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Client Alert

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Japan Corporate and Tax Quarterly Update: August Issue

In brief

In this issue, we focus on a typical tender offer process and trends in structuring techniques in Japan.

The number of public M&A acquisitions of Japanese listed companies via tender offers has been increasing. 42 such deals were announced in 2017, rising to 71 in 2021. The number of unsolicited tender offers is also increasing in line with the swelling ranks of foreign investors (including activist funds) and decreased cross-shareholdings in connection with the corporate governance reforms. Since the issuance of the Fair M&A Guidelines ("**Fair M&A Guidelines**") in June 2019, we have seen more tender offer deals where parties have introduced measures to ensure the fairness of transactions as set out in the Fair M&A Guidelines (including establishment of special committees by targets), regardless of whether a structural conflict of interest exists between a target's general shareholders and directors (i.e., a management buyout).

In this section, we outline a typical process used to acquire all of the shares in a Japanese listed company by way of a friendly tender offer followed by a squeeze out of the minority shareholders.

In this issue

Overview of the typical tender offer process and trends in structuring techniques

1. Preliminary stage

1.1 Structuring of the transaction

At this stage, the bidder discusses the structure for the transaction based on public information on the target. Typically, structuring is driven by a tax consideration. In the event a Japanese parent company or corporate shareholder holds substantial shares in the target, the shares owned by the large shareholder are frequently acquired by the target after the successful completion of the tender offer process. This allows the acquirer to enjoy tax benefits from characterization of income as a "deemed dividend" subject to the received dividend deduction (100%, 50% or 20% depending on ownership percentage). For this reason, the sale and purchase price of the shares is often set below the tender offer price to take this tax benefit into account.

For Japanese tax purposes, a gain derived by a foreign corporate shareholder from the sale of shares in a Japanese corporation is taxed in Japan at the rate of 25.59% if the foreign corporate shareholder owns at least 25% of the total issued shares in the Japanese corporation and sells at least 5% of the total issued shares in the Japanese corporation in a single taxable year ("**25%/5% Rule**"), unless an applicable tax treaty protects the foreign corporate shareholder from being taxed on the gain in Japan. Therefore, a foreign bidder may want to consider an acquisition structure that could bypass this Japanese capital gain tax upon exit. Certain tax treaties (e.g., Japan-US, Japan-UK, Japan-Netherlands and Japan-Hong Kong) eliminate Japanese capital gain tax. Thus, interposing an intermediate holding company in a favorable jurisdiction is still effective, although enjoying treaty benefits without any substance or business purpose is becoming increasingly challenging.

For purposes of the 25%/5% Rule, a partnership is considered to be a single shareholder even if the ownership share allocated to each limited partner is less than 25%/5%. Private equity investors often set up multiple partnerships (e.g., with entities in the Cayman Islands), each of which owns less than 25% of the total issued shares in the Japanese target.

A dividend withholding tax at the rate of 20.42% under domestic tax law can be reduced or entirely eliminated by the applicable of a tax treaty as well.

A strategic foreign buyer may want to carefully consider the post-acquisition reorganization in the early stages of the acquisition process to assess future Japanese tax exposure which could impact the target's valuation. Although transactions involving valuable intangible assets held by a Japanese target are generally taxable, the intangibles can be integrated into an existing pool of intangible assets in a low tax jurisdiction. A transformation from a full-fledged manufacturer with R&D functions to a contract manufacturer with R&D service provider status is possible, although careful planning is needed since Japan does not have an explicit "exit tax."

Tax-free reorganization under Japanese tax law enables a certain flexibility for conducting post-acquisition integration in a tax-free manner. A bidding company that assumes external debt in Japan may merge it into a Japanese target post-closing in a tax-free manner in order to unite the debt and the target's business in the same legal entity. Careful planning is required when the Japanese target has a tax loss carry forward since such a carry forward can be entirely eliminated if the merger takes place within five years after the bidding company acquires majority ownership in the Japanese target.

1.2 Bidder's initial approach to the target and/or its key shareholders and execution of preliminary agreements (if necessary)

The bidder first approaches the target and proposes its contemplated acquisition. There is no restriction on when the bidder may approach the major shareholders. The timing of this depends on various factors, including who takes the initiative in the preliminary negotiations with the bidder (i.e., the target or the major shareholder). The target is not required to disclose any preliminary M&A discussions with a potential buyer at this stage to the extent the preliminary agreements are non-binding.

1.3 Target's establishment of a special committee

As stated above, since the issuance of the Fair M&A Guidelines, it has become common for a target to establish a special committee to review the tender offer process regardless of whether a structural conflict of interest exists between the general shareholders and directors of the target (i.e., in a management buyout).

2. Two months – one business day prior to the tender offer launch date

2.1 Due diligence based on nonpublic materials

The concept of prior due diligence by the bidder is generally accepted in the Japanese market.

2.2 Preparation of tender offer registration statement and prior consultation with the Kanto Local Finance Bureau

When launching a tender offer, a bidder must file a tender offer registration statement (the "**Tender Offer Registration Statement**") via the Electronic Disclosure for Investors' NETwork (the "**EDINET**") with the Ministry of Finance of Japan. In practice, two to three weeks' prior consultation with the Kanto Local Finance Bureau is required before the launch of the tender offer.

2.3 Negotiation and execution of agreements related to the tender offer

It is not uncommon for a bidder to negotiate and enter into a tender offer agreement with the target's major shareholders (if any) before the launch of the tender offer under which the bidder agrees to launch the tender offer under the agreed terms and conditions and the major shareholders agree to tender their shares when the tender offer is launched. An outline of the tender offer agreement with the major shareholders must be disclosed in the Tender Offer Registration Statement and other documents to be disclosed by the bidder and the target.

In parallel with this, the bidder will discuss the tender offer price and other terms of the tender offer with the target and its special committee. There is no legal restriction on the minimum or maximum offer price. It is also possible for a bidder to negotiate and enter into an agreement with the target before launching the tender offer under which the bidder agrees

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to launch the tender offer under the agreed terms and conditions and the target agrees to express its support for the transaction and recommend that its shareholders tender their shares.

2.4 Negotiations with respect to financing / securing a commitment letter

The Tender Offer Registration Statement must include, as attachments, documents demonstrating that the bidder has sufficient funds to complete the tender offer (e.g., a bank statement showing the balance of the bidder's deposits, an equity commitment letter and/or a debt commitment letter issued by a lending bank).

The ability to draw down on debt facilities can be subject to various conditions precedent. However, all such conditions precedent (i) must be objective and specific enough to demonstrate that there is a "high likelihood" that the bidder will be able to draw down the debt for settlement of the tender offer and (ii) must be summarized in the debt commitment letter attached to the Tender Offer Registration Statement. This information then becomes publicly available as an attachment to the Tender Offer Registration Statement when the tender offer is launched.

2.5 Antitrust law filing and other regulatory filings (if necessary)

The bidder is required to disclose in the Tender Offer Registration Statement any regulatory permit (including merger clearance) required for completion of the tender offer. If a disclosed regulatory permit has not been obtained by the end of the tender offer period, the bidder is entitled (but not obliged) to withdraw the tender offer. It is common for a bidder to make filings with the relevant authorities before launching a tender offer so that it can obtain clearance before or during the tender offer period.

3. One business day prior to the tender offer launch date

3.1 Resolution by the target's board of directors

The target's board will pass a resolution on whether it will express its support for the transaction and recommend that its shareholders tender their shares.

3.2 Announcement of tender offer and approval by the board

The bidder will publicly announce the commencement of its tender offer and the target will publicly announce whether it supports the transaction and recommends that its shareholders tender their shares. These announcements are typically made one business day before the launch of the tender offer unless the transaction must be announced earlier to obtain regulatory approval or for some other reason.

4. Tender offer launch

4.1 Disclosure by the bidder and the target

The bidder makes public notice of the commencement of the tender offer and files the Tender Offer Registration Statement via EDINET. The target files its position statement via EDINET.

5. Offering Period (30 business days)

Generally, a 30 business day period is set if a squeeze-out of the minority shareholders is expected after the tender offer.

6. One business day after last day of the tender offer period

The bidder publicly announces the result of the tender offer and files the tender offer result report via EDINET.

The target makes a public announcement related to changes in the parent company / major shareholders by the target if the tender offer is completed successfully.

7. Five business days after the last day of the tender offer period

If the tender offer is completed successfully, the shareholders tender their shares and receive consideration and the bidder legally acquires the tendered shares.

8. One to three months after the last day of the tender offer period

8.1 Squeeze-out

If, following the tender offer, the bidder holds (by itself and/or through its 100% direct or indirect subsidiaries) 90% or more of the total voting rights, the bidder can force all other shareholders to transfer their shares to the bidder subject to the approval of the target's board.

Even if the bidder fails to obtain 90% of the voting rights, it is still possible to effect a squeeze-out using share consolidation. Implementation of this share consolidation squeeze-out scheme requires shareholder approval by a two-thirds majority vote of the shareholders present at a shareholders' meeting and a court order, which makes this process more time-consuming.

A squeeze-out transaction is basically tax neutral for the Japanese target if the bidder itself acquires at least 2/3 of the total issued shares (excluding treasury shares) in the Japanese target prior to the squeeze-out transaction. Still, it is not impossible to structure the transaction in a taxable manner one way or the other (e.g., as a taxable cash-out merger) that may be more tax-efficient than a tax-free squeeze out in a special situation where, for example, the Japanese target has a tax loss carryforward sufficient to offset a gain from the transfer of valuable IP, resulting in a tax basis step-up for lower taxes on the gain.

8.2 Delisting

The target's shares are delisted from the Tokyo Stock Exchange two business days before the effective date of the squeeze-out.

Changes to Japan's transfer pricing guidelines: amendments relating to cost contribution arrangements

On June 10, 2022, Japan's National Tax Agency (NTA) finalized amendments to the Commissioner's Directive on the Operation of Transfer Pricing (Administrative Guidelines).The revisions followed a discussion draft released on March 4 and a public consultation process which ran until April 12. On June 10, the results of the public consultation process were published by the NTA.

The amendments to the Administrative Guidelines primarily relate to cost contribution arrangements (CCAs) and transfer pricing for financial transactions, and reflect recent OECD guidance on these issues. This article will focus on the amendments relating to CCAs. Changes to the guidance related to financial transactions will be covered in a subsequent article.

It is relevant to note that the Administrative Guidelines do not have the force of law in Japan. However, Japanese tax authorities at all levels can be expected to act in accordance with the Administrative Guidelines in connection with transfer pricing matters. As Japanese transfer pricing law does not contain specific rules relating to CCAs, the Administrative Guidelines, together with the OECD Transfer Pricing Guidelines, represent authoritative guidance on how the arm's length principle can be expected to be applied to CCAs in Japan.

Summary of the revisions

1. (3-15) Definition of a CCA

The amendments revise the definition of a CCA. Prior to the amendment, the definition of a CCA in the Administrative Guidelines was as follows:

> …a contract with a common purpose, such as developing a specific intangible asset.

This definition was revised to:

> …an agreement between the parties to a contract to jointly develop, produce or acquire intangible or tangible assets and develop, provide or receive services (hereinafter referred to as "joint activities") for the purpose of increasing revenue, decreasing costs or obtaining other benefits arising from the business conducted by each party and contribute to such joint activities (including assuming the risks and bearing the costs associated with such joint activities).

The revised definition expands the scope of a CCA, and clarifies that "assumption of risk" is included in the contribution to the joint activity in a manner which is consistent with the OECD Transfer Pricing Guidelines.

The clarification that the development of tangible assets as well as the provision of services can be subject to a CCA increases the potential applicability of CCAs. For example, under the revised definition, a CCA could cover capital expenditure for industries that that require large capital investments, or for services related to certain centralized group functions.

2. (3-16) Application of the arm's length principle to CCAs

Prior to the amendments, the Administrative Guidelines did not clearly describe how the arm's length principle would apply to CCAs. The amendments clarify that a CCA is considered to be consistent with the arm's length principle when the following requirements are met:

(1) The proportion of the total amount of expected benefit ("**Expected Proportion of Benefit**") is properly estimated;

(2) The amount of each participant's value contribution is consistent with the amount of consideration that would be paid if the transaction were conducted at arm's length and in accordance with the terms and conditions of a transaction between independent parties; and

(3) The proportion of the value of each participant's contribution is consistent with the Expected Proportion of Benefit.

In addition, the revised guidelines clarify that, "if an adjustment payment is made to align the contribution value ratio with the Expected Proportion of Benefit, the amount after the payment shall be considered to be the value of the contribution of each participant." They also state that, "if the amount of the expenses borne by a participant under the

CCA does not differ significantly from the value of the participant's contribution, the expense amount may be treated as the value of the participant's contribution."

These amendments can be expected to improve the predictability of the application of the arm's length principle to CCAs in Japan.

3. (3-17) Points to consider in relation to CCAs

Section 3-17 of the Administrative Guidelines sets out criteria to be considered by an examiner when analyzing a CCA during a transfer pricing audit. The amendments significantly revise and add to the criteria, which now instruct an examiner to analyze whether:

(1) The details set forth in the contract are consistent with the work actually performed by the CCA participant and other facts relating to the CCA;

(2) all participants obtain the expected benefits;

(3) the expected benefit ratio has been properly calculated;

(4) the contribution value ratio has been properly calculated;

(5) each participant's respective value contribution percentage is consistent with its respective expected benefit percentage, and if not, whether an adjusted amount of payment was given or received; and

(6) appropriate compensation has been paid or received when a participant joins or withdraws from a CCA or when the CCA is terminated.

The expansion of the criteria may presage more detailed review by examiners during an audit. In addition, the expanded criteria provide guidance to taxpayers on areas an examiner is likely to focus on — useful for preparation for a potential audit.

4. (3-19) Documents to be inspected at the time a CCA is examined

Section 3-19 of the Administrative Guidelines lists documents that an examiner should request and review when conducting an audit of a CCA. The revised list now includes documents describing:

(1) The names, locations, capital relationships and business activities of CCA participants;

(2) The history of negotiations and discussions leading to the conclusion of the CCA by the participants;

(3) The period during which the joint activities will be conducted;

(4) The scope, contents and progress management methods of the joint activities;

(5) The form of each participant's contribution to the joint activities, the method for calculating the value of their respective contributions and the details of the calculation of the contribution value ratios (if the percentage of the costs required for the joint activities can be used as the contribution value ratio, details of the calculation of the percentage of the costs and the reasons for using the percentage of the costs);

(6) The role of each participant in the formation and management of intangible or tangible assets used in the joint activities;

(7) The method for calculating the expected benefit ratio and the reasons for using it;

(8) The intended use of the deliverables resulting from the joint activity;

(9) The details of any adjustment in the contribution value in the event of a discrepancy between the expected benefit ratio and the realized benefit ratio; and

(10)Details of any changes in the terms and conditions of the contract and revision or termination of the CCA.

Although there is no stand-alone requirement for contemporaneous documentation and ordinary documentation thresholds apply to CCA-related transactions, taxpayers are expected to prepare these documents and deliver them to an examiner upon request.

Conclusion

CCAs have important commercial purposes, and are often used by multinational groups to allow for efficient funding of large capital expenditures. As CCAs often cover joint development of intangible assets across multiple jurisdictions, the tax considerations associated with a CCA can be complex. Importantly, this includes transfer pricing related to intangible asset development and ownership.

Guidance on CCAs provided by the OECD and jurisdictions including Japan allow for a higher level of confidence in the outcome of transfer pricing analyses of CCAs where the guidance is followed. The recent amendments to the Administrative Guidance provide further clarification of the application of the arm's length principle to CCAs. Alignment of the Japanese guidance with the OECD Guidelines on Transfer Pricing signals that tax examiners in Japan can be expected to analyze CCAs in a manner consistent with OECD principles. Further, the expansion of the definition of a CCA means that the principles used to analyze a CCA for intangible assets can equally be applied to CCAs covering tangible assets and intra-group services. This in turn expands the potential commercial benefits for funding capital expenditures not related to intangible assets.

From a transfer pricing perspective, the CCA framework provides a higher level of predictability for taxpayers when compared to other transfer pricing methods typically used for highly integrated transactions (such as shared intangible asset ownership). For example, the residual profit split method (RPSM) is often used for such transactions. However, when applying the RPSM, there are often differences in opinion between taxpayers and the tax authorities (both in Japan and other jurisdictions) regarding factors such as the split factor for residual profit, and many disputes have historically arisen in Japan relating to this issue. A CCA is a useful tool to manage such transfer pricing risks.

From a transfer pricing audit and documentary support perspective, the amendments to the Administrative Guidelines both expand and clarify the issues a tax examiner can be expected to focus on, and the level of documentary support a taxpayer is required to prepare and provide. For example, taxpayers will likely be required to prepare more rigorously and systematically for the explanation of: i) consistency between the contract and the facts; ii) selection of the best indicator for the expected benefit ratio; iii) agreement between the expected benefit ratio and the contribution value ratio; iv) the adjustment payment amount; and v) treatment at the time of commencement and withdrawal.

Finally, while the amendments to the Administrative Guidelines provide additional predictability to taxpayers, they do not eliminate the risk of an audit or transfer pricing adjustment. Additionally, the update to the Administrative Guidelines for CCAs may signal that the tax authorities will increase their focus on CCAs in the future. In this context, Advance Pricing Arrangements (APAs) remain the primary risk mitigation strategy for taxpayers with complex transactions, including CCAs.

2022 tax reform bill

On March 22, 2022, the National Diet approved its 2022 tax reform bill (the "**Bill**"), which was enacted on April 1, 2022. The Bill 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 Bill 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 most likely to have the greatest impact on multinational corporations doing business in Japan.

1. **Withholding tax on dividends from wholly-owned subsidiaries**

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,[1] 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.[2]

Under the previous rules, withholding tax is imposed when a parent corporation receives a dividend from a wholly-owned subsidiary that is part of a 100% group (or from an "affiliated subsidiary"; a subsidiary in which the recipient owns more than one-third of the total number of outstanding shares). The parent corporation is then entitled to receive a refund or credit for the withholding tax at the time it files its corporate tax return,[3] 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.

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

2. **Earnings stripping rules**

Japan's earnings stripping rules restrict deductions for net interest expenses that exceed 20% of a Japanese company’s adjusted taxable income. Under the previous rules, foreign companies are only subject to the earnings stripping provisions on income attributable to a Japanese permanent establishment ("**PE**"). However, under the Bill, 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 such income is attributable to the Japanese PE.[4]

3. **Wage increase tax credit**

Under the previous 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**")[5]) if certain wage payments made in the current fiscal year ("**FY**") exceed certain wage payments made in the previous FY.

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[1] Article 177(1) of the Individual Income Tax Act ("**IITA**"), as amended.
[2] Article 177(2) of the IITA and Article 301(2) of the Enforcement Order to the IITA, as amended.
[3] 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 in which companies used bridge loans for the withholding tax amount to alleviate such concerns.
[4] Article 66-5-2(8) etc., of the Special Tax Measures Act ("**STMA**").
[5] An SME is a company with stated capital of JPY 100 million or less and that is not 50% or more held by a large company (i.e., a company with stated capital of over JPY 100 million) 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) of over JPY 1.5 billion will not be considered an SME.

The Bill 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:[6]

(7) Wages paid to continuously employed employees in the current FY ≥ Wages paid to continuously employed employees in the prior FY x 103%

(8) Wages paid to continuously employed employees in the current FY ≥ Wages paid to continuously employed employees in the prior FY x 104%

(9) Education and training expenses in the current FY ≥ Education and training expenses 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

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.[7]

(1) Total wage payments in the current FY ≥ Total wage payments in the prior FY x 101.5%

(2) Total wage payments in the current FY ≥ Total wage payments in the prior FY x 102.5%

(3) 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.

[6] Article 42-12-5(1) of the STMA.
[7] Article 42-12-5(2) of the STMA.

Additionally, note that companies with stated capital of JPY 1 billion or more 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 April 1, 2022 and March 31, 2024.

4. Disallowance of certain special tax measures for large companies

The previous 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 Bill, 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 April 1, 2022 and March 31, 2023) and at least 1% (for FYs beginning on or after April 1, 2023) if both of the following apply:[8]

(1) The amount of stated capital is more than JPY 1 billion and the number of regular employees is 1,000 or more, and

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

[8] Article 42-13(5) of the STMA.

The Ministry of Justice's recent notice to tech giants may affect tax and business planning in Japan for all overseas businesses

Introduction

The Ministry of Justice and the Ministry of Internal Affairs and Communications have recently approached certain foreign companies (particularly tech companies) and issued notices requiring that they register in Japan under the Companies Act.

In this article, we comment on this issue and provide our perspectives on the Japanese Companies Act, tax and other related laws and regulations, such as the Telecommunications Business Act. Although registration as a foreign company under the Companies Act itself is fairly straightforward, registered companies are subject to certain continuous obligations, such as publication of financial statements and updating of their registered information. Registration may also have Japanese tax implications and impact legal proceedings in Japan.

In this context, foreign companies should consider these issues and potential actions based on their specific circumstances.

Summary of recent requests from the Japanese government

At the end of 2021, the Ministry of Justice and the Ministry of Internal Affairs and Communications issued a notice addressed to foreign companies that are registered or notified in Japan as telecommunications carriers regarding the registration obligations of foreign companies. The notice refers to the Ministry of Justice's guidance on the registration obligations of foreign companies under the Japanese Companies Act[9] and requests that foreign companies not in compliance with their registration obligations promptly apply for registration.

On March 29, 2022, the Ministry of Justice issued a notice to 48 foreign IT service providers that appear to be noncompliant with their registration obligations, urging them to register in accordance with the Companies Act. In June 2022, the Ministry of Justice again sent letters to the companies reiterating the requirement to register under the Japanese Companies Act, this time providing a deadline for registration of June 13, 2022 and stating that non-compliance would result in notification of the courts requesting that a fine be imposed. Notwithstanding this, Japanese press reports indicate that many companies appear to be holding off on registration in Japan and, as of the date of writing, the Ministry of Justice has requested that the courts fine seven of the 48 companies that have not registered.

As additional background, in the past, many foreign companies did not fulfil their registration obligations unless they had a physical presence in Japan, presumably because the authorities did not proactively regulate registration compliance. However, with the growth of e-commerce via the internet, it has become easier for foreign companies to provide services in Japan without a physical presence. At the same time, the lack of registration makes it difficult (particularly for consumers who receive services directly from foreign companies) to obtain adequate relief if problems arise and to ascertain the company's business information (e.g., company representative, business size, etc.), which in turn hinders proper tax administration. It is assumed that these issues led to the above request by the Ministry of Justice.

Although at this point it appears that these notices are only being issued to foreign corporations that are registered or notified as telecommunications carriers, the registration requirement under the Companies Act applies to all foreign companies, regardless of whether a company is registered or notified as a telecommunications carrier. Accordingly, this recent policy shift to tighten monitoring of registration obligations could have an impact on all foreign companies that do business with Japanese customers.

Legal framework under Japanese law

(1) Companies Act

[9] https://www.moj.go.jp/EN/MINJI/m_minji07_00002.html.

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- When a foreign company, "intends to carry out transactions continuously," "in Japan," it must appoint a local representative in Japan (at least one of whom must have an address in Japan)[10] and register as a foreign company at the competent Legal Affairs Bureau within three weeks after appointing a local representative for the first time. A foreign company will be prohibited from carrying out business in Japan until it has registered as a foreign company.[11] It should be noted that even if a foreign company has a subsidiary in Japan and the subsidiary is registered under the Companies Act, the foreign company itself is not exempt from the obligation to register, as long as it directly carries out transactions in Japan. The representative has the statutory authority to represent and bind the foreign company for any and all matters in connection with the company's business in Japan,[12] and no internal restrictions imposed on the authority of the representative can be asserted against a bona fide third party.[13]

- The purpose of this foreign company registration system under the Companies Act is understood to be a means of enabling a counterparty to deal with disputes arising from transactions in Japan and facilitate the filing of lawsuits in Japan.

- The definition of the phrase, "in Japan," here is interpreted to be (potentially) applicable to cases in which foreign companies do not have any physical presence (e.g., an agent or branch office) in Japan and conduct transactions exclusively via the internet, if the company continuously conducts transactional activities targeting Japanese customers via the internet or other means (e.g., soliciting Japanese customers by creating an easily accessible website in the Japanese language). On the other hand, there is a prevailing view that this definition does not apply if Japanese individuals or corporations proactively access the websites of foreign companies to conduct transactions, and the foreign companies do not conduct any activities targeting Japanese customers or markets (e.g., the foreign company does not have a Japanese website, and Japanese individuals or corporations are accessing the company's regular website also used by customers outside Japan).

- The phrase, "intend to carry out transactions continuously," is interpreted as continuous transactional activities with Japanese customers by a foreign company under a certain business plan formulated by the foreign company. Activities that do not go beyond an incidental one-off transaction, market research or information gathering are not considered to fall under this definition.

- In determining whether business conducted by a foreign company falls under both of the above definitions, it is necessary to consider the specific circumstances of each case.

- Where business conducted by a foreign company falls under both of the above definitions:

  i. if the foreign company does not establish a branch office in Japan, the foreign company must be registered at the domicile of the representative in Japan;[14] or

  ii. if the foreign company establishes a branch office in Japan, the foreign company must be registered at the location of the branch office.[15]

- Failure to comply with the above registration requirements may result in the imposition of a civil fine of up to JPY 1 million on the representative or manager of the foreign company in Japan.[16]

- In addition, a person (e.g., the foreign company's representative in Japan, the foreign company itself) who continuously conducts business in Japan without registering as a foreign company (in violation of Article 818, Paragraph 1 of the Companies Act) (i) may be subject to a civil fine equivalent to the amount of the registration and license tax for the establishment of the company and (ii) may also be jointly and severally liable with the foreign company to perform any obligations to the counterparty that arose as a result of the

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[10] Companies Act, Article 817, Paragraph 1.
[11] Companies Act, Article 818, Paragraph 1.
[12] Companies Act, Article 817, Paragraph 2.
[13] Companies Act, Article 817, Paragraph 3.
[14] Companies Act, Article 933, Paragraph 1(1).
[15] Companies Act, Article 933, Paragraph 1(2).
[16] Companies Act, Article 976, Paragraph 1.

business in Japan.[17] Furthermore, if a foreign company fails to comply with a written warning from the Minister of Justice, the court may, upon petition by the Minister of Justice or other stakeholders, issue an order prohibiting the continuation of the company's business in Japan, an order closing its place of business or even an order commencing liquidation of the assets of the foreign company.[18]

(2) Telecommunications Business Act

- Under the Telecommunications Business Act as revised in 2020, when a foreign corporation provides telecommunications services from a foreign country to customers in Japan (specifically, when it is clear that the intention is to provide services to the domestic market from the perspective of the language of the service, etc.), the company is required to register or file a notification in the same way as a domestic telecommunications carrier.

- Further, such foreign companies are required to designate a domestic representative or domestic agent and inform the Minister of Internal Affairs and Communications when making such registration or notification. The domestic representative or agent is expected to receive notifications from the Minister on behalf of the foreign company and serve as a contact point between the Ministry of Internal Affairs and Communications and the foreign company. In other words, the domestic representative under the Telecommunications Business Act is a representative or agent only with respect to telecommunications services.

- A foreign company that fails to appoint a representative/agent may have its name published on the internet and other media.

Practical impacts of registering a foreign company

(1) Companies Act

When a foreign company is registered, as is generally required for Japanese corporations, the registration must be updated when there is a subsequent change in the registered matters or when a new registration matter arises. Please refer to the website of the Ministry of Justice[19] for specific matters requiring registration by a foreign company.

If a foreign company that is a business entity similar in form to a Japanese joint stock company (*kabushiki-kaisha, KK*) is registered, public notice of the equivalent balance sheet must be given in Japan without delay after completion of the necessary procedures, which are similar to those required for the approval of financial statements for a Japanese joint stock company.[20]

(2) Impact on civil proceedings

Under the Code of Civil Procedure, a lawsuit may be filed in Japanese court against a foreign company when it relates to the business of the foreign company's office located in Japan or its business in Japan.[21] In particular, for businesses conducted via the internet, Item 5 of Article 3-3 of said Code plays an important role in recognizing jurisdiction over a foreign company with respect to a case relating to business in Japan, even if the foreign company does not have any physical presence in Japan. In this respect, whether a foreign company is deemed to engage in business in Japan is highly fact-specific. Regardless of whether the foreign company has a designated and registered representative in Japan, as a matter of fact, it has long been recognized that Japanese courts can have jurisdiction for a lawsuit filed against a foreign company conducting business in Japan using the internet.

However, when filing a lawsuit against a foreign company that has no registered representative in Japan, it is necessary to obtain a certificate of qualification from the public authority of the country where the foreign company is located. Litigation materials, such as the complaint and evidence, must be translated from Japanese to the local language and served internationally to the location of the foreign company[22], which usually requires considerable time and expense.

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[17] Companies Act, Article 818, Paragraph 2.
[18] Companies Act, Article 827, Paragraph 1(4) and Article 822, Paragraph 1.
[19] https://www.moj.go.jp/EN/MINJI/m_minji07_00002.html.
[20] Companies Act, Article 819, Paragraph 1; Article 214 of the Ordinance for Enforcement of the Companies Act.
[21] Japan Code of Civil Procedure, Article 3-3, Items 4 and 5.
[22] See Japan Code of Civil Procedure, Article 108.

After a complaint is filed with the Japanese court, it can take more than six months before a trial begins in a lawsuit against a foreign company. In contrast, when a foreign company is registered in Japan, it is possible to obtain a certificate of qualification in Japan, and even if the company does not have a business office, etc. in Japan, it is sufficient to serve litigation materials and other necessary documents in the Japanese language using the address of the representative in Japan, thus eliminating the abovementioned burden of filing a lawsuit against a foreign company. Japanese consumers, trade counterparts and the like who have been hesitant to file lawsuits against foreign companies due to this burden will be able to file lawsuits against foreign companies much more easily, and foreign companies may see an increase in lawsuits brought by Japanese consumers after registering in Japan.

(3) Tax considerations

From a Japanese tax perspective, registration of a representative in Japan under the Companies Act could potentially create permanent establishment ("**PE**") risk. The existence of a PE in Japan is determined based on the specific facts and circumstances of a particular taxpayer. In this context, while registration under the Companies Act may not, in and of itself, be considered to immediately or automatically trigger a PE in Japan, such a registration may be a factor taken into account by the Japanese tax authorities in making the factual PE determination. Given this, careful attention should be paid to the PE considerations of registration under the Companies Act. Depending on the circumstances of a particular taxpayer, there may be ways for the foreign company to comply with its obligations under the Companies Act and the Telecommunications Business Act while mitigating the risk of a PE being created.

As background, a brief explanation of the Japanese tax treatment of PEs is as follows.

First, a foreign company is liable to pay Japanese corporate tax on its Japanese domestic source income,[23] and where a foreign company conducts business via a PE, income attributed to the PE is considered to be Japanese domestic source income and taxable in Japan.[24]

Second, the term "permanent establishment" is defined[25] to be: (a) a branch office, factory or any other fixed place for conducting business which is held by a foreign corporation and located in Japan (a so-called "fixed place of business PE")[26]; (b) a place held by a foreign corporation and located in Japan where the foreign corporation carries out construction or installation work or provides services related to directing or supervising such work or any other place equivalent thereto (a so-called "construction PE");[27] or (c) a person assigned to Japan and authorized by a foreign corporation to conclude a contract on behalf of the corporation or any other person equivalent thereto (a so-called "dependent agent PE").[28]

The definition of PE under Japanese domestic law was expanded by the 2018 Japanese tax legislation in order to be consistent with the new PE definition under the Multilateral Convention to Implement Tax Treaty-Related Measures to Prevent Base Erosion and Profit Shifting ("**MLI**") (or BEPS Action Item 7 discussions by the OECD). The expanded PE definition for categories (a) and (c) above can be summarized as follows (as the relevant PEs in this case would be (a) and (c)):

- Activities such as storage, display and delivery were excluded from the scope of a fixed place of business PE in Japan. Under the tax legislation, where such activities go beyond the nature of preparatory and auxiliary

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[23] See Japanese Corporate Tax Act, Articles 4(3) and 8(1).
[24] See Japanese Corporate Tax Act, Article 138(1)(i). Similarly, where a PE exists, the attributable income is also subject to the local corporate inhabitants tax, enterprise tax and special corporate enterprise tax (collectively, local taxes). The current Japanese effective tax rate (including local taxes) is around 34% (or around 30% if the factor-based enterprise tax applies to a company; i.e., where the company is not a small or medium-sized enterprise for enterprise tax purposes whose registered capital exceeds JPY 100 million).
[25] See Japanese Corporate Tax Act, Article 2(12-19).
[26] Generally, a place, "at the disposal of the enterprise," which exists for, "a certain duration," constitutes a fixed place of business.
[27] This PE category would be not relevant here.
[28] Indeed, a person in Japan other than an independent agent, who acts on behalf of an enterprise who, "has and habitually exercises," the authority to conclude contracts in the name of the enterprise or plays the principal role leading to the conclusion of certain contracts falls within the definition of a dependent agent.

work with respect to a foreign company carrying out business activities in Japan, such activities would constitute a PE in Japan.[29]

- A person who engages in activities, "relating to," the conclusion of a contract regarding the transfer of ownership of assets of a foreign company has been added to the definition of a, "dependent agent PE." This provision appears to expand the scope of a dependent agent PE to cover a person who is not necessarily a bona fide agent (e.g., a contract concluding agent) and, in a practical sense, appears to be aimed at capturing so-called "commissionaires," the use of which was targeted by the BEPS project.[30]

- In addition to the above, a person who works mostly or exclusively for one or two "closely related" (defined as having a greater than 50% relationship) principals will be excluded from the scope of the "independent agent" exception.[31]

That said, Japanese domestic tax law clarifies that where the PE provision under domestic law differs from that of a treaty applicable to a taxpayer, the PE provision under the applicable treaty will still apply. This is the so-called "treaty override doctrine," which has traditionally been applicable for Japanese tax purposes by virtue of Article 98(2) of the Japanese Constitution.[32] Accordingly, where an applicable treaty exists, the definition of a PE under the treaty should apply. Some treaties were also amended in light of the MLI or BEPS Action Item 7 discussions by the OECD.[33]

In view of the above, a relevant issue for tax purposes in relation to the registration of a representative in Japan would be the broad authority given to registered representatives under the Companies Act. Depending on the specific circumstances of the foreign company, there is a potential risk that the representative in Japan may be considered to fall within the definition of a dependent agent-type PE or a fixed place of business PE (based on the location of the representative in Japan) described above. If such an assertion is made by the Japanese tax authorities, this would give rise to a taxable presence (and filing obligations) for the foreign company in Japan.

In this context, foreign companies that have been notified by the Ministry of Justice or that are otherwise considering whether the registration requirement applies to them should consider the PE implications of registration. As a first step, this may involve identification of the current business model in Japan, including details of the operations of the Japanese subsidiary, if any (and interactions between the foreign affiliates and the Japanese subsidiary), and consideration of the applicable PE definitions under the domestic tax law or the applicable tax treaty. If a PE risk is identified, there may be several solutions or steps that can be taken to mitigate this risk.

For example, as the tax law is silent on the corporate tax treatment of the registration of a representative in Japan, it may be possible to consider a tax ruling request in this regard (although the Japanese tax authorities would not readily accept a ruling request which involves many factual matters). On the other hand, as mentioned above, only income attributable to a PE is taxable in Japan, and such income attributable to a PE would be determined broadly based on the functions, assets and risks associated with the activities giving rise to the PE. Considering this, in order to identify the income attributable to a PE (or to justify that no or only nominal attributable income should be calculated), it would also be worthwhile to consider performing a sort of TP analysis.

Possible future developments and implications

As mentioned above, foreign companies have historically not sufficiently fulfilled their registration obligations due to the administrative burden and cost of maintaining and updating registries, as well as the reluctance to disclose a financial statement in Japan. Another factor is that there have been no known cases of sanctions to date, such as fines being imposed for violations of registration obligations (also, even were there to be such sanctions, they would be as low as JPY 1 million).

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[29] See Japanese Corporate Tax Act Enforcement Order, Article 4-4(4).
[30] See Japanese Corporate Tax Act Enforcement Order, Article 4-4(7)
[31] See Japanese Corporate Tax Act Enforcement Order, Article 4-4(8)
[32] In addition, Article 2 (12-19) of the Japanese Corporate Tax Act, which states the PE definitions, further clarifies that, if an applicable tax treaty concluded by Japan contains any provisions that differ from domestic tax law, the definition of a permanent establishment under the treaty shall apply.
[33] For example, under the Japan-Netherlands Tax Treaty ("NL Treaty"), the PE definitions were expanded in 2019 due to MLI/BEPS, and Article 13 of the MLI (Artificial Avoidance of Permanent Establishment Status through the Specific Activity Exemptions) and Article 15 of the MLI (Definition of a Person Closely Related to an Enterprise) are embedded in the NL Treaty.

However, with the rapid increase in cross-border B2C and B2B transactions due to the growth of the digital economy in recent years, the Japanese government has been amending laws and enacting new ones to impose legal restrictions on foreign tech companies. The recent issuance of notices by the Ministry of Internal Affairs and Communications and the Ministry of Justice appear to be in line with this trend.

Although recipients of the notices issued by the Ministry of Justice are currently limited to foreign tech companies that are registered or notified as telecommunications carriers, the Companies Act states that a company is obligated to register (whether it is a telecommunications carrier or not) as long as it satisfies the conditions under the Companies Act. Accordingly, it is possible that the Japanese government may extend similar requests to companies in other industries, especially in industries with strict requirements, to protect their domestic customers and/or counterparties. Therefore, foreign companies that engage in certain business activities with Japanese customers/counterparties need to carefully monitor future escalation in the level of the Japanese government's enforcement of these registration obligations, reexamine whether they are required to register under the Companies Act in light of their business activities and closely examine the potential impacts and implications.

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