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Japan Tax Bulletin

Tax Qualified Corporate Reorganizations under Japan tax law

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On 22 December 2016, a proposal by Japan's ruling coalition containing several changes to the tax code for fiscal year 2017 was approved by the Cabinet. The coalition has since adopted several of these changes and plans to introduce them at the start of the 2017 fiscal year. In the proposal, it was announced that spin-offs, a type of corporate reorganization, will be treated as tax qualified under certain criteria.

1. *Tax qualified corporate reorganizations*

After the reform, Japan tax law will describe seven types of tax qualified corporate reorganizations:

- Merger
- Corporate Division
  - Separation-type
  - Subsidiary-type
- Share Exchange
- Share Transfer
- Contribution-in-kind
- Dividend in kind
- Spin-off (New)
  - By Corporate Division
  - By Dividend in-kind

2. *Treatment of tax qualified corporate reorganization under Japan tax law*

When a company performs a corporate reorganization (e.g. merger) fulfilling the criteria described at 3 below, the merger will be treated as tax qualified. The assets and liabilities are transferred and received at their book values and any gains on the transfer will be deferred. As a result, there will be no corporate tax impact for either the parties to the merger or the merged company's shareholders.

If the criteria are not met, the surviving company is deemed to purchase the merged company's assets and liabilities at market value. The merged company's net assets are revalued from book value to market value and corporate tax levied on the difference.

For merging company, the difference between the actual purchase price and the market value of the net assets is treated as goodwill.

For the merged company's shareholders, a certain amount of the market value of the exchanged assets would be deemed to be dividend income from the merged company and would be taxable income in the hands of the shareholders.

3. *Criteria for "tax qualified" reorganization (excluding Spin-offs)*

For any type of qualified corporate reorganization, the consideration paid by the transferee corporation to the shareholders of the transferor corporation should be in the form of its own shares.

Alternatively, a merger that meets the requirements described below will be a tax qualified reorganization:

3.1. *Merger with a 100% ownership relationship*

A wholly-owned industrial group internal merger, where one group of corporations/individuals owns, directly or indirectly, all of the stock of the other corporation.

3.2. *Merger with ownership of more than 50% but less than 100%*

A controlled industrial group internal merger, where one group of the corporations/individuals owns between 50% and 100% of the stock of the other corporation and the principal business is expected to be continued, and at least 80% of the employees of the transferor corporation are expected to be employed by the transferee corporation

3.3. *Merger performed for conducting a joint business*

A merger other than those listed above which satisfies the following criteria:

A) Existing business relations
The jointly operated business is a merger of the principal business of the transferee corporation and a related business of the transferor corporation.

B) Either of the following criteria is met:
(a) Scale
One of the merged businesses is not five times larger than that of the other one (considering sales, employees, capital, etc.).
(b) Key directors
Key directors of both of the businesses are expected to be key directors in the transferee corporation.

C) Continuing employment
At least 80% of the employees of the transferor corporation are expected to be employed by the transferee corporation

D) Continuing business
The principal business of the transferor corporation is expected to be continued.

E) Continuing shareholding
If there are fewer than 50 shareholders of the transferor corporation, at least 80% of the shareholders of the transferor corporation are expected to continue as shareholders of the transferee corporation.

4. "Tax qualified" Spin-offs (New)

4.1. Spin-off by Corporate Division

A separation-type corporate division, in which a corporation hives off one of its businesses to a succeeding company established as a result of corporate division, will be treated as a tax qualified corporate division if the criteria listed below are met. This is limited to spin-offs where the shareholders of the transferor corporation only receive shares issued by the succeeding corporation in proportion to the ratio of their shareholding in the transferor corporation. As a result, the assets and liabilities will be transferred at book value to the succeeding corporation and any gains on the transfer will be deferred.

A) No group of corporations/individuals owns more than 50% of the transferor corporation before the corporate division and it is expected that no group will continuously own more than 50% of the succeeding corporation after the corporate division.

B) The main assets and liabilities of the transferred business are transferred to the succeeding corporation.

C) At least 80% of the employees of the transferor corporation are expected to be employed by the succeeding corporation.

D) The transferred business of the transferor corporation is expected to be continued in the succeeding corporation.

E) Key directors or employees of the transferor corporation are expected to be key directors in the succeeding corporation.

4.2. Spin-off by Dividend in kind

Where a corporation distributes all of its shares in its wholly-owned subsidiary to its shareholders, if the criteria below are fulfilled, this dividend in-kind will be treated as tax qualified. Again, this is limited to spin-offs where the shareholders of the transferor corporation only receive shares issued by the succeeding corporation in proportion to the ratio of their shareholding in the transferor corporation. As a result, any gains on the transfer of the shares will not be recognized and withholding tax on the dividends will not be levied.

A) No group of corporations/individuals owns more than 50% of the distributing corporation before the dividend in-kind and it is expected that no group will continuously own more than 50% of the subsidiary after the dividend in-kind.

B) At least 80% of the employees of the subsidiary are expected to be employed.

C) The principle business of the subsidiary is expected to be continued.

D) Key directors of the subsidiary are expected not to be retired from the position as a key director.

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