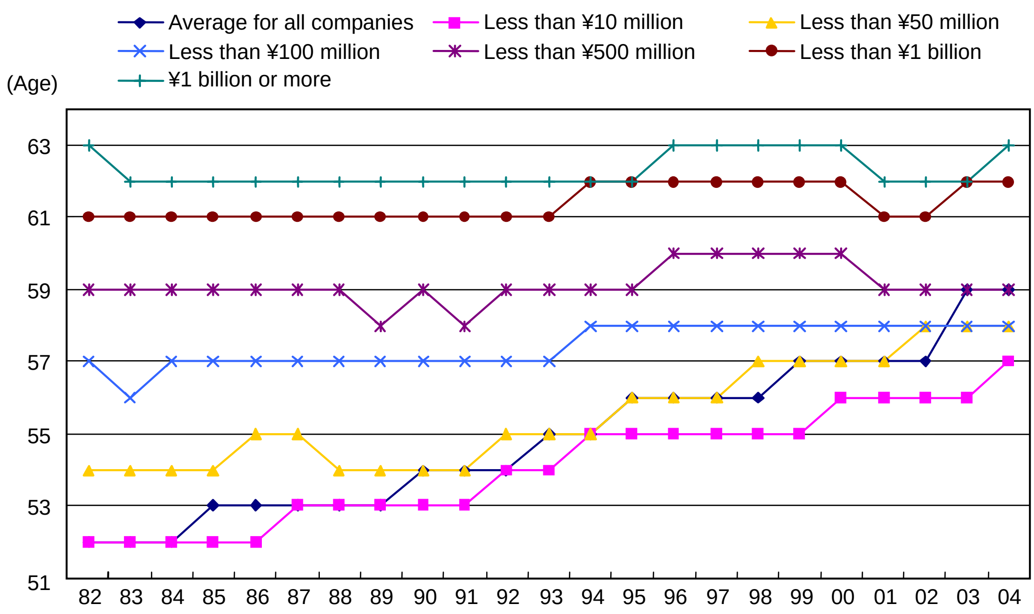
Financial Institutions and the Issue of Business Succession in Japan

Takanori Hamada

I. Introduction

In Japan, small businesses[1] account for 99% of companies and 70% of company employees. For almost 40 years they have generated a steady 55%-60% of total corporate added value and made a mark for themselves on the corporate landscape. Moreover, they have played an important role in developing new technologies and services. At the same time, however, they have felt many of the effects that increasing longevity has had on Japanese society. As can be seen in Figure 1, the average age of company presidents in Japan has been rising steadily every year, and the issue of business succession has become a growing risk for small businesses.

Figure 1 Company Capitalization and Average Age of Company Presidents in Japan



Note: Decimal places correspond to months.
Source: Teikoku Databank, "Shacho Kotairitsu Chosa" [Survey of Company President Turnover Rates].

[1] The Small and Medium Enterprises Basic Law has a different definition of what constitutes a small business for each sector. For example, the definition for "manufacturing, etc." is: "either (1) a company capitalized at not more than ¥300 million or (2) a company with not more than 300 regular employees."

The Small and Medium Enterprise Agency therefore decided to set up a study group to examine all aspects of this issue, including the response of the private sector, and come up with effective proposals. The study group has met six times since it was set up in December 2004. In considering some of the issues involved as well as the challenges and opportunities they present to financial institutions, this report refers to the study group's report[2] on its discussions between December 2004 and March 2005.

II. The Issues Involved in Business Succession in Japan

1. The burden of inheritance tax, and the system of payment in kind

In the past, many of the problems of business succession were related to the burden of inheritance tax or gift tax. In order to obtain the funds needed to pay this tax, it was often necessary to sell off some of a company's assets, and a variety of ways have been devised to reduce this burden.[3] As a result, it has been possible to avoid paying inheritance tax in all but 4.5% of cases, so it would be wrong to think that the tax burden was the only problem presented by business succession.

However, many of the cases where inheritance tax cannot be avoided involve companies that are either leaders in their local area or their field of business. Also, since the amount of tax in such cases can be significant, the issue of how this burden affects business succession still needs to be considered.

One way of dealing with this problem is to use the option to pay in kind. This option is permitted if the necessary cash is not available. In the case of companies like those mentioned above, most of the inheritance will consist of unlisted shares in which there is no market. If the tax office agrees that no other assets are available to make the payment in kind, the successor can apply to use the shares he has inherited. However, in order to obtain this approval, the local tax office must first ask the local finance bureau to investigate the case. Also, even if the formal requirements for payment in kind[4] are met (as in the case of unlisted shares in which there is no

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2 See "Jigyo Shokei Kanren Hoseito Kenkyukai Hokoku (An) — Chusho Kigyo ni Okeru Enkatsu na Jigyo no Shokei o Sapoto Suru Kankyo no Seibi" [A (Draft) Report by the Study Group on Legislation Governing Business Succession: Making It Easier to Help Small Businesses Achieve a Smooth Succession]. The author is a member.

3 These include: lower rates of inheritance and gift tax, and a larger basic allowance; special treatment for (1) housing and land used for business purposes, (2) treasury stock and (3) the deemed dividend on treasury stock sold to the family business; and the option to pay the balance of gift tax when the giver dies.

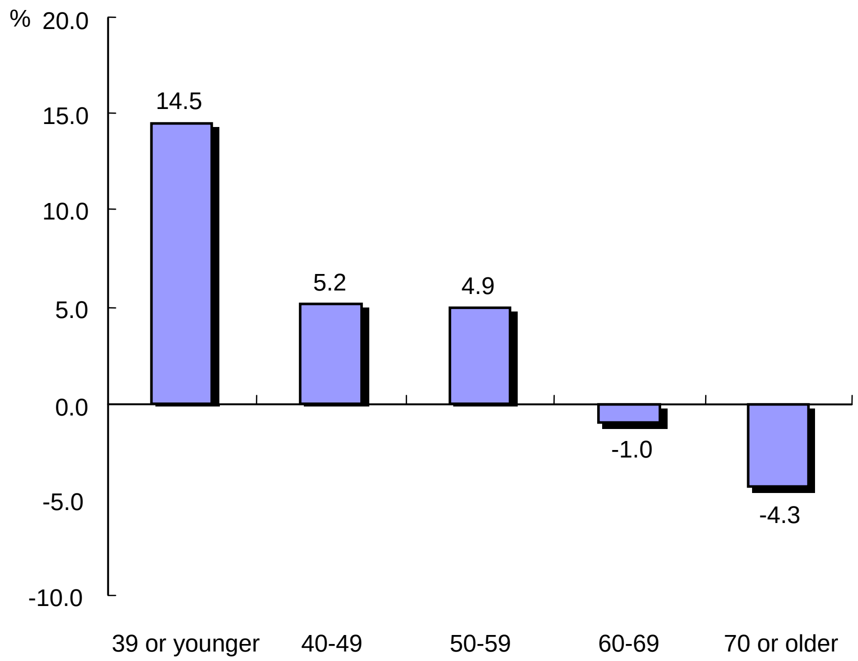
4 Following amendments to taxation law in fiscal 2002 clarifying how and the circumstances in which tax payments may be made in kind, company shares may now be used to make tax payments provided (1) there is a purchaser for the shares and (2) key indicators of the company that has issued the shares (e.g., its ratio of recurring profit to total assets) have been better than the average for companies in that sector for the previous two fiscal years.

market), it can be difficult to obtain approval because of disagreements between the tax authorities and the successor (e.g., over how the assets should be administered and disposed of).

2. Different attitudes to business succession

As was mentioned above, the average age of company presidents has increased in line with the general increase in longevity in Japan. What is interesting, however, is the fact that there is a clear correlation between the age of an owner-manager and the rate at which a company is expanding: the younger the owner-manager, the higher the rate at which the number of employees tends to grow (Figure 2).

Figure 2 Age of Owner-Manager and Rate of Growth of Number of Employees



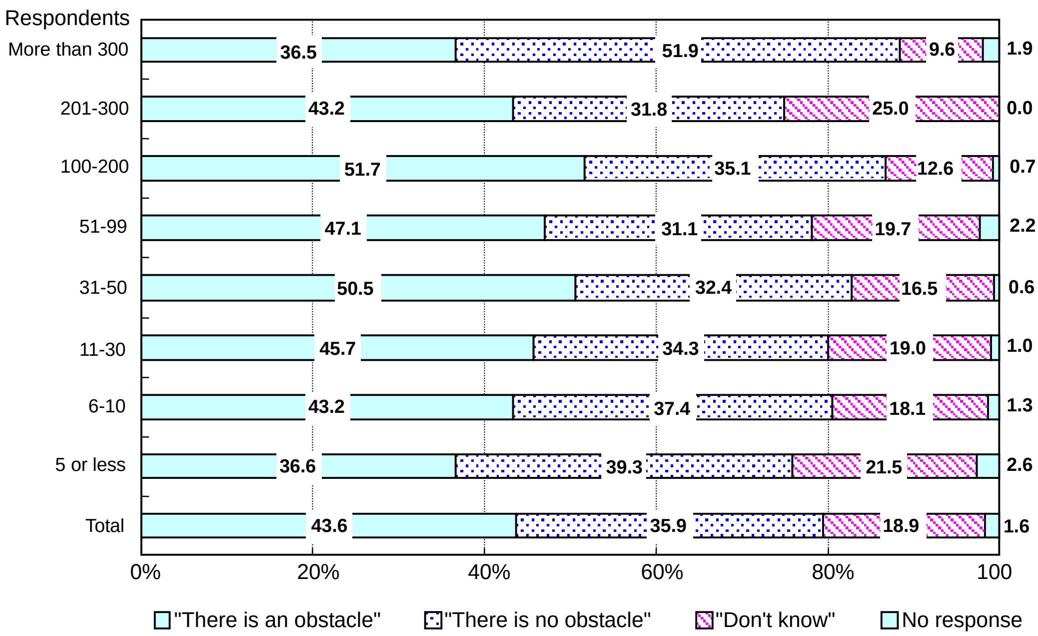
Note: 1. Ages are as of 1998.
2. Companies whose owner-manager had been in post for less than three years as of 1998 have been excluded in order to eliminate the effect of business start-ups and successions.
3. The rate of growth of the number of employees is for 1998-2003.

Source: Ministry of Economy, Trade and Industry, "Basic Survey of Japanese Business Structure and Activities," 1998; Ministry of Economy, Trade and Industry/Small and Medium Enterprise Agency, "Basic Survey on Commercial and Manufacturing Structure and Activities," 1998; Small and Medium Enterprise Agency, "Survey of Corporate Management," December 2003.

This suggests that reducing the age of a company's owner-manager will tend to increase the rate at which it expands and that this could prove an effective means of maintaining and even increasing levels of employment.

Another point that should be noted is that, while 40% of owner-managers see some obstacle to the transfer of their businesses, nearly 20% are either not particularly concerned or do not see it as their problem (Figure 3).

Figure 3 Obstacles to a Smooth Business Succession



Source: "Jigyo Shokei ni Kansuru Anketo" [Business Succession Questionnaire], 2001.

This latter attitude is particularly common among owner-managers with a strong sense of ownership. There are probably many companies where employees find it difficult to talk about who will take over from the existing owner-manager and where it is impossible to do anything about it until he dies.

Normally, one would expect a company's creditors to be concerned that ownership was transferred smoothly. In the case of the kind of owner-manager mentioned above, however, they tend to more concerned about losing business as a result of raising the subject and to treat it as a private matter. It seems that in Japan the perceived vested interests of all those concerned with business succession create an atmosphere where it is impossible to confront the issue head on and that this has led to a conspiracy of silence about the problem. There have been numerous cases where the unexpected has happened and disagreement over the succession to a business has resulted in court action that has threatened not only the future of the business but its very survival.

In fact, there is a wide range of options available to an owner-manager in this situation. These range from transferring some of his authority to his successor or sounding out the views of senior management to transferring some of his shares in the company to his successor in advance. The better prepared a company is for the succession of its business, the more likely the process is to go smoothly.

3. The problem of finding a successor

In Japan it is becoming less common for the owner-manager of a company to be succeeded by his son or another relative, and in nearly 40% of cases the successor is someone from outside the family.[5] There are various possible reasons for this, including changing attitudes to work, but one major factor is probably the uncertain future that many companies face as business becomes increasingly competitive. This is particularly true of local companies, with some owner-managers preferring to sell out rather than ask their family to assume the not inconsiderable risk of running a business.

Moreover, even if a successor is found, there is no guarantee that he will be accepted by the employees and be able to do his job properly. Unlike the United States or Europe, where there is a well developed market in managers, in Japan companies normally groom their own managers. With more than half of owner-managers reporting that a lack of proper in-house manager training poses a threat to the succession of their businesses, the training and selection of a successor is one of the most serious problems facing small businesses in Japan.

4. The problem of securing ownership

Even if a successor is found who is accepted by the employees, he will still need to have the financial resources to secure his right of ownership. A successor to a small business will need to have the company's shares valued and, if he is also the son or another relative of the previous owner-manager, follow the process governing inheritances, gifts and share purchases before he can become the actual owner. He will therefore need to have the financial resources to purchase the shares or pay inheritance and gift tax; but, the more successful the company, the higher the likely estimated value of the shares. As a successor will need to have the necessary financial resources before he becomes president, this can often prove to be an obstacle. It is also difficult for financial institutions to lend a successor money unless the succession issue has been resolved, and public-sector financial institutions will not even consider lending money for tax payments as they regard this as a personal matter.

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5 See Tokyo Shoko Research, "Kokeisha Kyoiku ni Kansuru Jittai Chosa" [Survey of Training Opportunities for Business Successors], 2003.

According to a survey by the Small and Medium Enterprise Agency,[6] the larger the company, the more likely a lack of financial resources is to prove an obstacle to the succession of the business, with more than two thirds of companies employing between 200 and 300 employees reporting that they have been affected in this way.

Establishing who exactly owns a company can also be a major problem. Generally speaking, the older a company, the more dispersed its shareholders are likely to be. If shares are held not only by an owner-manager's relatives but also his associates, ownership can become even more dispersed when the latter die and the shares are passed on. Also, even if a successor is able to secure the financial resources he needs to make good his claim to ownership, he may not always succeed in persuading shareholders to part with their shares if they cannot agree on a price. Even if all the shares are passed on or gifted to members of the same family, disagreements among the heirs can arise where an attempt has been made to concentrate ownership (e.g., as a result of each descendant's right under Japanese law to a certain portion of the estate[7]).

Because of problems such as these, many owner-managers see the issue of business succession in a negative light. There may also be a perception gap where some owner-managers have a weak grasp of what exactly is involved in business succession and others wrongly assume that their successor will face a huge inheritance tax bill even though they (the owner-managers) have never calculated what their shares are worth or what their successor's inheritance tax liability would be.

And even some of those owner-managers who have an accurate perception of the issue of business succession are unsure what they should do or keep their concerns to themselves because they do not know anyone they feel they can discuss them with.

There are a number of serious obstacles to making business succession easier in Japan: namely, the low level of awareness of the problem among owner-managers, the absence of detailed advice and solutions, and the absence of a nationwide assistance network, including a shortage of points of contact with private-sector business succession specialists working for financial institutions, law firms and tax consultancies.

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6 See Small and Medium Enterprise Agency, "Jigyo Shokei ni Kansuru Anketo" [Business Succession Questionnaire], 2001.

7 Under Japanese law, spouses and lineal descendants are guaranteed a certain portion of an inherited estate, and this right cannot be violated by specific testamentary gifts and the like. This means that, if a large proportion of an inherited estate consists of company shares, there are limits on specific testamentary gifts and living gifts that exceed this guaranteed portion. An heir who has received such a gift is obliged to repay the amount by which it exceeds another heir's guaranteed portion if the latter makes an official request for this to be done.

For the successor, succeeding to a business is similar to starting a new business but using existing resources. For a company unable to find a successor, it represents an opportunity to try to turn the business around by reorganizing it or injecting fresh blood. The company therefore needs to consider a wide range of issues and options. For a financial institution, it represents an opportunity to offer the new owner-manager a range of services, including private banking and investment banking (e.g., advice on management buyouts or mergers and acquisitions). However, there are only a limited number of companies to which such services can be offered cost-effectively. Moreover, the fact that there is always a financial or tax risk involved means that not many financial institutions have been queuing up to provide such services.

III. Business Succession Support Services and Some of the Challenges They Face

1. Business and human resource matching support services

In order to help companies with their business succession, a number of chambers of commerce and industry have shown a lead by providing business succession support services or by trying to match potential successors to businesses. For example, according to the White Paper on Small and Medium Enterprises in Japan 2004, the Nagano Chamber of Commerce and Industry discovered in a needs analysis of 14,000 businesses in its area that roughly 4,000 were considering going out of business because they were unable to find a successor. Because of its concern about the effect that the disappearance of such a large number of businesses and jobs would have on both the region's economy and its culture, the Chamber set up a "business support center" in 2002 in an effort to find suitable successors. The center's information campaigns and seminars are gradually bearing fruit as the number of successful matches has grown from five in 2003 (its second year of existence) to 12 in (December) 2004. Other chambers of commerce and industry, including the one in Tokyo, have followed suit. Efforts are also under way to extend this kind of service to neighboring prefectures. For example, on its website the Japan Chamber of Commerce and Industry provides a nationwide human resource matching service[8] that coordinates the efforts of some 30 regional branches and organizes seminars and meetings. Nor are such efforts confined to chambers of commerce and industry: one of the major trust banks now offers a fee-based business succession consulting service.[9]

Efforts of this kind help companies to understand the implications of business succession and to plan well ahead so as to avoid some of the pitfalls. At the same time,

[8] The website's URL is http://www.objinzai.jp/index.html.
[9] See Nihon Keizai Shimbun, "Jigyo Shokei Yuryo de Shinan: Mitsubishi Shintaku Chushomuke Shinsabisu" [Mitsubishi Trust & Banking Offers Fee-Based Business Succession Consulting Service], 14 October 2004.

increasing longevity increases the need for a nationwide business succession support center providing an interregional M&A matching service and for greater cooperation among regional networks.

However, although this kind of human resource matching is a good way of obtaining primary data from websites, there are many things (e.g., compatibility with other employees) that cannot be assessed by data alone. In many cases, it is a matter of "nice packaging with meager contents that need to be improved." Human resource matching is actually a very hit-and-miss business presenting major challenges such as how to improve the contents of the packaging in terms of both quality and quantity, and how to train people who can make the most of the packaging.

One way of meeting these challenges would be to strengthen ties with smaller, regional financial institutions, which need to contribute more to their local regions, especially by reviving their economies and making it easier for local businesses to gain access to finance. For example, the major trust bank mentioned above is apparently considering forming an alliance with one or more regional banks. However, there are limits to what can be achieved when relationship banking is limited to particular regions. Small local businesses are likely to find more human resource matches and be involved in more M&A deals if they have greater access to a nationwide information network.

2. Support from government-backed financial institutions

As was mentioned above, public-sector financial institutions currently will not lend money to pay taxes as part of a business succession. Nor will government-backed financial institutions offer loans for leveraged buyouts.

Similarly, the Organization for Small & Medium Enterprises and Regional Innovation, Japan (SMRJ), which invests in funds designed to help either venture businesses during their first seven years or small businesses that are trying to achieve a turnaround or to make a fresh start, does not invest in M&A and management buyout funds designed to facilitate business succession.

Although there must clearly be limits to the extent to which public-sector financial institutions can lend money or invest in funds to help companies pay taxes, greater assistance will hopefully be offered, especially by government-backed financial institutions, for as wide a range of purposes as possible, including loans and funds for leveraged buyouts. There is also ample scope for small regional financial institutions to participate in such loans. There have already been examples of such cases, and, hopefully, they will gain more experience of turnarounds and become more involved in business successions where the successor is not a family member.

3. Training successors

Chambers of commerce and industry (see above) offer training courses in skills ranging from personnel management to finance and accounting for both owner-managers and employees. There are also courses on setting up in business for the first time and in branching out into new business areas for both successors and existing owner-managers looking to overhaul their businesses. The Institute for Small Business Management and Technology offers a similar range of courses, and anyone who either owns or manages a small business can apply.

A number of private-sector institutions have also developed all-round training courses for business successors,[10] and this is an area where local universities could play a more active role. One of the main responsibilities of universities is to produce graduates who can meet the demands of society. However, cooperation between small businesses and universities leaves much to be desired.

In a recent interim report[11] the Central Council for Education recommended that universities should try to differentiate themselves by focusing more on particular areas: global excellence in teaching and research; higher vocational training; broad vocational training; lifelong education for the local community; and contributing to society (contributing to local community and acting as an interface for business, academia and government). As well as cooperating with local small businesses and developing the best programs possible, they will need to ensure that the work experience they offer their students is more than just experience and actually helps to solve some of the problems small businesses face by cooperating with these businesses to ensure that their educational programs are practical. Moreover, the curriculum of many law schools is currently designed mainly to help students pass their bar exams. In future, they will increasingly need to turn out legal specialists in areas such as M&A and corporate turnaround.

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10 Nihon Keizai Shimbun, "Chusho no Kokeisha Kyoiku: LEC Daigaku ga 4nensei Kosu" [Training Courses for Successors to Small Businesses: LEC Tokyo Legal Mind University Offers a Four-Year Degree Program], 6 October 2004.

11 See Central Council for Education, "Wagakuni Kotokyoiku no Shoraizo (Chukan Hokoku)" [The Future of Higher Education in Japan (Interim Report)], 20 December 2004.

IV. The Future

There are two main types of business succession: those where the successor is a family member ("family succession") and those (e.g., involving mergers and acquisitions) where he is not ("non-family succession"). In both cases, choosing the right person and ensuring that he is trained properly are vital. The rest of this report considers some likely trends in areas other than human resources.

1. Family succession

The most important consideration in the case of family succession is what to do about the company's capital. Theoretically, it is possible to overcome some of the constraints on concentrating ownership by including restrictions on transferring shares in the company's articles of incorporation. Alternatively, classified stock can be used to bequeath shares with limited voting rights to members of the family other than the successor. However, classified stock is a new concept in Japan, and practice has still to catch up with theory. Therefore, very few small businesses have made any use of this device.

Another means of concentrating ownership would be to use a trust. However, trusts are still not widely used in Japan—partly because their use requires a high degree of expertise, and partly because concrete strategies involving the use of classified stock to ensure a smooth business succession have still to be worked out. And, even if they were worked out, the lack of a method of valuing non-listed classified stock would make it difficult to determine their asset value. The absence of such a method is probably one of the main reasons why lawyers, accountants and financial institutions in Japan have yet to come up with a good solution for business successions.

Business succession within a family can also involve disputes among family members over the distribution of the estate that can affect the succession itself. More needs to be done to make it easier for owner-managers to draw up business succession plans using living gifts or specific testamentary gifts. They need to be made more aware (e.g., by information campaigns) of the implications of business succession and of the need to make such plans. More also needs to be done to make share valuations more transparent in order to reduce inheritance disputes.

1) Examples of solutions for business succession plans

(1) Developing a model for classified stock

It will probably become increasingly important for owner-managers of small businesses to decide where they want to strike a balance between equity and voting rights, and how exactly to classify the company's shares in terms of voting rights, dividends and the distribution of residual assets. Bequeathing the shares to the successor and any other members of the family should then ensure a smooth business succession. However, careful consideration will need to be given to how the shares are classified, and considerable experience of the procedures for doing this will be necessary.

(2) Simplifying the inheritance procedures

Heirs sometimes waive their right under Japanese law to a certain portion of the estate or to their right of inheritance in order to avoid disputes with other heirs, but the procedure for making such a statement in the family court is complicated. It would therefore be desirable from the point of view of reducing the administrative burden of business succession if this procedure could be simplified by using the services of a notary public instead.

(3) The use of trusts

As the Trust Business Law as amended has made it possible for more people to act as trust advisers, greater use can be expected to be made of trusts in business successions.

For example, it may be possible to use a stock administration trust to set up a third-party beneficiary trust with an heir as the beneficiary. However, it is not clear how the tax rules and the sections of the Commercial Code governing trusts should be interpreted. Further study is needed as well as official guidelines.

More also needs to be done to encourage the use of testamentary trusts in order to minimize the number of problems caused by inheritances.

2) Making share valuations more transparent

The solutions proposed above all presume that more will be done to make share valuations more transparent. For example, if greater use is to be made of classified stock, there is an urgent need to establish a method of valuing unlisted classified stock (e.g., by valuing preferred and deferred stock using the same method as for corporate bonds), taking into account the implications for tax law.

Also, it would be better to carry out more detailed studies of valuing shares for inheritance purposes in advance instead of waiting for particular cases to occur.

Finally, a majority of the study group agreed that the Inheritance Tax Law Basic Circular's rule that shares in which there is no market do not qualify as "assets inappropriate for administration or disposal" should be applied more flexibly to allow them to be used to make tax payments in kind. Hopefully, the tax authorities will consider such proposals.

2. Non-family succession

The most important consideration in the case of non-family succession is how to find a successor or a buyer for the business. Mention has already been made of business and human resource matching services. These tend to emphasize the number of deals they have arranged, but more attention should be paid to the quality of their service.

The key to future success will be whether a nationwide matching network can be set up and a better service provided. Here small local financial institutions have an important role to play. Shinkin banks and other cooperative financial institutions have been trying to strengthen the ties between their central bodies (e.g., Shinkin Central Bank) and their local branches. However, more should also be done to strengthen ties with the existing human resource matching networks (run by organizations such as the chambers of commerce and industry) in order to improve their service.

More could also be done to encourage the use of mergers and acquisitions in business succession. In recent years companies have emerged that specialize in arranging mergers and acquisitions involving small businesses. However, although their success rate is improving, it could be better. As in the case of human resource matching, the main reason for this is a lack of information—especially about prospective buyers. The negative image attached to selling a business is probably partly responsible for this. Many owner-managers of small businesses are reluctant to disclose information even to their banks, far less private-sector M&A specialists. The matching business needs to be radically overhauled.

Another effective solution in non-family business successions is the management buyout, where managers and some of the employees purchase part of a company. Obtaining the necessary cash, however, can be difficult, and there have been fewer buyouts than might have been expected.

V. Conclusion: The Role of Financial Institutions

This report has examined some of the issues and challenges involved in business succession with reference to the Small and Medium Enterprise Agency study group's report on its discussions between December 2004 and March 2005. In this final section, the author would like to give his personal views on the role that financial institutions can play in this area.

Helping small businesses to ensure a smooth succession is one of the main challenges facing small local financial institutions in their efforts to develop a relationship banking capability and was the subject of a report recently published by the Financial Services Agency.[12] Trying to maintain a commitment to the local economy while improving profitability is no easy task for such institutions in that both new areas of business such as turnarounds and market-based business as well as more established areas such as business succession involve costs but offer only limited deal opportunities. In addition, small local financial institutions face fierce competition from the major financial institutions for business from the top small local companies, and their margins are being squeezed as a result. They therefore have to develop a strategy that takes this into account.

1. The costs of a commitment to the local economy

A commitment to the local economy involves considerable costs. Therefore small local financial institutions need to be sure before they commit themselves to offering a particular service and they will have to take these costs into account when tackling some of the issues facing small businesses (e.g., business succession). Generating enough profit to cover these costs is no easy matter—especially in the face of competition from bigger rivals (see above).

The only way small local financial institutions will be able to lower their commitment costs is to share them (e.g., by forming alliances with financial institutions from other areas and public-sector bodies such as local governments). Provided the public and private sectors cooperate in offering one-stop business succession solutions ranging from seminars and human resource networks to M&A matching, small local financial institutions should be able to achieve the economies of scale they need to cut these costs. Some small businesses have always been at the forefront of technological innovation, and some provide new services; so it can be wrong to judge a small business simply by numerical indicators such as sales or profits.

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[12] For further details see Yasuyuki Fuchita, "Chiiki Keizai ni Koken Suru Kin'yu to Arata na Akushon Puroguramu ni Tsuite" [The Financial Services Agency's New Action Program and Role of Financial Institutions in Helping to Revitalize the Regions], Kin'yu Shihon Shijo Doko Repoto [Nomura Institute of Capital Markets Research], No. 05-13.

In the case of traditional industries, failure to find a business successor may mean that a region loses part of its tradition and culture. There are therefore limits to how far human resource networks and M&A matching systems can serve the needs of small businesses of such diversity. A more integrated approach is needed to helping small businesses with their succession, and small local financial institutions can play a key role by providing up-to-date information. Such an approach will need to respect the differences between the public and private sectors.

Financial institutions will also need to respect each other's differences. They should therefore take a fresh look at themselves in order to identify their local strengths and seek to form a symbiotic relationship with one another.

2. Demonstrating leadership

The economic future of Japan's regions depends on small local businesses becoming profitable again and achieving sustained growth. With the average age of the population rising, however, many owner-managers are worried about whether they will be able to find a successor. Also, while there is no doubt that it is important to try to increase the appeal of the regions, more could be done to link urban development and attempts to revitalize local businesses. Small local financial institutions clearly have a key role to play here. How successful they are in achieving this will have a direct impact on their bottom line.

Small local financial institutions need to demonstrate leadership and team up with other local organizations such as local authorities and universities in order to revitalize their local economy.

The issue of succession in small businesses and M&A activity by local financial institutions both need to be seen as part of the process of revitalizing the local economy.

In an aging society, efforts to assist businesses with their succession problems should be seen as efforts to help businesses to continue to grow rather than as personal problems of their owner-managers. Not only that: turning a business around requires human and organizational support from both the public and private sectors, and financial institutions (and especially small local financial institutions) have a key role to play in this endeavor.