

Japan Inbound Tax & Legal Newsletter

Continuity of control requirement for minority squeeze-out transactions relaxed

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In Brief

Japan issued the 2019 Tax Reform Act, along with enforcement orders and regulations, on 29 March 2019. Most of the rules are effective for taxable years beginning on or after 1 April 2019 and several of the provisions likely will impact inbound M&A transactions in Japan. This article analyzes the new relaxation of the “continuity of control” requirement for certain minority squeeze-out (MSO) transactions (i.e. acquisition transactions in which the target’s minority shareholders are compelled to sell their shares for cash).

1. Pre and Post-reform tax treatment

Before discussing this issue in detail, it may be helpful to understand the general treatment of MSOs under Japanese tax laws and how the legislation has evolved in recent years.

The 2017 tax reform characterized certain MSO transactions as share-for-share exchanges. These transactions include: (i) a class of shares being subject to a class-wide call; (ii) share consolidations; and (iii) demands for a cash-out that can achieve economic effects similar to share-for-share exchanges stipulated under the Company Act (i.e. compulsory acquisitions of all interests in a target company (Target Co)). As a result of this characterization, the above transactions are subject to the rules of previous corporate income tax regimes for share-for-share exchanges. Therefore, if certain tax requirements are not met, the target company acquired through one of these types of MSO transactions will be subject to mark-to-market taxation with respect to certain assets (goodwill is excluded). These tax requirements arise in the following situations: (i) transactions between companies where the acquirer controls 100% of Target Co (100% controlling relationship); (ii) transactions between companies with greater than a 50% but less than a 100% controlling relationship; and (iii) transactions between companies with a 50% or less controlling relationship.

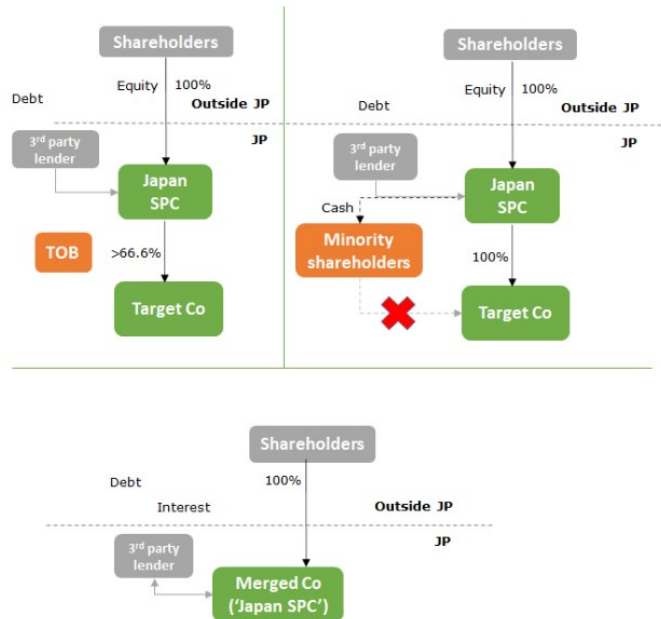
Since a typical MSO transaction begins with a tender offer to acquire at least two-thirds of the total shares in Target Co, the second scenario (i.e. transactions between companies with greater than a 50% but less than a 100% controlling relationship) requires further analysis. Before the 2019 tax reform, MSOs qualified as share-for-share exchanges if they met the following three requirements:

- Target Co’s controlling shareholders were expected to continue retaining greater than a 50% interest in the acquired corporation at the time of the MSO transaction (greater than 50% control requirement);
- Target Co’s main business was expected to continue and approximately 80% or more of its employees were expected to remain after the MSO; and
- If the acquiring corporation owned less than two-thirds of the total issued shares of Target Co prior to the MSO, no consideration other than the shares of the controlling shareholder (or its 100% direct parent) was delivered to the minority shareholders as consideration for the MSO.

The greater than 50% control requirement was deemed to be satisfied if the MSO was expected to be followed by a tax-qualified upstream merger of Target Co into the controlling shareholder. However, this condition was relaxed under the 2019 tax reform for MSOs conducted on and after 1 April 2019. The greater than 50% control requirement will be deemed to be satisfied if the MSO is expected to be followed by either a tax-qualified upstream merger or a tax-qualified downstream merger between the controlling shareholder and Target Co.

2. Common squeeze-out scenario

Leveraged buyouts by foreign acquirers typically involve the following steps:



- Japan SPC is incorporated as the acquisition vehicle,
- Japan SPC raises debt from a third-party lender and the debt is collateralized by Target Co's future cash flow,
- Japan SPC acquires two-thirds of the shares in Target Co in a takeover bid (TOB),
- Japan SPC cashes out the minority shareholders (MSO transaction), and
- Japan SPC merges with Target Co to achieve debt efficiency (i.e. "old" Target Co's income will help the merged entity (Merged Co) service its debt and Merged Co will be able to use its interest deductions to offset "old" Target Co's future taxable income).

Before the 2019 tax reform, a foreign acquirer had no option but to undertake an upstream merger to fulfill the greater than 50% control requirement following an MSO transaction, which typically resulted in the following:

- Liability for Japanese registration taxes for the transfer of any real property previously owned by Target Co;
- Liability for capital gain taxes in certain foreign subsidiary jurisdictions, as applicable; and
- Legal issues such as the need to amend licenses, registrations, permits and other legal documentation to reflect the name of the surviving company.

However, these issues have been addressed in the 2019 tax reform since an MSO no longer will be "tainted" even if it is followed by a tax-qualified downstream merger.

Deloitte's View

Although lenders may not prefer a downstream merger because a target may become insolvent for accounting purposes, the 2019 tax reform gives tax executives broader M&A options, subject to a further analysis of the relevant tax, legal and accounting implications.

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