphs 2, 3 and 4 of the Corporate Tax Act, and Article 122-14, Paragraph 4 of the Order for Enforcement of the Corporate Tax Act).

It should be noted that the treatment with respect to the transfer of the Applicable Assets by the transferee corporation extends to and includes the transfer of the Applicable Assets to a Japanese corporation with which it is in a 100% Control Relationship. If the Applicable Assets are transferred more than once among a group of corporations that are in 100% Control Relationships with one another, the gain or loss shall be recognized by the initial transferor.

In a transaction wherein S1 transfers Applicable Assets to P (assuming that P is a Japanese corporation), S1 will not recognize gain or loss on such transfer. If P, however, subsequently transfers the same assets to S2, S1 shall recognize gain at the time of the transfer by P. The amount of gain or loss recognized is the amount of gain or loss which would have been realized at the time of the transfer from S1 to P. As such, it can be considered that the recognition of gain or loss will have been deferred.

(b) Treatment of Donations

Generally (i.e., not in the context of the Group Taxation Regime), only a limited amount of a donation made by a corporation may be treated as a deductible loss (Article 37, Paragraph 1 of the Corporate Tax Act). If the donation is made between corporations filing a consolidated tax return, the no amount of the donation can be taken as a deduction on its corporate tax return (Article 37, Paragraph 2 of the Corporate Tax Act). In such a transaction, therefore, the corporation that receives the donation must include in its calculation of its revenue the amount donated (Article 22, Paragraph 3 of the Corporate Tax Act).

The non-recognition treatment as set out in the Tax Reforms will apply to transfers where the fair value of the assets is paid by the transferee. If the consideration paid by the transferee is higher or lower than the fair value of the asset to be transferred, the amount of excess or shortfall shall be treated as a donation for tax purposes, and certain adjustments will be required.[1]

Under the Tax Reforms, if the donation is made between corporations in a 100% Control Relationship, the amount donated cannot be taken as deduction by the corporation that made such donation; however, the corporation that received the donation is not required to include such donated amount in its calculation of its revenue (Article 25-2, Article 37, Paragraph 2 of the Corporate Tax Act). In such cases, the respective book value of the donor and donee corporation shall be adjusted by their respective immediate parent corporation. The book value of the donor corporation will be reduced by the amount donated, and the book value of the donee corporation will be increased by the amount donated.

As an example, assume that S1 transfers Applicable Assets to P (assuming P is a Japanese corporation), and P gives no consideration therefor. In such an instance, pursuant to the Tax Reforms, the fair value of such assets will be treated as a donation from S1 to P. Neither S1 nor P, however, will be required to recognize any gain or loss from such transfer. Similarly to an ordinary transfer of Applicable Assets as described in Section 2(a) above, in the event that P subsequently transfers the Applicable Assets donated to it by S1, S1 will then be required to recognize the gain or loss at the time of such transfer by P.

[1] In the event that the consideration paid results in a shortfall, the transferor will be considered as the donor, and where the consideration results in an excess over fair value, the transferee will be considered as the donor.

Please note that the treatment above will apply to corporations in a 100% Control Relationship only to the extent that 100% of the shares of these corporations are held by the same corporation. If the ultimate parent that holds such shares is an individual, the above treatment will not apply. Assuming that P is an individual, and that any portion of Applicable Assets are considered to be a donation by S1 to S2, then S2 must recognize the fair value of such donated amount.

(3) Transfer by a Distribution in Kind

A distribution in kind is a distribution of surplus by a corporation to a shareholder where such distributed asset is in a form other than cash. In principle, the corporation distributing the asset must recognize built-in gain or loss at the time of distribution. Further, the distributing corporation is subject to a withholding tax on such distribution, and the withholding tax rate is 20% of the value of the asset distributed.

Under the Tax Reforms, a distribution in kind between Japanese corporations which are in a 100% Control Relationship was newly defined as "tax-qualified distribution in kind" (Article 2, Item 12-5 of the Corporate Tax Act). By being considered as a tax-qualified-distribution-in-kind, (i) the distribution will be treated as a transfer at book value (Article 62-5, Paragraph 3 of the Corporate Tax Act), and (ii) there will be no requirement to withhold 20% of the value of the distribution for withholding tax purposes (Article 24, Paragraph 1 of the Corporate Tax Act).

Therefore, if assets are transferred from S1 to P (assuming that P is a Japanese corporation) in a tax-qualified distribution in kind, such assets can be transferred at book value, without consideration and without withholding for withholding tax purposes. Unlike in a donation of Applicable Assets, if P subsequently transfers such assets, S1 will never be required to recognize any related gain or loss.

(4) Transfer of Business

The Tax Reforms will undoubtedly affect the manner in which restructuring is conducted within group companies.

For example, assume S1 transfers a business to P (where P is a Japanese corporation). Previously, the only way to carry out such transfer without being taxed on the built-in-gains related to the Applicable Assets in such business was to structure such deal as a tax-qualified-corporate split (*kaisha bunkatsu*). It should be noted that a corporate split is a type of corporate reorganization under which the businesses of the transferor are split and then merged into the transferee.

Under the Tax Reforms, such a transfer of business (i.e., S1 donating the business to P) will be without built-in-gains of assets being subject to corporate tax. This method is worth considering as it may be used to avoid the time-consuming procedures necessary for a corporate split.

There are, however, a few issues that must be considered in carrying out a donation. The Tax Reforms notwithstanding, capital gains/losses must be recognized regarding assets that have a book value of not more than JPY 10 million. In many cases, goodwill is not recorded by the transferor corporation on the balance sheet as an asset. As the book value of such goodwill, if any, is less than JPY 10 million, the gain related to the sale of such internally-generated goodwill must be recognized and is subject to corporate taxation.

(5) Additional Notes

These newly introduced provisions will apply to all corporations that satisfy certain requirements. Applicable corporations (i.e., those meeting such requirements) do not have the discretion to elect such treatment; there is no "opt-in" or "opt-out" choice. Accordingly, a corporation that has transferred Applicable Assets to a company with which it is in a 100% Control Relationship cannot choose to recognize any gain or loss that might be associated with such Transferred Assets

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This newsletter is published as a general service to clients and friends and does not constitute legal advice. This newsletter is co-authored by Kotaro Okamoto, Yoshinori Aoyagi and Jeffrey Eagan of Anderson Mori and Tomotsune.

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