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# Tax on Inbound Investment

## in 31 jurisdictions worldwide

# 2014

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# CONTENTS

# Japan

**Yushi Hegawa**

Nagashima Ohno & Tsunematsu

## Acquisitions (from the buyer's perspective)

### 1 Tax treatment of different acquisitions

What are the differences in tax treatment between an acquisition of stock in a company and the acquisition of business assets and liabilities?

In the case of an acquisition of shares of the target company, the buyer is treated as having acquired the shares rather than the individual assets and liabilities of the target company, and would book such shares at the then fair market value (which will usually equal the purchase price in unrelated third-party deals), which constitutes the tax basis of such shares together with other acquisition costs.

In the case of an acquisition of business assets and liabilities of the target company, the buyer is treated as having acquired the individual business assets and liabilities of the target company, and would book such individual assets at the then fair market value, which constitutes the tax basis of such individual assets together with other acquisition costs.

However, if such acquisition is structured as a tax-qualified reorganisation (which should be rare, as discussed below), the tax basis is carried forward from the seller in the hands of the buyer.

### 2 Step-up in basis

In what circumstances does a purchaser get a step-up in basis in the business assets of the target company? Can goodwill and other intangibles be depreciated for tax purposes in the event of the purchase of those assets, and the purchase of stock in a company owning those assets?

In the case of an acquisition of shares of the target company, no step-up in the tax basis of the assets of the target company takes place (ie, there is no section 338 or section 338(h)(10) election under Japanese tax law), and the tax basis of the business assets of the target company remains intact in the hands of the target company. Furthermore, no goodwill is recognised in the case of an acquisition of shares of the target company either. This means that the acquisition cost of the shares cannot be expensed in a tax-deductible manner until the final disposition of the shares.

On the other hand, in the case of an acquisition of business assets and liabilities of the target company, unless such acquisition is a tax-qualified company split transaction, the tax basis of the business assets so acquired is stepped up to the then fair market value. In this case the positive difference, if any, between the purchase price paid and the fair market value of the net assets acquired is treated as goodwill (technically referred to as an 'asset adjustment account') in the hands of the buyer (provided that the buyer is subject to full Japanese income taxation), and will be amortised over a period of five years on a straight-line basis and the amortisation expenses will be tax-deductible.

As such, generally speaking, an acquisition of business assets is more advantageous to the buyer (provided that the buyer is subject to full Japanese income taxation) solely from a Japanese tax viewpoint.

### 3 Domicile of acquisition company

Is it preferable for an acquisition to be executed by an acquisition company established in or out of your jurisdiction?

In the case of an acquisition of shares of the target company, it depends. It is often the case that, if the applicable tax treaty between Japan and a given foreign jurisdiction allows for a favourable tax treatment in respect of Japanese source taxation on dividends to be paid by the Japanese target company (ie, exemption or low withholding tax rate) or capital gains arising from the sale of the shares of the Japanese target company (ie, total exemption), an acquisition vehicle will be established in that offshore jurisdiction in view of such tax benefits.

However, it is important to take into consideration whether the applicable tax treaty contains 'limitation on benefits' provisions, as well as their impact on the structuring, and potential 'treaty shopping' allegations that may be made by the Japanese tax authority.

On the other hand, if the buyer intends to implement post-acquisition restructurings utilising Japanese statutory reorganisation transactions (eg, mergers, company splits, etc), the acquisition vehicle will usually be established as a Japanese corporation because of limitations under Japanese corporate law (ie, only Japanese corporations can be a party to such statutory reorganisations). Japanese corporations are also used as the acquisition vehicle if the buyer introduces debt to finance the acquisition and intends to offset the interest expense on such debt against the business income generated from the acquired business (ie, so-called 'debt pushdown'). Further, the acquisition vehicle must be a Japanese corporation if the buyer intends to use the Japanese consolidated tax filing system where the acquisition vehicle will be the head of the consolidated group.

In the case of an acquisition of business assets of the target company, the acquisition vehicle will usually be established as a Japanese corporation that is a subsidiary of the ultimate buyer. This is due to, among other reasons, permanent establishment concerns (ie, if an offshore company acquired tangible business assets, it would likely be deemed as carrying on business within Japan and as such would be found to have a permanent establishment in Japan) and consumption tax reasons (ie, so that the buyer can claim input tax credit to recover the consumption taxes paid to the seller by making an appropriate election).

### 4 Company mergers and share exchanges

Are company mergers or share exchanges common forms of acquisition?

These are not very popular as a structure for an acquisition between unrelated third parties (rather than a business combination or integration).

Popular forms are share purchases for cash and asset purchases for cash (either by way of sale and purchase or company split for cash consideration). This may be partly because of various limitations on triangular mergers and triangular share exchanges under Japanese law.

Such limitations include the fact that:
- no reverse triangular merger is available under Japanese law and it would cause difficulties if the target company had to be the dissolving company;
- only shares of the direct parent company of the acquisition vehicle can be used for tax-qualified triangular mergers and triangular share exchanges, and shares of the indirect ultimate parent company of the acquisition vehicle will not qualify;
- even the acquisition vehicle must have some business substance to do tax-qualified triangular mergers and triangular share exchanges and must not be a mere shell; and
- there are technical Japanese corporate law issues to be resolved for the acquisition company to acquire shares of its direct parent company.

Exchange offers (ie, the purchase of target shares in exchange for shares of the buyer; a transaction technically different from a share exchange which is a statutory reorganisation transaction) are not popular either, partly because no tax-free (or deferral) treatment is available under Japanese tax law. While special legislation has recently been enacted to facilitate exchange offers, this mainly relates to corporate laws and financial regulations and, as such, tax-free (or deferral) treatment has not yet been made available.

### 5 Tax benefits in issuing stock

Is there a tax benefit to the acquirer in issuing stock as consideration rather than cash?

This is not likely. If the parties intend to structure the acquisition as a tax-qualified reorganisation transaction (merger, company split, etc), then the consideration must solely consist of stock of the acquiring company. However, in the case of typical acquisitions between unrelated third parties (rather than a business combination or integration), it is rare that the requirements for a tax-qualified reorganisation are met.

That is, where there is no shareholding relationship between the acquiring company and the target company prior to the acquisition, the acquisition will not qualify as a tax-qualified reorganisation, unless such acquisition satisfies the requirements so that there will be formed a joint business operation between the parties, ie:
- the businesses of the parties are related to each other;
- 80 per cent or more of the employees continue to be engaged in the business concerned and the primary businesses are continued;
- the ratio of the size of the businesses of the parties is within a range of 1:5 or the key management members remain the same; and
- with certain exceptions, the ownership structure resulting from the transaction is expected to continue within the applicable parameters).

As such, in the context of typical acquisitions between unrelated third parties, it is unlikely that there would be benefits for the buyer to issue stock rather than paying cash (and other) consideration.

In addition, because no tax-free (or deferral) treatment is available for exchange offers under Japanese tax law, as discussed above, from a tax viewpoint, we see no material benefit in issuing stock.

### 6 Transaction taxes

Are documentary taxes payable on the acquisition of stock or business assets and, if so, what are the rates and who is accountable? Are any other transaction taxes payable?

No stamp duty or other documentary taxes will be payable in the case of an acquisition of stock, either by way of sale and purchase of the shares or by way of statutory share exchange. Furthermore, no consumption taxes or Japanese VAT will be payable.

In the case of an acquisition of business assets, if the acquisition is by way of sale and purchase of business assets, stamp duty will apply on a progressive basis (up to ¥600,000) according to the amount of the consideration, and consumption taxes will be payable by the seller (and added on to the purchase price for the buyer to bear) at the rate of 5 per cent (8 per cent from 1 April 2014 and 10 per cent from 1 October 2015, owing to the very recent consumption tax reform) of the gross consideration allocated to each taxable asset acquired. If the acquisition is by way of company split with cash (and other) consideration, stamp duty of ¥40,000 will apply, but no consumption taxes will be payable.

It should also be noted that, in the case of an acquisition of business assets, other transaction taxes, such as real property acquisition tax and registration and licence tax, may be payable depending on the circumstances of the acquisition.

In addition, if the buyer of the business assets had to bear consumption taxes, the buyer will be entitled to claim input tax credit against its own consumption tax liability, subject to certain statutory requirements being met.

### 7 Net operating losses, other tax attributes and insolvency proceedings

Are net operating losses, tax credits or other types of deferred tax asset subject to any limitations after a change of control of the target or in any other circumstances? If not, are there techniques for preserving them? Are acquisitions or reorganisations of bankrupt or insolvent companies subject to any special rules or tax regimes?

If a change of control (ie, transfer of a majority of the shares of the target company, either directly or indirectly via its parent company) occurs as a result of the (direct or indirect) acquisition of the shares of the target company, subject to certain triggering events – as explained below – taking place following the acquisition, the net operating loss carry-forwards and unrealised built-in losses of the target company will be subject to certain limitation.

The triggering events that arise frequently in practice include, among others:
- the target company, which was dormant when so acquired, resuming business following the acquisition;
- the target company ceasing all business that was operated when so acquired, and then introducing new funds and assets that exceed five times the scale of the previous business; and
- all of the senior officials as well as 20 per cent or more of the employees of the target company resigning from the target company, followed by the target company developing certain new business that exceeds five times the scale of the previous business.

In addition, even if the rule mentioned above is not triggered, there is another rule of limitation on the net operating loss carry-forwards in the event of an acquisition; ie, if the buyer acquires a majority of the shares of the target company and, within five years from such acquisition, merges the target company into the buyer, the net operating loss carry-forwards of the target company or of the buyer will be subject to certain limitation as a result of the merger, unless the merger satisfies specific conditions indicating that the target company and the buyer are forming a joint business operation. Similar limitation will apply to unrealised built-in losses.

Other tax attributes of the target company will, in principle, remain intact.

There are no special tax regimes specifically applicable to acquisitions of bankrupt or insolvent companies; however, bankrupt or insolvent companies may, in general (subject to certain requirements being met), use even unrealised built-in losses in their assets to offset taxable income and use expired net operating loss carry-forwards in order to shelter discharge of debt income that may arise in the course of the insolvency proceeding.

### 8 Interest relief

Does an acquisition company get interest relief for borrowings to acquire the target? Are there restrictions on deductibility where the lender is foreign, a related party, or both? Can withholding taxes on interest payments be easily avoided? Is debt pushdown easily achieved? In particular, are there capitalisation rules that prevent the pushdown of excessive debt?

Interest payable by an acquisition company on the acquisition debt will generally be deductible as an expense for its Japanese corporate income tax purposes.

However, if the acquisition debt is owed to a foreign corporation, which is a controlling shareholder (owning directly or indirectly 50 per cent or more of the total shares) of the acquisition company, the 'thin capitalisation' rules apply, and, generally speaking, interest payable upon the portion of the acquisition debt exceeding three times the shareholders' equity of the acquisition company will be non-deductible. The 'thin capitalisation' rules apply not only in the case of direct financing by the controlling shareholder, but also in other similar cases, such as financing by third parties with a guarantee provided by the controlling shareholder.

Transfer pricing rules also apply to interest payable to affiliated foreign corporations of the acquisition company in order to require that the interest rate be arm's length (ie, the portion of the interest exceeding the arm's-length rate will be denied deduction). One Japanese court precedent indicates that the arm's-length interest rate generally refers to the rate available in the market for similar finance transactions.

Further, as a result of the 2012 annual tax reform, a Japanese version of the 'earnings stripping' rules has been introduced, and will apply from taxable years beginning on or after 1 April 2013. There, if the 'net' amount of the interest paid to certain foreign related parties of the Japanese taxpayer in a taxable year exceeds 50 per cent of certain 'adjusted income' (meaning taxable income before that interest deduction, depreciation, etc) of that Japanese taxpayer in that taxable year (ie, interest paid to affiliates is excessive as compared to taxable income), the excess portion of the interest will not be deductible in that taxable year. The excess portion will be carried forward for seven future taxable years, however, and will be deductible to the extent the above conditions are met in the relevant future taxable year. There is a certain de minimis exception, as well as an exception where the gross amount of interest paid to foreign related parties does not exceed 50 per cent of the total gross amount of interest (including interest paid to third parties).

Debt pushdown is frequently employed in the Japanese practice, but it must be made within the limitations outlined above.

It is not easy to avoid withholding tax on interest payable to foreign creditors unless the applicable tax treaty provides for exemption (see question 13 for details).

### 9 Protections for acquisitions

What forms of protection are generally sought for stock and business asset acquisitions? How are they documented? How are any payments made following a claim under a warranty or indemnity treated from a tax perspective? Are they subject to withholding taxes or taxable in the hands of the recipient?

For both stock and business asset acquisitions, it is very common that representations and warranties on certain tax matters and other factual matters are agreed upon by the seller for the benefit of the buyer, together with an indemnification obligation in the event of breach of such representations and warranties by the seller.

In the case of acquisition of shares, tax matters that are typically subject to the representations and warranties include, among other items, the due and correct filing of all tax returns and the due payment of all taxes payable by the target company.

These are typically documented in the definitive agreement relating to the acquisition.

The tax treatment of an indemnification payment by the seller to the buyer is not necessarily clear; however, one tax tribunal precedent indicates that an indemnification payment under a share purchase agreement may be treated as a downward adjustment to the purchase price of the shares (or to the tax basis of the shares in the hands of the buyer) if it is clearly indicated so on the agreement, rather than as separate taxable income in the hands of the buyer.

No withholding tax will apply to an indemnification payment.

## Post-acquisition planning

### 10 Restructuring

What post-acquisition restructuring, if any, is typically carried out and why?

Typically conducted post-acquisition reorganisations include a merger of the target company with the acquisition vehicle such that the acquisition debt can be repaid by the cash flow generated by the target company's business, and to offset the interest expenses on the acquisition debt against the business income of the target company (ie, debt pushdown).

Consolidation election is sometimes made in lieu of the merger, so that the interest expenses incurred by the Japanese acquisition vehicle (which is the head of the consolidated group) will be offset against the business income of the target company (which is the consolidated subsidiary). However, it must be noted that making a consolidation election generally entails that all the assets (including goodwill; subject to some minor exceptions) of the target company be marked to market and the appreciations and gains, if any, will be taxed.

In addition, if the buyer had existing Japanese businesses prior to the acquisition, it is typical that the Japanese business so acquired will be integrated with such existing businesses by way of merger, company splits, etc.

It is very common that these post-acquisition reorganisations be made as a tax-qualified reorganisation and it is generally easy to structure them as so given that there is already a majority shareholding relationship among the parties.

Broadly speaking, the requirements for 'tax-qualified reorganisation' are met if no consideration other than the shares of the party taking over the business (including the shares of the direct parent company in the case of triangular mergers) is paid out, and:

- it is implemented between a parent and a wholly owned (direct or indirect) subsidiary or between wholly owned (direct or indirect) subsidiaries;
- it is implemented between a parent and a (direct or indirect) subsidiary or between (direct or indirect) subsidiaries, where 80 per cent or more of the employees continue to be engaged in the business concerned and the primary businesses are continued; or
- it is implemented for a 'joint business operation', where:
  - the businesses of the parties are related to each other;
  - 80 per cent or more of the employees continue to be engaged in the business concerned and the primary businesses are continued;
  - the ratio of the size of the businesses of the parties is within a range of 1:5 or the key management members remain the same; and
  - with certain exceptions, the ownership structure resulting from the transaction is expected to continue within the applicable parameters.

In the case of a 'tax-qualified reorganisation' business combination, neither the seller company nor the target company is subject to income taxation at the time of the transaction and their tax bases for the relevant shares or assets remain intact after the transaction

**Update and trends**

Practitioners recognise that the Japanese tax authority continues to scrutinise M&A and reorganisation transactions closely and to challenge the tax position taken by taxpayers if the Japanese tax authority finds that they are avoiding Japanese taxation.

It is particularly noteworthy that the legal basis of the challenges by the Japanese tax authority is no longer limited to technical interpretation of individual tax rules. Instead, the Japanese tax authority has come to rely on comprehensive general anti-avoidance provisions embedded in the tax statutes, which were not invoked in the past to challenge sophisticated M&A and reorganisation transactions.

Public reports indicate that there are several cases where assessments of significant tax amounts were issued to disallow the taxpayers' position in large M&A and reorganisation transactions. Among such cases, most recently, it was reported that the Japanese operation company of a multinational music company received a deficiency assessment of taxable income of ¥9 billion, arising from disallowance of deduction of interest expenses with respect to an inter-company loan that the Japanese company borrowed from its foreign affiliate to fund the restructuring of the Japanese operation. The Japanese tax authority appears to have invoked the general anti-avoidance statute applicable to closely held companies to deny the interest deduction, alleging that there was little business purpose in conducting such reorganisation where the substance of the Japanese operation remained, substantially, the same as before.

This case is significant in that:
- a 'debt pushdown' transaction, commonly employed in inbound investment practice, was disallowed;
- even an international transaction became the subject of the general anti-avoidance statute; and
- the general anti-avoidance statute was invoked, regardless of the individual-specific tax rules limiting interest deduction (eg, thin capitalisation, earnings stripping, etc), where the tax authority believed that there was little business purpose, to disallow the entire amount of the interest deduction.

It is crucial that taxpayers exercise the utmost care in structuring a transaction by performing thoughtful legal analysis, bearing in mind all possible challenges and allegations that could be made by the Japanese tax authority. Particularly, it is crucial in recent practice to verify that valid non-tax business purposes or reasons supporting the economic rationale of the M&A and reorganisation transactions exist, and to be prepared to establish them in accordance with the tax authority in the event of audit.

(thus, tax deferral) and in general the shareholders of the parties are not subject to income taxation (also, tax deferral).

### 11 Spin-offs

Can tax neutral spin-offs of businesses be executed and, if so, can the net operating losses of the spun-off business be preserved? Is it possible to achieve a spin-off without triggering transfer taxes?

Spin-offs of businesses can be made tax-free if the transaction is structured as a tax-qualified company split or a tax-qualified in-kind distribution. If it so qualifies, there will be no immediate taxation at the company level (eg, deferral of capital gains taxation on the transfer) or at the shareholder level.

Note that a tax-qualified company split must be structured in order to satisfy the requirements mentioned in question 10, and a tax-qualified in-kind distribution is construed as not usable for distribution of 'business' (which includes liabilities) and is typically used to distribute shares of the subsidiary of the distributing company to the shareholders of the distributing company.

Net operating losses of the spun-off business will not be preserved but instead will remain with the original company.

### 12 Migration of residence

Is it possible to migrate the residence of the acquisition company or target company from your jurisdiction without tax consequences?

No, as far as Japanese taxation is concerned.

There is no concept of migration or domestication of taxpayers' residence under Japanese tax law. So long as the acquisition company or target company is a Japanese corporation, it remains a resident taxpayer of Japan subject to full Japanese income taxation. This is regardless of any migration or domestication measures implemented under foreign law.

However, as a separate but relevant matter, it is technically possible to do a 'corporate inversion' transaction, whereby a Japanese-owned Japanese corporation will become effectively foreign-owned by interposing a foreign holding company (which is usually established in a low-tax or tax-favourable jurisdiction).

These 'corporate inversion' transactions are, however, subject to certain special taxation rules to prevent avoidance of Japanese taxation.

### 13 Interest and dividend payments

Are interest and dividend payments made out of your jurisdiction subject to withholding taxes and, if so, at what rates? Are there domestic exemptions from these withholdings or are they treaty-dependent?

Yes. The withholding tax rate under Japanese domestic law is 20.42 per cent on either interest on the acquisition debt (in the form of a loan) payable by the Japanese target company to the foreign creditor or dividends payable by the Japanese target company (not publicly listed) to its foreign parent company.

No exemption is available under Japanese domestic law for these withholding taxes.

Tax-qualified eurobonds (ie, bonds issued outside Japan and whose interest is paid outside Japan) are generally free from interest withholding tax if certain formalities are met and it is technically possible to procure the acquisition debt by way of these tax-qualified eurobonds. However, withholding tax does apply at 15.315 per cent if interest on tax-qualified eurobonds is paid to certain 'specially related parties' of the issuer of the eurobonds (eg, the issuer's parent company).

As such, exemption from these withholding taxes is not available under Japanese domestic law, and generally depends upon tax treaties. Japan has tax treaties whereby the above-mentioned interest withholding tax rate is reduced, generally to 10 per cent with, inter alia, Australia, Austria, Belgium, Canada, Denmark, Finland, France, Germany, Hong Kong, Ireland, Italy, Luxembourg, the Netherlands, Norway, Singapore, Spain, Sweden, Switzerland, the United Kingdom and the United States. Under the income tax treaty between Japan and the United States, certain limited categories of qualified US residents receiving interest may, subject to compliance with certain procedural requirements under Japanese law, be fully exempt from Japanese withholding tax for interest. Under the tax treaties with the United Kingdom, France, Australia, the Netherlands and Switzerland, similar exemptions to those provided in the tax treaty between Japan and the United States will be available (provided that no exemption will apply to pension funds in the case of Australia). Moreover, Japan and the United States have recently signed a protocol amending the current tax treaty, whereby interest paid to qualified US residents is expected to be generally exempt from Japanese withholding tax; however, the amending protocol has not yet been ratified and accordingly it is not certain at what specific time the amendment enters into force. In order to avail themselves of such reduced rate of, or exemption from, Japanese withholding tax under any applicable tax treaty, foreign creditors are required to submit an Application Form for Income Tax Convention regarding Relief from Japanese Income Tax on Interest (as well as any other required forms and documents) in advance through the Japanese obligor to the relevant tax authority before payment of interest.

Owing to the imposition of a special additional withholding tax (2.1 per cent of the original withholding tax amount) to secure funds for reconstruction from the Great East Japan Earthquake, the original withholding tax rates of 15 per cent and 20 per cent, as applicable, have effectively been increased to 15.315 per cent and 20.42 per cent respectively during the period beginning on 1 January 2013 and ending on 31 December 2037.

### 14 Tax-efficient extraction of profits

What other tax-efficient means are adopted for extracting profits from your jurisdiction?

There is virtually no feasible way to repatriate profits out of Japan completely tax-free.

There is a TK arrangement, which is a contractual arrangement under Japanese commercial law between a TK operator and a TK investor, where the TK operator will run a business under its own name and for its account, and distribute a certain portion of the profits earned by it to the TK investor in accordance with the profit-distribution ratio agreed upon under the TK agreement.

Where the TK investor is a foreign company, the profit distribution by the Japanese TK operator is deductible for its Japanese corporate income tax purposes, and while the profit distribution is subject to 20.42 per cent withholding tax, some tax treaties (eg, one with Ireland) exempt such withholding tax by virtue of the 'other income' provision.

As such, technically, it is possible to repatriate profits out of Japan on a completely tax-free basis by entering into the TK agreement between the target company (as the TK operator) and the foreign financier (as the TK investor).

However, the TK arrangement has been subject to close scrutiny and challenge by the Japanese tax authority (eg, by way of denying the deduction of the Japanese TK operator, or finding a permanent establishment of the foreign TK investor), and practitioners are generally hesitant to use that structure because of the risk of disallowance.

Other structures included using tax-qualified eurobonds (as mentioned in question 13) where the amount of interest was to be calculated by reference to the profits of the issuer (by doing so, the profit-linked interest was deductible and no withholding tax applied to the interest). However, this structure was virtually eliminated by a recent tax law reform that imposed withholding tax on interest on such profit-linked eurobonds (although the interest deduction was not expressly denied).

## Disposals (from the seller's perspective)

### 15 Disposals

How are disposals most commonly carried out – a disposal of the business assets, the stock in the local company or stock in the foreign holding company?

Sale of shares of the target company and sale of the business assets of the target company are both common. The structure is in many cases determined by legal considerations depending on the circumstances of the individual deals.

In either case, the seller that is a Japanese corporation will be subject to Japanese income taxation at the effective rate of 35 to 36 per cent (national corporate and local inhabitants and enterprise taxes) in general, upon the net gains arising from the sale (for three taxable years beginning on or after 1 April 2012, this rate will be 38 per cent, as a result of the special additional corporate tax to secure funds for reconstruction necessitated by the Great East Japan Earthquake).

However, if such disposal is structured as a tax-qualified reorganisation (which should be rare, as discussed above), there would be no immediate taxation upon the seller and the taxation would be deferred.

### 16 Disposals of stock

Where the disposal is of stock in the local company by a non-resident company, will gains on disposal be exempt from tax? Are there special rules dealing with the disposal of stock in real property, energy and natural resource companies?

In general, a foreign shareholder of the Japanese target company having no permanent establishment in Japan will not be subject to Japanese taxation on the capital gains arising from the sale of shares of the Japanese target company.

However, the foreign shareholder is subject to Japanese taxation on the capital gains if the foreign shareholder, together with certain related persons (its affiliates and related parties, etc) as defined in Japanese tax laws and partnerships in which the foreign shareholder is directly or indirectly a partner:

- owns or owned 25 per cent or more of the total shares of the Japanese target company at any time during a period of three years on or before the end of the fiscal period of the foreign shareholder in which the sale of the target shares took place; and
- sells 5 per cent or more of the total shares of the Japanese target company in that fiscal period.

This exceptional rule is commonly referred to as the '25/5 rule' in practice.

It is common in practice to structure the offshore ownership to avoid this 25/5 rule so as to avoid capital gains taxation in Japan in the event of the exit from the investment.

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In addition, in the case where the Japanese target company is a so-called real estate holding company (ie, if, in general, at least 50 per cent of the total assets of that company consist of real estate located in Japan), special rules apply so that more than 2 per cent (if that company is not publicly listed) or more than 5 per cent (if that company is publicly listed) ownership by the foreign shareholder will trigger Japanese capital gains taxation. A typical example of this includes a Japanese REIT.

In each case, the tax rate is in general 25.5 per cent on the net capital gains (for three taxable years beginning on or after 1 April 2012, 28.05 per cent, owing to the special additional corporate tax to secure funds for reconstruction from the Great East Japan Earthquake).

These domestic tax law consequences, however, may be amended by the capital gains clause of the applicable tax treaty.

### 17 Avoiding and deferring tax

If a gain is taxable on the disposal either of the shares in the local company or of the business assets by the local company, are there any methods for deferring or avoiding the tax?

Tax-free (or deferral) treatment is available if the disposal is structured as a tax-qualified reorganisation.

In the case of a disposal or acquisition (rather than a business combination or integration) between unrelated third parties, however, it is generally difficult to satisfy the requirements for a tax-qualified reorganisation.

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