PRACTICE GUIDES

Japan M&A

Contributing Editor
Tatsuya Morita

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Japan M&A

Practice Guide

Contributing Editor
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Tax Issues Arising from M&A in Japan

Norio Mitsuuchi, Harold Godsoe and Kohei Honda[1]

Introduction

This chapter focuses on tax issues of importance to M&A dealmakers working with corporations in Japan. It is divided into three sections. M&A dealmakers might not be familiar with tax matters in Japan, so first we summarise the relevant basic tax information and recent amendments to Japanese laws[2] important in the M&A tax landscape.

Second, we outline the main tax issues to be considered in a deal, organised by phases. To optimise taxation, an M&A dealmaker should engage a tax adviser very early and examine all issues at all phases before the deal begins.

Third, as with the deal structure, we outline international tax issues relevant to cross-border investments involving Japanese companies by phases, but all issues at all phases should be considered and kept in sight at the time the investment begins.

The tax landscape for M&A in Japan

General tax framework

Income taxes

A corporation is a taxable entity under the Japan Corporate Tax Act (CTA). A domestic Japanese corporation, which is defined as a corporation that has a main, registered office in Japan, is taxed by the national and local governments based on its amount of worldwide net income in its

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1 Norio Mitsuuchi is a counsel and Harold Godsoe and Kohei Honda are associates with Kojima Law Offices. Although Norio Mitsuuchi worked for the Tokyo Regional Taxation Bureau while contributing to this article, any opinions expressed here are not supported by the tax authorities and are the personal opinion of the authors.

2 This article is written based on Japanese law effective on 1 April 2021. For ease of reference, in principle, we use legal terms as defined in Japanese laws (whether tax laws or otherwise) in line with the translations adopted by the Japanese Law Translation Database System: see www.japaneselawtranslation.go.jp.

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fiscal year. A foreign corporation is defined as a corporation other than a domestic corporation. A foreign corporation without permanent establishment in Japan is taxed only by the national government, and only on the amount of its Japanese source income, as defined in Japanese tax law, in a given fiscal year of the corporation.

Similarly, Japan-resident individuals are taxed under the Income Tax Act (ITA). A Japan-resident individual is, in principle, taxed by the national and local governments on its worldwide net income in a calendar year, while a non-resident in Japan is taxed only by the national government on specific Japanese-source income in a calendar year.

A corporation's taxable income is calculated based on the corporation's own corporate financial accounting, with some tax adjustments applied under the CTA. The current effective tax rate for a domestic corporation is approximately 30 per cent, combining the national corporate income tax rate (currently 23.2 per cent) and local tax rate (which depends on local governments).

Transfer taxes

Transaction taxes capture some percentage of the value of property for the national or local government when property changes ownership. Among transfer taxes, Japan's consumption tax (similar to EU VAT) is of great importance to M&A dealmakers, as it may result in significant additional expense for the buyer in an asset deal. The current rate is 10 per cent of the consideration paid for taxable assets and taxable provision of services.

At the time of deal structuring, M&A dealmakers should also consider whether and how much impact may be incurred from other transfer taxes: stamp duties, corporate registration taxes, real estate registration taxes and real estate acquisition taxes.

Recent amendments to tax law

2020 amendments

Under the 2020 tax amendments, two changes were passed with particular importance for M&A dealmakers: the group tax relief system and, in the area of international taxation, a new specific anti-avoidance rule (SAAR).

The group tax relief system will replace the currently effective consolidated tax return system. In the consolidated tax return system, the 'consolidation parent company' files a consolidated tax return on the combined income of all corporations included in the consolidation (ie, entities under a 100 per cent controlling interest descending from the consolidation parent company). Under the new group relief system, which applies to companies in which the group parent's fiscal year starts on or after 1 April 2022, each corporation in a 100 per cent wholly owned group files a tax return after transferring losses within the group corporations. The amendment changes the method of adjusting the book value of investments, and there is a concern that when selling shares of a subsidiary out of a group, the gain on the transfer will be calculated based on the net book value (or net asset value) for tax purposes, regardless of the acquisition price, making it easier for the tax authority to discover a taxable gain on the transfer.

The new SAAR was introduced to prevent companies from inappropriately creating capital losses by first distributing dividends of 10 per cent or more of the value of a subsidiary and then selling shares in that subsidiary by a reduced amount. Softbank Group (a major Japanese company) generated capital losses in this manner in relation to an M&A deal with Arm Ltd (a British corporation) in 2018, and this SAAR was purposely introduced to prevent this type of tax

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burden optimisation in the future. After this amendment, excessive pre-deal dividend distribution from subsidiaries to a parent cannot be used to optimise taxation. See 'Pre-deal' below.

2021 amendments

Under the 2021 amendments, two additional relevant changes to the laws were passed: a special tax-free treatment on share delivery and special measures to aid small and medium-sized enterprises (SMEs) to mitigate against hidden, out-of-book debts after a share purchase.

Share delivery is a variant of a corporate reorganisation by share exchanges introduced in the Japan Companies Act. Special tax-free treatment for this kind of transaction encourages share-compensated M&A transactions (both arm's length M&A transactions and takeover bids (TOBs)). See 'Deal structuring' below.

Special measures to aid SMEs allow the buyer of an SME special taxation benefits on special reserve funds set aside to compensate for the specific risks of acquiring SMEs that may only arise after an M&A transaction (off-balance-sheet liabilities, contingent liabilities, etc). For Japanese tax purposes, SMEs are corporations with a capital amount of ¥100 million or less. (A corporation with a capital amount of more than ¥100 million is classified as a large corporation.) See 'Post-deal' below.

M&A-related tax issues in Japan by deal phase

All parties to M&A transactions in Japan should look at all phases of the deal as a whole in the early days of a deal's conception, in order to optimise taxation. This is generally true in any jurisdiction, but is particularly important in Japan, where the tax authority's respect for the formalism of the rules means that moves in the deal must be made with precision to satisfy those rules. We consider the issues by phases, but a tax adviser should be engaged early, and all issues in all phases should be considered before the deal begins.

Pre-deal

The first pre-deal phase anticipates the main acquisition transaction. There are two common actions that M&A dealmakers can consider, in any jurisdiction, to minimise taxation on the value received by the seller in the main acquisition transaction.

Dividends before the deal

A parent company's domestic dividend income from a subsidiary is exempt from taxation as corporate income, in proportion to the percentage of shares held (eg, where 100 per cent of shares are owned, this is a full exemption; where more than one-third of shares are held, the exemption is the dividend amount minus interest on debt, etc). This is similar to many countries' tax laws, and so an experienced seller may be inclined to receive part of the value of a deal in pre-sale dividends, rather than as proceeds from the main acquisition transaction. As noted above, owing to recent amendments to the tax law in 2020, this action is still effective, but the scope has been narrowed.

Carve-outs

It is also common before the main acquisition transaction that the parties carve out specific business assets that the buyer may intend to be divested or otherwise spun off afterwards. Compared with completing the full transaction with a target corporation wholly intact, a carve-out

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will save a seller from paying taxes on that part of the target corporation that effectively avoids being sold. A seller might achieve a tax-free carve-out by using a tax-free corporate split. Buyers should consider whether the target assets intended for the carve-out may be necessary for the management of the business after the acquisition (in some cases, a carve-out might actually be required by the competition laws of a relevant jurisdiction) and should negotiate the scope of the carve-out with the seller.

Deal structuring

Tax-free transactions

In the second deal-structuring phase, the available types of M&A transactions interplay from a tax perspective and determine whether the transaction can be tax-free. As shown in Table 1, under a taxable transaction (this is the general treatment under Japanese tax laws), assets and liabilities are transferred at fair market value (ie, the tax authority applies capital gains and losses) for tax purposes, unless the transaction is carried out between corporations within a relationship of wholly owned control. Under a tax-free transaction, assets and liabilities are transferred at net book value (ie, the tax authority defers settlement of gains and losses) for tax purposes. A tax-free transaction is only possible if the requirements set forth below are met.

Table 1: Tax consequences of taxable and tax-free transactions for target company and its shareholder

Tax status	Taxation of target company	Taxation of target company shareholder
Taxable	Gains or losses through M&A transactions should be included in the calculation of taxable income of the target company in the fiscal year during which the M&A deal was made.	• Capital gains through the transfer of shares are taxed. • Taxes on deemed dividend income are imposed.
Tax-free (if requirements are met)	Target's assets and liabilities are transferred to the buyer at their net book value.	• No tax is imposed on capital gain; no deemed dividend income is payable to shareholders.

M&A transactions defined in Japanese civil laws

The interpretation of Japanese tax law by the tax authority is quite distinctive compared with other major jurisdictions. The Japanese tax authority has an unusual respect for the formality of the civil laws (ie, private laws) in looking at an M&A deal, rather than the substance of the deal. This means that M&A dealmakers need to approach the formal requirements for M&A transactions defined in the civil laws (as well as in the CTA, for tax purposes) very carefully, rather than relying on substantial compliance (ie, there is no reliance on substance over form, as might be the case in a US context).

There are four types of M&A transaction: share purchases, asset purchases, reorganisations under the Companies Act and corporate shareholder transactions. The four types of M&A transaction can be categorised from two points of view: what part of the target is transferred and what compensation is exchanged for it, as set out in Table 2.

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Table 2: Types of M&A transaction

Transaction type		What is transferred?	For what compensation?
Share purchase		Shares	Cash
Asset purchase		Business assets	Cash
Reorganisations	*Merger*	Business assets	Shares[3] and/or cash
	Corporate split		
	Share exchange	Shares	
	Share transfer		
	Share delivery		
Corporate shareholder transactions	*Cash contribution*	Cash	Shares
	Contribution in kind	Business assets	
	Distribution in kind		

Share purchases (including TOBs) and asset purchases are sales of a whole or a part of the shares or business assets of a target company, respectively, from one party to the other in exchange for cash. Tax treatments on share purchases and asset purchases are not specifically mentioned in the CTA, and so they are taxable. To qualify as a tax-free transaction in Japan, a hard rule before the 2017 tax amendment was that no compensation other than the shares of the buyer could be paid. Although this strict rule has been eased since the 2017 amendments, in principle, cash-only compensation still cannot be tax-free in M&A transactions in Japan.

Reorganisations and corporate shareholder transactions can be tax-free because a whole or a part of the compensation exchanged for the assets transferred are not cash but shares of the buyer.

Reorganisations are exhaustively stipulated in the Japan Companies Act and the same concepts are used in the CTA for taxation. There are five types:

- merger (*gappei*): a transaction in which an acquiring company comprehensively succeeds to all of the rights and obligations of a target company (or a newly established company comprehensively succeeds to all of the rights and obligations of two or more existing companies) in exchange for shares of the acquiring company and/or cash;
- corporate split (*kaisha-bunkatsu*): similar to a merger but the parties can choose the rights and obligations transferred, and whether wholly or partly;
- share-for-share exchange (*kabushiki-kokan*): a share-for-share transaction to establish a full controlling relationship between the parties;
- share transfer (*kabushiki-iten*): a variant of a share-for-share exchange by which a newly established corporation gains full controlling interest of one or more existing companies; and
- share delivery (*kabushiki-koufu*): a variant of a share exchange, newly introduced by the reformed Companies Act in force from 1 March 2021. After a share delivery transaction, the buyer becomes, not a 100 per cent shareholder of the target, but rather a shareholder exercising controlling power over the target. A 2021 tax amendment (effective from 1 April 2021) introduced special tax treatment on a share delivery. If 80 per cent or more of

3 For reorganisations, shares of a parent (or wholly owning listed company) of an acquiring company can be used as compensation. In this case, it would be triangular mergers, share exchanges, etc.

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the compensation paid to a target company is in the form of the acquiring company's shares, the share delivery transaction can be tax-free even if up to 20 per cent of the compensation is cash.

Corporate shareholder transactions come in three kinds:

- cash contribution by a third-party shareholder in exchange for shares of the target company (*daisansha-wariate-zoshi*);
- contributions in kind in exchange for shares of the target company (*gembutsu-shusshi*); and
- distributions in kind from a subsidiary to a parent company (*gembutsu-bumpai*). Spin-offs are a kind of distribution in kind. When the 2017 tax amendments introduced tax-free treatment for spin-offs, there were substantially no spin-off cases in Japanese M&A. In 2019, however, Koshidaka Holdings, a Japanese listed company, announced the first major deal applying a tax-free spin-off.

Other than (generally) a no-cash compensation requirement, the following additional requirements need to be met in order to qualify as tax-free transactions under the CTA:

If a full controlling interest relationship (100 per cent capital ownership) exists between the buyer and target, there are no other requirements (other than the no-cash compensation requirement).

If there is a controlling interest relationship (more than 50 per cent but less than 100 per cent) between buyer and target, the requirements are continuation of the transferred business and 80 per cent or more of the officers and/or employees continuing to work for the transferred business.

In M&A transactions between companies without controlling interest relationships (ie, 50 per cent or less), the requirements (referred to as joint enterprise requirements) are:

- continuation of the transferred business;
- 80 per cent or more of the officers and/or employees continue to work for the transferred business;
- one of the main businesses of the target must have a relationship with one of the businesses of the acquirer;
- the relative business size of the related businesses specified in the previous requirement must be within a ratio of approximately 1:5 or at least one of the senior directors from each of the acquirer and target must become senior directors of the acquirer; and
- a shareholder of the target that held more than 50 per cent of the target's shares must continue to hold shares of the acquirer received in the deal.

By reviewing these requirements, foreign buyers who intend to enter the Japanese market without any subsidiaries or affiliates in Japan before the deal should be aware that they cannot fulfil the top two choices of requirements at the time of the M&A deal. As such, the last choice of requirements (ie, joint enterprise requirements) should be explored if they seek to complete tax-free M&A transactions. Otherwise, foreign buyers should carefully structure the M&A deal by combining several related transactions: first, making the necessary taxable transactions (eg, taxable share purchase, taxable reorganisations or cash contributions) to obtain controlling power, and then tax-free reorganisations or corporate shareholder transactions as the second (and third) transactional step, in order to optimise tax efficiency.

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Squeeze-outs

The 2017 tax amendments introduced a significant change to the strict distinction between taxable and tax-free transactions, which affects the use of squeeze-outs. Before the 2017 amendments, cash compensation M&A transactions could never be tax-free. A transaction was taxable if an acquiring company paid cash compensation to minority shareholders who were against the reorganisation in order to gain a full controlling interest over an existing Japanese company after a share purchase, merger or share exchange (or share delivery after the recent tax reforms).

However, after the amendments, cash compensation is allowed for a tax-free squeeze-out if the acquiring company holds two-thirds or more of outstanding shares of the target company. If a buyer has a prospect of obtaining approval of two-thirds or more of the existing shareholders to the acquisitions at the beginning of transactions (and perhaps the rest of the existing shareholders might be against the acquisitions), merger, share exchange or share delivery can be tax-free with the use of squeeze-outs.

Taxable transactions: pros and cons of asset deals versus share deals

In most cases, the main acquisition transaction between independent parties is a taxable share purchase or asset purchase. To compare the tax impact of the two, Table 3 summarises the pros and cons of share purchases and asset purchases for buyers.

Table 3: Asset deals versus share deals

Deal type	Pros	Cons
Share purchase	• No need to renegotiate existing contracts. • Buyer has the possibility to use depreciation and net operating losses (NOL) after the deal. • Consumption tax is not levied and other transfer taxes are generally less imposed than in an asset deal.	• All legal and tax risks are preserved in the target company. • No goodwill of the target company is available for amortisation by the Buyer. • Reduced availability of debt push-down (See cross-border M&A section below).
Asset purchase	• No inherited liabilities from target company limits the tax risks. • Buyer may step up and depreciate or amortise purchased assets (including intangible assets) for tax purposes (except for land). • Five-year equal rate amortisation of goodwill.	• Total tax cost may be increased (by two-level taxation on target company and its shareholder), which may result in raising deal prices. • Buyer may need to renegotiate existing contracts. • NOL after the deal remain with the seller. • Consumption tax is imposed. • Real estate registration tax and real estate acquisition tax are imposed only on asset purchase transactions.

Consumption tax issues

Among the four types of M&A transactions (ie, share purchases, asset purchases, reorganisations or corporate shareholder transactions), only asset purchases are subject to consumption tax of (currently) 10 per cent of the consideration exchanged for taxable assets or services. The other three types of M&A deal are exempt from consumption tax. However, even in the other three types of M&A transactions, transaction fees associated with the deal such as brokerage fees, upfront fees or agent fees with regard to M&A deal financing can be subject to consumption tax.

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There are some specifically exempted entities that may be of practical use in avoiding consumption tax issues in an M&A deal:

- a business with ¥10 million or less of taxable sales, in principle, for each of the past two years, and in the first six-month period of the year preceding the applicable tax period; and
- a business with a capital amount of ¥10 million or less, for two years after its establishment.

If a buyer chooses such a seller for an asset purchase, consumption tax can, in principle, be substantially exempted.

From 1 October 2023, a new, EU-style, qualified invoice system will be in force in Japan. Corporations paying consumption tax will only be allowed to recover consumption tax where a qualified invoice has been issued by a registered invoice issuer. Therefore, M&A dealmakers contemplating a deal near that time would be advised to register an acquiring company or target company as a taxable entity to engage in business in Japan.

Post-deal

In the third post-deal phase, the opportunities for risk and gain from a tax perspective are greatest for the buyer. The buyer's tax concerns mainly arise in post-merger integration and with the risks that can be avoided in connection with running afoul of Japanese tax authorities.

Net operating losses

The net operating losses (NOL) of a corporation can be carried forward up to 10 fiscal years. For a large corporation, half of the taxable income can be deductible against NOL, while an SME can offset all taxable income against NOL. In some cases, using the NOL of a target company is limited to prevent tax abuse. Using NOL is at issue not only in the case of a share purchase but also in the case of a merger. With a share purchase, the target company still exists after an M&A transaction and can naturally use its own NOL. However, with a merger, the target company disappears immediately after the deal. Whether the acquiring company can use the NOL of the target company can be a significant tax issue. Especially for tax-free mergers in intragroup reorganisations (ie, more than 50 per cent controlling interest relationships between parties), the acquiring party needs to fulfil deemed joint enterprise requirements. See 'Tax-free transactions' above.

Special SME rules

Following the 2021 tax amendment, special measures to aid SMEs allow the buyer of an SME special taxation benefits on special reserve funds set aside to compensate for the specific risks of acquiring an SME that may only arise after an M&A transaction (off-balance-sheet liabilities, contingent liabilities, etc). The buyer of the SME must execute a share purchase (see 'Deal structuring' above), the acquisition price must be ¥1 billion or less, and the SME must have been approved for a managerial ability improvement plan. If all conditions are met, the special reserve funds can be deductible expenses. After a five-year lapse of time from the M&A transactions, five equal portions will be included in taxable income over the following five years (ie, tax deferral).

Step-up tax basis of depreciable assets

Through asset purchases and taxable reorganisations, assets are transferred at fair market value. As between assets transferred by fair market value and book value, after a deal, the buyer can use more depreciation for assets transferred by fair market value (ie, the tax basis is stepped

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up) than for assets transferred at book value. If the buyer expects to gain taxable profits from an acquired business immediately after the deal, this step-up tax basis of depreciable assets is preferable. This means that taxable deals can be a practical option to minimise overall taxation.

Amortisation of goodwill

If the purchase price paid by the buyer to the seller is more than the fair market value of the net assets of a target company, the difference between the purchase price and the amount of net assets is recognised as goodwill. Under Japanese tax law, goodwill created through asset purchase or taxable reorganisations can be amortised (ie, can be used as expenses, deducted from gains) in equal portions over five years.

Tax investigations

Tax investigations against corporations doing business in Japan (including foreign companies) are undertaken periodically by the Japanese tax authorities.

Taxpayers need to keep documents relevant to M&A transactions and be ready for tax investigations for at least five fiscal years (ideally seven to 10 fiscal years) after the filing date of tax returns that include gains or losses from M&A transactions. If the tax authorities suspect tax fraud, they may conduct tax investigations as far back as seven fiscal years. In connection with tax investigations on the use of NOL, tax authorities can go back 10 fiscal years.

Tax authorities usually respect the formalities taken by taxpayers (ie, the parties to the transaction). That said, although it would be rare, tax-abusive transactions might be denied in accordance with the anti-tax abuse provisions of the CTA.

The 2016 *Yahoo* case[4] provided some guidance on what the tax authority is thinking when going after corporations for tax avoidance. In that case, the court held that in judging whether there is abuse, the tax authority needs to consider whether a corporation's act or calculation to optimise taxation is unnatural, by using a procedure or method of reorganisation that is not normally expected, or by creating a form that deviates from the actual situation; and whether the acts or calculations are intended to reduce the tax burden by using reorganisation, and deviate from the original intent and purpose of the taxation on reorganisation provisions, taking into consideration the business purpose and other circumstances that provide reasonable grounds for such acts or calculations other than the mere reduction of tax burdens.

Specific issues arising from cross-border M&A involving Japanese companies

Parties to a cross-border M&A transaction into Japan should look at all phases of the investment as a whole. We examine the issues to take into account in cross-border M&A with Japanese corporations by phases, but all issues at all phases should be kept in sight when the deal begins.

Investment phase

Judicial double taxation and its relief

The central tax issue in cross-border M&A is the risk of international or judicial double taxation on the same income of both foreign buyers and the Japanese target companies, in each phase

4 *Yahoo Japan Corporation* case (Supreme Court, Decision of 29 February 2016, Minshu, Vol 70, No. 2, p242)

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(ie, investment, repatriation and exit). Japanese domestic corporations, including Japanese subsidiaries of foreign corporations, are subject to Japanese income tax for their worldwide income. A foreign company that has a permanent establishment (eg, a branch office, representative office, dependent agent, etc) in Japan is subject to Japanese income tax for the income obtained through that permanent establishment.

There is relief for this issue from domestic statutes, and also relief provided by tax treaties. In order to avoid double taxation unilaterally, the CTA adopts the Foreign Tax Credit and Dividend Received Deduction. (A maximum 95 per cent of dividend income from a foreign subsidiary can be excluded from the taxable income of a domestic shareholder, different from dividend income from a domestic subsidiary.) To avoid double taxation bilaterally, Japan has entered into 79 double-taxation avoidance treaties with about 143 countries and regions as at 1 April 2021. The double-taxation avoidance treaties to which Japan is a party are based on the OECD model tax convention. Under Japanese law, if there are conflicts between a treaty and domestic law, the treaty always prevails. For an example of the resolution of such conflicts, see 'Repatriation phase' below.

Choice of acquisition vehicle

When a foreign company plans to acquire a Japanese company, the buyer should consider a suitable acquisition vehicle for the deal. In choosing an acquisition vehicle, the foreign buyer should determine what entities the foreign buyer would like to offset the costs for acquisition against: if against the profit of a Japanese domestic corporation, the foreign buyer may prefer setting up a Japanese acquisition subsidiary, while if against its own profits, the foreign buyer may prefer to directly acquire the target or acquire through partnership, depending on the tax laws of the buyer's own jurisdiction.

Foreign buyer exception

When a foreign buyer intends to directly invest in a Japanese corporation, the four types of M&A transaction available are the same as the M&A transactions between Japanese domestic corporations, as described above: share purchases, asset purchases, reorganisations under the Companies Act and corporate shareholder transactions.

However, a foreign buyer cannot be a party to reorganisations under the Companies Act. For instance, a foreign company cannot merge directly with a Japanese domestic corporation. However, a domestic corporation can pay compensation in the form of a foreign parent company's shares (ie, a triangular merger).

Furthermore, in many cases, foreign buyers cannot avail themselves of tax benefits that Japanese domestic companies enjoy, as Japanese tax law has many exceptional rules against international tax avoidance. The contribution in kind from a foreign company to a Japanese domestic company is a good example. A foreign company can be taxed in Japan on the difference between the fair market value minus the book value of the assets transferred by a contribution in kind and such contributions can never be a tax-free transaction.

Debt push-down

Debt push-down is a way of effective M&A financing in Japan. In order to improve investment efficiency, debts for M&A financing are often pushed down from a foreign buyer to the target.

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A current dispute over debt push-down as M&A financing involves Universal Music Japan GK, a Japanese subsidiary of the international group. Universal Music borrowed money from a foreign company within its group and when the Japanese subsidiary deducted the interest from its profits, the tax office disallowed it as tax avoidance under the CTA, and Universal Music filed a complaint. The Tokyo High Court rendered a judgment in favour of Universal Music.[5] The case is currently working its way through the Supreme Court.

Transfer-pricing issues

Transfer-pricing is a cross-border tax issue in which companies doing business globally allocate profits and losses from one country in another. The practice can create huge tax liabilities and long-term tax disputes with the tax authorities. IHI, a Japanese listed company, was subjected to ¥10 billion of additional corporate tax in connection with transactions with its Thailand subsidiaries by the tax authorities in 2018. (The case is currently being disputed in the courts.) Nihon Gaishi, another Japanese listed company, was fined ¥6.2 billion by the tax authorities in 2012 in connection with transactions with its Polish subsidiary. (This case was also disputed at the Tax Tribunal and the court and, after eight years from imposition of the tax, the Tokyo District Court ruled in favour of Nihon Gaishi in November 2020, and revoked taxation of ¥5.2 billion.)

Japanese transfer-pricing regulations are largely in line with the OECD transfer-pricing guidelines. An M&A dealmaker should structure relevant joint R&D agreements and/or licensing agreements regarding (especially) the intangible assets of foreign parents and Japanese subsidiaries and should start to prepare transfer-pricing documents in accordance with Japanese transfer-pricing regulations in the very first investment phase.

Repatriation phase

Taxation on dividend income versus taxation on capital gains

In the repatriation phase, dividend income of a foreign parent company is usually subject to withholding tax, while capital gains of a foreign parent are usually not. However, there are some exceptions.

Withholding tax rates on dividend distributed from a Japanese subsidiary to a foreign parent company without a permanent establishment under the ITA is 20.42 per cent. However, a foreign company with a permanent establishment is required to file a tax return and the amount paid to the tax office as withholding tax can be recovered. If one of Japan's many double-taxation avoidance treaties applies, the withholding tax rate on dividend income paid by a Japanese company to a foreign shareholder with 25 per cent or more shares (or, in the Japan–US double-taxation avoidance treaty, only 10 per cent or more shares held) can be reduced up to 5 per cent.

On the other hand, if a foreign company without a permanent establishment transfers a small portion (ie, less than 5 per cent) of the outstanding shares in a Japanese subsidiary to the other entity, withholding tax from the share transfer is not usually imposed on its capital gains. However, there are some exceptions, described under 'Exit phase'.

5 *Universal Music* case (Tokyo High Court, Decision of 24 June 2020 (case No. 2020 (Gyou-Ko) 213))

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Exit phase

In the exit phase of an investment in Japan, unique source income on capital gains in Japan can be a surprise to a foreign shareholder.

Usually, share purchase transactions between foreign companies (ie, not between Japanese domestic corporations) are not subject to Japanese tax, since the parties are not residents in Japan. However, two situations can cause issues. First, if 5 per cent or more of the shares in a Japanese company are transferred from a foreign company holding a quarter of the Japanese company's shares for three years or more, the gains from the transfer are subject to corporate income tax, and the foreign company is required to file a tax return. Second, if a foreign company transfers shares of a Japanese domestic company, with 50 per cent or more of its assets in real estate in Japan, the foreign company's gains from the transfer are subject to corporate income tax, and the foreign company is required to file a tax return in Japan.

However, unless a Japanese double-taxation avoidance treaty specifically allows such special source income, foreign companies are not required to report the income in either of the above situations. Careful examination of the double-taxation avoidance treaties between Japan and the foreign countries where the foreign company is a resident is advisable.

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Appendix 1

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Norio Mitsuuchi is a counsel at Kojima Law Offices, admitted in Japan. His area of expertise covers cross-border transactions (including cross-border M&A), corporate law (mainly corporate governance issues), dispute resolution and international and domestic taxation. He frequently advises and represents clients from the United States, some European countries and China on complex, cross-border corporate and tax matters in Japan.

He worked for the Tokyo Regional Taxation Bureau from 2019 to 2021, serving as a review officer in charge of tax investigations over large enterprises and foreign enterprises. During this period, he advised other tax officers from a lawyer's point of view on how they can or cannot impose tax on large enterprises and foreign enterprises.

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