

## Newsletter

20 December 2016

### Japan 2017 Tax Reform Proposal

#### Introduction

On December 8, 2016, the ruling parties and the government issued the 2017 tax reform proposal ("Proposal"). This newsletter focuses on key proposed tax revisions set out in the Proposal, including significant changes to Japan's CFC rules, the introduction of a tax-free corporate spin off regime, and other changes that may be relevant to Japanese and non-Japanese multinational enterprises doing business in Japan. It is expected that the tax reform bill will be submitted at the next ordinary session of the Diet, scheduled to take place some time in late January, and passed in late March 2017.

#### Major Proposed Changes:

- I. [Changes to Japan's CFC Rules](#)
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## I. Changes to Japan's CFC Rules

### Key points

- The new rules are scheduled to apply with respect to fiscal years of foreign subsidiaries beginning on or after April 1, 2018.
- The current framework, which categorizes a foreign subsidiary based on its effective tax rate (trigger tax rate = 20%), will basically remain as is; the Proposal did not include a reduction of the trigger tax rate in response to the UK's reduced corporate tax rate.\*
- Under the current rules, a foreign subsidiary with an effective tax rate of at least 20% is exempt from application of Japan's CFC rules in any case. Under the Proposal, a foreign subsidiary with an effective tax rate of 20% or more (located in such places as the Netherlands, Belgium, Switzerland, Luxemburg, etc.) would be captured by the rules, unless the subsidiary satisfies certain substance requirements. Certain offshore holding companies thus may be subject to concurrent taxation under the new rules, although foreign subsidiaries with an effective tax rate of 30% or more would continue to be exempt.
- The Proposal significantly expands the scope of taxable passive income of a foreign subsidiary with an effective tax rate of less than 20% but which is exempt from full taxation due to the "active business exemption". Nonetheless, interest income on qualified intra-group loans will be excluded from the scope of taxable passive income.
- The definition of a "foreign subsidiary" will be changed to exclude foreign corporations with a 50% or less ownership interest in each entity in the chain. For instance, a foreign subsidiary that is owned exactly 50% by a Japanese corporation and 50% by a non-Japanese corporation would be outside the scope of CFC rules under the Proposal (under the current rules, such subsidiary may be caught by the rules if the non-Japanese corporation has Japanese shareholders).
- While the Proposal expands the scope of potential taxation under the CFC rules, several exceptions are introduced as well. The language of many of the requirements of these exceptions is not clear, however; for example, requirements to "engage in all activities that are normally required to conduct the business in an appropriate manner", to be "actively involved in manufacturing activity by performing significant functions" in the "ordinary course of business" are not defined. These ambiguities could lead to great uncertainty, depending on how the final tax reform bill is drafted.

\* The current UK corporate income tax rate of 20% (as of Dec 2016) is scheduled to be reduced to 19% in April 2017, and possibly reduced to 17% after 2020.



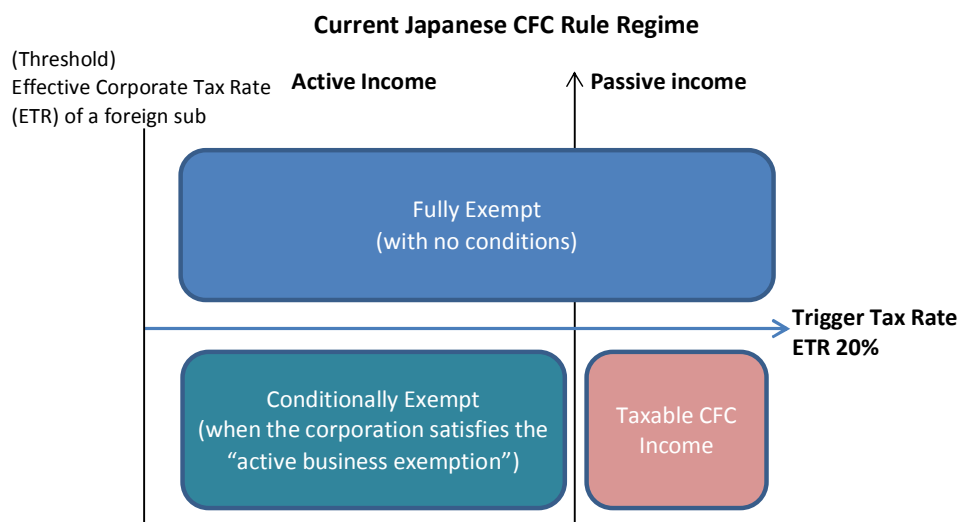
## Proposed Changes

### 1. Overview

The changes to the Japan's CFC rules in the Proposal are reported to be a symbol of the Japanese government's efforts to respond to the BEPS final report. In fact, the idea of strengthening Japan's CFC rules has been attracting significant media coverage since July 2016. These changes, the biggest since the current classification of taxable foreign subsidiaries based on effective tax rates was introduced in 1992, would widely affect all Japanese multinational enterprises with subsidiaries located outside of Japan. Japanese multinational enterprises may need to analyze the ramifications of the changes to their specific businesses and structures and, if necessary, undertake strategic restructuring prior to the proposed effective date of the new rule (April 1, 2018).

#### (A) Current Regime

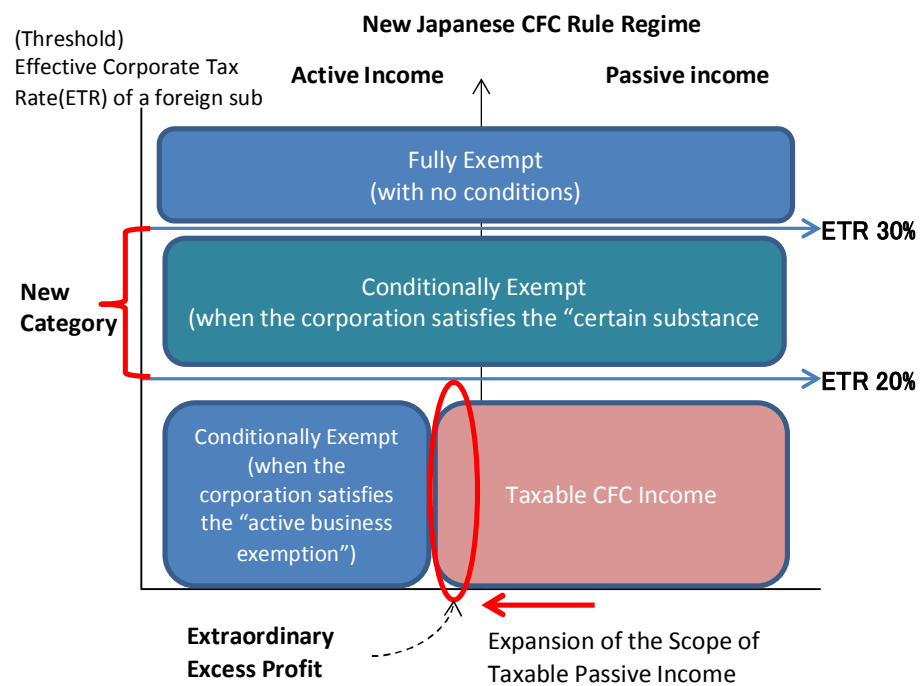
Under the current regime, a foreign subsidiary is classified in one of two categories based on the effective tax rate test, which looks to whether the subsidiary is taxed at an effective tax rate of less than 20% or not. If the foreign subsidiary is taxed at an effective rate of less than 20%, it is further tested to determine whether it can satisfy the "active business" exemption. If it qualifies, one next looks at whether the subsidiary has taxable passive income or not. The basic framework can be illustrated as follows:



Source: Baker McKenzie (Tokyo)

#### (B) New Rule

The Proposal would create one additional group under the CFC rules. The three categories would be (i) a foreign subsidiary with an effective tax rate of at least 20%, but less than 30%, (ii) a foreign subsidiary with an effective tax rate of less than 20%, and (iii) a foreign subsidiary with an effective tax rate of at least 30%. The Proposal also significantly expands the scope of taxable passive income and creates a new concept, "extraordinary excess profit". Income in the "extraordinary excess profit" category would be taxed immediately, regardless of whether such excess profit was derived from an active business or not. The new framework can be illustrated as follows:



Source : Baker McKenzie (Tokyo)

We analyze each significant change under the Proposal in greater detail below.

**2. \*\*New Concept\*\* Full Inclusion of Income of a Foreign Subsidiary with an Effective Tax Rate of 20% to 30%**

Under currently effective CFC rules, the "effective tax rate of less than 20%" threshold is significant; as long as a foreign subsidiary has an effective tax rate of 20% or more, the foreign subsidiary is not "caught" by the rules. Many Japanese multinational enterprises likely considered this threshold in choosing a jurisdiction in which to set up an offshore holding/finance company. Some jurisdictions appear to have maintained their headline tax rates at 20% with Japan's CFC rules in mind, in an effort to attract Japanese corporate investment.

Under the Proposal, a foreign subsidiary with an effective tax rate of at least 20%, but less than 30%, would be subject to concurrent taxation at the parent level under Japan's CFC rules unless all of following conditions are satisfied. If all of the following conditions are satisfied, the Japanese company can avoid the CFC rule's requirement to concurrently include subsidiaries' passive income, as discussed in greater detail below.

**(A) Main or Head Office of the Subsidiary is Not Located in a "blacklisted" Jurisdiction (i.e., One Designated by the Ministry of Finance)**

The Proposal indicates that that when a subsidiary is established certain jurisdictions that the Ministry of Finance "designates", the subsidiary will *per se* be caught by the CFC Rules. Specifically, jurisdictions on this "blacklist" would be ones that are not cooperative with Japan with respect to tax related information exchange. The Proposal does not specify which jurisdictions will



be on the list. If a foreign subsidiary is located in such a jurisdiction, however, it will be subject to Japan's CFC rules regardless of its substance.

### (B) Company is Not a "Cash Box Company"

A foreign subsidiary would be considered a "cash box company" if its ratio of "passive investment assets" to total assets is greater than 50%, *and* its ratio of "passive income" to total assets is greater than 30%. A foreign subsidiary failing this test would be subject to the full income inclusion rule, even if it engages in an active business. The formulas for the determination are as summarized below. (Note that different formulas apply with respect to "licensed offshore finance subsidiaries".)

- ① Passive investment asset test  
(total of securities, loan receivables, intangible assets and other assets generating passive income) / total assets > 50%
- ② Passive income test  
Passive income (interest, dividends, gains from the sale of securities, royalties on intangible assets etc. / total assets > 30%

Interest income on qualified intra-group loans and dividend income received from another subsidiary (in which the first subsidiary has at least a 25% ownership interest) will be excluded from the scope of passive income. Portfolio investments would not normally create a 30% return on assets; therefore, there would be very limited circumstances in which a foreign subsidiary would satisfy both tests. A foreign subsidiary that might typically be categorized as a "cash box company" would be (i) an intangible asset holding company, or (ii) a company seeking capital gains from minority investment (*i.e.*, venture capital).

### (C) Company is Not a "Mailbox Company"

A foreign subsidiary satisfying either of following two conditions would not be treated as a "mailbox company".

- ① The subsidiary has an office, factory or other fixed place of business ("Fixed Place Test").
- ② The company administers, controls and operates its business by itself in its place of incorporation ("Control and Administration Test").

The above are two of several conditions that must be satisfied in connection with the active business exemption under the current CFC rules. Interestingly, as opposed to the active business exemption requirements (for a foreign subsidiary with an effective tax rate of less than 20%) where all of the conditions must be satisfied, the Proposal provides that satisfaction of either of the above two conditions would enable a foreign subsidiary with an effective tax rate of 20% or more, but less than 30%, to qualify for the exemption. It is generally believed that the Fixed Place Test requires the objective existence of a fixed place (*e.g.*, a rental office). Perhaps because the analysis is relatively straightforward, the Fixed Place Test has not been an area for dispute; rather, the Control and Administration Test is considered more difficult to satisfy.

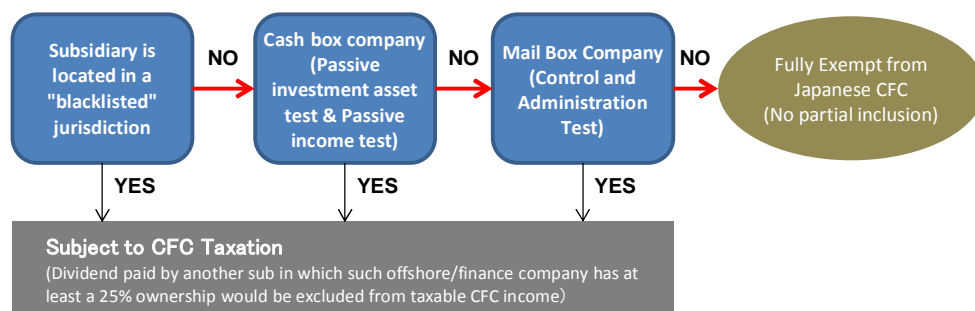


The Control and Administration Test poses certain practical difficulties. For example, it is not clear to what extent a parent may be involved in matters concerning the foreign subsidiary's operations, such that the subsidiary would still satisfy the Control and Administration Test. The prevailing interpretation is that if the parent (or other group entity) merely authorizes and makes final decisions regarding the actions of the foreign subsidiary pursuant to internal decision making procedures, this in and of itself should not cause the Control and Administration Test to be failed. If, however, the parent is actively involved in negotiations with local customers, credit management, or taking or making purchase orders, or in other matters that are necessary in connection with the foreign subsidiary's ordinary course of business, the Control and Administration Test may be considered to be failed. The biggest factor in proving satisfaction of the Control and Administration Test would seem to be the number of directors and employees the foreign subsidiary actually has in the local country.

Historically, Japanese multinational enterprises have tended to set up offshore holding / finance companies with limited substance, located in jurisdictions with a headline tax rate of at least 20% (e.g., the Netherlands). The companies would then engage local service providers to act as local directors, so as to satisfy local corporate law requirements (e.g., requirement of having at least one local director). Assuming that the Proposal takes effect as drafted, it is very likely that offshore holding / finance companies with no "real" directors or employees would trigger taxation under Japan's CFC rules, unless they satisfied the Fixed Place Test. Even if the new rule captures such offshore holding /finance companies, however, dividend income paid by another corporation in which such offshore/finance company has at least a 25% ownership would be excluded from taxable CFC income. Thus, adverse consequences would be limited to cases in which such offshore holding / finance company had made portfolio investments using surplus cash, or engaged in non-qualified intra-group financing activities.

The flow chart below illustrates the process of determining whether a company falls under the new CFC rule category (effective tax rate of 20% to 30%).

**CFC Judgment Flow for a foreign subsidiary with an effective tax rate of at least 20%, but less than 30%**



Source: Baker McKenzie

Under the current rules, the effective tax rate of a foreign subsidiary is tested on a year-by-year basis, and carryforward losses are only allowed if they arise in a fiscal year in which the company has an effective tax rate of 20% or more. As a result, an arguably unreasonable consequence arises under the



current CFC rules where a foreign subsidiary suffers losses in a fiscal year in which its effective tax rate is 20% or more, but cannot use such NOLs to offset taxable income in a year in which the effective tax rate goes below 20%. Although not explicitly dealt with in the Proposal, the issue may go away due to the creation of the new category (*i.e.*, the effective tax rate of 20% to 30%).

Under current rules, the Japanese parent of a foreign subsidiary may need to bear extra administrative burdens every year in order to determine whether the CFC rule applies to a foreign subsidiary located in a jurisdiction with a headline tax rate of at least 20%. We believe such additional administrative action can be a good opportunity for a tax group at the Japanese company's headquarter to control the tax costs of the group on a worldwide basis, and to build a better internal governance structure from a tax perspective.

### 3. Expansion of Scope of Partial inclusion (Article 66-6(4) of the Special Tax Measures Act)

The biggest adverse impact of the Proposal to Japanese headquartered company may be the expansion of the scope of partial inclusion of "passive income". The Proposal provides the following changes.

	Current Scope	Proposed Changes	
		Scope of taxable income	Exclusion
①	Interest, Originally Issued Discount of bonds.	Any interest	① Interest income from qualified intra-group finance. ② Interest income of a foreign subsidiary licensed to conduct a lending business under the local law. ③ Interest on bank deposits derived in the ordinary course of business.
②	Dividends paid by a company in which the ownership percentage is less than 10%.	Any dividend	Dividends paid by company with a less than 25% ownership. 10% ownership requirement continues to apply to companies in oil & gas industry,
③	<b>New category</b>	Securities lending	None
④	Capital gains derived from the sale of shares (less than 10% ownership) and bonds	Capital gain derived from the sale of any security	Capital gain derived from the sale of shares (less than 25% ownership)



	Current Scope	Proposed Changes	
		Scope of taxable income	Exclusion
⑤	<b>New category</b>	Income from derivative transactions	Derivative transactions for hedging purposes Income from derivative transactions of a foreign subsidiary licensed to conduct a futures trading business under the local law.
⑥	<b>New category</b>	Foreign exchange gains or losses	Foreign exchange gain or loss arising in the ordinary course of business.
⑦	<b>New category</b>	Any other financial income (e.g., income paid by collective investment fund, revaluation gain of securities for sale)	
⑧	Lease of ships and aircraft	Lease of any tangible property	Lease of tangible property used in the home jurisdiction Lease of tangible property which qualifies under certain substance requirements
⑨	Royalties on intellectual property	Royalties on any intangible asset	Any intangible asset developed by the company itself Any intangible asset used by the company in its own business
⑩	<b>New category</b>	Capital gains derived from the sale of intangible assets	Any intangible asset developed by the company itself Any intangible asset used by the company in its own business
⑪	<b>New category</b>	Extraordinary excess profit	Certain exclusions (as described below)

In general, the scope of taxable passive income will be expanded in all income categories, and new income categories will be created. Notable changes include the following.

#### (A) Interest Income from Qualified Intra-Group Finance Activities

A foreign subsidiary with an effective tax rate of less than 20%, but which qualifies for the active business exemption, may frequently use its surplus





cash to provide loans to other group company, or may function as an active finance company. Excluding interest income arising from qualified intra-group financing from the scope of taxable passive income is welcomed, so as to support the competitiveness of Japanese multinational enterprises.

In order to qualify for the exception, however, "directors or employees of a foreign subsidiary must perform, in a jurisdiction where the head office is situated, all activities that are normally required for conducting a lending business in an appropriate manner". Among other things, it seems to be particularly difficult to draw a clear line regarding what is meant by conducting a lending business "in an appropriate manner", and what specifically is meant by "all activities that are normally required" for such business. This creates a practical difficulty, this since these requirements must be satisfied in order for the exclusion to apply.

Since the wording of the Proposal refers to "interest", rather than "interest and the like", intra-group guarantee fees may be outside the scope of taxable passive income for purposes of the law, if the tax bill is submitted to the Diet using exactly the same language as the Proposal.

#### **(B) Interest Income on Bank Deposits and Exchange Gain Arising in the Ordinary Course of Business**

The Proposal does not clarify what the "ordinary course of business" means in this context. If not clarified in the actual tax reform bill, great uncertainty will remain for both tax payers and the authorities regarding what constitutes "the ordinary course of business" for purposes of the law.

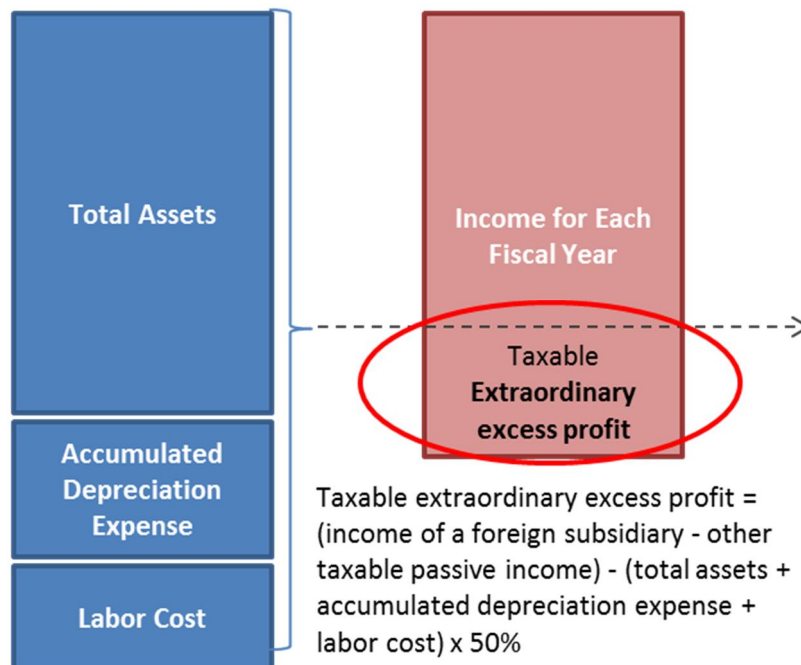
#### **(C) Extraordinary Excess Profit**

Under this provision, the extraordinary profit of a foreign subsidiary would be taxed even if the foreign subsidiary engaged in an active business. The Proposal provides the following formula for computing "extraordinary excess profit".

Taxable extraordinary excess profit = (income of a foreign subsidiary - other taxable passive income) - (total assets + accumulated depreciation expense + labor costs) x 50%



## Calculation of "Extraordinary Excess Profit"



While the details remain to be seen, one would expect that traditional manufacturing activities would not likely generate "extraordinary excess profit" under the above formulate, since it would be necessary for the activities to earn at least a 50% return on assets.

Because Japan's CFC rules apply on a year-by-year basis, however, there could be cases in which a company, especially those operating businesses with high volatility, to generate extraordinary excess profit in a single fiscal year. We believe the following are cases in which a company might generate extraordinary excess profits.

### **Example 1: Business Requires Minimal Capital Expenditure, but Has Valuable Intangible Assets.**

Where a company's business model involves creating valuable intangible assets using operating expenses such as R&D expense, but the company has low cost of goods sold, it may generate extra ordinary excess profit. Examples of areas in which this might occur would be pharmaceuticals and software, since these businesses tend not to require the use of a large amount of capital expenditures. This may particularly be the case if a subsidiary outsources R&D to another company, resulting in the subsidiary incurring lower labor costs.

### **Example 2: Company Does Not have Its Own Factory, or Company Largely Outsources Manufacturing**

A company with a highly recognized brand that sells products it does not itself manufacture may also generate extraordinary excess profit, if the only "labor cost" added to total asset costs is its own. This is because such a company would tend to generate a higher return on assets. Companies that



might fall into this category would include those that sell luxury goods, premium foods, or premium beverages.

One of the tax authority's assumptions in enacting this provision may be that Japan parent companies have contributed to the development of valuable brands. If the tax authorities can confirm, however, that a Japanese parent contributed to the development of its foreign subsidiary's valuable intangible assets, arguably the authorities should address the issue through Japan's transfer pricing rules, rather than through the CFC rules. And in the alternative, if the Japan parent did not contribute to the development of valuable intangibles possessed by, for example, a subsidiary that the Japanese multinational enterprise acquired, there is no rationale for Japan to tax extraordinary excess profits generated by that foreign subsidiary.

### Example 3: Sale of Business, or Real Property Used in Business

Under the CFC rules currently in effect, gain derived by a foreign subsidiary from the sale of an active business, or from the sale of real property used in such active business, should not be subject to concurrent taxation under Japan's CFC rules due to the active business exemption. Depending on the timing of measurement of the total assets, however, the above formula may lead to extraordinary excess profit in the fiscal year in which the sale took place.

Keeping in mind the three examples set out above, it will be important to consider the wording of the final tax reform bill, as inclusion of the proposed extraordinary excess profit provision could lead to various issues, as described above.

### (D) Computation of Taxable Passive Income and Loss Carryforward

Under the Proposal, taxable passive income will be classified into one of the following two groups, and computed separately as follows.

	Income Categories	Computation Method
<b>Group 1</b> (each income category cannot be negative)	Interest, dividends, stock lending, royalties, leases of tangible assets, and extraordinary excess profit.	The total of these income categories.
<b>Group 2</b> (each income category can be negative, and can be used to offset one other)	Gain on the sale of securities, income from derivative transactions, foreign exchange gains or losses, other financial income, gain on the sale of intangible assets.	<ul style="list-style-type: none"> <li>● The total of these income categories (if the total is a loss, it cannot be used to offset income of Group 1)</li> <li>● Losses of Group 2 incurred within the preceding 7 years can be used to offset income of Group 2 in the current year.</li> </ul>

Under currently effective CFC rules, the amount of taxable passive income is limited to the net income of the foreign subsidiary. This limitation may be



abolished under the Proposal, however, such that passive income can be taxed even if the foreign subsidiary as a whole is generating losses.

#### 4. Partial Inclusion for a Licensed Financial Subsidiary (New Rule)

A special rule applies to a foreign subsidiary engaging in a financial instrument business or insurance business pursuant to applicable local law if directors and employees of which perform, in the jurisdiction in which the head office is situated, all activities that are normally required for conducting the business in an appropriate manner (a "Licensed Financial Subsidiary").

The scope and method of computation of taxable passive income of a Licensed Financial Subsidiary is as follows.

	Income Categories	Computation Method
<b>Group 1</b>	Income from extraordinary overcapitalization.	No detailed method of computation is provided. Losses cannot be used to offset other income category or be carried forward.
<b>Group 2</b>	(i) Lease of tangible assets (ii) Royalties (iii) Extraordinary excess profits	Losses cannot be used to offset other income categories or be carried forward.
<b>Group 3</b>	Gain on sale of intangible assets	Losses can be used to offset income of Group 2. Losses of Group 3 incurred within preceding 7 years can be used to offset income of Group 3 in the current year.

The Proposal further provides that "taxable income" is limited to the greater of (i) income of Group 1, or (ii) aggregation of Groups 2 and 3. To the extent the Licensed Financial Subsidiary does not have income of Group 2 and 3 (which may largely be the case), no taxable passive income will arise as long as it does not have income from extraordinary overcapitalization. Note that the Proposal is silent as to what constitutes "extraordinary overcapitalization".

#### 5. Calculation of Indirect Ownership (Article 66-6 (2) of the Special Measures Tax Act)

Under the currently effective CFC rules, the "indirect ownership percentage" is derived by multiplying each ownership interest down the chain to a tested foreign corporation. Therefore, a foreign corporation owned jointly (50%/50%) by a Japanese corporation and a non-Japanese corporation could still be regarded as a foreign subsidiary subject to Japan's CFC rules if the foreign counterpart has Japanese shareholders. Under the Proposal,



however, indirect ownership is only counted if there is a more than 50% ownership in each level down the chain to a tested foreign corporation.

Further, the Proposal includes an amendment under which a foreign corporation would be subject to Japan's CFC rules if the Japanese parent (or its foreign subsidiary) has a right to claim the entire amount of the proceeds of a liquidation of the foreign corporation. Further analysis should be conducted when the language of the draft tax reform bill is finalized, as the final amendment may lead to an increase in the scope of the "effective control" principle.

## 6. Changes to Active Business Exemption (Article 66-6 (3) of the Special Measures Tax Act)

Under the current CFC rules, a foreign subsidiary that satisfies all the conditions of the "active business" exemption is excluded from the scope of Japan's CFC rules, even if the subsidiary's effective tax rate is less than 20%. The Proposal provides certain changes to the active business exemption, including the following.

	Current rule	New rule
Business test	Leasing of aircrafts and ships does not satisfy the business test under any circumstances.	Leasing of aircrafts and ships may satisfy the business test if certain substance requirements are satisfied.
Fixed place test / Control and administration test	If a significant portion of the foreign subsidiary's functions are outsourced to another person, the control and administration test may not be satisfied.	A foreign subsidiary that is engaged in an insurance business and that has a local license will still qualify for the control and administration test even if it outsources functions to another person (subject to satisfaction of other applicable requirements).
Head office test (requires that the prime business of a foreign subsidiary be conducted in a country in which the head office is located)	If the foreign subsidiary outsources a large part of the manufacturing process to another person in a different jurisdiction (e.g., toll manufacturing), the head office test may not be satisfied, since the manufacturing activity is viewed as having been conducted outside of the jurisdiction of the head office.	A foreign subsidiary that outsources its manufacturing process may still satisfy the head office test if the subsidiary is regarded as playing a significant role in the manufacturing process.

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## II. Introduction of Tax Free Corporate Spin-Off Method

### Key changes

- The Proposal introduces a tax-free spin off method. One of the requirements for tax free treatment will be that the controlling shareholders do not exit before or after the corporate spin-off. It remains to be seen whether the "non controlling shareholders" requirement applies to a spin-off followed by a tax-qualified merger or share exchange. A split-off (*i.e.*, where shares in Spin Co are delivered in exchange of its own shares) appears to remain outside the scope Japan's tax-free transaction regime.
- After the new law takes effect, it may not be possible to intentionally structure a minority squeeze out as a non-tax qualified reorganization (which may, in certain cases, be more favorable to a taxpayer in the context of a series of transactions than a tax qualified (or tax-deferred) reorganization), by using cash consideration in the squeeze-out related reorganization.
- In an acquisition of a publicly listed company followed by a certain type of squeeze out transaction, it will no longer be necessary to recognize revaluation gain upon entering into a tax consolidated group.
- The new rules may resolve a long standing issue regarding recognition of revaluation gain with respect to "self-created goodwill" at the election of or entry into a tax consolidation.

The Ministry of Economy, Trade and Industry requested that the government introduce tax deferral measures to facilitate more flexibility in corporate reorganizations, such as by allowing taxpayers to undergo "spin-off" transactions. The Proposal responds to this request and sets out proposed changes to the corporate tax law that would allow spin-off transactions that satisfy certain requirements to be tax free. The Proposal also sets out several other important changes to the corporate reorganization rules. In this section, we discuss notable changes to the corporate reorganization rules.

### 1. Introduction of Tax-Free Spin-Off Regime

The Proposal provides for two kinds of tax-free spin-offs, each subject to a separate set of conditions. The tax-free spin-off rules should come into effect with respect to corporate splits or in-kind distributions that takes place on or after April 1, 2017.



	Vertical Corporate Split (transfer of business to SpinCo followed by a distribution of shares in SpinCo to its shareholders)	In-Kind Distribution of Shares in Subsidiary
Transaction	Transfer of business to SpinCo followed by a distribution of shares in SpinCo to its shareholders proportionally.	Distribution of shares in a wholly owned subsidiary to its shareholders proportionally.
Control Test	ParentCo must not have a controlling shareholder before a spin-off, and SpinCo cannot be expected to have a controlling shareholders after the spin-off.	
Asset Test	The major assets and liabilities of Parent Co used in a spin-off business must be transferred to SpinCo.	None
Employee Retention Test	Approximately more than 80% of the employees engaged in the spun-off business must be expected to be employed by SpinCo	Approximately more than 80% of the employees of SpinCo must be expected to be retained after the spin-off.
Business Continuity Test	The spun-off business must be expected to be conducted by SpinCo continuously after the spin off.	
Director Test	A director or employee of Parent Co must become a "designated director" of SpinCo.	All of the "designated directors" of SpinCo may not resign as a result of the spin-off.

A key requirement for a tax free spin-off is that there is no "controlling shareholder" prior to the spin-off. This is a new concept; the existing corporate reorganization rules provide for tax-free treatment primarily if there is "control" between the parties involved. Because of this, the new rule appears to be intended to apply to a spin-off transaction conducted by a listed company.

### Key Point 1: SpinCo Must Not be Controlled by Any Person

In the USA, where corporate spin-offs are not uncommon, corporations do not appear to conduct straight spin-offs (*i.e.*, spinning off only a certain business) alone; rather corporations usually couple the spin-off with an acquisition of the SpinCo by another company. Such a transaction is commonly referred to as Reverse Morris Trust ("RMT").

The tax-free spin off included in the Proposal does not seem to extend to a RMT-type spin off, since SpinCo must not be expected to be controlled by any person after the spin off. In considering the existing corporate reorganization rules, however, it seems possible that this restriction would not



be violated if SpinCo were merged into another person by way of a tax-qualified merger.

### **Key Point 2: Rules Do Not Contemplate Tax Free "Split-Off"**

Corporations in the U.S. will often undertake a split off transaction (*i.e.*, corporation delivers shares of SpinCo to its shareholders in exchange for its own shares), and/or give shareholders the right not to exchange shares, rather than to undertake a spin-off transaction, so as to avoid dilution of the company's share price. It appears that this type of transaction is not included as a type of tax free transaction under the Proposal.

### **Key Point 3: Non-Tax Issues**

As discussed above, the tax-free spin off rules appear designed to facilitate spin-offs by listed companies. The Japanese stock exchange's listing rules may also need to be amended in order to allow the shares of SpinCo to be listed immediately after the transfer of the spun-off business by Parent Co.

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## **III. Changes to Japan's Corporate Reorganization Regime**

### **1. Treatment of "Cash Out" Squeeze Out Transactions**

The Proposal amends the taxable corporate reorganization rules by allowing a certain corporate reorganization such as merger or share exchange to be used to squeeze out minority shareholders even if "cash" is delivered to the minority shareholders. Under the current rules, if cash is delivered to minority shareholders, the squeeze out transaction is automatically treated as a taxable corporate reorganization. A taxable transaction may under certain circumstances be more favorable to the taxpayer than a tax-free reorganization, because the taxpayer can obtain a basis step up etc. Under the new rules, however, delivering cash to minority shareholders will be disregarded if the corporation acquiring the Target already owns 2/3 of the total issued shares of the Target prior to the squeeze out transaction. The transaction will thus likely be treated as a tax-free merger or share exchange under the new rule.

The new rule will apply to transactions conducted on or after October 1, 2017.

### **2. Application of Corporate Reorganization Rules to Transactions that are Not Corporate Reorganizations**

Under the current rules, certain minority squeeze out transactions are not considered corporate reorganizations if the taxpayer uses transactions other than those that are part of the corporate reorganization rules under the Companies Act; for example, the rules call for mandatory share repurchases by the company and a mandatory right of large shareholders to acquire shares from minority shareholders. Such minority squeeze out transactions would lead to recognition of revaluation gain if the acquirer is a member of a





tax consolidated group because the transaction would not be considered an acquisition by way of a tax-free reorganization.

Under the new rules, it is expected that such squeeze out transactions can be treated as a tax-free corporate reorganization, and would be excluded from the scope of revaluation gain rules under the tax consolidation rules.

The new rule will apply to transactions conducted on or after October 1, 2017.

### 3. Recognition of Revaluation Gain under Tax Consolidation Rules and in Taxable Share Exchanges

Under the current rules, when a corporation elects tax consolidation, or a domestic corporation either enters into an existing tax consolidated group or undertakes a taxable share exchange, built in gain or loss of certain assets owned by the tax consolidated subsidiary or a corporation entering into an existing tax consolidation group or a corporation acquired by way of taxable exchange must be recognized and taxed immediately. A long standing issue in practice has been whether goodwill is subject to this revaluation rule.

Under the Proposal, any asset which has a tax basis of less than JPY 10 million will be excluded from the scope of assets that must be revalued; therefore, the need for revaluation will not only be relaxed for goodwill, but for any off-balance sheet intangible assets that are clearly within the scope of revaluation under the current rule, including patents and trademarks.

The new rule would apply to transactions conducted on or after October 1, 2017.

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## IV. Changes to Gift/Inheritance Tax Rules

The proposals include revisions to Japan's gift and inheritance tax rules which, if incorporated as proposed, will increase complexity of the current regime, and change the scope of foreign and Japanese persons potentially subject to the tax.

### 1. Overview of Proposed Rules

The new rules introduce new categories of residents for inheritance / gift tax purposes; specifically, a "short-term visitor" and a foreigner with a "temporary address".

The proposed rules can be summarized as follows:

HEIR / GIFT RECIPIENT		Currently has Address in Japan		Does Not Currently Have Address In Japan		
		"Temporary Address" *1	Japanese Citizen	Not a Japanese Citizen		Not a Japanese Citizen
				Had an Address in Japan at Sometime in the Last 10 Years	No Address in Japan at Anytime in the Last 10 Years	
DECEDENT / GIFT DONOR						
Currently Has Japan Address		D/F	D/F	D/F	D/F	D/F
	"Temporary Address" *1	D/F	D only	D/F	D only	D only
Does Not Currently Have an Address in Japan	Had an Address in Japan at Sometime in the Last 10 Years	D/F	D/F	D/F	D/F	D/F
	"Short-Term Visitor" *2	D/F	D only	D/F	D only	D only
	No Address in Japan at Anytime in Last 10 Years	D/F	D only	D/F	D only	

D = Domestic (Japan-situs) assets F = Foreign (non-Japan-situs) assets

\*1 A foreigner with a "Temporary Address" is one who is in Japan on a working visa (not a PR or spousal visa) and has lived in Japan for a total of 10 or fewer years out of the last 15 up to the date of the inheritance.

\*2 A "Short-Term Visitor" is a non-Japanese national who resided in Japan for a total of 10 or fewer years out of the last 15 up to the date of the inheritance.



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## 2. Changes From Previous Rules

### (A). Thresholds Changed from Five Years to Ten Years

Under the previous rules, the relevant thresholds for changes in tax treatment were having had an address in Japan at any time in the last five years; the threshold has been raised to any time in the last ten years.

### (B). Introduction of "Short-Term Visitor" and Foreigner with a "Temporary Address"

The proposal introduces two new categories of short term residents, who would be taxed only on assets located in Japan upon an inheritance or gift, rather than on worldwide income. This would be an improvement from the current rules, which make no distinction between "short-term visitors" or foreigners with a "temporary address" and other residents of Japan, whose worldwide assets are subject to taxation in the event of an inheritance.

### (C). Heirs of Long-Term Foreign Residents Subject to Tax on Residents' Worldwide Assets Even After Individual has Left Japan

Under the proposed rules, where a foreigner other than one who is a "short-term visitor" - meaning a non-Japanese national who has resided in Japan for a total of 10 or fewer years out of the last 15 - who has resided in Japan at any time in the last 10 years dies, his or her heirs are subject to Japanese inheritance tax on the decedent's worldwide assets. Put another way, a foreigner who has resided in Japan, regardless of visa-type, for more than 10 out of the last 15 dies, even if the foreigner has expatriated, his or her heirs will be caught by this provision.

The provisions as drafted in the proposal, would appear to capture within the scope of worldwide inheritance taxation, a non-Japanese national who has expatriated from Japan, who dies within five-years of his or expatriation. For example, assume Mr. X, a US national, lived in Japan from 2003 - 2018. In January 2018, Mr. X expatriates from Japan to live in the US. According to the new provision, Mr. X's heirs would be subject to Japanese inheritance tax on Mr. X's worldwide assets if Mr. X resided in Japan at any time in the previous 10 years. Thus, under these rules, Mr. X's heirs would be subject to Japanese inheritance tax on Mr. X's assets if Mr. X passes away at any time up to 2018. This 10 year rule does not apply, however, to a "short-term visitor" of Japan. Although the wording of the current tax proposal is not crystal clear, this would appear to mean that if Mr. X passes away after January 2023, his heirs<sup>1</sup> would only be subject to Japanese inheritance tax on Mr. X's Japan-situs assets. This is because after January 2023, Mr. X should be considered a "short-term visitor" of Japan, as he would have resided in Japan for less than 10 out of the 15 years up to his passing. As a short-term visitor, his heirs should only be subject to Japanese inheritance tax on Mr. X's Japan-situs assets.

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<sup>1</sup> The example in this paragraph assumes that Mr. X's heirs are themselves either non-Japanese nationals, or if they are Japanese nationals, that they have not resided in Japan at anytime in the last 10 years.



### 3. Conclusions

As noted at the outset, the new rules appear to be a "mixed bag" for foreign nationals residing in Japan.

On the positive side, the introduction of new "short-term" residency and "temporary address" rules, allow a non-Japanese national, who may be in Japan temporarily in connection with, for example, a work-related transfer, to potentially escape from the net of Japanese inheritance taxes on worldwide assets. This change, if adopted as proposed, will hopefully make it easier for foreign and Japanese corporations to entice talented foreign personnel to transfer to Japan.

On the negative side, the new rule appears to capture current long-term residents within the net of Japanese inheritance taxation on worldwide assets, for five years after such persons have completely expatriated from Japan. This change was unexpected, and appears inconsistent with international standards. Whether the government consents to rolling back this tax proposal remains to be seen, and we will provide another update as soon as there are developments.

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