Proceedings from the
2009 Sho Sato Conference
on Tax Law, Social Policy,
and the Economy

Tax-Free Treatment for Corporate Reorganizations in Japan

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This paper was presented at a Sho Sato Conference held on March 9-10, 2009, under the auspices of the Institute for Legal Research and in cooperation with the Robbins Religious and Civil Law Collection, School of Law, University of California, Berkeley.

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Tetsuya Watanabe[1]

Introduction and Premises: Japanese Current Fiscal Situation

Japan introduced basic rules for tax-free corporate reorganization with the Corporation Taxation Act (CTA)[2] in 2001. More recently, in 2006 the Diet added new rules for triangular type of reorganization such as triangular merger in the response to the introduction of the consideration relaxation rule by the Companies Act[3] of the same year.

In general, reorganization transactions are taxable because they are so-called realization events. However, if the transactions are qualified reorganizations under the law, no gain or loss would be recognized both on the corporate and shareholder level (deemed dividends would not be recognized either), and the basis of the assets or stocks transferred would be carried over. Consequently, they are sometimes referred to as "tax-free reorganizations." These treatments are similar to like-kind exchange, involuntary conversion, or buying a new residence.

This paper will explain the contents of these Japanese new rules of corporate reorganization and examine each requirement for tax-free treatment from the comparative perspective.

Before entering the topic of reorganization I would like to mention briefly the Japanese current fiscal situation and basic tax rules for corporate transactions. The GDP of Japan in 2007 fiscal year is over 515 trillion yen which is the second largest in the world. The national revenue in 2008 is 83 trillion yen (and will be 88 trillion yen in coming 2009). In the total revenue only 64% comes from tax and the rest essentially from public bond issues. Japan also has heavy fiscal deficit these days, which has been accumulated year by year, and present state are 607 trillion yen in national government and 197 trillion yen in local governments. The total amount of 804 trillion yen is more than 157% of one year's GDP; that is a quite anxious situation.

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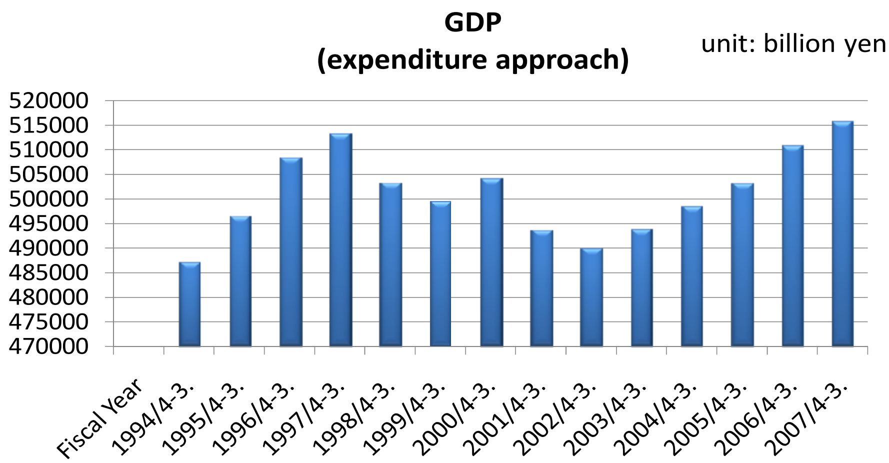
[2] *See* Cabinet Secretariat, English translation of the Corporation Tax Act (Limited to the provisions related to foreign corporations), available at http://www.cas.go.jp/jp/seisaku/hourei/data/cta_2.pdf (last visited May 15, 2009).

[3] *See* Cabinet Secretariat, English translation of the Companies Act (PART I to PART IV), available at http://www.cas.go.jp/jp/seisaku/hourei/data/CA1_4_2.pdf (last visited May 15, 2009).

GDP



data: http://www.esri.cao.go.jp/jp/sna/qe083-2/gdemenuja.html
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General Account Budget for (FY2009 Budget)

(unit: billion yen)

	FY2008 (Initial)	FY2009 (Initial)	FY2008 → FY2009	Note
(Revenues)				
Tax Revenues	53,554.0	46,103.0	-7,451.0	• Including tax cut (-435.0) • A portion of Gasoline Tax, have been transferred into Special Account for Social Infrastructure Improvement directly (650.0 billion) budgeted into general account. (The same change occurred in expenditure side.)
Non-tax Revenues	4,159.3	9,151.0	4,991.7	• Including transfer from Special Account for Fiscal Investment and Loan Program Fund (Fiscal Loan Program Fund Account) (4,235.0)
Government Bond Issues	25,348.0	33,294.0	7,946.0	• Bond dependency ratio: 37.6% (FY2008: 30.5%)
Construction Bonds	5,212.0	7,579.0	2,367.0	
Special Deficit-financing Bonds	20,136.0	25,715.0	5,579.0	
Total	83,061.3	88,548.0	5,486.7	
(Expenditures)				
National Debt Service	20,163.2	20,243.7	80.5	
Local Allocation Tax Grants, etc	15,613.6	16,573.3	959.7	
General Expenditures	47,284.5	51,731.0	4,446.5	• Including rise in state contribution of basic pension (2,300.2)
Social Security	21,782.9	24,834.4	3,051.5	
Contingencies	350.0	1,350.0	1,000.0	• Newly create Contingencies for Emergency Economic Responses (1,000.0).
Total	83,061.3	88,548.0	5,486.7	

http://www.mof.go.jp/english/budget/e20081224a.pdf
(last visited May 4, 2009)

Long-term Debt Outstanding (FY2009 Budget)

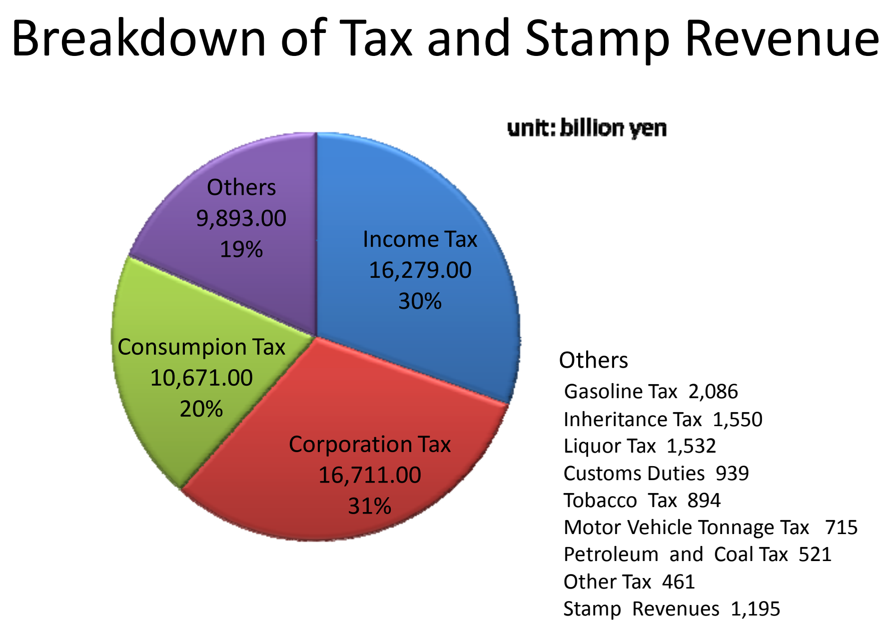
(Unit : Trillion Yen)

	FY1995 <Settlement>	FY2000 <Settlement>	FY2007 <Settlement>	FY2008 <Revised>	FY2009 <Budget>
Central Gov.	285	464	568 (551)	591 (571)	607 (595)
General Bonds	225	368	541 (524)	563 (543)	581 (569)
Percentage of GDP	45.4	72.9	105.0 (101.7)	110.6 (106.6)	113.9 (111.5)
Local Gov.	125	181	199	197	197
Percentage of GDP	25.1	36.0	38.5	38.6	38.6
Total	410	646	767 (750)	787 (767)	804 (792)
Percentage of GDP	82.6	128.1	148.6 (145.3)	154.6 (150.7)	157.5 (155.2)

(Note)
1. GDP for FY2008: estimates, FY2009 forecast
2. Figures in parentheses exclude front-loading issuance of refunding bonds.
3. Government bonds outstanding of Special Account for Fiscal Loan Program Funds is 123 trillion yen as of the end of FY2009.

http://www.mof.go.jp/english/budget/e20081224a.pdf
(last visited May 4, 2009)

Of course tax revenue is very important, and estimated at 53.554 trillion yen in 2008 budget. The corporate tax (corporate income tax) is 31% of the total tax and stamp revenue. Though that amount is lower due to the current economic crisis, this is still one of the main tax revenues in Japan.



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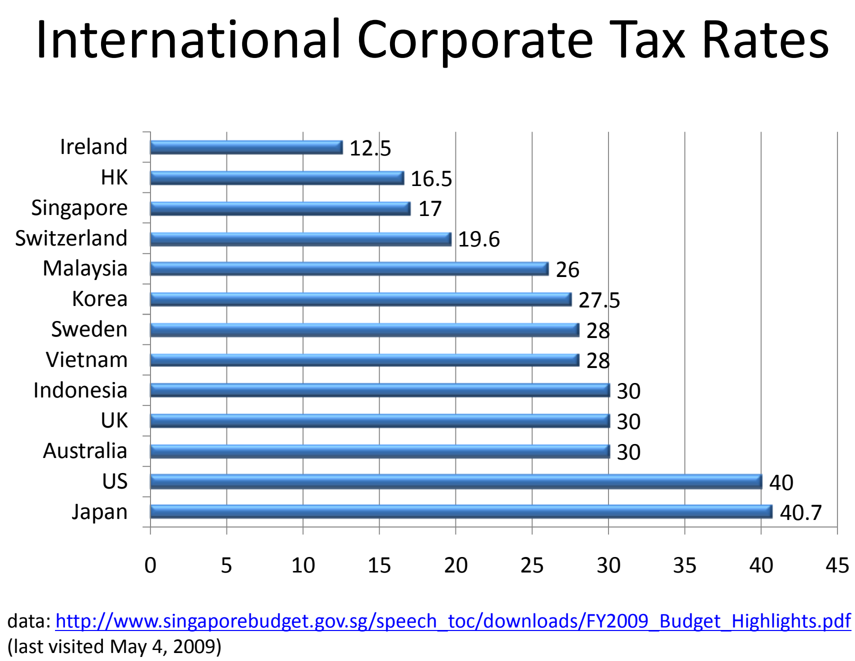
Like the United States, the rate of corporate tax in Japan is quite high compared to other developed countries. On the other hand, there are many low rate countries or jurisdictions like Singapore. Since Singapore newly introduced a 1% cut in headline rate from 18% to 17% (effective from 2010 fiscal year),[4] the differential with Japan is more than double. The Japanese top individual income tax rate is also very high, at 50% including local tax.

[4] BUDGET HIGHLIGHTS, Financial Year 2009 Keeping Jobs, Building for the Future Misc. 2 of 2009 at 29, available at http://www.singaporebudget.gov.sg/speech_toc/downloads/FY2009_Budget_Highlights.pdf (last visited May 4, 2009).



Since the corporate tax rate is so high (and income taxation for stock transfer is not low enough) in Japan, it would be a great concern whether a transaction is qualified or not for the taxpayer who has plans to conduct a reorganization. Though it is mentioned later in detail, if transactions qualify as qualified reorganizations, basically non-recognition treatments are allowed both at the shareholder and corporation levels. Gains or losses from qualified reorganizations such as qualified mergers are realized but not recognized. If transactions are not qualified reorganization, target corporations are taxed for their assets dispositions and shareholders of target corporations (in the case of merger, shareholders of merged corporations) are taxed as if they received dividends (deemed dividends). The shareholders also may be taxed for capital gains from their stock.

For individual stockholders, dividends are included in ordinary income and subject to withholding tax of 20% tax rate under the Income Tax Act (ITA), Arts. 181-182.[5] However, a taxpayer who owns less than 5% of listed company stock can elect for separate withholding taxation at a 7% rate under the Act on Special Measures Concerning Taxation (ASMT), Art. 8-5. Taxpayers may credit some amount of dividends received

[5] For corporate stockholders, the amount equivalent to 50% of the amount dividends (not from foreign corporation) received by domestic corporations are not be included in gross revenue in computing taxable income (CTA, Art. 23(1)). In the case of qualified dividends received from a corporation as a member of the same affiliated group or from a not less than 25%-owned corporation, 100% of the amount of dividends are not to be included (CTA, Arts. 23(1) & (5)).

(10% or 5%, depending on dividend income) unless they elect the separate withholding taxation (ITA, Arts. 92). This dividend credit system is only a partial integration for avoiding double taxation between corporations and shareholders.

Capital gain from stock transfers by individual stockholders is taxed at a 15% flat rate (ASMT, Art. 37-10(1)). However, the amount of less than 5,000,000 yen gain is taxable at a 7% rate by the end of 2010 (Supplementary of ASMT, Art. 43(2)). Generally capital losses from stock transfers cannot be offset to any other type of gain or income, and cannot be carried forward or carried back either. Capital losses from stock transfers can offset only the same type of gain in the same accounting year. The rest of losses is deemed zero (ASMT, Art. 37-10(1)).

As a side note, there are also non-recognition treatments for other transactions such as (1) like-kind exchange (ITA, Art. 58), (2) gift and inheritance (ITA, Art. 60), (3) involuntary conversion (ASMT, Art. 33) and (4) sale of principal residence (ASMT, Art. 36-2).

The United States has the same or similar rules too. (1) Like-kind exchange is under IRC §1031. (2) Gifts are under IRC §102, but only in the case of gifts, basis is transferred under IRC §1015. In inheritance cases the basis is stepped up to the FMV under IRC §1014. (3) Involuntary conversion is under IRC §1033. (4) Sale of principal residence was under former IRC §1034, but now §121 covers this type of transaction and under § 121 it may be tax free.[6]

1. What are Reorganizations?

CTA Arts. 62 to 62-9 are provisions for "income calculation of reorganization" and Art. 62-8(9) refers to "qualified reorganizations" as "qualified merger," "qualified corporate division," "qualified investment in kind," and "qualified subsequent incorporation." CTA Art. 132-2, which is a general anti-avoidance provision for reorganization, adds "stock exchange" and "stock transfer" to these four categories as reorganizations in a 2008 amendment. This paper will mainly treat merger or corporate division, which is one of the most important categories of reorganization.

According to Abrams and Doernberg, the term reorganization encompasses "all corporate rearrangements by which the assets of corporation are transferred to a new

[6] On the other hands, Japan doesn't have non-recognition rule for the transfers of property between spouses or incident to divorce, which is under §1041 of IRC. Accordingly if a taxpayer transfers property to his or her spouse, he or she is taxed on capital gain of that property in Japan. About transfer of property incident to divorce, there is a famous Supreme Court case (29 Minshu 641 (Sup. Ct., May 27, 1975)) which said the husband was taxed on transfer of property not only in the case of damage to his wife but also in the case of mere distribution of property incident to divorce. However there are critics of this decision. *See* Kaneko Hiroshi, *"Shotokuzei to Capital Gain [Individual Income Tax and Capital Gains]," Japan Tax Law Review* 3 (1975): 40, 52.

corporate entity or are retained by the corporation but controlled by new shareholders."[7] This may be also true for Japanese reorganization. For example, "The assets of a corporation are transferred to a new corporate entity" fits to merger or corporate division and "The assets of a corporation are retained by the corporation but controlled by new shareholders" is the case of investment in kind or stock for stock exchange.

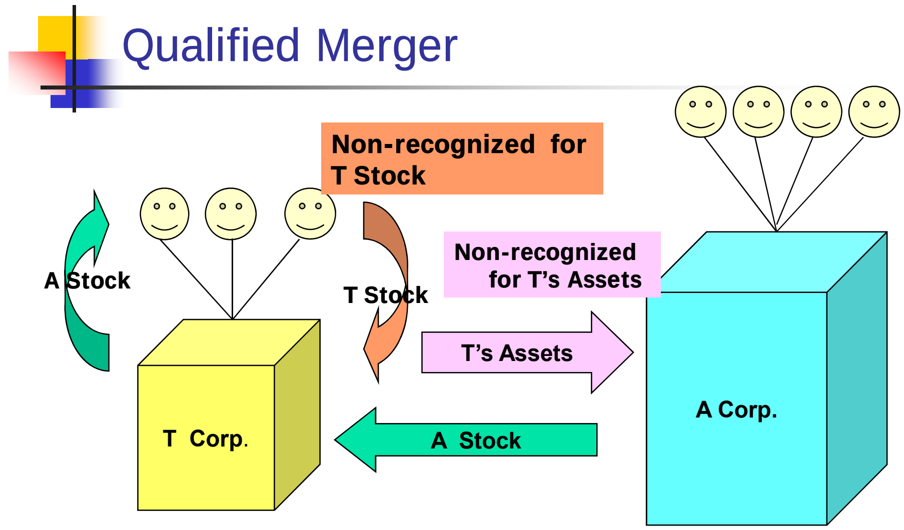
CTA Art. 62 provides that when a corporation transfers assets or liabilities by merger or corporate division, it is treated as if that corporation transfers the assets or liabilities at fair market value (FMV). In other words, merger and corporate division are realization events.[8]

However, if transaction falls within qualified reorganization, it is treated as deemed book value transfer and gains or losses are deferred under CTA Art. 62-2(1). For example target corporation (T corp.) merges into acquiring corporation (A corp.) by merger. Suppose the asset's basis in T corp. is 100 and its FMV is 300, and the T stock basis in T shareholder is 50 and FMV is 150. If the transaction is qualified merger, T corp. is treated as if it transfer asset at 100 not 300. So T corp. is not taxed and basis of the asset in A corp. will be 100 (transferred basis). That means A corp. may be taxed when it sell the assets in future.

T shareholder releases T stock and receives A stock by merger. In the case of qualified merger, T shareholder is not taxed and the basis of A stock will be 50 under Income Tax Act Enforcement Order (ITAEO), Art. 112. That figure (50) is same as the basis of T stock which he or she released (substituted basis).

[7] *See* Howard E. Abrams & Richard L. Doernberg, Federal Corporate Taxation, 217(6th ed. New York, 2008).

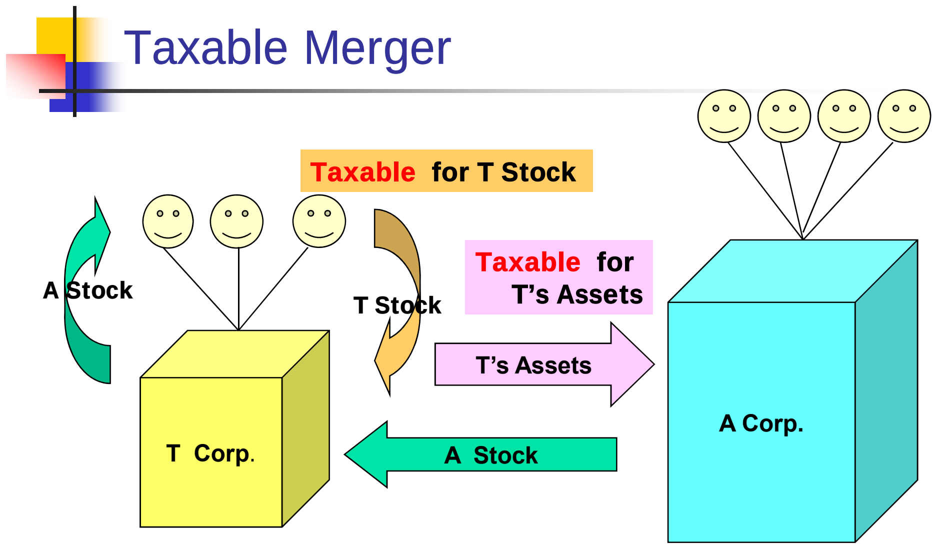
[8] However, there is no word or definition of "realization" in any tax statute in Japan.



On the other hand, if transaction is not qualified merger, T corp. is taxed as if it disposes (sells) the assets at FMV and the basis of the assets in A corp. will become also at FMV. T shareholder is taxed on deemed dividends under ITA Art. 25(1)(i)[9] and also may be taxed on capital gains under ASMT Art. 37-10(3)(i).[10]

[9] Though ITA, Art. 25(1) (i) and ITAEO, Art. 61(2)(i) are not written literally, the amount of deemed dividend is calculated substantially according to the earning surplus (*rieki tsumitatekingaku*) of the target corporation.

[10] In the case of taxation on deemed dividends only, the basis of A stock in the hand of former T shareholder will be the basis of T stock plus the amount of T shareholder tax (ITAEO, Art. 112). In the case of taxation on deemed dividends and capital gains, the basis of A stock will be same as FMV.



2. Effects of Companies Act

Corporation law such as the Companies Act always has great significance for tax law. The Japanese Corporation Tax Act first introduced systematic tax-free corporate reorganization rules in 2001, just one year after the corporation law (it was the Commercial Code at that time and changed to the Companies Act in 2006) had introduced new corporate division rules.

Before making tax rules for corporate divisions in the Corporation Tax Act, the former ASMT Art. 37-13-2 (or 37-14(1)(ii)) had already introduced the tax-free stock for stock exchange and stock transfer rules in 1999. Though this was an ASMT amendment, it also had been affected by the Commercial Code, which introduced stock exchange and stock transfer in the same year. The tax rules of stock exchange and stock transfer moved from the ASMT to CTA by 2007 amendment and currently in CTA, Arts. 2(xii)-16 and 17.

More recently, in 2006 the Companies Act introduced the consideration relaxation rule, which allowed triangular type reorganizations such as triangular mergers. In triangular reorganizations an acquiring company may use the stock of its parent company (not its own stock) as consideration to shareholders of the target company. Responding to the amendment of the Companies Act, the Japanese Diet added new tax rules for qualified triangular type reorganizations in 2007. For example, in a triangular merger the parent company should have all subsidiary stock under CTA Art. 2(xii)-8 (namely, the parent should be a 100% parent company).[11]

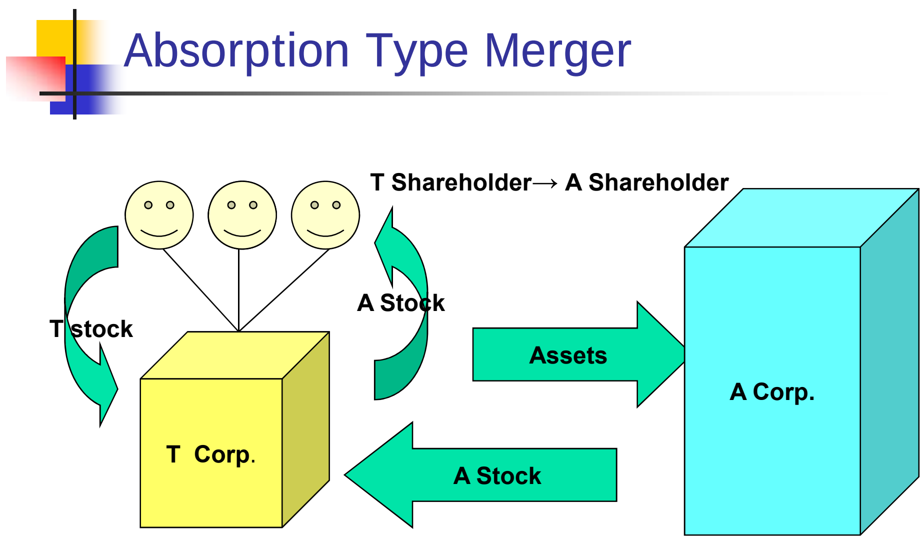
[11] If each type of Japanese reorganization were applied to U.S. counterparts, merger would be Type A reorganization under IRC §368(a)(1)(A), stock exchange would be Type B reorganization under IRC

To become a qualified reorganization, the starting point is the Companies Act. If a transaction is not a reorganization under the Companies Act, it will not be a reorganization under the Corporation Tax Act either. In other words, to be a qualified reorganization for tax purpose, the transaction must first be a reorganization under the Companies Act.[12]

3. Types of Reorganizations

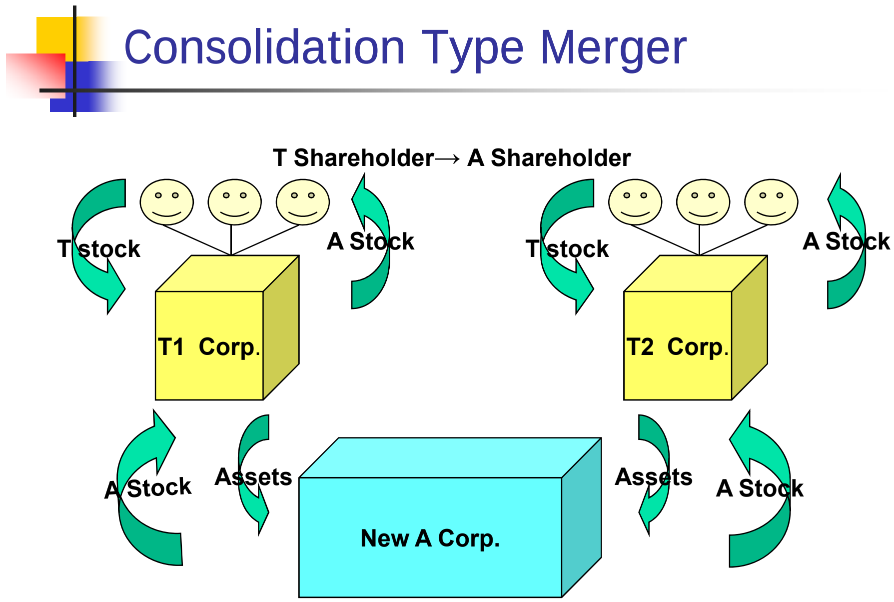
(1) Merger

There are two types of mergers, absorption-type mergers and consolidation-type mergers (Companies Act, Art. 2(xxviii)). The former is any merger effected by a company with another company whereby the surviving company succeeds to any and all rights and obligations of the absorbed company (Companies Act, Art. 2(xxvii)). The latter is any merger effected by two or more companies whereby the new company incorporated by the merger succeeds to any and all rights and obligations of the companies consolidated by the merger. Both types of merger can be qualified reorganizations in the Corporation Tax Act (Companies Act, Art. 2(xxviii)).



§368(a)(1)(B) and corporate division would be divisive Type D reorganization under IRC §368(a)(1)(D) and 355. But strictly speaking, they are deferent with each other and requirements are also deferent. Furthermore Japan doesn't have Type C, acquisitive Type D or Type E etc.

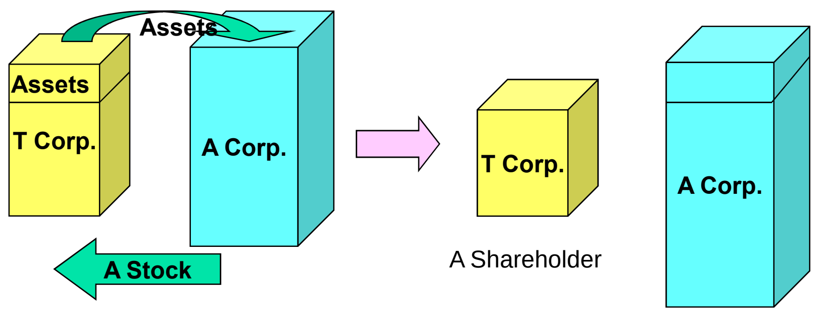
[12] That is to say, transactions should be mergers, corporate divisions, stock exchanges, stock transfers, investments in kind and subsequent incorporations under the Companies Act. However, strictly speaking, investments in kind and subsequent incorporations are not reorganizations in Companies Act. But still transactions should be investments in kind or subsequent incorporations under the Companies Act to become qualified reorganizations in tax law.



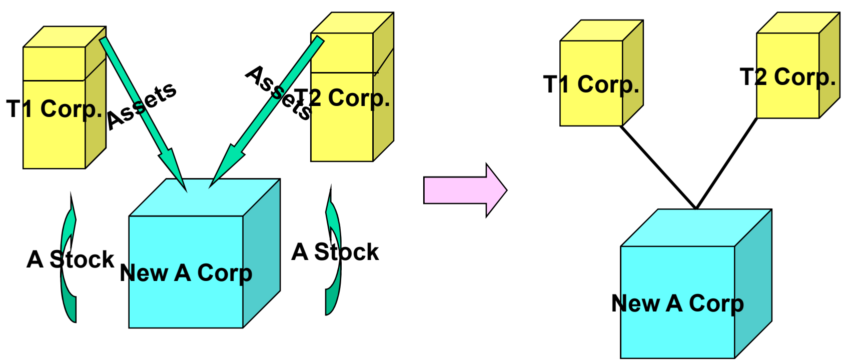
(2) Corporate division

Like mergers, corporate divisions also are split into absorption-type and incorporation-type. Absorption-type corporate division is any corporate division whereby the succeeding company succeeds, after the corporate division, to any rights and obligations, in whole or in part, in connection with the business of the stock company or the limited liability company which is divided (Companies Act, Art. 2(xxix)). Incorporation-type corporate division is any corporate division whereby the new company incorporated by the corporate division succeeds to any rights and obligations, in whole or in part, in connection with the business of the stock company or the limited liability company that is divided (Companies Act, Art. 2(xxx)).

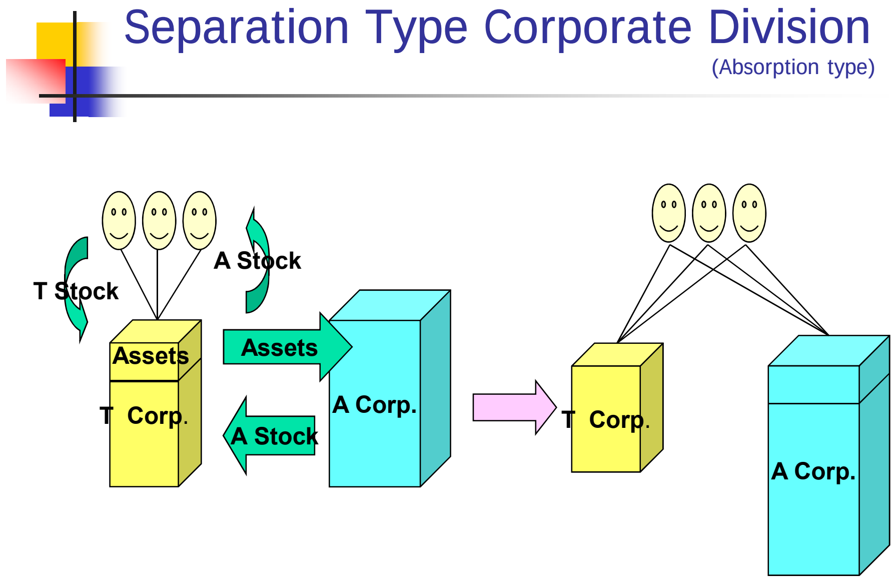
Absorption Type Corporate Division

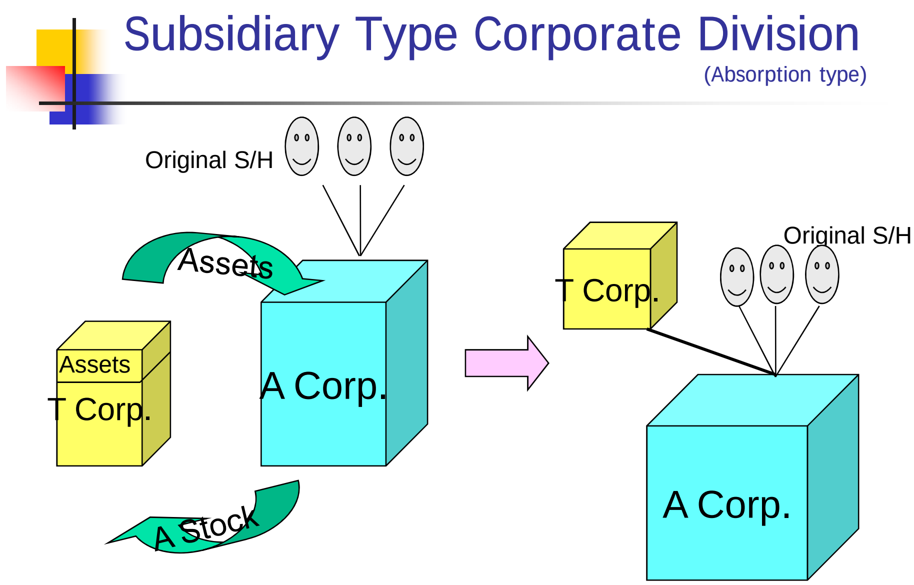


Incorporation Type Corporate Division



Additionally there are two types of corporate divisions in tax law. These are separation-type corporate divisions and subsidiary-type corporate divisions. The former is a corporate division where stocks of the acquiring corporation, which are received by the target corporation, are delivered to shareholders of the target corporation on the date of the corporate division (CTA, Arts. 2(xii)-9). The latter is a corporate division where the stocks of the acquiring corporation, which are received by the target corporation, are not delivered to shareholders of a target corporation on the date of corporate division (CTA, Arts. 2(xii)-10).

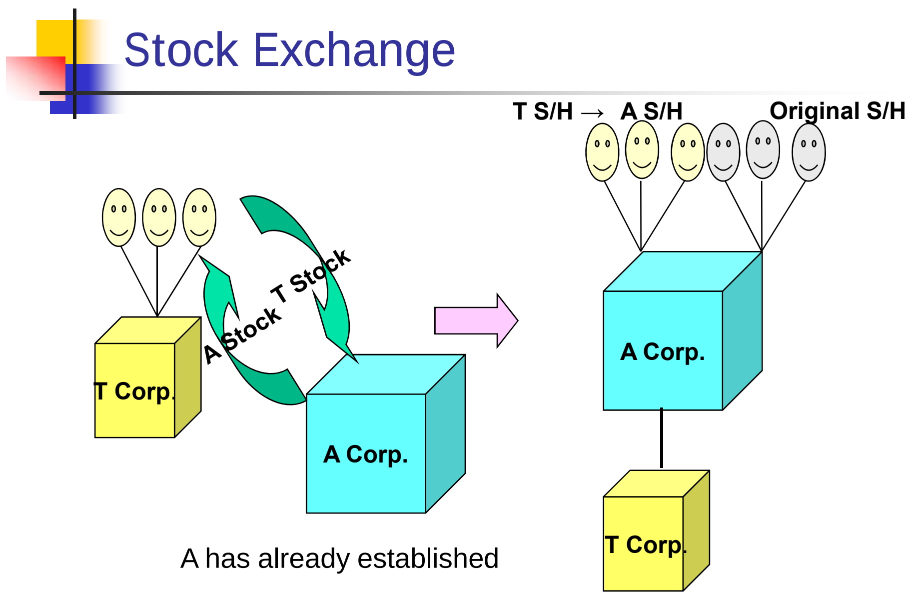


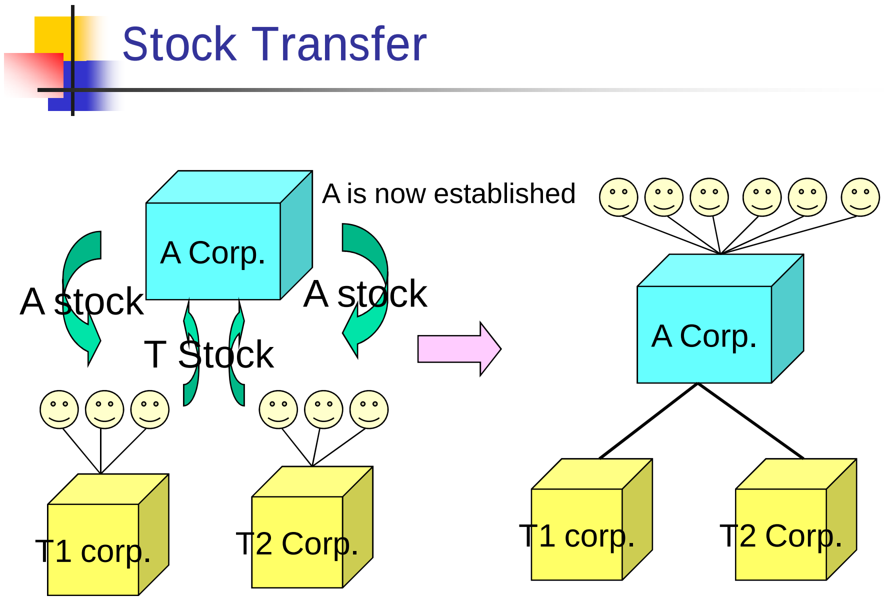


Accordingly, in total there are four types of corporate divisions which are absorption/separation type, absorption/subsidiary type, incorporation/separation type and incorporation/subsidiary type corporate divisions.

(3) Stock exchange and stock transfer

Stock exchange is any exchange of shares whereby a stock company causes all of its issued shares to be acquired by another stock company or limited liability company (Companies Act, Art. 2(xxxi)). Stock transfer is any transfer whereby a stock company causes all of its issued shares to be acquired by a newly incorporated stock company (Companies Act, Art. 2(xxxii)).



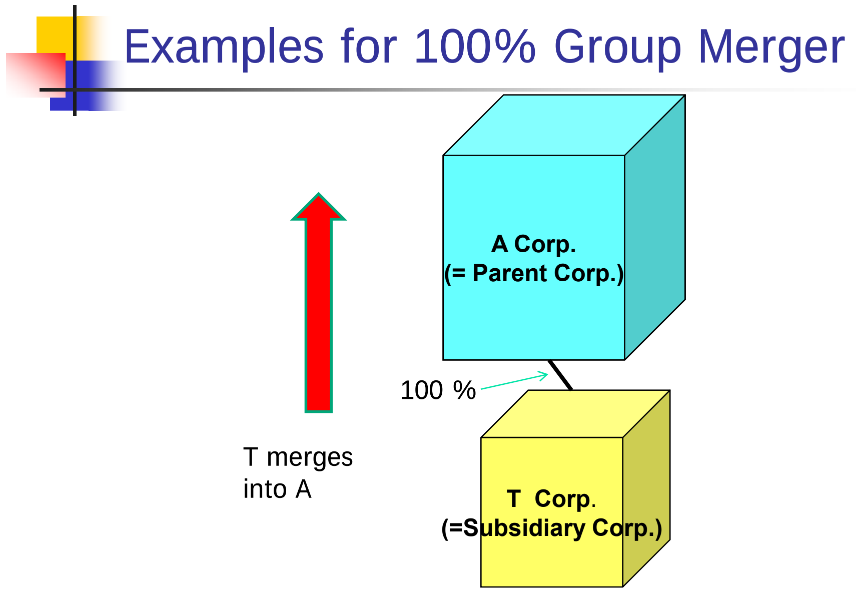


4. Three Categories of Reorganization in Tax Law

For tax purpose there are three categories of reorganization, which are (1) 100% group Reorganization, (2) over 50% group reorganization and (3) joint business reorganization. This could also be termed two categories, group reorganization ((1) and (2)) and non group reorganization (3). The reason to distinguish from (1) to (3) is the requirements for qualified reorganization applied to each category are different.

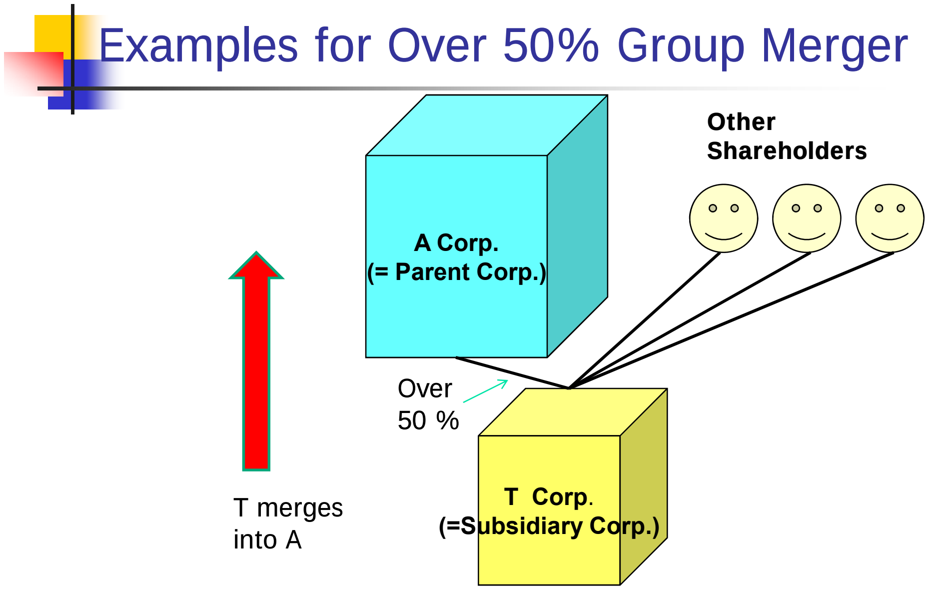
(1) 100% group reorganization

Reorganization within 100% corporate group is called a 100% group reorganization. For example, a 100% group merger means the merger in which there are relations that, between the receiving corporation (usually acquiring corporation) and the transferor corporation (usually target corporation) involved in the merger, either corporation holds directly or indirectly the whole of stocks issued of the other corporation (CTA, Art. 2(xxii)-8(a)). So if A corp. has 100% T stock (T corp. is 100% subsidiary of A corp.) then T corp. merges into A corp., that is 100% group merger.



(2) Over 50% group reorganization

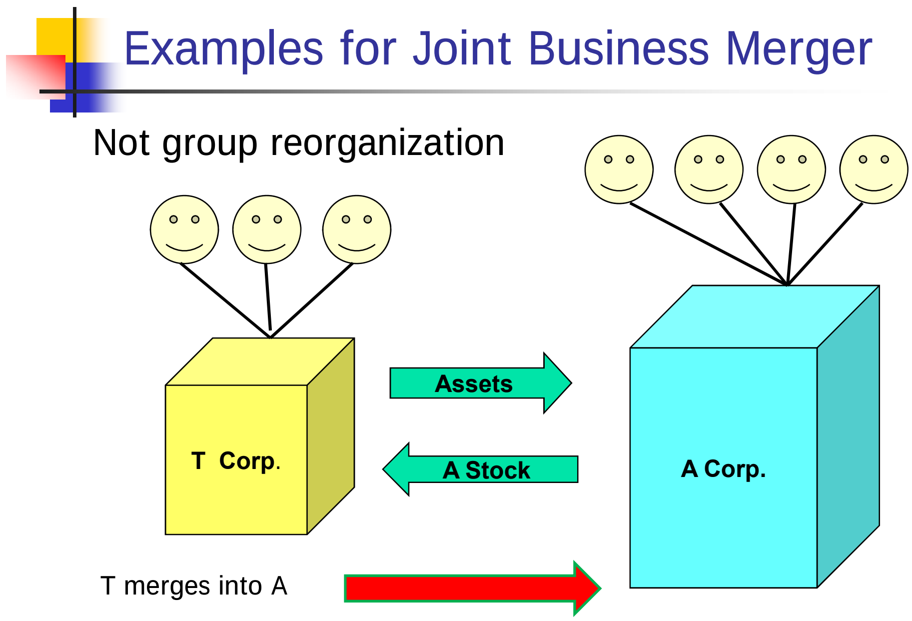
Reorganization within over 50% (but less than 100%) corporate group is called over 50% group reorganization. In the case of merger, the merger in which there are relations that, between the receiving corporation and the transferor corporation involved in the merger, either corporation holds directly or indirectly more than 50% but less than 100% stocks issued of the other corporation is over 50% group merger (CTA, Art. 2(xii)-8(b)). If A corp. has 60% T stock (T corp. is 60% subsidiary of A corp.) then T corp. merges into A corp., that is over 50% group merger.



(3) Joint business reorganization

Joint business reorganization is the reorganization which isn't group reorganization and Cabinet Order prescribes as reorganization for the purpose that the receiving corporation and the transferor corporation are jointly engaged in businesses.[13] If A corp. doesn't have over 50% T stock, say 0% (T shareholders and A shareholders have no relationship) then T corp. merges into A corp., that is one of joint business merger.

[13] In the case of merger, the Cabinet Order prescribes as a merger for the purpose that the transferee corporation and the transferor corporation are jointly engaged in businesses is a joint business merger under CTA, Art. 2(xxii)-8(c).



5. Reason for Tax Deferral

What is the basic reason for tax deferral treatment of qualified reorganization? We can see it in the *Tax Commission Paper*, which was the document for the second general meeting of Tax Commission in October 3, 2000.[14] This paper states the rationale for tax deferral as following:

> The main issue of tax rule for reorganizations such as corporate divisions or mergers is how to treat loss or gain of assets transferred by the reorganization. Generally when a corporation transfers the assets to others, it is treated as a transaction at FMV where gain or loss arises. This is also true in the case of reorganization by which the assets are transferred.
>
> However, before and after the transfer of the assets by reorganization, when there is nothing really changing in substance, it is appropriate to continue the same tax situation as before. Accordingly if there is a continuity of control to the transferred assets after the reorganization, corporations could defer the gain or loss of transferred assets.

[14] "Kaisha Bunkatsu – Gappei tou no Kigyou Soshiki Saihensei ni kakaru Zeisei no Kihonteki Kangaekata [*The Basic Theory for Tax System of Corporate Reorganization such as Mergers and Corporate Divisions*]" [Hereinafter *The Tax Commission Paper*] II-1; available at http://www.cao.go.jp/zeicho/siryou/a02kai_2.html (last visited May 15, 2009).

> In the case of separation type corporate division or merger, the gain or losses from old stock in the hands of shareholders of the divided corporation or merged corporation (stock in divided corporation or merged corporation) also should generally arise. However when shareholders keep continuing their investment, on the base of the reasons mentioned above, that gain or loss could be deferred.

So according to the Tax Commission, two continuities, namely "continuity of control to the transferred assets" in corporate level and "continuity of investment" in shareholder level are the reasons for tax deferral treatment.[15] These seem to be based on neutrality of taxation. Therefore tax deferral on qualified reorganization is different from tax preference. The basic purpose of tax deferral may not promotion but non-impediment of proper corporate reorganization. Accordingly deferral treatments should not depend on taxpayer's choice.

6. Requirements for The Qualified Reorganization

(1) Each requirements

To be a qualified reorganization, there are basically eights statutory requirements which rest on in what categories transaction falls. They are (i) no boot, (ii) transfer major assets and liabilities, (iii) continuity of employees, (iv) succession of business, (v) related business, (vi) similarity of size (vii) continuity of senior officers, and (viii) continuity of shareholding requirements.

• No boot requirement

Under this requirement, consideration of reorganization should be stock in acquiring corporation (or stock in parent of acquiring corporation in the case of triangular reorganization). If other than stock in acquiring corporation, for example money is provided as a consideration, even though a small amount, transaction becomes disqualified reorganization then both of corporation and shareholder would be taxed.

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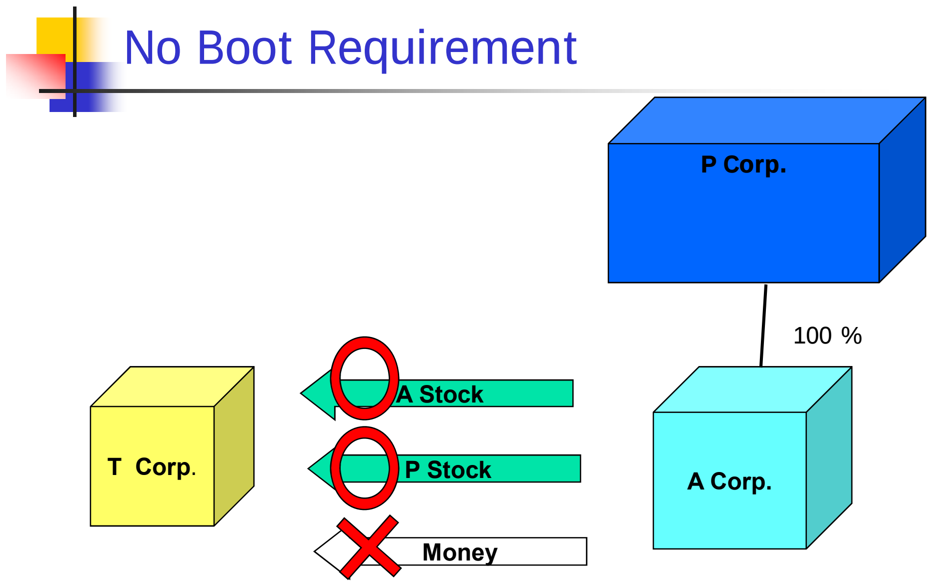
[15] *See* Tetsuya Watanabe, "Kigyō Soshiki Saihenzeisei [*Basic theory of Tax Free Corporate Reorganizations*]," *Japan Tax law Review* 31 (2003): 39.

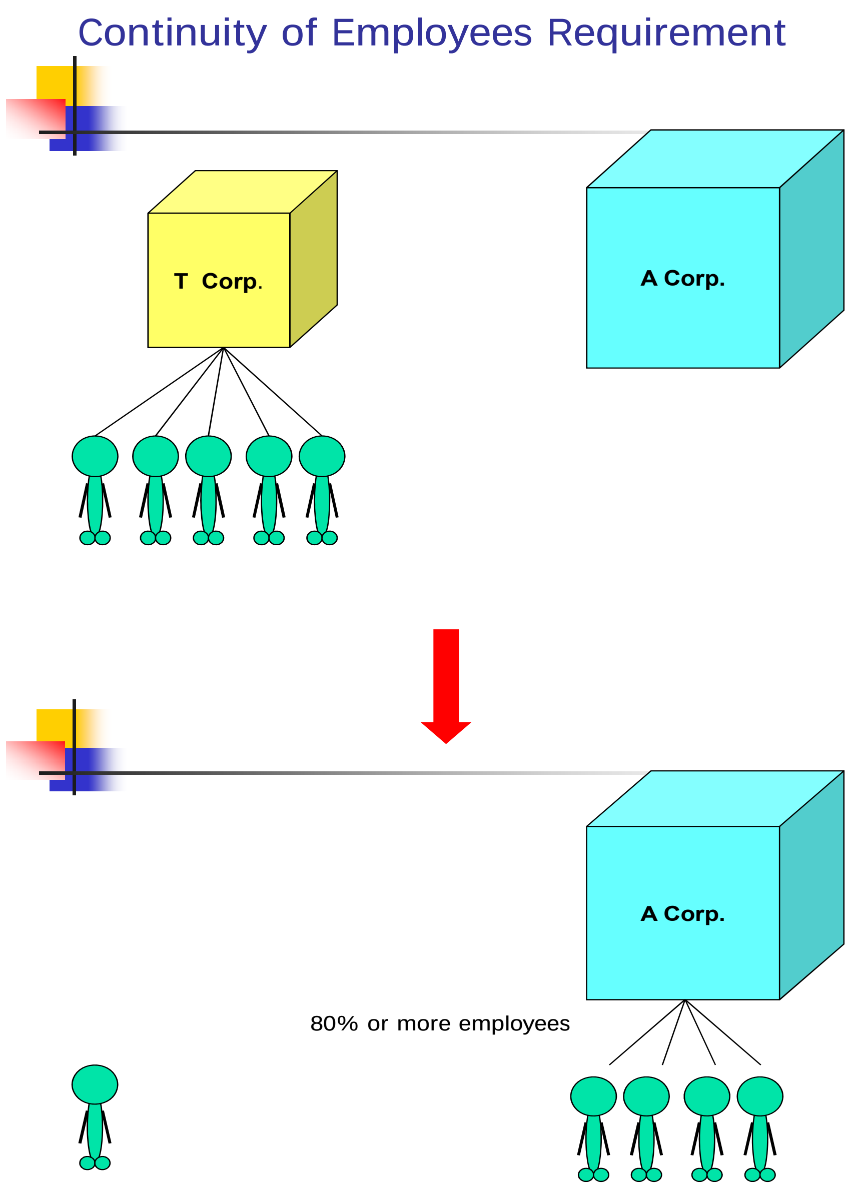


• Transfer major assets and liabilities requirement

The major assets and liabilities utilized in the business of transferor corporation (target corporation) are transferred to the receiving corporation (acquiring corporation). However this requirement is not made in mergers. Since in merger all assets and liabilities of the target corporation are transferred to the acquiring corporation (that is one of the main character of merger), it may be unnecessary to put this requirement in the statute.

• Continuity of employees requirement

80% or more of the employees engaged in the transferred business (in the target corporation) are expected to continue to be employed by the receiving corporation.



• Succession of business requirement

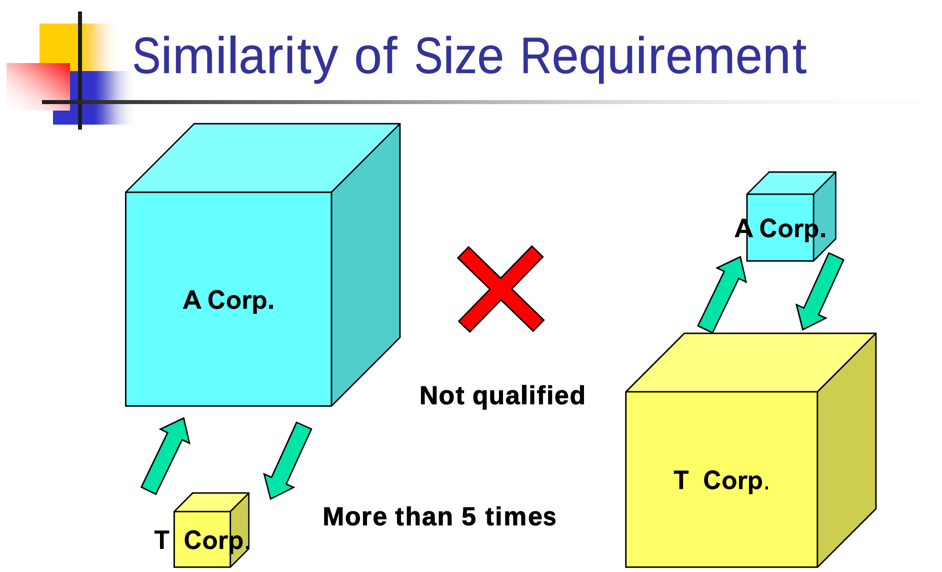
The transferred business of the transferor corporation is expected to be succeeded by the receiving corporation. This is similar to Continuity of Business Enterprise (COBE) requirement in U.S. tax law, which is satisfied if the acquiring corporation either continues the target corporation's historic business or uses a significant portion of the target's historic business assets in a business.[16]

• Related business requirement

Transferred business of the transferor corporation and one of the businesses of the receiving corporation are mutually related.

• Similarity of size requirements requirement

The transferor business in the transferor corporation is not larger than five times the mutually related business in the receiving corporation or smaller than one fifth of the mutually related business in the receiving corporation in terms of one of the following indices (1) revenue of the business, (2) number of employees hired in the business, or (3) amount of capital (in the case of merger).



[16] Reg. §1.368-1(d)(1); Rev. Rul. 81-25, 1981-1 C.B. 132. It is said that COBE requirement is rather loose and reasonably easy satisfy. If the target corporation has more than one line of business, that acquiring corporation continues one significant line of business would be enough or if acquiring corporation simply uses a significant portion of the target's historic business assets in any business, COBE requirement is satisfied. *See* Cheryl D. Block, *Corporate Taxation: Examples & Explanations* (3rd ed., New York, 2004) 373.

• Continuity of senior officers requirement

One or more senior officers of the pre-reorganization transferor corporation and one or more senior officers of the pre-reorganization receiving co before the reorganization are expected to be hired as senior officers of the receiving corporation after the corporate division.

• Continuity of shareholding requirement

If the transferor corporation retains the shares of the receiving corporation (such as subsidiary type corporate division), the transferor corporation is expected to continue to hold all the shares of the receiving corporation; or if the transferor corporation distributes the shares of the receiving corporation to its shareholders (such as separation-type corporate division) and the number of shareholders of the transferor corporation before the reorganization is 50 or less, the shareholders of the transferor corporation who held 80% or more of the voting rights of the transferor corporation are expected to continue to hold all the shares of the receiving corporation received in the reorganization.[17]

(2) Requirements for each category

As mentioned above, there are three types of reorganization. The requirements for qualified reorganization depend on those categories.

(i) There is basically one requirement for 100% group reorganization. That is "no boot" requirement.[18]
(ii) For over 50% group reorganization, they need "transfer of major assets and liabilities," "continuity of employees" and "succession of business" requirements, besides no boot requirement.
(iii) For joint business reorganization, in addition to these four requirements above, there are four other requirements; "related business," "similarity of size," "continuity of senior officers" and "continuity of shareholding" requirements. However, for "similarity of size" and "continuity of senior officers" requirements, satisfying one of those is enough (a transaction does not have to satisfy both of these requirements).

[17] Thus when number of target shareholder is more than 50 in the latter case, there is no continuity of shareholding requirement.

[18] However, you should note that after the reorganization if 100% group relationship is broken, for example in the case of corporate division, parent (acquiring corporation) sells 5% of subsidiary (target corporation) stocks after reorganization, there is no more 100% group reorganization and requirements for over 50% group reorganization should be applied. This is same as the case of over 50% group reorganization.

Finally, there is one more provision which is applicable for all categories. That is the general anti-avoidance rule for reorganization under CTA, Art. 132-2.

7. Analysis

(1) Category problem

Japanese tax law has only these three categories of reorganization. Thus a transaction that doesn't fall in any of three categories can't become a qualified reorganization.

As an example, there is an incorporation/separation type corporate division made by one corporation. Suppose P corp. is a publicly traded company and doing two types of business; business X and business Y. P corp. makes S corp., then transfers all assets of business X to S corp. then P corp. receives S stock as consideration and distributes all S stock to P shareholders.

This transaction is allowed by Companies Act but doesn't meet any category o=f the Corporation Tax Act because it isn't a group reorganization nor joint business reorganization (P corp. and S corp. are not jointly engaged in businesses). Accordingly it isn't qualified corporate division. In other words, unlike U.S. tax law, spin-offs type corporate divisions (which are not group reorganizations) can not become qualified reorganization generally in Japan.

However this tax treatment is unreasonable because there are both "continuity of control" and "continuity of investment" in the *Tax Commission Paper.*[19] It may be worried that tax rules hinder the sound business transactions.[20]

(2) Some of requirements might lack significance of existence (rationale)

• No boot requirement

Because of no boot requirement, there is extremely inconvenient inflexibility. Even if one yen, if an acquiring corporation distributes to one shareholder of the target corporation, other shareholders who do not receive any boot are also taxed. This

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[19] Split-offs are also generally prohibited in Japanese tax law as qualified reorganizations under CTA, Art. 2(xii)-11. For example, individual A and B started business in X corp. with 50-50% share. Though X corp. business was doing well, the opinions of A and B gradually became disagree each other. Then they decided to make split-off by which X corp. distributed half of its assets to found new corporation Y and A released all of his X stocks in exchange of all issued Y stocks. This type of transaction also can not become qualified corporate division and that seems unreasonable too. This treatment is also deferent from U.S. tax law.

[20] The relationship between deferral reasons on the *Tax Commission Paper* and current provisions may not be always clear also. For example, in the case of over 50% group absorption type corporate division, acquiring corporation should keep holding over 50% T stocks under CTA, Art. 2-(xii)-11(b) and CTA Enforcement Order, Art. 4-2(7). However it is hard to understand why this means the "continuity of investment" in shareholder level. From the continuity of investment viewpoint, shareholder should hold distributed acquiring corporation stock (not target corporation stock). This understanding has more consistencies with the *Tax Commission Paper*.

requirement removes flexibility from rules remarkably and prohibits a corporation moving to its proper business organization.

There is another problem that parties very easily make transactions disqualified to distribute boot. Disqualifying does not always make a taxpayer unhappy. For example, if a taxpayer has unrealized loss and transactions become a qualified reorganization, the taxpayer cannot recognize (i.e. deduct) that loss. Therefore some taxpayers may make purposefully disqualified transactions. The stricter requirements make purposefully disqualifying easier. To permit some amount of boot might be needed to prevent such transactions

If Japanese tax law comes to allow some amount of boot, we have to consider and decide what is boot, how much amount of boot should be permitted, who distributes boot (target or acquiring corporation) and also make the taxing rule for both boot distributing side and recipient side. These things will bring much administrative cost including compliance burden. Even though, allowing boot is necessary to remove the inflexibility from current rule.

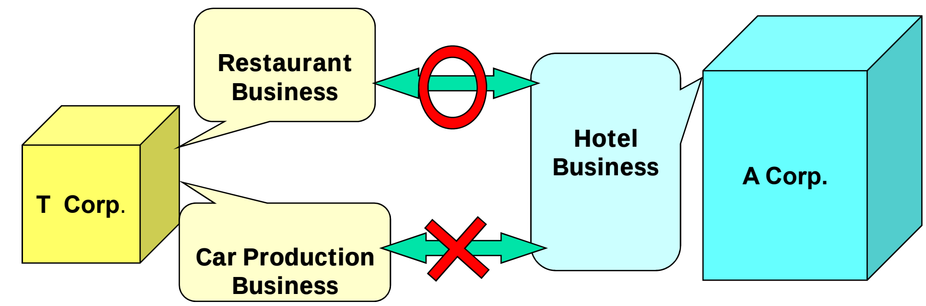
• Continuity of employees requirement

It may be hard to understand the relationship between this requirement and “continuity of control” or “continuity of investment” in the *Tax Commission Paper*. Why should continuity of employment be required for tax deferral treatment? Of course, maintaining employment is important policy, but that seems like a matter of labor law, not tax law. Tax law should be neutral for corporate restructuring. If it is necessary to use the tax system for securing employment from the policy viewpoint, the Diet must explain that purpose for public. We haven’t seen such opinions yet.

• Related business requirement

Under this requirement, it is difficult for corporations that are not mutually related to make conglomerates as a qualified reorganization. Suppose T corp. is running a business in car production and A corp. is doing hotel business. If T corp. merges into A corp., that transaction cannot satisfy the related business requirement because the car production business and the hotel business are not mutually related. However if T corp. is doing restaurant business, the transaction can be qualified merger. But why does tax law prohibit forming conglomerates?

Related Business Requirement



- Hotel and Restaurant may be allowed but Hotel and Car Production may be not.

The related business requirement also could be a severe obstacle in the case of cross-border inbound triangular mergers. The transferred business of the transferor corporation (i.e. the target corporation) and that of the businesses of the receiving corporation (i.e. the subsidiary corporation) should be mutually related under CTA Enforcement Ordinance, Arts. 4-2(4)(ii). If the foreign parent incorporates its subsidiary in Japan to make a triangular merger, the subsidiary should run a business that has a mutual relationship with the target. Therefore, the parent cannot make a shell or SPC as a subsidiary in Japan even if the foreign parent's business is very similar to that of the Japanese target (because the issue is the subsidiary business, not the parent one).[21]

• Similarity of size requirements

Under this requirement if the acquiring corporation is larger than five times or smaller than one fifth than target corporation, both corporations cannot get into merger as a qualified transaction. Suppose T corp. is a target of a takeover by A corp. by means of merger. T corp. is owned by one shareholder and A corp. is a publicly traded company. The size of A corp. is much bigger than T corp. In the course of merger T's shareholder gets A stock and he can sell it in a stock market the same day. In this case A stock that T's shareholder receives is thought of something the same as money. Accordingly it may

[21] *See* Tetsuya Watanabe, "Sankaku Gappei nikansuru Heisei 19nendo Zeiseikaisei [*Tax Reform in 2007 for Triangular Merger*]," *MARR* 153 (2007): 32. *See also* "Kyōdōjigyō wo Itonamutameno Soshikisaihensei(Sankaku Gappeitō wo hukumu) nikansuru Q&A~Jigyō Kanrensei Yō ken no Hantei nituite~[*Q&A for The Joint Business Reorganization (including Triangular Merger ect.)~about the Decision for Related Business Requirement~*]," available at http://www.nta.go.jp/shiraberu/zeiho-kaishaku/joho-zeikaishaku/hojin/6037/01.pdf (last visited May 15, 2009).

be reasonable that law doesn't allow this type of merger as a qualified transaction. But as a tax policy point of view, we should still consider whether "five times" and "one fifth" are proper figures or not.[22] We should also consider when A's stocks are not publicly traded.

• Continuity of senior officers requirement

There troubling for the same reason as the continuity of employment requirement, though senior officers are not usually protected by labor law. Because of this requirement it is hard for the acquiring corporation to discharge a senior officer after the reorganization even if performance of that officer is very bad. It is strange that the position of senior officers is protected by tax law.

• Continuity of shareholding requirement

The continuity of shareholding requirement resembles the continuity of interest (COI) doctrine, which is one of the most important judicial doctrines in the United States. The COI doctrine has required that some amounts of consideration be equity of the acquiring corporation.[23] The main content of this doctrine is that the original owners should retain a continuing interest in the reorganized corporation.[24] The "interest" in this context means the equity interest.[25]

But the continuity of shareholding requirement in the Corporation Tax Act is not always consistent with "continuity of control to the transferred assets" for the corporation level tax deferral and "continuity of investment" for the shareholder level tax deferral in the *Tax Commission Paper*. For example in the case of a joint business merger, the shareholder of T corp. should hold A stock not only for the shareholder level but also for

[22] *See* Boris I. Bittker & James S. *Eustice, Federal Income Taxation of Corporations & Shareholders* (7th ed., New York, 2000 and 2005 Cumulative Supplement) ¶12.02[2]; Richard A. Westin & Richard C. E. Beck, *Federal Income Taxation of Business Enterprises*, (2nd ed., Florida 2008) 551.

[23] Like Japanese law (in the case of number of target shareholders are more than 50), U.S. law does not require to keep holding acquiring corporation stock on the hand of shareholder in target corporation under §1.368-1(e) either. The reasons in both countries are administrative cost or traceability. For the Japanese law, *see* Tomonaga-Yamada, "Kaisya Bunkatsu touno Soshiki Saihensei ni kakaru Zeisei nituite[*Tax Rules for Reorganizations such as Corporate Divisions*]," *Sozeikenkyu* 614 (2000): 62. For the U.S. law, *see* Committee on Taxation of Corporations of the Association of the Bar of the City of New York, Postreorganization Transactions and Continuity of Shareholder Interest, *Tax Notes* 72 (1996): 1401, 1406; Peter L. Faber, "Post-Reorganization Sales and Continuity of Interest," *Tax Notes* 68 (1995): 863, 873.

[24] *See* Bittker & Eustice, *Federal Income Taxation of Corporations & Shareholders*, ¶12.21[1].

[25] *Id. See also* Robert A. Rizzi, "Continuity of Interest and Reorganizations: Toward a Unified Theory," *Journal of Corporate Taxation* 17 (1991): 362.

the corporate level tax deferral.[26] Because whoever keeps holding A stock is a "shareholder," however, this may be a matter of only continuity of investment, not continuity of control.[27]

Regarding qualified triangular mergers, the Ministry of Finance (MOF) explained why they allowed stock in the 100% parent as qualified consideration.[28] It indicated "In the case of 100% parent stocks, by holding these stocks it is possible to continue substantial control in the merged corporation, namely even through the parent stock, it is possible to make the same situation as direct control by stocks in the merging corporation." MOF did not mention who control the merged corporation but it is thought the shareholders of merged corporation. If so "continuity of control" may be a very similar concept to "continuity of investment."[29] However, whether MOF has changed its attitude is not still clear.[30]

(3) Divisive transactions

In Japanese law, divisive reorganizations (such as absorption-type corporate division) are treated equally as acquisitive reorganizations (such as merger). For example, T corp. has several businesses including a bank business with unrealized gain. A corp. wishes to acquire only the bank business in T corp. If T corp. sells the bank business to A corp., T corp. will be taxed on the capital gains in the bank business (assets and liabilities). However, if T corp. transfers the bank business to A corp. by qualified absorption (separation) type corporate division, T corp. will not be taxed.

T corp. can select which business (bank or other business) to transfer to A corp. This situation resembles sale. On the other hand, mergers, in which all assets of target corporations come into the acquiring corporation, differ from absorption-type corporate divisions, where parts of the assets in the target corporations are extracted selectively and transferred to the acquiring corporation.

U.S. law is nervous of divisive transactions and treats these differently from acquisitive transactions. §355 is the provision for tax-free corporate division, the requirements of which are very different from the provisions for acquisitive reorganization such as §368(a) , (b) or (c).[31] For example, if T corp. above spins-off all

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[26] Corporation Tax Act Enforcement Order, Art. 4-2(4)-5.

[27] *See* Tadao Okamura, *Hōjinzeihō Kōgi* [*Corporate Taxation*] (3rd ed. , Kyoto, 2008), 337.

[28] *Kaisei Zeihō no Subete* [*Everything on Tax Reform*] (Tokyo, 2007),272.

[29] *See* Okamura, *Hōjinzeihō Kōgi* [*Corporate Taxation*], 345.

[30] Even it has changed, the matter should belong to Diet not MOF.

[31] There are also case law such as Elkhorn case. Helvering v. Elkhorn Coal Co., 95 F. 2d 732 (4th Cir. 1937), cert. denied, 305 U.S. 605, reh'g denied, 305 U.S. 670 (1938).

businesses except for the bank business and merges into A corp.,[32] T corp. will be taxed on the capital gains under §355(e).

When we observe the absorption-type corporate division from the acquiring corporation side, the transaction has acquisitive elements (A corp. acquires a business in T corp.). But from the target corporation's point of view, there are divisive factors (T corp. divides its businesses and transfers). If Japanese tax law allows treatment of divisive transactions under the same rules as acquisitive transactions, the Diet or Government should explain the reason why they do not treat the two types of transactions differently.

(4) General anti-avoidance provision

There is a general anti-avoidance rule for corporate reorganization in Corporation Tax Act (Art. 132-2). The content of the provision is as follows:

> In making corrections or determinations of corporate taxes on the corporations pertaining to merger etc., if the director of the tax office realizes that the admission of certain transactions or book entries of corporations would result in improper decrease of the burden of corporation taxes, the director of the tax office may compute the tax base of a corporation tax, the amount of deficits, or the amount of corporation tax on the corporation according to his recognition, notwithstanding the transactions or the book entries by the corporation.

According to the *Tax Commission Paper,* the purpose of this provision is anti-abuse against disguising a sale as a qualified reorganization.[33] However, it is still not clear what kind of avoidance would be assumed. Though the content of the provision is so ambiguous, the *Tax Commission* didn't indicate any example transaction.

We don't have any case law in reorganization transaction since 2001 when the Diet first introduced this rule. It should be difficult for the government side to tax by general anti-avoidance provision without a reliable standard. At this moment, this provision could work only as a threat to taxpayers and remove the foreseeable tax consequences. The Diet should enact specific (not general) anti-avoidance provisions,

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[32] This transaction is in Morris Trust case and substantially same as absorption type corporate division however U.S. law doesn't have absorption type corporate division. *See* Commissioner v. Morris Trust, 367 F. 2d 794(4th Cir. 1966). For section 355 (e), *see* Stuart M. Finkelstein & Stuart Lazar, "IRS Overhauls Spin-Off Ruling Guidelines," *Taxes* 74 (1996): 366, 372; Scott E. Stewart, "New Rules for Spinoffs: An analysis of Section 355(e),"*Tax Lawyer* 51 (1998): 649, 651; Richard L. Reinhold, "Section 355(e): How We Got Here and Where We Are," *Tax Notes* 82 (1999): 1485; Scott D. Polsky, "The Cause & True Effects of Code Sec. 355(e)," *Taxes* 76 (1998): 29.

[33] *See* the *Tax Commission Paper, at V*.

including government ordinances with examples, if the Diet really thinks it needs such rules.

On the other hand, the *Jizen Shoukai Seido* (a kind of advance ruling system)[34] which started in 2004 contributes some predictability for taxpayers. But more case law and specific provisions are still necessary to make this system work well, otherwise the government might deny taxpayers' transactions without clear standards. It also means less predictability even though by the *Jizen Shoukai* taxpayers have the chance to refrain from a transaction that they would have tried to make. The only difference is whether the denial by tax authority would be before (by *Jizen Shoukai*) or after (by general anti-avoidance rule) the transaction. There is still ambiguity as well.

Conclusion

It may be difficult to discover the rationale of qualified requirement in Japanese tax rules. In other words, the relationship between each requirement and "continuity of control" or "continuity of investment" are not clear enough. Compared to Japanese law, U.S. law attaches greater importance to shareholder level continuity than corporate level. In short, the "continuity of interest" doctrine is crucial for tax deferral treatments[35] in U.S law.

If Japanese law comes to look at the shareholder level more and introduce something like the continuity of interest doctrine in U.S. law, it could change to allow some amount of boot and spin-off type corporate divisions. It may also repeal some qualified requirements such as "continuity of employees," "related business," or "similarity of size" requirements, which U.S. law doesn't have.

However, it may be possible that Japanese law concerns maintenance of the business before and after reorganization. Accordingly if employees, size, or business contents are changed after the reorganization, that means something changed. In other words, it cannot be said that "nothing really changed," and such kind of transactions may not be qualified reorganizations.

Moreover compared to the United States, Japanese law has benefitted from the fact that it was able to introduce comprehensive legislation in this field without prior legislation and has thus been able to develop a consistent and predictable model in which almost the same rule applies to all reorganization transactions. In U.S. law, it is often difficult to understand the relationship (and possible overlap) between the rules for each

[34] *Kashin* 1-2 and 1-3 (Feb. 14. 2004). This system is improved in 2008, available on the Web; http://www.nta.go.jp/shiraberu/sodan/jizenshokai/bunsho/01.htm (last visit in 2009/05/15)

[35] *See* Bittker & Eustice, *Federal Income Taxation of Corporations & Shareholders,* ¶12.21[1].

type of reorganization because of the long history of the legislation and its many amendments.[36] The limit of the current Japanese system is that not all of the rules have a clear rationale and the Diet still should try to explain the rationale of each requirement.

[36] For policy considerations, *see* The American Law Institute, *Federal Income Tax Project-Subchapter C-Proposals on Corporate Acquisitions and Dispositions and Reporter's Study on Corporate Distributions* (Philadelphia, 1982). *See also* Robert C. Clark, "The Morphogenesis of Subchapter C: An Essay in Statutory Evolution and Reform," *Yale Law Journal* 87 (1977): 90.