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Topics

Amendment to the Tax Law

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I. Introduction

On December 16, 2022, the Liberal Democratic Party released the outline for the 2023 Tax Reform ("**Outline**") which mainly focuses on revitalizing the economy by distributing assets and funds to various sources. The congress passed tax law amendment ("**Amendment**") in relation to the Outline on March 28, 2023, and the Amendment was published on March 31, 2023 and became effective on April 1, 2023 unless otherwise stipulated.

In this newsletter, we will introduce the main content of the Amendment to the tax law related to corporate matters such as (i) the Spin-off, (ii) the Qualified Stock Option, (iii) the Share Delivery and (iv) the Global Minimum Tax Rules. The law amended by the Amendment shall be called the "Amended Laws" hereinafter.

II. Spin-off

1. Prior to the enactment of the Amended Laws

A stock distribution type spin-off is a transaction in which a company deliver shares of its existing wholly-owned subsidiary to its shareholders so that such subsidiary's business will be independent

from such company.

If a stock distribution type spin-off falls under a qualified reorganization, (I) shareholders of a company executing a spin-off ("**Spin-off Parent Company**") shall be exempt from taxation on distribution of the shares of the wholly-owned subsidiary of the Spin-off Parent Company ("**Spun-off Company**") and (II) taxation on capital gains on transfer of shares of the Spun-off Company by the Spin-off Parent Company to its shareholders shall be deferred. Prior to the enactment of the Amended Laws, the following requirements had to be met in order for a stock distribution type spin-off to fall under a qualified reorganization.

A) Non-Controlling

The Spin-off Parent Company is a corporation that is not controlled by any other person immediately prior to the spin-off, and the Spun-off Company is not expected to be controlled by any other person after the spin-off. In this context, "controlled" generally means a relationship in which 50% or more of the shares are held by any other person.

B) Proportional Delivery of Only Shares

Only shares of the Spun-off Company are delivered to the shareholders of the Spin-off Parent Company in proportion to the number of shares held by the shareholders of the Spin-off Parent Company and all of the shares of the Spun-off Company are delivered to the shareholders of the Spin-off Parent Company.

C) Continuity of Employees' Engagement

It is expected that approximately 80% or more of the employees of the Spun-off Company will continue to be engaged in the business of the Spun-off Company.

D) Continuity of Main Business

The Spun-off Company's main business is expected to continue to be conducted by the Spun-off Company after the spin-off.

E) Continuity of Specified Officers' Engagement

Not all of the presidents, vice presidents, representative directors, representative executive officers, senior managing directors and executive managing directors, or any persons equivalent thereto who are engaged in the management ("**Specified Officers**") of the Spun-off Company will retire upon the spin-off.

2. The Amended Laws

Under the Amended Laws, a stock distribution type spin-off which meets the following requirements also falls under a qualified reorganization.

A) Business Restructuring Plan

The Spin-off Parent Company must have obtained approval of the competent minister for its business restructuring plan under the Act on Strengthening Industrial Competitiveness between April 1, 2023 and March 31, 2024.

B) Proportional Delivery of Only Shares

Only shares of the Spun-off Company are delivered to the shareholders of the Spin-off Parent Company in proportion to the number of shares held by the shareholders of the Spin-off Parent Company.

C) Continued Shareholding Percentage

The number of shares of the Spun-off Company held by the Spin-off Parent Company immediately after the spin-off must be less than 20% of the total number of shares issued and outstanding of the Spun-off Company.

D) Continuity of Employees' Engagement

It is expected that approximately 90% or more of the employees of the Spun-off Company will continue to be engaged in the business of the Spun-off Company.

E) Non-Controlling, Continuity of Main Business, and Continuity of Specified Officers' Engagement

The Spin-off Parent Company and the Spun-off Company need to satisfy the same requirements as described in item 1-A), 1-D) and 1-E) above.

F) Granting of Stock Options, etc.

Stock options have been granted or are expected to be granted to the Specified Officers of the Spun-off Company, etc.

Prior to the enactment of the Amended Laws, all shares of the Spun-off Company have to be distributed in order to fall under a qualified reorganization as described in item 1-B) above. But under the Amended Laws, as described in item 2-C) above, the Spin-off Parent Company may retain less

than 20% of the shares of the Spun-off Company. However, as described in item 2-A) above, this Amendment is a temporary measure and therefore the business restructuring plan must be approved under the Act on Strengthening Industrial Competitiveness between April 1, 2023 and March 31, 2024. Please note that the revision to allow spin-offs of subsidiaries other than wholly- owned subsidiaries as qualified reorganizations, which was described in the METI's 2022 tax reform request, has not been included in the Amended Laws.

III. Qualified Stock Option

Under Japanese tax law, a beneficial tax treatment is provided to qualified stock option (i.e. no tax will be imposed upon acquisition or exercise of qualified stock option and holder of qualified stock option will be subject to income tax on the capital gain arising from the sales of shares acquired upon exercise at a flat rate.).

For the purpose of encouraging the hiring of human resources for (a) deep tech companies which require a long period for business development and (b) startups which intend to grow significantly by taking a long unlisted period in order to expand their business to overseas actively, one of the requirements for qualified stock option with respect to the exercise period has been eased as follows. Prior to the enactment of the Amended Laws, as one of the requirements for the qualified stock option, stock options must be exercised within the period from the date 2 years after the date of the resolution to grant such stock option to the date 10 years after the date of such resolution. Under the Amended Laws, the maximum period of 10 years may be extended to the date 15 years after the date of resolution of grant, so long as the stock option meets some requirements, such as being granted by unlisted companies that have been in business for less than 5 years since their incorporation at the timing of granting the stock options.

Please note that stock options which are granted from foreign parent companies to officers or employees of Japanese subsidiaries are not treated as qualified stock options.

IV. Share Delivery

The share delivery is a reorganization in which a stock company ("**Share Delivery Parent Company**") makes a target company a subsidiary by acquiring shares of the target company ("**Share Delivery Subsidiary Company**") from the Share Delivery Subsidiary Company's shareholders in exchange for its own shares or other consideration. Both Share Delivery Parent Company and Share Delivery Subsidiary Company need to be Japanese corporations.

Shareholders of the Share Delivery Subsidiary Company who accept the share delivery are eligible for deferral of taxation on their capital gain, under the condition that the value of the shares of the Share Delivery Parent Company is at least 80% of the total value of the assets received by the shareholders of the Share Delivery Subsidiary Company as consideration of the share delivery ("**Share Delivery Tax Deferral**").

The Share Delivery Tax Deferral is not applicable to non-Japanese residents or overseas corporations unless the capital gains or losses arising from a share delivery is attributable to their permanent establishment in Japan. However, even if the Share Delivery Tax Deferral is not applied to non-Japanese residents or overseas corporations, the capital gains or losses arising from a share transfer by non-Japanese residents or overseas corporations owing to share delivery by a Japanese company is subject to income tax or corporation tax in limited cases where, for example, such share transfer falls under the 25-5 percent rule or the transfer of the shares is of a real estate-related corporation and this taxation is not exempted under applicable tax treaty.

Under the Amended Laws, in light of concerns that the Share Delivery Tax Deferral is being used for private tax avoidance by owners of the listed companies in a manner that they transfer the shares of the listed companies to their private asset management company, in the case where the Share Delivery Parent Company falls under the category of a family corporation (which is generally defined as a corporation in which three or fewer groups own 50% or more of the shares) after the share delivery, will be excluded from the Share Delivery Tax Deferral, provided, however, that a nonpersonal family corporation (which is generally defined as a corporation that would not be a family corporation if a non-family corporation is excluded from the shares used as the basis for determining a family corporation) is excluded from the category of a family corporation. This amendment of the Share Delivery Tax Deferral will be applied to share deliveries executed on and after October 1, 2023.

V. Global Minimum Tax Rules

The Global Minimum Tax Rules consists of the Income Inclusion Rule ("**IIR**") which will be applied to subject fiscal years beginning on or after April 2024, and the Undertaxed Profits Rule ("**UTPR**") which will be enacted into law in the tax reform of 2024 and thereafter.

The Global Minimum Tax Rules is applied to multinational corporate groups with total revenues of at least 750 million euros in two or more of the four fiscal years immediately prior to the subject fiscal year ("**Specified Multinational Corporate Group(s)**"). The Global Minimum Tax Rules do not apply

to companies belonging to the Specified Multinational Corporate Groups located in countries where the average amount of income of such companies is less than 10 million euros and the average amount of profit or loss of such companies is less than 1 million euros. The average amount of income and profit or loss is calculated based on the amounts for the subject fiscal year and the two fiscal years immediately prior to the subject fiscal year.

The IIR is a taxation rule under which the ultimate parent company located in Japan can be subject to taxation in Japan which is basically calculated by multiplying the income of a subsidiary by the difference between the minimum tax rate (15%) ("**Minimum Tax Rate**") and the effective corporate tax rate in the country where the subsidiary belonging to the Specified Multinational Corporate Group is located in the case where such effective corporate tax is less than the Minimum Tax Rate.

As mentioned above, the IIR is a tax rule of income aggregation to a parent company when its subsidiary is located in a country with less tax burden. Even if the parent company is located in a country with less tax burden, the parent company cannot be subject to taxation under the IIR if the IIR is not enforced in the country where the parent company is located. In order to address this issue, under the UTPR, if the tax burden of a parent company is less than the Minimum Tax Rate, its subsidiary in Japan can be subject to taxation on the shortfall.

The Global Minimum Tax Rules are similar to the existing Controlled Foreign Company Rules ("**CFC Rules**"), but these two tax rules will coexist since the Outline states that the CFC rule will remain important as a measure to prevent tax avoidance through foreign subsidiaries even after the introduction of the Global Minimum Tax Rules.

That said, the exemption provisions of CFC rules will be amended as follows.
Prior to the enactment of the Amended Laws, if the effective tax rate of a specified foreign affiliated company in each fiscal year is 30% or more ("**Threshold**"), the domestic corporation is exempt from income inclusion. Under the Amended Laws, the Threshold will be amended to 27% or more, which will be applied to fiscal years beginning on or after April 2024.

VI. Takeaways

The main takeaways of this memorandum are:

A) A stock distribution type spin-off in which the Spin-off Parent Company retain less than 20% of the shares of the Spun-off Company may fall under a qualified reorganization.
B) The maximum exercise period, which is one of the requirements for the qualified stock option,

may be extended from 10 years after the date of the resolution to grant such stock option to the date 15 years after the date of such resolution so long as stock options meet some requirements.

C) The Share Delivery Tax Deferral will no longer apply to shareholders of the Share Delivery Subsidiary Company if the Share Delivery Parent Company falls under the category of a family corporation, excluding a nonpersonal family corporation, after the share transfer.

D) The IIR has been introduced in Japan and the UTPR is also expected to be introduced in Japan. The IIR is a taxation rule under which if the tax burden of a subsidiary of a Japanese ultimate parent company is less than the Minimum Tax Rate, such a Japanese ultimate parent company can be subject to taxation in Japan on the shortfall.

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If you have any questions regarding the matters covered in this memorandum, please reach out to your usual TMI contact or the attorneys listed below.

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Important Judicial Decisions relating to Shareholders' Meetings

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I. Introduction

In 2021, Japanese courts issued two important decisions with respect to the Companies Act of Japan (the "**Companies Act**") relating to shareholders' meetings. We first discuss in this Newsletter a case where the court stated that shareholders have the right to make advisory proposals (i.e., proposals that do not always come to realization) at shareholders' meetings, in connection with the purpose of the shareholders' meeting. In the second case, the court concluded it was appropriate to consider the circumstances at the shareholders' meeting and not only by looking to the ballot description indicated by the submitting shareholder.

II. Shareholder's Right to Make an "Advisory Proposal" at a Shareholders' Meeting (Kyoto District Court Decision of June 7, 2021)

1. Outline

A shareholder, RMB Japan Opportunities Fund LP (the "**Proposing Shareholder**"), having 300 voting rights or more, for six months or more, of Faith, Inc. (the "**Company**"), a Japanese listed company on the First Section of the Tokyo Stock Exchange, requested pursuant to Article 303, Paragraph 1 and Article 305, Paragraph 1 of the Companies Act, that a purpose of the Company's upcoming annual shareholders' meeting (the "**Shareholders' Meeting**") should include the consideration of the Company making a dividend of all common shares of its subsidiary, NIPPON COLUMBIA CO., LTD. (the "**Subsidiary**") by way of a share-distribution-type spin-off, on the condition that (i) the Minister of Economy, Trade and Industry approves a business restructuring plan under the Act on Strengthening Industrial Competitiveness and (ii) such common shares of the Subsidiary be listed on the Tokyo Stock Exchange (the "**Proposal**"). However, the board of directors of the Company decided not to include the Proposal in the purpose of the Shareholders' Meeting, since they determined that the

Proposal to be unlawful. In response, the Proposing Shareholder filed a petition seeking a judicial determination that the Proposal was valid and the ordering of a provisional remedy requiring the Proposal be included in the purpose of the Shareholders' Meeting.

2. Court Decision

The Kyoto District Court dismissed the Shareholders' petition.

However, before reaching its decision, the Court made some noteworthy findings. First, while making a proposal to a shareholders' meeting was within a shareholders' right, the Court admitted that this Proposal had certain features. Specifically, the Court noted that the Proposal requires (a) a high degree of business judgment and (b) considerable time and effort for the approval of the business restructuring plan and listing of the Subsidiary's shares. Further, the Court explained that the business restructuring plan might not be approved by the Minister of Economy, Trade and Industry and the Subsidiary's shares might not be successfully listed. Because of these conditions and uncertainties, the Court considered that the view that the Proposal would only have an advisory meaning rather than being legally binding even if adopted by the shareholders has a "certain validity".

The Court then went on to point out that, since the Companies Act does not clearly exclude matters from the statutory proposal rights of shareholders, shareholders have right to propose matters that fall within the scope of resolutions to be considered at shareholders' meetings, unless there are special circumstances.

The Court next reasoned that, in light of this, the Proposal for a share-distribution-type spin-off is a matter that the Shareholders have a right to make, since (i) the subject of the Proposal concerned dividends of surplus, which do require resolutions of shareholders' meetings under the Companies Act,[1] and (ii) the fact that the implementation of such a dividend requires a high degree of business judgment is not sufficient to constitute a special circumstance necessitating its exclusion.

Despite these findings, the Court nevertheless dismissed the Proposing Shareholder's petition. The Court stated that the necessity of ordering provisional relief is determined based on a comprehensive consideration of the damage and risk to both parties that would be incurred if the Proposal was not approved and the disadvantage and damage that the Company would suffer if the Proposal was approved. The Court also concluded that the petition lacked necessity or urgency, noting that (i) there was no seasonal need to include the subject of the Proposal in the purpose of the Shareholders'

[1] Article 309, Paragraph 2, Item 10 of the Companies Act

Meeting, (ii) if the Proposal was approved, the Company would have to re-prepare and circulate again the reference documents for the Shareholders' Meeting, and (iii) it would be considerably difficult for the Company to circulate such documents by the statutory convocation deadline, which might make it impossible for the Company to hold the Shareholders' Meeting.

3. Key Takeaways

While the Shareholders did not prevail, this case did have some important developments that may benefit shareholders generally. In particular, the case established the principle that, unless there are "special circumstances," shareholders may have the right to make advisory proposals (i.e., proposals that do not always come to realization) if the subject matter of the proposal falls within those which require resolutions of shareholders' meetings.

- In some other jurisdictions, such as the United States, shareholders may not make proposals with respect to the consideration of specific transactions, such as a spin-off, or the operations of the company's business. Instead, shareholders can seek to elect directors who then would evaluate, approve and recommend to shareholders transactions or changes in operations sought by such shareholders.
- In contrast, since a share-distribution-type spin-off is a dividend of surplus which requires a resolution of a shareholders' meeting[2] in Japan, shareholders may have right to directly propose a share-distribution-type spin-off by a Japanese company. Importantly, this case does indicate that such a proposal can be realized upon through a petition ordering a provisional remedy if the proposal meets the requirements for provisional relief including the necessity of ordering provisional relief,[3] even if the directors of the Japanese company dismiss the proposal.
- Equally important, however, it is not clear from the judgment in this case as to what will be "special circumstances" justifying a board's exclusion of a shareholder's proposal.
- In addition, there is an argument that the directors were not obliged to prepare a business restructuring plan for the Company even if the Proposal was passed by the Shareholders' Meeting, since the Court stated that the view that the Proposal only had an advisory meaning rather than being

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[2] For a company with a board of directors, shareholders may only resolve at a shareholders' meeting the matters provided for in the Companies Act and the matters provided for in the company's articles of incorporation.

[3] Based on the Court's judgment here, cases where (i) shareholders have a highly seasonal need to include matters for a shareholder's proposal in the purpose of the targeted shareholders' meeting, (ii) shareholders may suffer specific damages if the shareholder's proposal is rejected, or (iii) the shareholder's proposal has been filed with the company well in advance and the company will not suffer any losses by including the shareholder's proposal in the meeting documents or which will not interfere with the proper holding of the meeting may be considered as being sufficient to support the granting of provisional relief.

legally binding has a "certain validity", and that Proposing Shareholder would have to next propose the election of directors who support the Proposal if the incumbent Company directors failed to prepare such plan.[4] If this is, in fact, the precedential understanding of this decision, then shareholders may be forced to propose the election of directors who support their positions if the incumbent directors do not comply with their proposals, similar to practice elsewhere. It is necessary to keep a watchful eye on future related judgments and theories in this regard.

- There is also a case in which the Tokyo High Court determined that a shareholder's advisory proposal did not fall within the matters which require resolutions of a shareholders' meeting and thus is not within the shareholder's right to propose.[5] That holding can be understood consistently with this decision of the Kyoto District Court.

III. Interpretation of Votes by Taking into Consideration Circumstances at a Shareholders' Meeting Other than the Indicated Ballot Description (Osaka High Court Decision of December 7, 2021)

1. Outline

Okay Corporation (the "**Plaintiff**") intended to make a tender offer bid for the shares of Kansai Super Market Ltd. (the "**Company**"). As a defensive response, the Company sought to integrate its management with that of another company, and held an extraordinary meeting of shareholders with the proposed share exchange as its agenda. A share exchange requires approval of a special resolution of the general meeting of shareholders (i.e., approval by two-thirds of voting rights was required).

A corporate shareholder of the Company (the "**Shareholder**") previously had submitted a voting form, stating that it was in favor of the Company's proposal. However, the director of the Shareholder also attended the extraordinary shareholders' meeting as the Shareholder's agent for the purpose of observing the meeting.

As a rule of the shareholders' meeting, if shareholders already exercised their voting rights by submitting voting forms in advance and then also attended the meeting, their prior vote would be treated as invalid or withdrawn. However, this rule was not fully explained to the shareholders at the

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[4] Hiroshi Murakami, *Acceptance or rejection of shareholder's proposals for a share-distribution-type spin-off: Kyoto District Court Decision. June 7, 2021 (Shojihomu material edition No. 449; at 90)*, Kanazawa Law, 183, 192 (2022)

[5] Tokyo High Court Decision of May 27, 2019

extraordinary meeting. As a result, the Shareholder's director mistakenly believed that the Shareholder's prior written vote would not be revoked and submitted a blank ballot at the extraordinary meeting to avoid double counting.

During the tallying process, the director became concerned about how his blank vote would be treated, and explained the purpose of his submission of a blank vote to a staff member of the Company. Based on this explanation, the chairman of the extraordinary meeting counted the Shareholder's blank ballot as affirmative votes for the share exchange proposal, consistent with the previously submitted voting form. This caused the proposal to be passed by the meeting. If the votes had been treated as abstentions—that is, the blank form submitted by the director was taken to mean no votes were being submitted by the Shareholder—then the proposal would not have passed.

The Plaintiff filed a motion for a provisional injunction against the share exchange, claiming that the Shareholder's vote was counted incorrectly, which constituted a basis for rescinding the resolution, as (i) the resolution was against the law in its method, and (ii) was extremely unfair.

2. Court Decision

The Kobe District Court sustained the Plaintiff's motion in the first instance. However, on appeal, the Osaka High Court dismissed the motion, and such dismissal was upheld by the Supreme Court of Japan.

The Osaka High Court stated in its ruling that the purpose of voting by paper ballot is to ensure the fairness of resolutions as well as to accurately reflect the will of shareholders. Therefore, the Court noted, in line with this purpose, the primary requirement is to objectively determine the contents of the vote, and generally this should be done by reference to the description indicated by the shareholder on the ballot.

However, the Court reasoned, if a shareholder is unable to properly determine what voting action to take when expressing its intention because the shareholder is unaware of certain voting rules, then the shareholder's will not be accurately reflected on the ballot. Consequently, when determining a shareholder's vote based solely on the paper ballot would be inconsistent with the purpose of accurately reflecting the will of the shareholders in the voting process, then the ballot's indicated description should not be the sole determinant.

In addition, the Court stated that if (i) the voting rule was not made known or explained in advance and the shareholder's misunderstanding of such rule was unavoidable, and (ii) if, by taking other

circumstances into consideration, it is clear that the shareholder's actual intention at the time of voting was different from what was determined based solely on the paper ballot due to this misunderstanding, and there is no risk that the treatment will be arbitrary, then exceptional treatment of looking beyond the indicated ballot description would not impair the fairness of the process by which the resolution voted upon.

Therefore, in these circumstances, the Court found that it is reasonable to permit the chairman of the extraordinary shareholders' meeting to interpret, and to tabulate, the votes of shareholders by taking into consideration circumstances other than the ballot descriptions. In this case, the director's explanation of his reasoning of submitting a blank ballot was properly considered by the meeting chairman. The Court stated that, in order to properly and accurately reflect the shareholders' intentions expressed through the exercise of their voting rights and tabulate such rights in the voting at the meeting, it would be rather preferable to look to such circumstances.

3. Key Takeaways

- This decision is the first judgment on the handling of cases where there is a discrepancy between the shareholder's intention and the description indicated on the ballot paper due to a misunderstanding by the shareholder of the voting rules, and is instructive in establishing the discretion of a meeting's chairman regarding the methods of taking and tallying votes at a shareholders' meeting.
- This case underscores the necessity of making the voting rules well known to the shareholders in order to be able to interpret their intentions solely by relying on the descriptions on their ballots.
- Notably, however, as a matter of legal theory, there is a view that an issue such as this should be handled in accordance with the Civil Code as being a matter of the miscomprehension of the shareholder's manifestation of intention, rather than permitting the meeting chairman to exercise discretion on interpreting such intention.

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