Client Alert

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Japan Corporate and Tax Quarterly Update: Recent legal reform - 2022 tax reform proposal and changes to the share delivery regime

In brief

On 10 December 2021, Japan announced its 2022 tax reform proposal, which contains a number of changes to the existing tax rules that may impact companies doing business in Japan, including changes that may provide some companies with a chance to reduce their Japanese tax burden, as well as changes that may result in potential pitfalls (eg, disallowance of certain incentives, etc.) for failure to comply with the new provisions.

Additionally, amendments were made to the Japanese Companies Act (JCA) in 2021 introducing a share delivery regime. This regime is now available as another M&A transaction regime under which a target corporation survives and an acquiring corporation delivers shares as consideration. The new share delivery regime can be used for partial acquisitions and does not require inspection by a person elected by the court. As such, it provides certain advantages over the previously existing methods for carrying out such transactions. In addition, the Japanese Corporate Tax Act (JCTA) was amended in 2021 to make it possible to structure transactions using the share delivery regime in a tax-free manner, thus providing potential tax benefits as well.

The following article provides a brief overview of the relevant 2022 tax reform proposal items that would likely have the largest impact on multinational companies doing business in Japan and outlines the recent legal changes related to the share delivery regime.

In this issue

2022 tax reform proposal

On 10 December 2021, the ruling party announced its 2022 tax reform proposal ("**Proposal**"), which was introduced as a bill to the National Diet on 25 January 2022. The Proposal reflects Prime Minister Kishida's goal of working to foster economic improvement with the objectives of a "positive cycle of growth and distribution" and "development of a new society post-COVID-19." Specifically, the Proposal includes various measures aimed at stimulating the economy by promoting business growth and innovation, such as updates to the wage increase tax credit.

The items outlined below are those that would likely have the largest impact on multinational corporations doing business in Japan. Please note, however, that the Proposal is merely an outline and has not yet been enacted. As such, the provisions of the Proposal may be subject to change.

1. Withholding tax on dividends from wholly-owned subsidiaries

Under the Proposal, the following dividends paid to domestic companies will no longer be subject to withholding tax:

- dividends paid with respect to shares of wholly-owned domestic subsidiaries, and
- dividends paid with respect to shares of domestic affiliated companies in which more than one-third of the outstanding shares are directly owned, as of the dividend record date.

Under the current rules, withholding tax is imposed when a parent corporation receives a dividend from a wholly-owned subsidiary that is part of a 100% group. The parent corporation is then entitled to receive a refund or credit of the withholding tax at the time it files its corporate tax return,[1] and when calculating its corporate tax amount, the parent corporation is able to exclude the entire amount of the dividend from income, resulting in no corporate tax being imposed. Thus, the revisions are meant to eliminate the inconsistency of imposing withholding tax on dividends that are not subject to corporate tax.

Practically speaking, the revisions would make it necessary to determine whether, at the time of the dividend, the dividend is received from a wholly-owned subsidiary or an "affiliated subsidiary" (generally, a subsidiary in which the recipient owns more than one-third of the total number of outstanding shares) to determine whether withholding tax would apply. However, as the scope of the revisions is limited to subsidiaries in which more than one-third of the outstanding shares are owned, such a determination should not create any additional administrative burden.

The revisions above will apply to dividends received on or after 1 October 2023.

2. Earnings stripping rules

Japan's earnings stripping rules restrict deductions for net interest expenses that exceeded 20% of a Japanese company’s adjusted taxable income. Under the current rules, foreign companies are only subject to the earnings stripping provisions on income attributable to a Japanese permanent establishment (PE). However, under the Proposal, the scope of the earnings stripping rules will be expanded to include Japan-source income of a foreign company without a PE in Japan, as well as Japan-source income of a foreign company with a PE in Japan, regardless of whether or not such income is attributable to the Japanese PE.

3. Wage increase tax credit

Under the current rules, companies filing blue form tax returns are generally entitled to take a credit of up to 20% (25% for small and medium-sized enterprises (SMEs)[2]) if certain wage payments made in the current fiscal year (FY) exceed certain wage payments made in the previous FY.

The Proposal will expand on the existing rules and provide increased credit amounts if companies meet certain conditions. For large companies (i.e., non-SMEs), the relevant conditions are as follows:

i. Wages paid to continuously employed employees in the current FY ≥ Wages paid to continuously employed employees in the prior FY x 103%

ii. Wages paid to continuously employed employees in the current FY ≥ Wages paid to continuously employed employees in the prior FY x 104%

iii. Education and training costs in the current FY ≥ Education and training costs in the prior FY x 120%

Specifically, the total credit amount for large companies will be increased as described below:

Companies meeting condition (i)	15% of total wage payment increase
Companies meeting condition (ii)	25% of total wage payment increase
Companies meeting conditions (i) and (iii)	20% of total wage payment increase
Companies meeting conditions (ii) and (iii)	30% of total wage payment increase

[1] Having to wait until the corporate tax return is filed to recover withholding tax paid on a dividend may result in cash flow concerns for the parent company, and in the M&A context, there have been some cases where companies have made bridge loans for the withholding tax amounts to alleviate such concerns.

[2] An SME is a company with JPY 100 million or less in stated capital and that is not 50% or more held by a large company (i.e., a company with more than JPY 100 million in stated capital) or two-thirds or more held by two or more large companies. Additionally, a company with annual average income (i.e., income in the three FYs prior to the current FY) over JPY 1.5 billion will not be considered an SME.

Baker McKenzie.

Similar to the conditions for large companies, the relevant conditions for companies qualifying for SME status are outlined below. Note that unlike the conditions for large companies, the conditions related to SMEs focus on total wage payments rather than wages paid specifically to continuously employed employees.

i. Total wage payments in the current FY ≥ Total wage payments in the prior FY x 101.5%

ii. Total wage payments in the current FY ≥ Total wage payments in the prior FY x 102.5%

iii. Education and training costs in the current FY ≥ Education and training costs in the prior FY x 110%

Specifically, the total credit amount for SMEs will be increased as follows:

Companies meeting condition (i)	15% of total wage payment increase
Companies meeting condition (ii)	30% of total wage payment increase
Companies meeting conditions (i) and (iii)	25% of total wage payment increase
Companies meeting conditions (ii) and (iii)	40% of total wage payment increase

Note that the total amount of the tax credit is capped at 20% of the corporate tax liability for the current FY.

Additionally, note that companies with JPY 1 billion or more in stated capital and 1,000 or more regular employees must notify the Ministry of Economy, Trade and Industry that they have made a public announcement via the Internet regarding, among other things, the policy of building appropriate relationships with business partners to be eligible to use the wage increase tax incentives.

The revised rules outlined above will apply to FYs beginning between 1 April 2022 and 31 March 2024.

4. Disallowance of certain special tax measures for large companies

The current rules provide that the R&D incentives and certain other tax credits will be disallowed for large companies if certain conditions are not met. One such condition is that wages paid to continuously employed employees in the current FY exceed wages paid to continuously employed employees in the prior FY (i.e., a greater than zero-percent increase).

However, under the Proposal, the threshold for disallowance is increased to require that wages paid to continuously employed employees in the current FY exceed those paid in the prior FY by at least 0.5% (for FYs beginning between 1 April 2022 and 31 March 2023) and at least 1% (for FYs beginning on or after 1 April 2023) if both of the following apply:

i. the amount of stated capital is more than JPY 1 billion and the number of regular employees is 1,000 or more, and

ii. the company had positive income (i.e., more than zero) in the prior FY.

Changes to the share delivery regime in 2021

1. Overview of legal and tax framework for M&A transactions in Japan

Over the last 15 years, the JCA and other related laws have been amended to accommodate a variety of needs related to M&A transactions and corporate reorganizations. These amendments were followed by the introduction of several new regimes to the JCTA, including a tax-free reorganization regime, to facilitate M&A transactions and corporate reorganizations.

One of the significant changes introduced by the JCA was a relaxation for certain types of consideration to be delivered upon certain corporate reorganizations, including mergers and share exchanges[3]. Previously, in general, only shares of the surviving corporation or purchasing corporation could be used as consideration for the merger or share exchange, but now

[3] A "share exchange" under the JCA is a type of corporate reorganization where a purchasing corporation and a target corporation enter into a share exchange agreement that requires prior approval by shareholders of both corporations, and whereby all outstanding shares in the target corporation will be transferred to the purchasing corporation by operation of law, without entering into share sale and purchase agreements individually.

other property, including shares in a parent corporation, can be delivered to shareholders of the target corporation such that a so-called triangular merger or share exchange can be implemented.

Subject to certain requirements, these M&A transactions, which are basically "share-for-share exchanges" in nature, can qualify for tax deferral treatment for JCTA purposes at either the shareholder level, corporate level or both. Additionally, in general and in some cases, certain planning opportunities may be available from a tax perspective by using a "taxable" transaction to crystalize tax deductible losses.

However, there were still several issues in connection with M&A transactions, in practice: (A) a "share exchange" can only be used to acquire all shares in a target corporation, so it cannot be used for a partial acquisition; (B) delivering cash to selling shareholders will disqualify the transaction from receiving tax-free reorganization treatment, even if cash represents only a small portion of the overall consideration; and (C) a tax-free share exchange must meet certain requirements, including the business continuity test, etc., so it could limit the flexibility of post-closing integration.

The JCA and JCTA were recently further amended to address these issues and provide additional flexibility in the M&A transaction space (discussed in greater detail below).

2. Share delivery regime

Corporate law changes

Until the amendments to the JCA earlier last year, only share exchanges and contributions in-kind were available as M&A transaction regimes under which a target corporation survives and the acquiring corporation delivers shares as consideration, but both share exchanges and contributions in-kind have their respective challenges in practice (i.e., a share exchange cannot be used for a partial acquisition, and a contribution in-kind requires inspection by a person elected by the court, unless any of the exemptions under the JCA are available). The amendments to the JCA have now been effective since 1 March 2021, and a new breakthrough regime, called "share delivery," is available as another M&A transaction regime under which a target corporation survives and an acquiring corporation delivers shares as consideration. The new share delivery regime can be used for partial acquisitions and does not require inspection by a person elected by the court.

a. Overview of share delivery

Share delivery is a regime under which a Japanese stock company (acquiring corporation) acquires shares in another Japanese stock company (target corporation) to make it a subsidiary and delivers its own shares to the selling shareholders as consideration. Share delivery can be used for a partial acquisition, which is clearly stated in the JCA, and does not require inspection by a person elected by the court, since it is stipulated as one of the corporate reorganization regimes under the JCA. The corporate procedure for share delivery is very similar to that of a share exchange, but it differs in that share delivery does not require approval from or a grant of appraisal rights to the target corporation's shareholders.

The basic share delivery procedures under the JCA are for the acquiring corporation to: (1) prepare a share delivery plan, (2) notify the target corporation's shareholders of its intention to acquire shares in the target corporation, (3) determine, at its sole discretion, and notify all or some of the applicants of how many shares are to be acquired from them, (4) prepare pre-disclosure documents, (5) obtain its shareholders' approval of the share delivery plan, (6) take steps to protect dissenting shareholders and (7) take steps to protect the creditors if consideration other than shares or share equivalents are delivered to the selling shareholders.

b. Advantages and disadvantages

The material advantages of share delivery are: (i) it can be used for a partial acquisition; (ii) delivering cash on top of shares to selling shareholders as a part of the consideration is permitted; (iii) it is not subject to the advantageous issuance of shares rules under the JCA,[4] and (iv) share options and/or bonds with share options of the target corporation can be acquired together with its shares.

However, you may need to note the following: (a) share delivery can be used only where both the acquiring corporation and the target corporation are Japanese stock companies (Kabushiki Kaisha); (b) the acquiring corporation cannot

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[4] An "advantageous issuance of shares" under the JCA means issuance of shares at a price extremely preferable to an acquirer. In the case of an advantageous issuance of shares, a stock company needs to obtain its shareholders' special resolution (approval by two thirds or more of attendees' voting rights with a majority quorum).

acquire additional shares in its existing subsidiary by way of share delivery, since share delivery can be used only when an acquiring corporation makes a certain stock company become its subsidiary; (c) share delivery may be subject to a tender offer regulation and/or disclosure regulation under the Japanese Financial Instruments and Exchange Act; and (d) "triangular share delivery" cannot be implemented due to regular restriction of a corporation's share acquisition in its parent stock company under the JCA.

Per item (a) above, although a foreign company cannot use the share delivery regime directly, it may utilize the new regime to acquire a Japanese stock company as follows:

- a foreign acquiring corporation establishes a 100% subsidiary (Company A), and Company A establishes a 100% subsidiary (Company B), both of which are Japanese stock companies;
- Company B acquires shares in the target corporation by way of share delivery;
- Company A acquires shares in the foreign acquiring corporation; and
- Company B merges into Company A and shares in the foreign acquiring corporation held by Company A are delivered to shareholders of Company B (including the former shareholders of the target corporation) as consideration.

Tax law changes

On 10 December 2020, the ruling parties and the government published the "2021 Tax Reform Proposal" or Zeisei Kaisei Taiko. The 2021 Tax Reform Proposal seems to focus on boosting the domestic economy, especially in areas which have been severely impacted by the COVID-19 pandemic.

Among these proposed amendments to the tax law, a proposed amendment to expand the scope of tax-free share exchanges may have a significant positive effect on M&A transactions and corporate reorganizations. The 2021 Tax Reform Bill was passed in late March 2021, and some of the changes, including the expansion of the scope of tax-free exchanges discussed herein, have already taken effect.

a. Current legislation - Tax-free share exchanges

Under the Individual Income Tax Act (IITA) and the JCTA, no gain or loss will be realized for shareholders transferring shares by way of a share exchange pursuant to the JCA and equivalent foreign corporate law. While a share exchange under the JCA is always tax-free for shareholders unless cash or other property is delivered, the target company may be subject to the "deemed asset sale" rule for certain asset categories if it is categorized as a non-tax qualified share exchange. A share exchange under the JCA can be used only when the buyer intends to acquire all issued shares in the target company.

Additionally, the Special Tax Measures Act (STMA) currently provides (under Article 62-2-2) a special tax deferral rule for a share exchange which is not by way of share exchange under the JCA (i.e., shareholders of the target company individually contribute shares to the buyer in exchange for new shares in the buyer), but only if such share exchange is approved in advance by the Ministry of Energy, Trade and Industry (METI) pursuant to the Act for Strengthening Industrial Competitiveness. However, it was reported that no such approval was granted by METI.

b. Expansion of the scope of tax-free exchanges (2021 Tax Reform)

The 2021 Tax Reform Bill provides that a recognition of gain or loss arising from the transfer of shares in one company to another company in exchange for new shares of another company pursuant to the share delivery regime under the JCA shall be deferred if the value of the new shares in the other company is at least 80% of the total value of consideration. Therefore, the requirement of obtaining METI approval will be removed.

This change can potentially have a significant impact in the area of M&A, as well as group reorganization. First, an acquisition of less than 100% of a Japanese company's ownership in exchange for new shares of the buyer may be carried out without incurring capital gain tax at the Japanese shareholder level. This cannot be done in a tax-free manner under the current rules, as a share exchange under the JCA will always result in 100% acquisition.

Second, the new rules may be applicable to intra-group reorganization as well. For example, under the current rules, a Japanese individual shareholder will be fully taxed on the gain resulting from a contribution of shares in a company which he/she controls in exchange for shares in another company which is controlled by the same person. The new rules may make such restructuring transactions tax-free.

Third, using cash as consideration can still qualify for tax-free treatment at the shareholder level, and recognition of gain corresponding to "shares" will be deferred.

Finally, there will be no tax consequences for the target corporation, and therefore, there will be greater flexibility to implement post-closing integration.

Recommended actions

While the Proposal did not include many topics that would likely prove to have a significant impact on multinational companies doing business in Japan, there are still several changes of which companies should be aware. While some changes, such as the expansion of the wage increase tax credit, may provide some companies with a chance to reduce their Japanese tax burdens, other changes, such as the expansion of the earnings stripping rules and rules regarding the disallowance of certain incentives for large companies, may result in potential pitfalls for companies that do not take the necessary steps to avoid falling within the scope of the new provisions. As such, companies should consult with their tax advisors to ensure that they understand the upcoming changes and take steps to maximum their potential benefits/reduce any potential impacts.

With regard to the new share delivery regime, prior to the amendments, only share exchanges and contributions in-kind were available as deal structuring options, both of which come with certain limitations that may make them less than ideal. While share delivery still presents certain restrictions that may limit its usefulness, the advantages it provides in comparison to the transaction schemes available prior to the amendments make it a beneficial alternative. Additionally, with the tax law changes as part of the 2021 Tax Reform Bill, share delivery may also have tax advantages and allow corporations to structure such M&A transactions in a tax-free manner. As a result, corporations contemplating transactions in which a target corporation is acquired (in whole or in part), with the target corporation surviving, and in which the acquiring corporation delivers shares as consideration, should consider whether the share delivery regime may be advantageous.

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