

Japan Corporate and Tax Quarterly Update: November Issue

Introduction

In April 2023, the Ministry of Economy, Trade and Industry (METI) published "Case Studies Relating to the use of Inbound M&A Transactions –Leveraging of Foreign Capital by Japanese Companies for Corporate Reforms, Management Enhancement and Dramatic Growth" ("**Case Studies**").¹ The Case Studies examine 20 inbound M&A transactions² and identify (i) issues Japanese companies have sought to address through inbound M&A; (ii) things parties should keep in mind concerning inbound M&A transactions; and (iii) benefits enjoyed by target companies as a result of inbound M&A. Transactions have been divided into four patterns/categories: (a) sale of a subsidiary or transfer of business (carve-out); (b) sale of / receipt of investment by large companies (i.e., not at the subsidiary-level); (c) sale of / receipt of investment by owner-operated companies; and (d) sale of / receipt of investment by a start-up company.

The Case Studies are intended to serve as reference material for Japanese companies, demystifying inbound M&A and encouraging the use of foreign investment to resolve management issues and/or accelerate corporate growth. They are nonetheless valuable and relevant to foreign investors, enabling them to better understand the motivations and concerns of Japanese target companies in inbound M&A transactions and formulate more effective acquisition and/or post-merger integration strategies.

This article will briefly outline the Case Studies before analyzing how foreign investors should utilize them to ensure that their investments in Japanese companies go smoothly. Please note that our interpretations and/or English translations of the Case Studies may differ from the provisional English translations provided by METI. As such, we recommend that readers of this article refer to the pages in the Case Studies indicated in the footnotes for more details.

In this issue

- Issues Japanese companies have sought to address through inbound M&A
- Things to keep in mind to ensure successful inbound M&A transactions
- Inbound M&A benefits enjoyed by target companies
- How should foreign investors utilize the Case Studies?

Issues Japanese companies have sought to address through inbound M&A

The Case Studies identify and are organized in accordance with the following issues³ Japanese companies have sought to address through inbound M&A.⁴

Corporate and business strategy

- Addressing the lack of synergy between a business/subsidiary and a company's main business

¹ A provisional English translation of the Case Studies is published at the link below:
https://www.meti.go.jp/english/press/2023/0419_002.html

² See page 13 of the Case Studies for a list of the 20 inbound M&A transactions examined in the Case Studies.

³ Page 14 of the Case Studies.

⁴ Page 6 of the Case Studies.



- Establishing a new revenue base by debuting new products, services and/or business models available overseas
- Ensuring a smooth business succession (e.g., transitioning to a management structure that does not over rely on a company's original owner)

Personnel and organizational structure

- Obtaining the services of highly-skilled individuals for management purposes that would otherwise be unavailable to the company
- Establishing certain organizational structures (e.g., for an IPO or equity story)

Capital and know-how

- Addressing insufficient know-how / networks for overseas expansion
- Using global expertise to promote DX and/or improve productivity
- Addressing insufficient capital and/or know-how concerning acquisition of competitors

Things to keep in mind to ensure successful inbound M&A transactions

The Case Studies identify the following matters of concern to Japanese companies and/or foreign investors and their legal advisors that can affect the smooth implementation of inbound M&A transactions.⁵

Commercial matters

- Differences in corporate culture between foreign investors and Japanese companies (e.g., management's vision, level of trust)
- Resistance to change among employees and business partners of Japanese companies (e.g., due to insufficient communication on the transformation)
- Inability to achieve the expected effects/benefits of inbound M&A transactions (e.g., due to differences in expectation, unexpected changes in external circumstances).
- Inability to conclude a deal after initiating/announcing negotiations (e.g., shortage of funds on the part of foreign investors, failure of a takeover bid).

Legal matters

- National security-related notification requirements under the Foreign Exchange and Foreign Trade Act of Japan for foreign investment in certain regulated industries
- Potential national economic security developments resulting in stricter foreign investment restrictions and/or requirements (e.g., the recently enacted "Act on the Promotion of National Security through Integrated Economic Measures")

⁵ Page 7 of the Case Studies.



The Case Studies note that Japanese companies can address some of the above matters in various ways (e.g., effective communication with not only the employees and business partners of the Japanese companies, but also with foreign investors for the purpose of ensuring that their interests, visions and directions align).

Benefits enjoyed by target companies resulting from inbound M&A transactions

The Case Studies identify and are organized⁶ in accordance with the following six main benefits enjoyed by target companies as a result of foreign investment.⁷

- 1) More sophisticated business and financial management through the acquisition of global expertise and management know-how
- 2) Stronger organizational structures through recruitment of highly-skilled individuals from foreign investors' extensive HR networks
- 3) More motivated employees through the introduction of new evaluation/appraisal systems
- 4) Development of employees with global perspectives and mindsets
- 5) Expansion of overseas distribution channels through use of foreign investors' global networks and/or brands
- 6) Improved range and quality of products/services through incorporation of overseas technologies, know-how and/or business models

The Case Studies also address some of the common misconceptions / false apprehensions a Japanese company may have (e.g., inbound M&A transactions always result in layoffs, companies/business are most often targeted for inbound M&A transactions when distressed).⁸

How foreign investors should utilize the Case Studies for investment in Japanese companies

Foreign investors have welcomed METI's publication of the Case Studies due to their capacity to shed light on the realities of inbound M&A transactions and address, to some extent, the Japanese public's traditional aversion to foreign investment.

As the Case Studies are designed as an easily-accessible and practical collection of case studies, foreign investors should expect potential Japanese target companies, regardless of their M&A experience, to reference the Case Studies when formulating their sale/carve-out and/or post-merger integration strategies. Accordingly, a careful examination of case studies similar to a contemplated transaction would allow foreign investors to anticipate a Japanese target company's potential concerns and frame structures and/or the negotiations accordingly.

⁶ Page 15 of the Case Studies.

⁷ Page 8 of the Case Studies. Also, page 9 of the Case Studies shares some actual comments from Japanese companies on the inbound M&A transactions examined, and page 15 of the Case Studies provides a list of cases with respect to each of the benefits listed above for reference

⁸ Page 64 of the Case Studies.



Recent and anticipated Japanese tax updates

Japanese tax law is amended each year through an annual "tax reform package". Recent tax reforms, including the 2023 tax reform package,⁹ have been aimed at promoting business growth and innovation and strengthening investment. Importantly, the 2023 tax reforms included measures incorporating the OECD's Pillar 2 legislation into Japanese domestic law. This article provides an update on Japan's Pillar 2 rules as well as a summary of the changes that may be included in the 2024 tax reforms.

Update on the incorporation of Pillar 2 rules into Japanese domestic tax law

The 2023 tax reform package enacted in March 2023 included the primary component of the Pillar 2 rules, being the income inclusion rule (IIR). This legislation contained the basic framework for Japan's IIR. Subsequent cabinet orders issued on 16 June 2023 and ministerial regulations issued on 30 June 2023 by Japan's Ministry of Finance (the legislation, cabinet orders and ministerial regulations are collectively referred to as the "Pillar 2 Provisions") provide the detailed regulations on how the IIR will operate in Japan. Both the cabinet orders and ministerial regulations have the force of law in Japan. The IIR will apply to fiscal years commencing on or after 1 April 2024.

Japan's Pillar 2 Provisions are broadly in line with the OECD's Pillar 2 Inclusive Framework (OECD Framework). While the substance of the Japanese IIR is aligned with the OECD Framework, the actual mechanics of the rule as contained in the Pillar 2 Provisions are very complex and do not directly incorporate the language used in the OECD Framework. This is partly due to the Japanese legislative drafting style, as well as the need to translate these rules into the Japanese language. Given this, it is conceivable that future disputes could arise concerning the interpretation of specific language, resulting in judicial interpretations that differ from the OECD Framework.

In addition, on 29 September 2023, the National Tax Agency (NTA) issued further guidance through an additional basic circular of the Corporate Tax Act Pillar 2 Provisions. The basic circular provides the NTA's interpretation of the Pillar 2 Provisions, including guidance on calculations required under the provisions, such as how permanent establishment (PE) or controlled foreign company (CFC) tax imposed on a headquarter company in Japan is pushed down to the relevant PE or CFC jurisdiction. It is relevant to note that Japan's Pillar 2 Provisions also incorporate elements of the OECD's administrative guidance. Such elements have the force of law in Japan, rather than simply being interpretative guidance. Additional guidance issued by the OECD can also be expected to be incorporated in Japanese law through the annual tax law amendment process, although there may be some time lag in such amendments.

With respect to compliance, filing and payment of tax under the IIR (i.e., the corporate tax on the international minimum tax amount) for a Japanese company is significantly different from ordinary corporate tax. A Japanese company covered by the rules must file an information return which includes certain information (e.g., the country ETR for each country in which companies of the specified multinational group are located, the international minimum tax amount of the specified multinational group, etc.) via Japan's "e-Tax" system and pay taxes related to the international minimum tax amount within one year and three months from fiscal year end. Although this differs from the standard corporate tax return due date, which is generally three months from year end (including extensions that are typically granted), Japanese taxpayers covered by the Pillar 2 rules will need to prepare a Pillar 2 return for the prior year at the same time as its current corporate income tax return. This is likely to lead to an increased administrative burden.

The 2023 tax reform package did not include a qualified domestic minimum top-up tax (QDMTT) or under-taxed payments rule (UTPR). The 2024 tax reform is expected to include the QDMTT and UTPR, with such provisions likely taking effect for fiscal years commencing on or after 1 April 2025. Recent announcements by METI on the 2024 tax reform note that further Pillar 2 measures may be included in the 2024 tax reform. This may refer to QDMTT or UTPR although neither is mentioned specifically. The timeline for the introduction of these measures may also in part depend

⁹ Approved by the National Diet on 28 March 2023.



on the issuance of additional OECD guidance (e.g., whether sufficient detail is available to allow for the drafting of legislation, cabinet orders and ministerial regulations).

It is worthwhile noting that Japan's Ministry of Finance has publicly acknowledged that Japan's CFC rules will not be abandoned or narrowed in response to the Pillar 2 rules, and the Japanese Tax Commission further confirmed this in a statement published in June 2023. Nevertheless, revisions to the Japanese CFC rules were needed to make them compatible with the Pillar 2 legislation and reduce the administrative burden on taxpayers that would be subject to both regimes. As a result, the 2023 tax reform made certain revisions to the current Japanese CFC rules, including reducing the ETR for exemption from the CFC rules for a specified foreign related company (*tokutei gaikoku kankei gaisha*) broadly a "post-box company" from 30% to 27%. Prior to the reform, certain companies with an ETR below 30% would be subject to CFC taxation, but such companies will now only be in scope of the CFC rules if their ETR is below 27%). Further modifications were made to the rules regarding foreign affiliate-related documents that must be attached to the tax return. The revisions to the Japanese CFC rules will apply to fiscal years of the Japanese corporation commencing on or after 1 April 2024.

Changes anticipated under the 2024 tax reforms

Amendments to Japanese tax legislation are made annually and are usually based on requests submitted to the Ministry of Finance by other ministries. These requests generally commence around the end of August each year, with a draft proposal for the following year's tax legislation announced in mid-December and tax legislation approved by the Diet in March of the following year. In this context, a recent METI announcement suggests that the 2024 tax reforms may contain numerous measures aimed at improving Japanese companies' global competitiveness, including the following recommendations.

- Measures to support investment and wage increases to improve Japan's global competitiveness, including:
 - Establishment of a tax system to encourage investment in infrastructure for the manufacturing of strategically important products (e.g., goods related to green transformation and digital transformation, developing infrastructure related to clean energy and electric vehicles). With reference to incentives included in past tax reform and to examples provided by METI, such measures may be incentives in the form of tax credits.
 - Increase domestic R&D through the introduction of an "innovation box." The METI announcement provides examples of other jurisdictions with innovation or patent box regimes. Although Pillar 2 might impact the feasibility of such regimes, given Japan's relatively high ETR and very limited number of cases in which ETRs approach 15%, there may still be room for it to operate in Japan.
- Measures to further strengthen the start-up ecosystem, including:
 - Expand tax deferral for stock options in certain circumstances. This may include extending tax deferral to the ultimate transfer date with no tax on economic gain upon exercise of options;
 - Expanded tax exemptions for reinvestment in start-ups by "angel investors"
 - Establishment of tax measures to encourage individual investment in listed venture funds to strengthen funding for start-ups
 - Expanded tax incentives (e.g., tax credits) to promote "open innovation".



- Measures to promote a business environment that responds to digitization of the economy, including:
 - Review of how JCT rules apply to the cross-border provision of services, including introduction of a so-called "deemed reseller" rule for platform operators which would effectively shift the burden of collection of JCT to the platform operator for cross-border, B2C sales of digital products.
 - With reference to Pillars 1 and 2, seek to prevent administrative burdens on companies by simplifying and clarifying the domestic tax rules. This would include further simplification of the Japanese CFC rules (e.g., aligning financial information used for CFC calculations with that used for Pillar 2 calculations and simplifying the list of companies potentially subject to CFC taxation, the economic activity determination criteria and other aspects of the CFC regime).

In addition to METI, the Financial Services Agency ("FSA") has also made a request related to the 2024 tax legislation. The following major topics included in the request may be of interest to foreign companies.

- Aggregation of the financial income taxation system
 - In a joint request with the Ministry of Agriculture, Forestry and Fisheries and METI, the FSA requested that the scope of the aggregation of profits and losses related to financial products be expanded to include derivative transactions, deposits, etc. The FSA notes that this would create an environment that would allow investors to easily invest in a variety of financial products and stimulate economic growth by helping increase the overall supply of funds available.
- Review of procedural tax treaty requirements and benefits for cross-border investments made through funds
 - For cross-border investment through funds, the tax treaty application procedures must in principle be completed at the beneficiary/investor level rather than at the fund level. As a result, funds with numerous investors may find themselves unable to obtain tax treaty benefits due to practical difficulties in complying with application procedures at the investor level. To help mitigate this issue, the FSA has requested that the government take necessary measures to ensure fund level benefit from Japan's tax treaties.

Finally, similar to provisions included in the US Inflation Reduction Act passed in August 2022, Prime Minister Kishida has announced that the Japanese government is considering giving tax benefits to firms that produce goods such as semiconductors, batteries and biotechnology for a period of five to ten years as part of an upcoming economic stimulus package aimed at attracting companies that produce/supply key goods. However, no specific details regarding these benefits have been released at this stage.



Contact Us



Ryutaro Oka

Partner

Tokyo

ryutaro.oka@bakermckenzie.com



Masao Katsuyama

Partner

Tokyo

masao.katsuyama@bakermckenzie.com



Masahiro Inaba

Partner

Tokyo

masahiro.inaba@bakermckenzie.com



Koji Oshima

Counsel

Tokyo

koji.oshima@bakermckenzie.com



Akihiro Kawasaki

Counsel

Tokyo

akihiro.kawasaki@bakermckenzie.com



Luke Tanner

Partner

Tokyo

luke.tanner@bakermckenzie.com



Corey Bass

Foreign Associate

Tokyo

corey.bass@bakermckenzie.com

© 2023 Baker & McKenzie. **Ownership:** This site (Site) is a proprietary resource owned exclusively by Baker McKenzie (meaning Baker & McKenzie International and its member firms, including Baker & McKenzie LLP). Use of this site does not of itself create a contractual relationship, nor any attorney/client relationship, between Baker McKenzie and any person. **Non-reliance and exclusion:** All information on this Site is of general comment and for informational purposes only and may not reflect the most current legal and regulatory developments. All summaries of the laws, regulation and practice are subject to change. The information on this Site is not offered as legal or any other advice on any particular matter, whether it be legal, procedural or otherwise. It is not intended to be a substitute for reference to (and compliance with) the detailed provisions of applicable laws, rules, regulations or forms. Legal advice should always be sought before taking any action or refraining from taking any action based on any information provided in this Site. Baker McKenzie, the editors and the contributing authors do not guarantee the accuracy of the contents and expressly disclaim any and all liability to any person in respect of the consequences of anything done or permitted to be done or omitted to be done wholly or partly in reliance upon the whole or any part of the contents of this Site. **Attorney Advertising:** This Site may qualify as "Attorney Advertising" requiring notice in some jurisdictions. To the extent that this Site may qualify as Attorney Advertising, PRIOR RESULTS DO NOT GUARANTEE A SIMILAR OUTCOME. All rights reserved. The content of the this Site is protected under international copyright conventions. Reproduction of the content of this Site without express written authorization is strictly prohibited.

