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2 August 2007 (No of pages: 7)

Tax Treatment of Triangular Mergers by Foreign Companies Made Simpler

Establishment of new subsidiaries made possible

The original Japanese report was released on 27 April.

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- Revised regulations for the implementation of corporate taxation Law announced by the Ministry of Finance (MOF) on 13 April 2007.

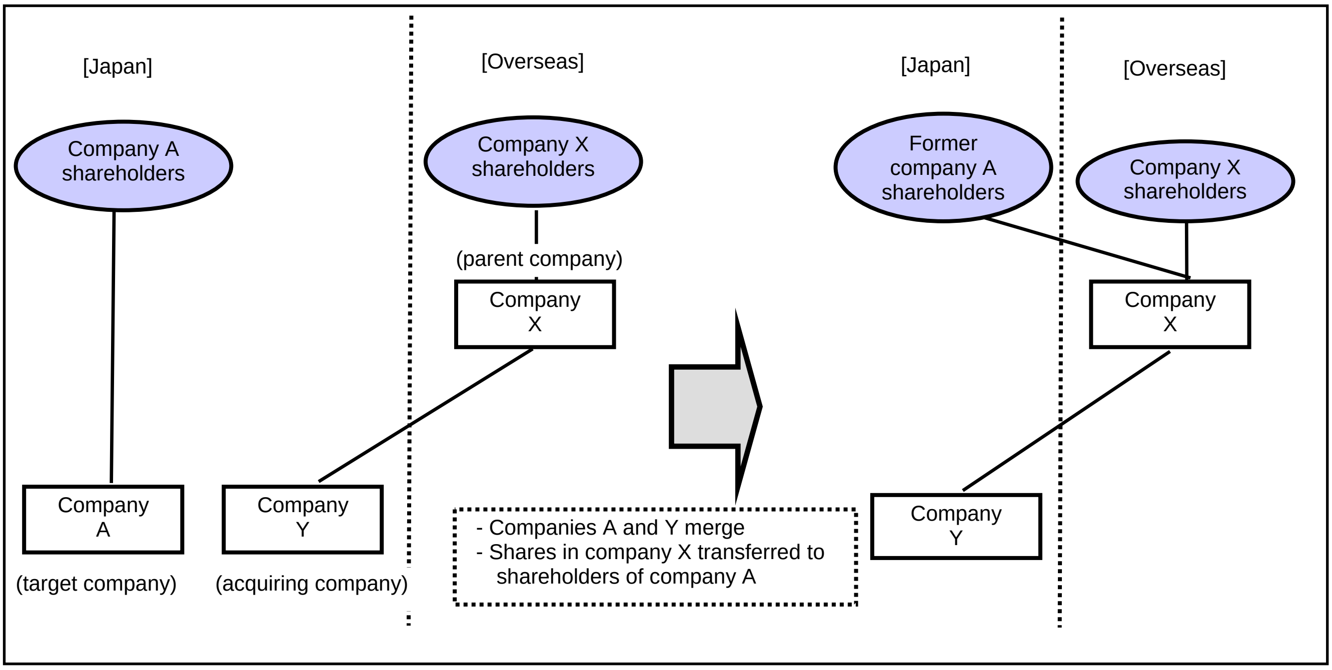
- Under the new regulations, in the event of the triangular merger of a Japanese company with a foreign company, providing the company established in Japan by the acquiring company (parent company) has commenced preparation for operations in Japan, the proposed merger will be deemed a qualifying merger and tax paid by the disappearing company treated as deferred taxation.

- The revised regulations are applicable with effect from the official announcement date.

I. System in Outline

The Corporation Law provides for the implementation, with effect from 1 May 2007, of triangular mergers wherein a target company (company A in Chart 1)'s shareholders (company A shareholders) can be compensated through the transfer of shares not of the acquiring company (company Y) but of the acquiring company's parent company (company X; deregulation of merger payment process; Corporation Law, Article 749-1-2).

Triangular Merger **Chart 1**



Source: Various data; compiled by DIR.

While mergers generally involve transfers of the acquiring company's shares, triangular mergers involve the transfer of shares in the acquiring company's parent company. For example, if foreign company X sets up a wholly owned subsidiary Y in Japan, which then takes over Japanese company A, using its own shares to compensate company A's shareholders, company Y will no longer be a wholly owned subsidiary of company X. However, if company A's shareholders are compensated through the transfer not of company Y shares but of parent company X shares, it is possible to ensure that company Y remains a wholly owned subsidiary of company X even after the merger.

If, in the event of a merger, the acquiring company compensates shareholders in the disappearing company with assets other than its own shares, such compensation is treated for tax purposes as a deemed dividend or capital gain on the transfer of shares in the hands of the disappearing company's shareholders. The disappearing company's assets, etc are similarly treated as having been transferred to the acquiring company and, as such, taxable as capital gains in the hands of the disappearing company. Under the previous tax system, transfers in the case of a triangular merger of parent company shares to disappearing company shareholders were treated as transfers of assets, etc other than acquiring company shares.

However, under changes made to the tax system in FY07, if an acquiring company (company Y in Chart 1) transfers shares (shares in company X in Chart 1) in its 100% parent company (acquiring company's direct parent only) to disappearing company (company A in Chart 1) shareholders, they will no longer be subject to taxation as capital gains in the hands of the disappearing company shareholders (shareholders in company A in Chart 1).

Furthermore, in the event that the acquiring company (company Y in Chart 1) transfers shares (shares in company X in Chart 1) in its 100% parent company (acquiring company's direct parent only) to disappearing company shareholders (shareholders of company A in Chart 1) such that said 100% parent-subsidiary relationship is maintained after the merger, if the merger falls to be defined as "internal corporate group merger" or "merger for the purpose of managing a joint enterprise", it will be treated as a "qualifying merger." In this case, the assets, etc of the disappearing company will not be held subject to capital gains tax nor will the shareholders of the disappearing company be held liable to "tax on deemed dividends."

Comparative Tax Liabilities of Parties in Qualifying and Non-Qualifying Mergers (after revision) Chart 2

		Taxation of merger target company	Taxation of merger target company shareholders	
			Taxation of deemed dividends	Taxation of capital gains on transferred shares
Non-qualifying merger	If assets other than shares in the acquiring company or its 100% (direct) parent company are transferred to target company shareholders	Assets, etc handed over by the target company are deemed to have been transferred to the acquiring company at market value, and the target company is held liable to tax on the capital gain	Yes	Yes
	If only shares in the acquiring company or its 100% (direct) parent company are transferred to target company shareholders			No
Qualifying merger		Assets, etc are treated as being handed over by the target company at book value on the last day of its final business year and not, as such, giving rise to a capital gain/loss (non-taxable)	No tax liability of any sort incurred by shareholders	

Source: Various data; compiled by DIR.

Qualifying Merger (triangular merger) Criteria (after revision) Chart 3

Merger compensation criteria: Acquiring company must transfer shares in its 100% parent company (must be a direct parent) to its target company shareholders, and maintain said 100% parent-subsidiary relationship after the merger, and the merger must qualify as an internal corporate group merger or a merger for the purpose of managing a joint enterprise

Internal corporate group merger		Merger for the purpose of managing a joint enterprise
Between companies with a 100% control relationship	Control shared with other companies	
100% control relationship (target company wholly owned by acquiring company) must be maintained	- 100% control relationship (target company wholly owned by acquiring company) must be maintained - At least 80% of employees must remain on payroll - Main business operations must be continued	- Operational relevance - No more than about 5-fold increase in scale of operations, and maintenance of key executives - At least 80% of employees must remain on payroll - Main business operations must be continued - At least 80% of the acquiring company's shares or its 100% parent company's shares must continue to be held (companies with less than 50 shareholders only)

Source: Various data; compiled by DIR.

II. Operational Relevance

When a foreign company enters into a triangular merger with a Japanese company, it is unlikely to have an existing control relationship with the company in question, which means that, to be deemed a qualifying merger, it must be a "merger for the purpose of managing a joint enterprise." For this definition to hold, there must be "operational relevance" between the business activities of the acquiring company and those of the target company.

In their FY07 tax reform framework, the ruling parties note, with respect to "operational relevance", that detailed consideration will be given to clarification of the legal basis for determining operational relevance with a view to clarifying how best to deal with it in practice. They further indicate that if it is clear from the outset that the acquiring company is a paper company, it should be treated as having no operational relevance. If a foreign company were to establish a new subsidiary in Japan, then enter into a triangular merger with a Japanese company, but the newly established subsidiary was not at that point engaging in business in Japan, it would be treated as a paper company. The merger may thus be treated as a non-qualifying merger in which case the tax burden may be heavier.

On 13 April, MOF finalized an ordinance partially revising the corporate tax regulations and clarifying criteria, as detailed below, for the determination of "operational relevance."

Operational Relevance Criteria **Chart 4**

To meet the conditions for operational relevance, a company must satisfy both 1 and 2 below.

1. **The acquiring company (company Y) and the target company (company A) must each meet all the following conditions.**
   a. They must either own or lease fixed facilities in the shape, for example, of offices, branches, factories, etc.
   b. They must have employees (in the case of directors, their business must be that of the company in question)
   c. They must be engaged in one or more of the following activities in their own name and for their own account.
      (1) Sale of products, etc (this means continuously engaged, for a consideration, in the sale of products, loan of assets, and/or provision of services, including the development of said products and/or production and services)
      (2) Advertising or otherwise publicizing inducements to apply for or enter into agreements for the sale of products, etc
      (3) Conducting market research for the acquisition of materials needed for the sale of products, etc
      (4) Applying for such administrative authorizations as may be required by law for the sale of products, etc, or else be in possession of such rights as may be covered by the authorizations in question
      (5) Filing or requesting such applications and/or registrations as may be needed for the acquisition or transfer of the necessary intellectual property rights, or else be in possession of such rights, etc
      (6) Own or lease the assets (other than fixed facilities) needed for the sale of products, etc
      (7) Other actions akin to those cited in (1) to (6) above

2. **Immediately prior to the merger, the target company (company A) and the acquiring company (company Y) must have had a mutual relationship of the sort described in one or other of a to c below.**
   a. The target and acquiring companies must be related inasmuch as their business operations are of the same type
   b. The target and acquiring companies must be related inasmuch as their products, assets, services, and/or managerial resources are the same or of a similar type
   c. The target and acquiring companies must be related inasmuch as it is envisaged that, once the merger is complete, the products, assets, services, and managerial resources of both companies will be used in the running of the merged business

In the event that the products, assets, services, and managerial resources of both the target and acquiring companies are to be used in running the business operations of the merged entity, the criteria outlined at 1 and 2 above will be deemed to be met.

For business operations to be recognized as "operationally relevant", the acquiring company and target company must both be involved in the establishment of an operating base, employment and/or selection of executive officers, and operation of the business itself (or in the preparation for such operation). In the event that an overseas company sets up a new subsidiary in Japan and engages in business, it must establish an operating base, take on staff and directors, advertise its business or conduct market surveys in Japan, and, if its business is the same as that of the disappearing Japanese company, even if it is not actually engaged in such business at the time, it will nevertheless be acknowledged to have operational relevance.

This latest ministerial ordinance goes a long way towards reducing tax system-related obstacles to the triangular merger of an overseas company with a Japanese company. However, in the event that an overseas company establishes an insubstantial paper company, which it then uses to enter into a triangular merger with a Japanese company, it will be deemed not to have "operational relevance" and the merger itself will be deemed a non-qualifying merger.

The revised ordinance came into effect on 13 April 2007, the date of its official announcement. It is therefore applicable to triangular mergers with effect from 1 May 2007, the date on which the ban on such mergers was lifted.