

Japan Inbound Tax & Legal Newsletter

“Consideration requirement” for triangular reorganization transactions relaxed

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In Brief

Japan’s 2019 Tax Reform Act and the related enforcement orders and regulations were published on 29 March 2019. Most of the rules are effective for taxable years beginning on or after 1 April 2019, and several of the provisions are likely to impact inbound M&A transactions. This article analyzes the reform’s relaxation of the “consideration requirement” for triangular reorganization transactions (i.e. reorganizations using shares in a direct and/or indirect parent as consideration) associated with mergers, demergers and share-for-share exchanges.

1. General tax treatment of reorganizations

Japan’s tax code prescribes several requirements for a reorganization transaction to qualify for tax deferral treatment as a “tax-qualified” reorganization. These requirements vary depending on the type of reorganization and shareholding relationship between the acquiring and acquired corporations; however, in general, the consideration used in the reorganization must be shares of the acquiring corporation or its parent corporation.

A reorganization transaction that does not meet the prescribed requirements is treated as a taxable transaction, i.e. the built-in gains inherent in the assets owned by the acquired corporation will be subject to Japanese corporate income tax. Further, a portion of the consideration delivered to the shareholders of a merged (or demerged) corporation may be subject to Japanese taxation in the hands of the shareholders as a deemed dividend.

In addition, if assets other than “qualifying shares” are issued as consideration in a reorganization, the shareholders of the acquired corporation may be subject to Japanese capital gains taxation on the built-in gain in the acquired corporation’s shares less the amount of any deemed dividend.

2. Pre and post-reform tax treatment

Prior to the 2019 tax reform, the consideration in tax-qualified reorganizations was limited to either (i) shares of the acquiring corporation, or (ii) shares of a corporation directly owning (and expected to continue owning) 100% of the shares of the acquiring corporation. Further, the definition of qualifying shares was limited to (i) shares of the acquiring corporation, and (ii) shares of a corporation directly owning 100% of the shares of the acquiring corporation.

The reform relaxes the consideration requirement to include shares of a corporation that indirectly owns (and is expected to continue owning) 100% of the shares of the acquiring corporation and expands the definition of qualifying shares to include shares of a corporation indirectly owning 100% of the acquiring corporation’s shares.

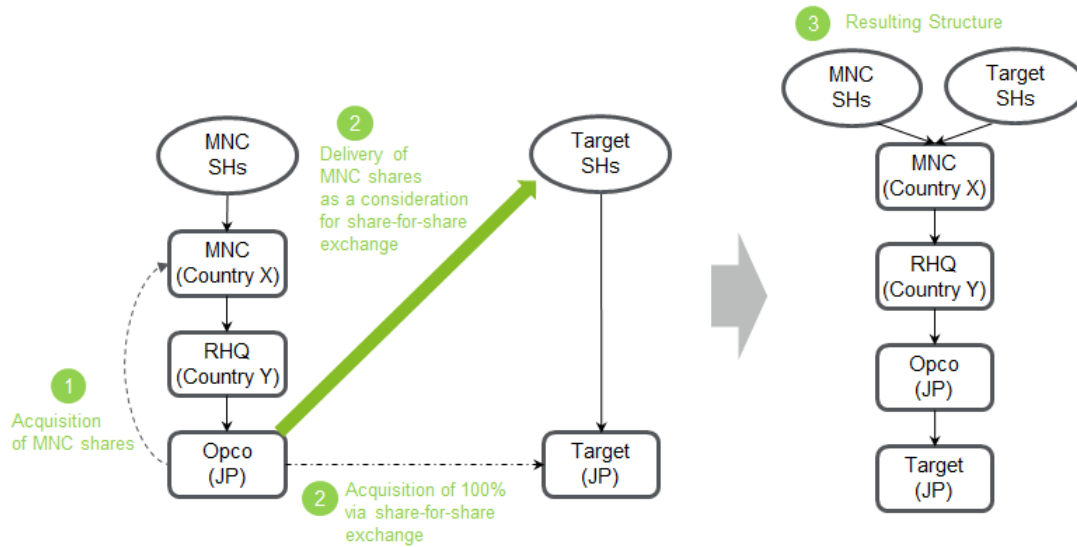
3. Potential impact on inbound transactions

It is a common practice for a foreign multinational corporation (MNC) to own a Japanese subsidiary (Japan Opco) via a wholly-owned intermediary regional headquarters company (RHQ).

Prior to the 2019 tax reform, if a foreign MNC intended to acquire a Japanese corporation with shares in a triangular reorganization, it had no option but to use the shares in the intermediary RHQ (the direct parent of the acquiring Japan Opco) as consideration, which would reduce the MNC’s ownership in the intermediary RHQ. Therefore, this was not a desirable option where the MNC wanted to maintain 100% ownership of the RHQ.

Following the reform, a triangular reorganization can qualify for tax deferral for Japanese tax purposes even if shares in a 100% indirect parent corporation are used as consideration. As such, this change may allow a foreign MNC to acquire a Japanese corporation tax-free using its own shares without losing its 100% ownership in an intermediary RHQ.

The following illustrates a triangular reorganization using the foreign MNC's shares as consideration:



1. Japan Opco acquires shares in MNC (its indirect parent) to use as consideration to acquire Japan Target.
2. Japan Opco acquires 100% of the shares in Japan Target via a share-for-share exchange and delivers the MNC shares to the shareholders of Japan Target.
3. The resulting structure maintains MNC's 100% ownership of RHQ post acquisition of Japan Target.

Deloitte's View

In addition to the Japanese tax issues outlined above, the following points should be considered when acquiring a Japanese target via a triangular reorganization using shares of a direct/indirect foreign parent. Accordingly, it is important to perform a detailed feasibility analysis from accounting, tax and legal perspectives in all relevant jurisdictions.

- Shares in a parent company used as consideration in a triangular reorganization may be subject to mark-to-market taxation in Japan, depending on the acquisition scheme, timing, etc.
- Even if qualifying shares of a direct/indirect foreign parent corporation are used as consideration in a triangular reorganization, the foreign shareholders of an acquired corporation may be subject to Japanese capital gains tax on the built-in gain in the acquired corporation's shares less the amount of any deemed dividend.
- If the consideration in a triangular reorganization is shares of a direct/indirect parent corporation that is domiciled in a low tax jurisdiction, Japan's anti-corporate inversion provision may apply and potentially have the following Japanese tax consequences:
 - Even where the requirements otherwise are met, the triangular reorganization may not qualify for tax deferral;
 - Even where qualifying shares are used as consideration in a triangular reorganization, the shareholders in the acquired corporation may be subject to capital gains tax on the receipt of the consideration; and
 - Certain profits retained by the direct/indirect parent corporation resident in a low tax jurisdiction may be subject to Japanese taxation at the level of the Japanese shareholders under rules similar to the Japanese controlled foreign company regime.

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