



Working Paper Series No. 004

The Concept of Qualified Reorganization in Japan

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ASLI Visiting Fellow
(12 January to 6 February 2009)

July 2009

The **ASLI Working Paper Series** is published electronically by the Asia Law Institute, whose Secretariat is based at the Faculty of Law, National University of Singapore.

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THE CONCEPT OF QUALIFIED REORGANIZATION IN JAPAN

TETSUYA WATANABE*

I. INTRODUCTION

Reorganization transactions such as mergers and corporate divisions are generally taxable both at shareholder and corporation levels. However, if the transactions are qualified reorganizations under the law, gains or losses and deemed dividends are not recognized, and the basis of the assets or stocks transferred is carried over. Consequently, they are sometimes referred to as “tax-free reorganizations.”

Since the meaning of “merger” (*gappei*) and “corporate division” (*bunkatsu*) in *Corporation Tax Act*¹ are basically borrowed from the *Companies Act*,² the concepts of qualified reorganization are also based on the *Companies Act*.³ As a result, if a transaction is not a reorganization under the *Companies Act*, it cannot amount to a qualified reorganization under the *Corporation Tax Act*.⁴

However, it is not necessarily logical to treat tax law as based on private law such as the *Commercial Code* or the *Civil Code*.⁵ The provisions of private law are not enacted or amended in consideration of tax law. Moreover, since the new *Companies Act*, which came into force in May 2006, not only relaxes the consideration rules relating to reorganization but also changes drastically the concepts of capital and dividends, the pre-existing difference between the *Companies Act* and *Corporation Tax Law* is now even greater.

It is also true that not all reorganizations under the *Companies Act* are treated as qualified transactions in tax law. The default rule in tax law is “disqualified reorganization”⁶ and only transactions which meet specific requirements are allowed tax deferral treatment.⁷ In

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1 (Law No. 34, 1965).

2 (Law No. 86, 2005).

3 See Hiroshi Kaneko, *Sozeiho*, 14th ed. (Tokyo: Kobundo, 2009) at 368. Reorganizations under the *Corporation Tax Act* consist of mergers, corporate divisions, investments in kind, subsequent incorporations, stock exchanges and stock transfers (Art. 132-2). Strictly speaking, investments in kind and subsequent incorporations are not reorganizations under the *Companies Act*, but those concepts in tax law are also based on the *Companies Act*.

4 See Tadao Okamura, *Hozinzeiho Kogi*, 3rd ed. (Seibundo, 2007) at 332.

5 See Tetsuya Watanabe, “*Kigyo Soshiki Saihenzeisei*” (2003) 31 Japan Tax L. Rev. 46.

6 *Corporation Tax Act*, Art. 62. If a transaction is not a qualified reorganization, a target corporation is taxed as if it is disposing of the assets at fair market value and the basis of the assets in the acquiring corporation will be fair market value. Shareholders of a target corporation are taxed on deemed dividends under the *Income Tax Act* (Law No.6, 2001), Art. 25(1), and may be also taxed on capital gains under the *Act on Special Measures Concerning Taxation*, (Law No.7, 2001), Art. 37-10(3)(i).

7 *Corporation Tax Act*, Art. 62(2). The rate of corporate tax in Japan is quite high compared to other developed countries. On the other hand, there are many countries or jurisdictions with low rates like Singapore, which has a newly introduced 1% cut to its headline rate (from 18% to 17%, effective from the 2010 fiscal year. See Sing., “Budget Headlines Financial Year 2009: Keeping Jobs, Building for the Future”, Misc. 2 of 2009 (22 January 2009) at 29, online: <http://www.singaporebudget.gov.sg/speech_toc/downloads/FY2009_Budget_Highlights.pdf>. Since the corporate tax rate in Japan is so high (and income taxation for stock transfer is not low enough), a taxpayer planning a reorganization would be greatly influenced by whether or not a transaction constitutes a qualified transaction.

the case of mergers, transactions must be mergers under the *Companies Act* in order to be qualified mergers for tax purposes. This is the starting point. To obtain deferral on the basis of qualified mergers, transactions must satisfy several requirements under tax law.

According to the 2000 report from the Tax Commission, “The Basic Theory for Tax System of Corporate Reorganization such as Mergers and Corporate Divisions”,⁸ two continuities namely “continuity of control to the transferred assets” at the corporate level and “continuity of investment” at the shareholder level formed the bases for tax deferral treatment.⁹ But the rationale for such reasoning, and the relationship between this ground for deferral and the current provisions, is not entirely clear.

This paper examines the current requirements and the rationale for qualified reorganizations and compares them with type C reorganization under U.S. tax law.

In U.S. tax law, “a statutory merger or consolidation” is one of type of reorganization, i.e., type A reorganization under the Internal Revenue Code, I.R.C. §368(a)(1)(A) (2007).¹⁰ However, there is also a type of reorganization which is the same acquisitive transaction as type A reorganization, and similar to a merger, but not based on state law. This is type C reorganization under I.R.C. §368(a)(1)(C).

Type C is referred to as a “de facto merger” or “practical merger.”¹¹ Transactions which are not mergers under state law but have the same character as mergers may enjoy tax deferral treatment if they satisfy specific requirements under the tax law. This idea seems to be useful for considering Japanese tax law policies from a comparative point of view.

II. TYPE C REORGANIZATION IN U.S. TAX LAW

A. *The features of Type C*

The main content of type C reorganization is corporate acquisition followed by “stock for asset exchange.” A simple example of a type C reorganization is when an acquiring corporation (A corp.) exchanges its own stock (A stock) for almost all assets of a target corporation (T corp.). After this exchange, T corp. distributes all A stock to T shareholders then liquidates. Accordingly, the economic effect of that transaction is similar to a merger. This is the reason why type C is referred as “de facto merger” or “practical merger”.¹²

I.R.C. §368(a)(1)(C) defines type C reorganizations as:

[T]he acquisition by one corporation, in exchange solely for all or a part of its voting stock (or in exchange solely for all or a part of the voting stock of a corporation which is in control of the acquiring corporation), of substantially all of the properties of another corporation, but in determining whether the exchange is solely for stock the assumption by the acquiring corporation of a liability of the other shall be disregarded.

8 The document for the second general meeting of the Tax Commission in 2000 (Oct. 3rd).

9 See Watanabe, *supra* note 5, at 39.

10 See Boris Bittker & James Eustice, *Federal Income Taxation of Corporations & Shareholders*, 7th ed. (Warren Gorham & Lamont, 2000) at ¶12.22 and 2008 Cumulative Supplement.

11 See Rev. Rul. 56-345, 1956-2 C.B. 206.

12 See Richard Westin & Richard Beck, *Federal Income Taxation of Business Enterprises: Cases, Statutes, Rulings*, 2nd ed. (Vandeplas Publishing, 2008).

Although this is not an easily understandable definition, there are three key characteristics: (1) the acquiring corporation should use its own voting stock as a consideration;¹³ (2) the acquiring corporation should acquire substantially all of the properties of the target corporation; and (3) if the acquiring corporation assumes a liability of the target corporation this will be disregarded in determining whether the exchange is solely for stock. So the principal requirements are: (1) exchange solely for voting stock; and (2) acquisition of substantially all of the properties.

B. History of Type C

The early version of type C reorganization was to be found in §202(c)(2) of the *Revenue Act of 1921*,¹⁴ which provided: “The term 'reorganization' means (A) a merger or consolidation (including the acquisition by one corporation of at least a majority of the voting stock and at least a majority of the total number of shares of all other classes of stock of another corporation, or substantially all the properties of another corporation), recapitalization, or mere change in identity, form, or place of organization of a corporations...”¹⁵ Accordingly, the predecessor to type C was the part of the provision in parenthesis.

Based on the way in which the provision was enacted, the part in parenthesis appeared to be merely an explanation or an example of a merger or consolidation. However, in the *Pinellas Ice*,¹⁶ the Supreme Court held that: “The words within the parenthesis may not be disregarded. They expand the meaning of ‘merger’ or ‘consolidation’ so as to include some things which partake of the nature of a merger or consolidation but are beyond the ordinary and commonly accepted meaning of those words – so as to embrace circumstances difficult to delimit but which in strictness cannot be designated as either merger or consolidation.”¹⁷ The result is that the current type C is clearly different and independent from current type A.¹⁸ Furthermore, The Supreme Court did not reduce the scope of reorganizations to mergers or consolidations but rather extended it to other types of transaction.¹⁹

Subsequently, §112(g)(1) of the *Revenue Act of 1934*²⁰ adopted two amendments following the Supreme Court decision: (1) before “merger” it put the word “statutory” to make provision for “a statutory merger or consolidation;” and (2) it removed the part in parenthesis and replaced it with “the acquisition by one corporation in exchange solely for

13 However, the stock of a parent company may also be qualified consideration under the parenthesis of I.R.C. §368(a)(1)(C). That is the case of a triangular type C reorganization.

14 c. 136, 42 Stat. 227.

15 *Ibid.* at 230. Recapitalization is the readjustment of the financial structure of a single corporation. This means that a characterization of the event as a reorganization for tax purposes is ordinarily important only to the persons who have exchanged their stock or securities for other stock or securities of one corporation. See Bittker & Eustice, *supra* note 10, ¶12.27[1].

16 *Pinellas Ice & Cold Storage Co. v. Commissioner*, 287 U.S. 462 (1933) [*Pinellas Ice*].

17 *Ibid.* at 469.

18 The transaction in parenthesis was also different from sale. See *Cortland Specialty Co. v. Commissioner*, 60 F. 2D 937 at 940 (2d Cir. 1932), cert. denied, 288 U.S. 599 (1933). See also David S. Miller, “The Devotion and Inevitable Extinction of The Continuity of Interest” (1996) 3 Fla. Tax Rev. 187 at 191.

19 See Byron Shoji, “Revenue Ruling 2003-79, The Return of Lop-Sided Spin-Off Treatment” (2004) 31 Corp. Tax'n 10 at 14.

20 c. 277, 48 Stat. 680.

all or a part of its voting stock: of at least 80 per centum of the voting stock and at least 80 per centum of the total number of shares of all other classes of stock of another corporation,”²¹ as an independent type of reorganization.

However, the bills of the House of Representatives (Congress) did not cover part (2) above.²² As for the property acquisitions not qualifying under such statute (state law), the House would have disqualified them entirely for reorganization treatment. The House report said that “the definition of a reorganization has been restricted so that the definition will conform more closely to the general requirements of corporation law, and will limit reorganization to ...statutory mergers and consolidations.”²³ The House considered that by these limitations it had removed the danger that taxable sales could be cast into the form of a reorganization.²⁴

However not all states had such statutes, and some had statutes of limited scope, particularly in that they did not authorize merger with a corporation chartered outside the state. Therefore, in order to provide treatment which would be roughly uniform across the nation, the Senate decided that an event should be specified which would be accepted as tantamount to a statutory merger or consolidation.²⁵ The Senate report stated: “The committee believes that these transactions ...are sufficiently similar to mergers and consolidations as to be entitled to similar treatment.”²⁶

Interestingly, the House demanded that non-recognition treatments for recapitalization or like-kind exchange should remain, though it insisted on eliminating the part in parenthesis in the reorganization provision. One of the reasons was that, as the Treasury Department indicated, if all exchanges were made taxable, it would be necessary to evaluate the property received in exchange in thousands of horse trades and similar barter transactions each year, and for the time being, at least, claims for theoretical losses would probably exceed any profits which could be established.²⁷ Moreover, for the retention (rather than elimination) of recapitalization as reorganization, the House also thought it would prevent large losses from being established by bondholders and stockholders who received securities in a newly reorganized enterprise which were substantially the same as their original investments.²⁸

C. Principal requirements

As mentioned above, the principal requirements of a type C reorganization are: (1) exchange solely for voting stock and (2) acquisition of substantially all of the properties.

Of these requirements, (1) did not exist in the *Revenue Act of 1921*. Accordingly if consideration was only cash or bonds in the acquiring corporation, there might still be the possibility that the transaction would be a tax-free reorganization under the statute.

21 *Ibid.* at 705.

22 U.S., H. R. Rep. No. 704, 73d Cong., 2d Sess. 14 (1934).

23 *Ibid.*

24 *Ibid.*

25 S. Rep. No. 558, 73d Cong., 2d Sess. 16 (1934).

26 See Richard L. Goldman, "The C Reorganization" (1973) 19 Tax L. Rev. 31 at 32. See also *American Potash & Chemical Corp. v. United States*, 185 Ct Cl 161 at 172 (1968).

27 See H. R. Rep., *supra* note 22, at 13.

28 *Ibid.*, at 14.

However the continuity of interest (COI) doctrine, one of the most important judicial doctrines, requires that some amount of the consideration should take the form of the equity of the acquiring corporation. The main content of this doctrine is that the original owners should retain a continuing interest in the reorganized corporation.²⁹ The “interest” in this context means the equity interest.³⁰

Under the COI doctrine, Congress required the voting stock as a consideration for type C reorganization when it removed the “substantially all assets acquisition” transaction from the “merger” as an independent reorganization in the *Revenue Act of 1934*.

Requirement (2), which already existed in *Revenue Act of 1921*, implies that because type C is similar to type A, it is allowed to be a tax-free reorganization. In other words, a transaction which is not similar to a merger (i.e. which has a divisive character) could not be a type C reorganization.³¹ The purpose of requirement (2) is to exclude divisive transactions from type C reorganizations.³²

D. *The consequences for parties to reorganization*

In this respect, we will consider the tax consequences for qualified reorganization. Assume that, in a typical type C reorganization, A corp. exchanges solely A voting stocks for all assets of T corp., then T distributes all of A voting stocks to its shareholders and liquidates.

In this case, T corp. is not taxable under I.R.C. §361(a) because T is a party to a reorganization and exchanges property, in pursuance of the plan of reorganization, solely for stock in A corp. which is also a party to the reorganization. The basis of A stocks in T corp. is the same as the basis of assets which T corp. transferred to A corp. under I.R.C. §361(b). T corp. is not taxed on the distribution of A stocks to the shareholders under I.R.C. §361(c)(1).

The shareholders of T corp. are not taxed under I.R.C. §354(a)(1), because the stocks in T corp., which is a party to a reorganization, are, in pursuance of the plan of reorganization, exchanged solely for stock in A corp., which is also a party to the reorganization. The basis of A stock is substituted to T stock which T's shareholder released under I.R.C. §358.

Finally A corp. is not taxed on the acquisition of T's assets under I.R.C. §1032(a), and the basis for the assets is the same as in T corp. under I.R.C. §362(b).³³

III. IMPLICATIONS FOR JAPANESE LAW OF TYPE C REORGANIZATION

29 See Bittker & Eustice, *supra* note 10, ¶12.21[1].

30 *Ibid.* See also Robert Rizzi, “Continuity of Interest and Reorganizations: Toward a Unified Theory” (1991) 17 J. Corp. Tax'n 362.

31 See Shoji, *supra* note 19, at 11.

32 For the liquidation requirement, see I.R.C. §368(a)(2)(G); P.L. 98-369, § 63(a) and U.S. Joint Committee on Tax'n, General Explanation of The Revenue Provisions of The Deficit Reduction Act, 1984 (H.R.4170, 98th Cong.; P. L. 98-369) at 190.

33 See Cheryl D. Block, *Corporate Taxation: Examples & Explanations*, 3rd ed. (Aspen Publishers, 2004) at 404.

A. *Congressional process*

The type C reorganization became an independent type of reorganization under the *Revenue Act of 1934*.

The House of Representatives considered that the definition of reorganization should conform more closely to corporation law for removing tax avoidance transactions. While recognizing the importance of anti-avoidance in this area, the Diet should also consider it important that the area is not subject to an ambiguous doctrine of economic substance.³⁴

At the same time, the House understood that if all non-recognition provisions were eliminated, then an enormous administrative cost would emerge, and in the end realized loss would exceed realized gain, which might bring a huge revenue loss.

It is also worth noting that reorganizations, such as a recapitalization provision, may work as an anti-loss realization rule when bondholders and stockholders receive securities in a newly reorganized enterprise which are substantially the same as their original investments.

B. *Continuity of interest (COI)*

Generally there are eight requirements for tax-free reorganization in Japanese tax law. In the case of qualified corporate division, they are: (1) no boot requirement; (2) transfer of major assets and liabilities requirement; (3) continuity of employees requirement; (4) succession of business requirement; (5) related business requirement; (6) continuity of senior officer requirement; (7) similarity of size requirement; and (8) continuity of shareholding requirement.³⁵ In those requirements, the continuity of shareholding requirement is similar to the COI in the U.S.

But the continuity of shareholding requirement in the *Corporation Tax Act* is not always consistent with “continuity of control to the transferred assets” with respect to corporation level tax deferral and “continuity of investment” with respect to shareholder level tax deferral in the Tax Commission Report. For example, in the case of a joint business merger, the shareholder of T corp. should hold A stock not only at the shareholder level but also at the corporate level for the tax deferral.³⁶ Since, however, a person holding A stock is a “shareholder,” this may be a matter of only continuity of investment, and not continuity of control.³⁷

U.S. law looks at continuity of propriety interest at shareholder level to decide whether or not a transaction qualifies. There are few corporate level viewpoints.³⁸

Moreover in the case of over 50% group absorption type corporate division, A corp. should keep over 50% of T stocks.³⁹ But it is hard to understand why this means continuity

34 What happened in the U.S. was the creation of specific anti-avoidance provisions, such as I.R.C. §368(a)(2)(G) (liquidation requirement).

35 *Corporation Tax Act Enforcement Order* (Cabinet Order No.194, 2001), Art. 4-2(8)(vi).

36 *Ibid.*, Art. 4-2(4)(v).

37 See Okamura, *supra* note 4, at 337.

38 At the corporate level, continuity of business is required under Reg. §1.368-1(d)(1). See Rev. Rul. 81-25, 1981-1 C.B. 132.

39 *Corporation Tax Act*, Arts. 2(xii)-11(b); *Corporation Tax Act Enforcement Order*, Art. 4-2(7). Absorption-type corporate division means any corporate division whereby a succeeding company succeeds after the corporate division, in whole or in part, to any rights and obligations, in whole or in

of investment at a shareholder level. From the COI point of view, the shareholder should hold distributed A stock (not T stock). This understanding is more consistent with the report of the Tax Commission.

Japanese law and U.S. law have some similarities in terms of COI. In Japanese law, when the number of target shareholders is more than 50, there is no continuity of shareholding requirement. Similarly, under §1.368-1(e), U.S. law does not require holding of A stock in the hands of shareholders in T corp. The reason in both cases is administrative cost and traceability.⁴⁰

C. Voting stock as a consideration

In the case of a merger, voting stocks are required as consideration under the continuity of shareholding requirement.⁴¹ But distributing non-voting stocks is not prohibited (non-voting stocks simply do not count for the continuity of shareholding requirement). In other words, non-voting stock is not boot.⁴²

In type C reorganization, the qualified consideration should be basically voting stock under the COI requirement. The reason is to distinguish reorganization from sale.⁴³ On the other hand, in Japan, for example in the case of a merger, if A corp. distributes its bonds, the transaction cannot qualify, whereas if A corp. distributes its non-voting stock, it can qualify. Since the new *Companies Act* allows distributing many more classes of shares than before, consideration of qualified reorganization must be limited to voting stock. We should also remember that the continuity of shareholding requirement is not required in “over 50 shareholder” cases.

Even when considering separately whether we should introduce type C reorganization in Japanese law, the requirement for qualified reorganization must be regarded from a tax law, and not a corporation law, point of view. The COI doctrine in U.S. tax law gives us valuable guidance.

The concept of COI is also helpful for assumption of liability. For example, when A corp. assumes a large liability of T corp., it may not qualify as type C reorganization under the COI requirement in the U.S. because shareholders’ equity is so thin that creditors, in substance, own the propriety interest of corporation.⁴⁴ But same type of transaction could qualify in Japan, because Japanese law does not have the same type of COI doctrine as U.S. law.

D. Boot relaxation rule

part, in connection with the business of the stock company or the limited liability company which is divided (*Companies Act*, Art. 2(xxix)).

40 For the Japanese law, see Hideki Tomonaga-Hiroshi Yamada, “*Kaisyū Bunkatsu touno Soshiki Saihensei ni kakaru Zeisei nituite*” (2000) 614 *Sozeikenkyū* 62. For U.S. law, see Committee on Taxation of Corporations of the Association of the Bar of the City of New York, “Post-reorganization Transactions and Continuity of Shareholder Interest” (1996) 72 *Tax Notes* 1401 at 1406; Faber, “Post-Reorganization Sales and Continuity of Interest” (1995) 68 *Tax Notes* 863 at 873.

41 *Corporation Tax Act Enforcement Order*, art. 4-2(4)(v).

42 *Corporation Tax Act*, Arts. 2(xii)-8, 2(xii)-11.

43 See Bittker & Eustice, *supra* note 10, ¶12.24[2][a].

44 See Bittker & Eustice, *ibid.* at ¶12.24[2][b].

Although U.S. law limits qualified consideration to voting stock, it allows some amounts of boot in qualified reorganization under I.R.C. §368(a)(2)(B). There are two useful implications; (1) “flexibility;” and (2) “anti purposive disqualification.”

Firstly, if voting stock is the only consideration, it substantially prohibits a corporation from making use of its proper business organization. Japanese law allows non-voting stock as consideration, but not boot. This “no boot” requirement is extremely inconvenient and inflexible. Even if A corp. distributes only one yen to one shareholder of T corp., other shareholders who do not receive any boot will also be taxable.

If, therefore, Japanese law is to consider introducing a boot system, we have to decide how much boot should be permitted, set the rules for taxing both the distributors and the recipients, and we also have to estimate the other administrative costs, including the compliance burden. However, since this amendment is necessary to remove the inflexibility from current rule, it is something which should be done.

Secondly, under current rules, it is very easy for distribution of boot to lead to disqualification. It is important to note that disqualification does not always make taxpayers unhappy. For example, if a taxpayer has an unrealized loss and a transaction becomes a qualified reorganization, the taxpayer cannot recognize (or deduct) that loss.

Therefore some taxpayers may deliberately become parties to disqualified transactions. The stricter requirements make such transactions easier. It might be necessary to permit some amount of boot in order to prevent such transactions.⁴⁵

E. *Acquisitive type D reorganization*

When bases of assets are lower than their fair market value, if a corporation is liquidated and then reincorporated, it is possible to enjoy higher depreciation deduction. On the other hand, when bases of assets are higher than their fair market value, using the liquidation-reincorporation scheme, a corporation could realize losses, while former shareholders could still control the new corporation.

The Japanese National Tax Agency does not have the weapons to deal with deliberate disqualifications in cases such as liquidation-reincorporation abuse. Nevertheless, the answer is not for the *Corporation Tax Act*, art. 132-2 and the *Income Tax Act*, art. 157(4) to be applied easily. If we wish to combat this type of scheme, specified provisions, not general anti-avoidance rules, should be enacted and applied. I.R.C. §368(a)(1)(D), dealing with acquisitive type D reorganization, might be a good example of such a provision.

Apart from anti-avoidance rules, acquisitive type D reorganization served as a reference for the “continuity of control” in the report by the Tax Commission. For example, when A corp. transfers the assets to T corp. and receives T shares, it is possible to say that A corp. controls T corp. But that transaction cannot be treated as a qualified reorganization even if there is “continuity of control” after the transaction.⁴⁶ One of the reasons is that this type of transaction is not a reorganization under the *Companies Act*. However, if we set up requirements for qualified transactions from the tax law (not the corporation law) point of

45 I.R.C. §356(c) prohibits loss recognition from some boot distributions. See also Daniel N. Shaviro, “An Efficiency Analysis of Realization and Recognition Rules Under the Federal Income Tax” (1992) 48 Tax L. Rev. 1 at 18; Joseph Isenberg, “The End of Taxation” (1990) 45 Tax L. Rev. 283 at 315; Lawrence Lokken, “The Time Value of Money Rules” (1986) 42 Tax L. Rev. 1.

46 See Okamura, *supra* note 4, at 335.

view, as in the U.S., such a transaction could be treated as a qualified reorganization in Japan.

This would also be important in terms of the relationship with the *Companies Act* in the case of a deliberate disqualification. If A corp., which has unrealized losses, transfers the assets to T corp. and gets the control of that corporation, A corp. can realize and recognize its losses, and substantially the same shareholders can keep the same business of A corp. as before. For example, if A corp. is much larger than T corp., and A corp. transfers many of its assets to T corp., as a result, A corp. receives more than 80% of T's outstanding shares and also recognizes its losses. However, if A corp. merges with T corp. in a qualified reorganization, A corp. cannot recognize the loss.

The reason why this deliberate disqualification is possible is that the tax rules of qualified reorganizations are based on the *Companies Act*. Requirements for the qualified reorganization which are not based on the *Companies Act* should be important from an anti-avoidance perspective. In the U.S., I.R.C. §368(a)(1)(D) may be applied to the transaction above, and A corp. will not be able to recognize the loss.

F. Anti divisive transaction rules

In the U.S. type C reorganization, not only the liquidation requirements in I.R.C. §368(a)(2)(G), but also *Elkhorn* rule⁴⁷ and anti-*Morris Trust* rule⁴⁸ (I.R.C. §355(e)) are working as anti-divisive transaction rules. In the case of type A reorganization also, a transaction with a divisive character may be disqualified under the tax law even if that transaction is a merger under state law.⁴⁹

However, it is hard to discover the concept of anti-divisive transactions in Japanese tax law, because absorption-type corporate divisions under the *Companies Act* are permitted in tax law.

It is possible to understand that the basic type of acquisitive reorganization in Japanese tax law is absorption-type corporate division, and that mergers are a special case of absorption-type corporate division. The transaction under which a corporation transfers all of its assets and liabilities to another corporation, receives the stocks of that corporation as a consideration, distributes that stock to its shareholders, then liquidates, is called as merger.⁵⁰ The transaction under which a corporation transfers part of (not all of) its assets and liabilities to another corporation may become corporate division. Accordingly, in absorption-type corporate divisions excluding mergers, the transferor corporation (divided corporation) does not liquidate and remains in existence. This is a distinctive characteristic of Japanese acquisitive reorganization (absorption-type corporate division) compared with type A or type C reorganization in the U.S.

47 *Helvering v. Elkhorn Coal Co.*, 95 F. 2d 732 (4th Cir. 1937), cert. denied, 305 U.S. 605, reh'g denied, 305 U.S. 670 (1938). See Harold R. Handler, "Variations on a Theme: The Disposition of Unwanted Assets" (1980) 35 Tax L. Rev. 389; and Bittker & Eustice, *supra* note 10, ¶12.24[2][c].

48 *Commissioner v. Morris Trust*, 367 F. 2d 794 (4th Cir. 1966). See Stuart M. Finkelstein & Stuart Lazar, "IRS Overhauls Spin-Off Ruling Guidelines" (1996) 74 Taxes 366 at 372; Scott E. Stewart, "New Rules for Spinoffs: An analysis of Section 355(e)" (1998) 51 Tax Law. 649 at 651; Richard Reinhold, "Section 355(e): How We Got Here and Where We Are" (1999) 82 Tax Notes 1485; and Scott Polsky, "The Cause & True Effects of Code Sec. 355(e)" (1998) 76:9 Taxes 29.

49 Rev. Rul.2000-5, I.R.B. 436. See Steven A. Bank, "Taxing Divisive and Disregarded Mergers" (2000) 34 Ga. L. Rev. 1523, at 1525.

50 See Okamura, *supra* note 4, at 329.

Certainly, looking at absorption-type corporate division from point of view of the acquiring corporation, the transaction has acquisitive elements (acquiring the target business). On the other hand, however, looking at it from the point of view of the target corporation, there are divisive factors (dividing the target business). If Japan allows divisive transactions to be governed by the same rules as acquisitive transactions, the Diet or the Government should explain the reason why the two types of transaction are not treated differently, as in the U.S.

However, perhaps the issue of whether an independent business unit is transferred or not, or, if there is a transfer, whether the same business is subsequently continuing or not, may really be the distinction between sale and qualified reorganization.⁵¹ From a policy perspective, these criteria could offer possible answers from a Japanese tax law perspective, although they are not sufficient to resolve the matter. We need to understand that selective transfer of assets resembles a sale. Mergers, in which all assets of target corporation come into acquiring corporation, differ from absorption-type corporate divisions, in which only part of the assets of a target corporation are extracted selectively and transferred to an acquiring corporation. The latter transaction is similar to a sale of assets.

Indeed, selected transferred assets still remain in the acquiring corporation. So there are chances to be taxed in future. However, this view may permit tax deferral for target assets as far as these assets remain in a corporate entity (the acquiring corporation), which doesn't seem right.

Moreover, at the very least, we need to consider what is the independent business or the continuity of business from the tax law (not corporation law) point of view. Also, there should be explanations as to why independent business transfers and business continuity are treated differently from mere asset sales.⁵² It is hard to discover this from the current provisions. In particular, since qualified considerations are not limited to voting stock, current tax rules in Japan cannot distinguish well between sales and qualified reorganizations. The position is quite different from that in the U.S.

IV. CONCLUSION

U.S. tax law has extended the scope of acquisitive reorganizations from type A to type C by setting independent requirements not based on state law. On the other hand, it protects against tax avoidance schemes.

The requirements of type C reorganization are embraced by two principal concepts: (1) COI and (2) anti-divisive transactions. First of all, COI should be adapted so that Japan pays attention more to the shareholder level than to the corporate level, and looks at how shareholders keep their interest (investment) in reorganized corporate forms. The meaning of "continuity of control" and "continuity of investment" in the Tax Commission report is esoteric and does not always correspond to current provisions.

51 *Corporation Tax Act*, Arts. 2(xii)-8(b) and 2(xii)-11(b).

52 See American Law Institute, *Federal Income Tax Project Subchapter C: Proposals of The American Law Institute on Corporate Acquisitions and Dispositions and Reporter's Study on Corporate Distributions* (American Law Institute, 1982) at 43, 72 and 96.

The rationale for tax deferral treatment should be reconstructed under the concept of COI.⁵³ I would suggest that (1) qualified consideration should be limited to voting stock; (2) a regular boot should be permitted; and (3) some of the requirements for qualified reorganization could be explained from the anti-avoidance viewpoint.⁵⁴

Secondly, preparing for anti divisive transactions would also be important. U.S. law distinguishes divisive transactions, which resemble sales of assets by target corporations, from acquisitive transactions. Generally the requirements for qualified divisive reorganizations are much more restrictive than for acquisitive ones.

One may question why the Diet in Japan has not addressed its mind to the problems inherent in divisive transactions. One of reasons might be that starting point for reorganization came under the aegis of corporation law, when the qualified reorganization rule was first introduced in *Corporation Tax Act* in 2001. In other words, the Diet might have missed the divisive nature of absorption-type corporate division simply because it is allowed under the *Companies Act*.

Would it be better to use the starting point for qualifying requirements as the *Companies Act* or to set an independent requirement? One possible answer to this question may lie in terms of cost. Unlike in the U.S.,⁵⁵ tax law and corporation law are part of the same national law in Japan. Japanese tax law is able to follow corporation law more easily than would be the case in the U.S. Since U.S. corporation law may vary from state to state, the U.S. needs unified criteria for federal tax purposes. Accordingly it is possible to say that Japan could make tax rules cost less than would be the case in the U.S.

Nevertheless we still need tax rules which are not based on the *Companies Act*, because the *Companies Act* was not enacted to address tax issues. Even if the screening requirements were to be based on the provisions of the *Companies Act*, we should still have a safety-net with other criteria to catch transactions which are similar to mergers or corporate divisions but which do not fall under the *Companies Act*. Such thinking is also necessary to deal with the issues arising from deliberate disqualification.

Had the Diet looked into these matters when the tax rules on reorganization were first introduced in 2001, it might have been easier to build up the concept of qualified mergers or corporate divisions in tax law, without basing these concepts on corporation law. This might have led to consideration of essential points such as the appropriate rationale for tax deferral, the differences between sale and reorganization, and what requirements might be appropriate. However, it is not too late. We are still in the early stages of development when compared to the U.S., and Japan may be able to introduce comprehensive legislation in this field and thus be able to develop a consistent and predictable model for reorganization transactions.⁵⁶

53 If Japan were to introduce the COI concept, the rule that individual taxpayers should report their capital gains from stock might have to be introduced too. To do this, it might be better for Japan also to introduce a taxpayer number system.

54 The concept of remote COI is also useful for triangular reorganizations.

55 See Goldman, *supra* note 26, at 32.

56 In U.S. law, it is often difficult to understand the relationship (and possible overlap) between the rules for each type of reorganization because of the long history of the legislation, and its many amendments. For policy considerations, see American Law Institute, *supra* note 52. See also Robert Charles Clark, "The Morphogenesis of Subchapter C: An Essay in Statutory Evolution and Reform" (1977) 87 Yale L. J. 90.