Legislation For Corporate Separations

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On May 24, 2000 the Japanese Diet passed draft revisions to the Commercial Code that will establish a system for governing corporate separations. With the establishment of corporate separation legislation after a wait of some 30 years, Japan will at long last have in place the legal infrastructure to facilitate speedy corporate restructuring, including mergers and share exchange systems. On the negative side however, discussions over accompanying tax measures are making little headway.

This report will introduce the details of the new corporate separation system, and examine problems with the current legislative framework and future issues.

1. Current Legislation

Under Japan's current legislative framework, the majority of companies separating company divisions do so by business transfers through an investment-in-kind under existing provisions in the Commercial Code. Additionally, the enactment of the Industrial Revitalization Law in October 1999 established special measures to promote corporate restructuring by introducing speedier and less costly methods for spinning off divisions.

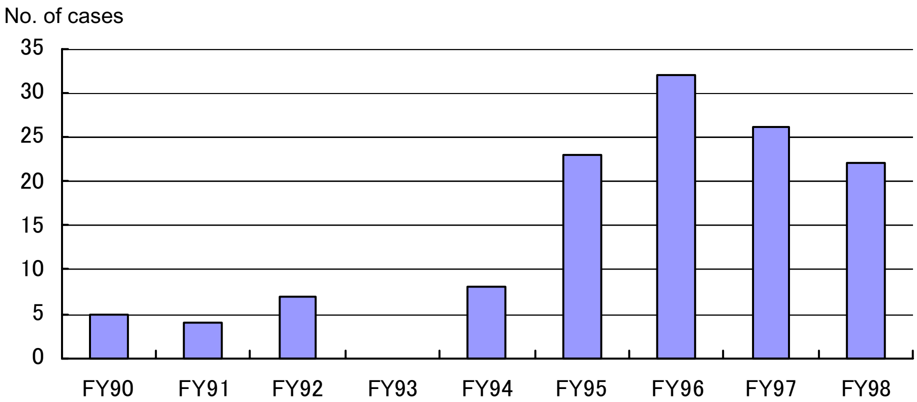
1) Business Transfer / Investment-in-kind Under the Commercial Code

Companies wishing to restructure by spinning off existing divisions, taking over divisions of other companies or transferring businesses already established as subsidiaries, currently have 4 choices as to how to proceed: (1) set up a new company, transferring operations through an investment-in-kind (Commercial Code, Article 168-1-5); (2) first set up a new company, then subsequently issue new shares and carry out an investment-in-kind (Article 280-2-1-3); (3) asset purchase agreement before establishment (Article 169-1-6); (4) asset purchase agreement in 2 years after establishment (Article 246). To carry out a corporate separation that involves the transfer of either entire operations or an important part thereof, or where the entire operations of another company are to be absorbed, requires a special resolution at a shareholders' meeting (Article 245).

A company carrying out an investment-in-kind is, as a rule, legally obliged to undergo an inspection in order to show that the company's capitalization will not be unduly affected by an over-estimate of the asset value.[1] Inspections with court-appointed inspectors tend to be avoided however since the assets in question cannot be used during the several months it takes to carry out the inspection, and as companies cannot rely on the fact that they will be given an inspector familiar with their particular industry.

However, there have been a number of cases where companies business strategies relied on corporate restructuring through corporate separations, and so despite the legal obstacles recent years have seen some 20 cases per year of companies spinning off own or absorbing other companies' divisions (Figure 1).

Figure 1 Recent Major Cases of Business Transfers among Listed Companies



Note: Though the number of cases of corporate separation for FY98 have not been specified in the comment, indications are that there was in fact a significant year-on-year increase.
Source: NRI, from Junkan Shouji Houmu special edition "Zoushi Hakusho (1991 to 1999)"

2) Special Provisions under the Industrial Revitalization Law

Under the Industrial Revitalization Law that came into effect in October 1999, up to 31 March 2003 a company may apply to the competent ministry, and if approval is received be subject to special provisions under the Commercial Code and Tax Law when undertaking corporate restructuring for the purposes of strengthening core businesses, or entering new sectors or adopting new production or sales methods.

Special provisions of the Commercial Code for in-kind investment and business transfers allow, subject to the approval of a restructuring plan by the competent ministry, for an inspection to be unnecessary where an investment in-kind is carried out, and where an entire business is to be absorbed for the transfer to be approved by a vote at a board meeting without needing a special resolution at a shareholders' meeting if the value of the business being taken over is less than 1/20 of the net assets of the company according to its most recent balance sheet (Industrial Revitalization Law, Article 10). Regarding transfers of debts during a

1 An inspection is not necessary where (1) the value of the investment-in-kind or assets purchased do not exceed 1/5 of the company's equity capital or ¥5 million; (2) the securities for the in-kind investment are exchanged at market price; (3) a lawyer certifies to the fair asset value of real estate offered in investment-in-kind(the Commercial Code, Article 173①,②,181②) .

business transfer, the consent of all creditors is not necessary, a simple notification being sufficient. This also enables a company to transfer all its debts at once (special provisions regarding creditors rights to object are set out in Article 11). Tax Law special provisions allow transfer tax from investments-in-kind in joint-ventures (where the company holds over a 25% stake) to be deferred, and for tax to be paid on only 20% of the transfer profits on the replacement purchase of long-term holdings. In addition to which the company can pay reduced registration and license tax and real estate acquisition tax on business transfers.

While still only a few companies have received approval under the Industrial Revitalization Law (a total 21 cases as of 13 March 2000), the number of applications has been increasing recently (Table 1).[2]

Table 1 Companies Approved Under the Industrial Revitalization Law

Company	Application – Approval Dates	Plan / Details of Special Provision Applied
Sumitomo Metal Industries	Application: 29/Oct/1999 Approved: 11/Nov/1999 (partially revised 28/Dec)	Spin off of Kokura Steel Works (March 2000). Purpose – to return to the black by achieving a 5% plus improvement in ROE for FY2000. inspection and debt transfer procedures simplified and tax on new company registration reduced. Special provisions for the nuclear power fuel insulator pipe business included special provisions for inspection of investment-in-kind, special provisions regarding notification of creditors' objections to business transfer, and reduced registration tax for the capital increase.
Mitsubishi Motors	Application: 20/Nov/1999 Approved: 26/Nov/1999	Spin-off of truck and bus division. Reduced registration and license tax for a third-party allotment of shares to Volvo (¥29 billion)
Oji Paper	Approved: 15/Nov/1999 (subsidiary)	Paper manufacturing equipment sales subsidiary Oji Packaging (paper equipment company jointly run by parent Oji Paper and affiliate) established. Reduction in registration and license tax.
Suzuki	Application: 9/Mar/2000 Approval: 22/Mar/2000	Plans a third party share allotment of ¥10 billion with Fuji Heavy Industries in order to pursue structural business reforms. Aims at using the funds to significantly boost productivity and lower unit costs, increasing capital capacity through reforms such as amalgamation of engine assembly lines, increased flexibility and use of sub-assembly. Registration and license tax for capital increase reduced.
Hino Motors	Application: 17/Mar/2000 Approved: 24/Mar/2000	Toyota Motors is to underwrite a ¥25 billion third party allotment of Hino Motors' shares. Reforms to include implementation of a new sales and management control system and its roll-out to regional offices, and setting up of an administrative centre, through which it plans to streamline its domestic sales operations. Reduction in registration and license tax for capital increase.
Zexel	Application: 17/Mar/2000 Approved: 24/Mar/2000	Transferring car air conditioner business to Tama Manufacturing, leaving parent able to specialize in fuel-injection auto pumps. In order to strengthen its subsidiary's finances to take on the new business it is also injecting ¥16.1 billion in capital. Also plans to cut unit costs and significantly boost productivity by reorganizing production lines. Special provisions on creditor objections to transfer of business, reduction in registration and license tax (capital increase, business transfer) and reduction in real estate acquisition tax (business transfer).

Source: NRI, from the Ministry of International Trade & Industry website.

2 According to the *Nihon Keizai Shimbun*, 14 March 2000

2. Outline of the Corporate Separation System

Since there is no specific corporate separation legislation at present in Japan, the procedures to carry out corporate restructuring (inspections, creditor protection, and many others) are extremely complicated. Further, the special provisions under the Industrial Revitalization Law are both provisional and limited in scope. The introduction of new corporate separation legislation should result in a much more streamlined procedure, and finally make it possible for companies to carry out a corporate separation through a long-awaited single unified process.

The Commercial Code sub-committee of the Legal System Council, after much deliberation, announced its interim draft proposals for the introduction of corporate separation legislation on 7 July 1999, and after calling for industry comments, approved outline draft revisions to the Commercial Code in February 2000, with the bill being put before the Diet on 10 March 2000. Eventually, the Diet passed the bill on 24 May 2000.

The corporate separation legislation contained in the bill differs in a number of ways from the interim draft proposals of July 1999. This section will outline the system as set out in the bill.[3]

1) Forms of Corporate Separations

A corporate separation is taken to mean the transfer of either a part or all of a company's operations (including rights and duties) to either a newly established company (*shinsetsu bunkatsu* or 'S' split, Article 373 of the bill) or an existing company (*kyushu-bunkatsu* or 'K' split, Article 374-16). Payment in consideration of the transferred operations is made in shares – if cash payment is made this does not fall under the new corporate separation legislation.

A corporate separation can be carried out on approval of the shareholders by a special resolution, and as is the case with the merger and share exchange systems, transfer of rights and duties can be carried out in a single unified process.

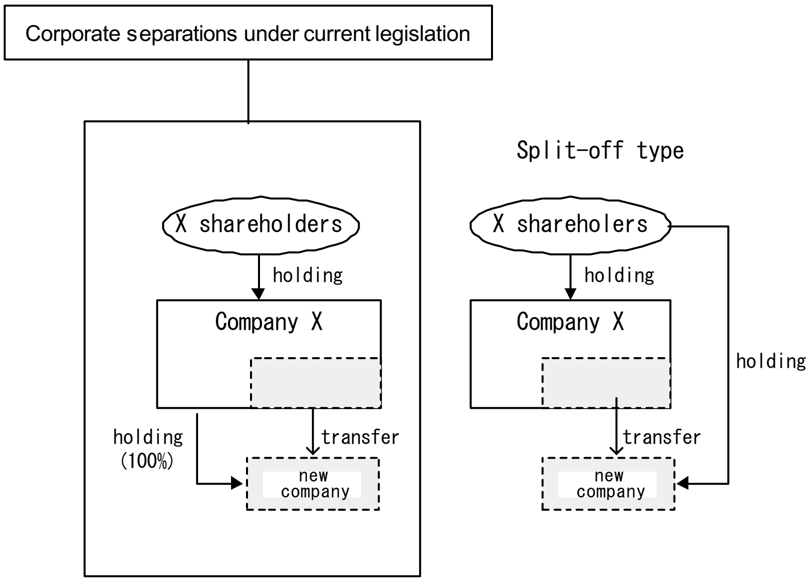
Currently, if a company is to separate a division, the only method available is for the parent to set up a wholly-owned subsidiary. There are no regulations governing whether the shares of the new subsidiary should be allocated among the shareholders of the parent company however, so this was assumed therefore to be disallowed. The revised Code therefore allows for the allocation of a portion of the shares in the newly established subsidiary to the parent shareholders. Under the new corporate separation system the existing method of 100% of the shares in the newly established subsidiary being held by the parent company is termed a physical separation, while the now recognized allocation of a portion of the shares in the subsidiary to the parent company shareholders is termed a shareholder separation (split-off type).

3 M. Hashimoto "Recent Developments In Corporate Restructuring Legislation," (Capital Research Journal, winter 1999).

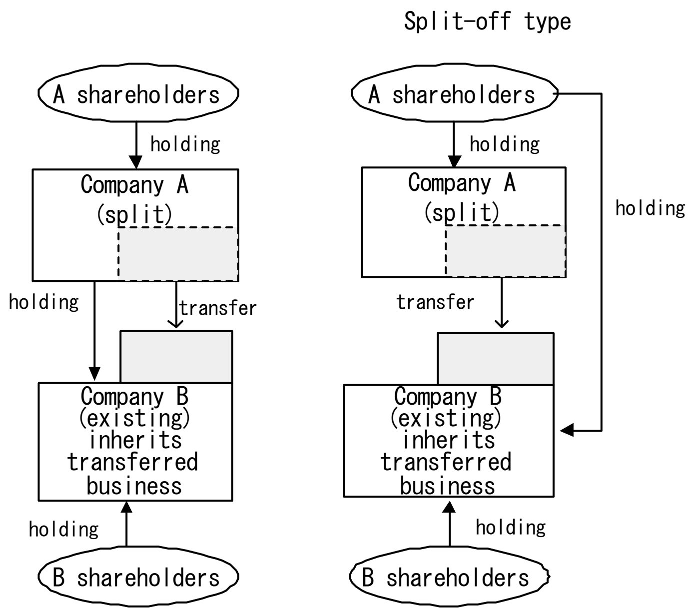
Accordingly under the revised Code there will be 4 types of corporate separation: (1) 'S' split (establishing a wholly-owned subsidiary), (2) 'S' split (split-off), (3) 'K' split (exchanging a division for an assignee company's shares), (4) 'K' split (split-off) (Figure 2).

Figure 2 Forms of Corporate Separations Under The Revised Commercial Code

(1) 'S' split



(2) 'K' split



Note: Corporate separations can be total or partial. In a total corporate separation, the shares of the subsidiary / assignee company are allocated to the shareholders rather than to the company itself. In a partial separation, the shares are allocated to both the company and the splitting company's shareholders.

Source: NRI

2) Corporate Separation Procedures

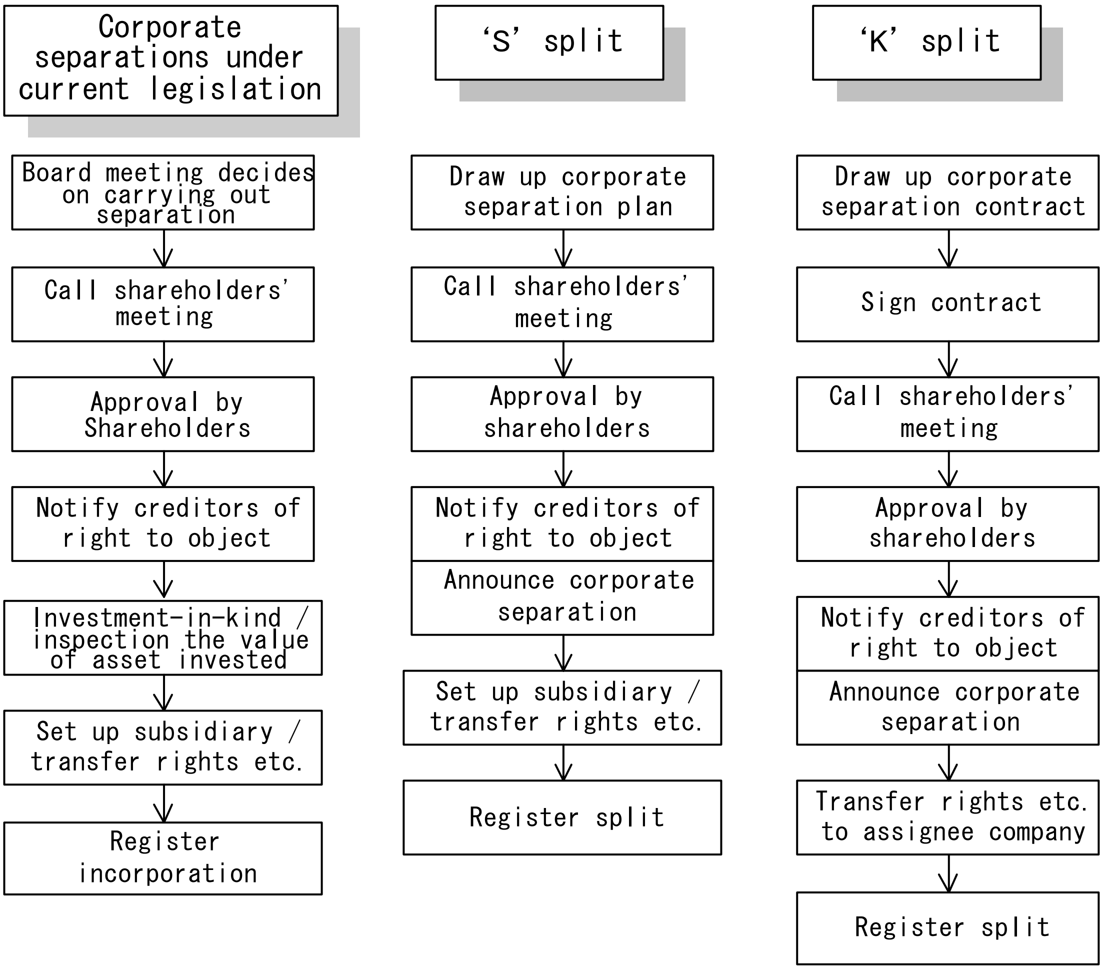
In an 'S' split a company must draw up a plan, call a shareholders' meeting and have the plan approved by a special shareholder resolution. Within 2 weeks following the resolution an official announcement (*kanpo*) must be made detailing the separation, the rights of the shareholders and terms under which the creditors may object to the separation.

The corporate separation must be notified individually to each of the company's identified creditors (Article 374 of the revised code). Against the objection of the creditors it must either make a repayment, offer collateral or put assets in trust. In the case of 'S' splits which establish a wholly-owned subsidiary, these protective procedures are not necessary for those creditors who have right of recourse to the splitting company for repayment. If under a corporate separation the debts of the splitting company are transferred to a newly established company without any obligation to obtain the consent of individual creditors but also without notification to the creditors, the splitting company and new (assignee) company are joint and severally liable for those debts regardless of any stipulation in the plan that the splitting company is not liable.

Documentation concerning the corporate separation must be made available at the head office of both the splitting company and any existing assignee company to their shareholders both before and after the shareholders meeting. Any shareholders objecting in writing at the shareholders' meeting to the corporate separation will, after the resolution is passed, be able to exercise their appraisal right.

In a 'K' split, first of all a corporate separation contract is drawn up and signed between the splitting company and the company set to be assigned those rights and duties. After passing a special resolution of the shareholders at both companies, the duty to notify the shareholders and creditors is the same as for an 'S' split (Figure 3).

Figure 3 Corporate Separation Procedures – Current and Revised



Source: NRI

3) Required Details

The corporate separation plan required for an 'S' split (Article 374) and the separation contract required for a 'K' split (Article 374-17) are the same in many respects (Tables 2,3).

The items they have in common are: (1) entries / changes to the articles of incorporation for the new / assignee company; (2) items relating to the allocation of shares issued by the new / assignee company; (3) items relating to capital or reserve requirements for the new / assignee company; (4) regulations governing split subsidies; (5) items relating to the rights and duties (such as credits and debts, labor contracts) assigned from the splitting company; (6) amount by which the capital or reserves of the splitting company should be reduced in case of a split-off corporate separation; (7) procedures for retiring or merging shares in case of a split-off corporate separation; (8) timing of the separation; (9) maximum amount a splitting company may pay out in profit distribution prior to the separation; (10) names of auditors and directors of the new company.

Item (2) above recognizes that shares of the new company may be allocated to the shareholders of the splitting company in addition to the company itself. Item (5) deals with transfer of rights and duties in labor contracts and convertible bonds / warrant-bonds. For example, in the case of a 'K' split, if the stock options transferred from the splitting company are rights to new stock while stock options in the assignee company are only exercisable into existing stock, in order for stock options to be transferable the use of both stock option types by a company is allowed in this special case only. Regarding item (6), while in the case of a split-off type corporate separation the assets of the existing company will be reduced, in the case of the other type of split, since the company obtains shares in return for the divested assets, there is no change in its capital and so no need to reduce the capital of the company carrying out the split. Item (7) recognizes that as the net assets of the company may be reduced as a result of the separation, since the number of outstanding shares is unchanged there is a possibility that the book value per share may dip below the legal minimum of ¥50,000 / share, and therefore the company may need to either retire shares or carry out a reverse split.

In the case of an 'S' split where several companies are carrying out a joint separation to create a new company, this needs to be stipulated in addition to the above terms. In the case of a 'K' split however, as with mergers and share exchanges, there is no need to separately specify the fact that it is a joint separation since in such a case the companies are all parties to the separation contract.

Moreover, while in a transfer of business operations the attached personnel will also transfer, unlike merger and share exchange systems, it is just the labor contracts of the personnel transferring rather than those of the whole company that are transferred, and the splitting company also continues to exist. Considering it important that the transfer of employees should not result in any contractual disadvantage, a bill regarding the inheritance of employee contracts has also been presented to the Diet at the same time as the current draft revisions.[4] This bill was also passed at the same time.

Table 2 Corporate Separation Plan – Required Items

(1) Regulations concerning articles of incorporation of the company to be formed by the separation
(2) Items concerning the allocation of shares to be issued by the new company
(3) Items related to capital and reserve requirements of the new company
(4) Regulations concerning subsidies for the separation
(5) Items related to the inheritance of rights and duties from the splitting company
(6) Amount of capital or reserves to be reduced in the case of a split-off type corporate separation
(7) Procedures for reverse splits or retirement of shares in the case of a split-off type corporate separation
(8) Period during which the separation must take place
(9) Maximum amount that can be paid out in profit distribution prior to the separation date
(10) Names of auditors and directors of the new company
(11) Whether the company is to be formed by a joint separation

4 The Democratic Party of Japan presented to the current plenary session of the Diet the "Bill Concerning Protection of Workers in the Event of Corporate Restructuring," on the grounds that workers employment and working conditions needed protection in the event of mergers and business transfers in addition to corporate separations. Finally, the Bill introduced by the government was amended jointly and passed.

Table 3 Corporate Separation Contract – Required Items

(1) Amended articles of incorporation of the company to which business is being transferred
(2) Items concerning the allocation of shares to be issued by the assignee company
(3) Items related to capital and reserve requirements of the assignee company
(4) Regulations concerning subsidies for the separation
(5) Items related to the inheritance of rights and duties from the splitting company
(6) Amount of capital or reserves to be reduced in the case of a split-off type corporate separation
(7) Procedures for reverse splits or retirement of shares in the case of a split-off type corporate separation
(8) Date on which shareholders are to meet to decide on the separation
(9) Timing of the separation
(9) Maximum amount that can be paid out in profit distribution prior to the split date
(10) Names of auditors and directors of the new company

4) Short-Form Corporate Separation / Business Transfer

For corporate separations that fulfil certain conditions and where the impact on the existing shareholders is considered to be minimal, as with mergers and share exchanges, a short-form procedure is available that simplifies the required procedures and does not require shareholder approval.

Short-form procedures are available to a splitting company for non-split-off type separations only, for both 'K' and 'S' splits where the assets to be separated represent 1/20 or less of the assets of the company (Articles 374-6 and 374-22 of the revised code). In the case of a short-form corporate separation, the shareholders have no right to a buy-out of their shares. For 'K' splits a short-form procedure is also available to the assignee company (Article 374-23 of the revised code), and since it does not affect the interests of the shareholders of the assignee company in case of either a split-off or non-split-off type separation, it is also applicable to a split-off type. The requirements for the assignee company are different to those of the splitting company, namely that the number of new shares issued due to the separation do not exceed 1/20 of the number of shares of the assignee, and where a split subsidy is paid, that the subsidy does not exceed 1/50 of the assignee's net assets according to the most recent balance sheet (Article 374-23-1). There is a set procedure whereby shareholders objecting to the assignee company short-form separation may exercise their appraisal rights (Article 374-23-5).

Where the entire business operations are being transferred, as long as the price does not exceed 1/20 of net assets, a shareholders' resolution is not required (Article 245-5).

5) Regulations Related to the Anti-Monopoly Law

The Anti-Monopoly Law amendment bill has also been presented to the Diet to complement the changes to corporate separation legislation.

In the interests of free and fair competition, the amended Anti-Monopoly Law will prescribe certain cases where companies may not cooperate in carrying out an 'S' or 'K' split (Article 15-2-1 of the amendment bill). It is prohibited in cases where: (1) the joint 'S' or 'K' split will substantially restrict competition in a certain area of business, or (2) the joint 'S' or 'K' split is founded on unfair trading practices.

Further, if the 'S' or 'K' split meets certain criteria[5], then the plan for the separation must be first of all submitted to the Fair Trading Commission (Article 2-3). However, if any of the parties to a joint 'S' or 'K' split own more than 50% of the total share issuance of all the other parties to the separation, or all the parties to the joint 'S' or 'K' split are over 50% owned by a single company, then notification to the Fair Trading Commission is not required (Article 4).

As with mergers, the companies that have submitted notification must carry out the joint 'S' or 'K' split within 30 days after the approval of that notification (Article 6).

3. Outstanding Special Tax Measures

Where a division is to be separated using an investment-in-kind, since there is no profit being made by the parent / subsidiary, it is subject to special tax treatment. For example, the difference between the book value of the transferred assets and the market value at the time the investment-in-kind is carried out is not subject to transfer tax, but can be cancelled out by booking an advanced depreciation reduction on the acquisition value of the subsidiary shares received in exchange for the transferred assets.[6]

FY2000 revisions to the tax law relating to corporate restructuring provide for reductions in registration and license tax when forming a new company or raising new capital. Registration and license tax for forming new companies by investment-in-kind and capital increases under the Industrial Revitalization Law have been reduced to 0.35% of equity capital already, but this is to be further reduced to 0.15% (Article 80 of the Tax Special Measures Law). The tax amendments were approved by the Diet on 24 March 2000.

Major tax system provisions relating to corporate separations were not included in the FY2000 tax amendments but have been put off to FY2001. Without some sort of special tax breaks it is unlikely that corporate separations will function as properly intended. Moreover, even if inter-divisional aggregation of profit and loss has been carried out prior to the corporate separations, since separating results in the previous divisions being treated separately for tax purposes, disadvantageous changes such as not being able to aggregate profit and loss would make major corporate separations difficult. The introduction of a consolidated tax system has long been called for in order to maintain tax neutrality, but the FY2000 tax amendments explicitly state that this is to be included in the corporate separation tax legislation to be introduced in FY2001.

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5 Notification is required for joint ‘S’ splits where the following criteria are met: if total assets of any one of the parties to the ‘S’ split (in the case of ‘S’ splits where the entire business operations are to be transferred only) is over ¥10 billion as prescribed by government ordinance, and (1) total assets of any one other party (entire business transfer only) is ¥1 billion or over as prescribed by government ordinance, or (2) total sales for the business division to be transferred according to the income statement prepared along with the most recent balance sheet of the other party (in the case of joint ‘S’ splits, only where an material part of the business operations concerned are to be transferred to the company to be established) are ¥1 billion or over as prescribed by government ordinance.

6 Advanced depreciation is also allowed in the case of securities obtained through an investment-in-kind (specified investment-in-kind) that meets certain criteria, such as where the parent owns 95% or more of the company being established by the separation and the value of the assets being received from the new company by the parent is less than the book value of the parent (Article 51 of the Corporate Taxation Law, the Corporate Taxation Ordinances 93,94,95).

Future changes to the tax system should include: (1) transfer of assets at less than book value to new companies formed out of a corporate separation (deferment of transfer tax); (2) reductions in real estate acquisition tax, automobile tax, specified land holding tax and registration and license tax for registration of subsequent land transfers; (3) reduction in registration and license tax for forming a new company out of a corporate separation; (4) freezing of "taxation on deemed dividends" and "transfer tax" on shares from the new company allocated to the non-splitting company; (5) recognition of inheritance of reserves belonging to transferred operations.[7]

Further, it appears that a special government tax investigation group has already started to look at the tax system for corporate separations and consolidated basis taxation, with an eye to including proposed amendments in bills to be introduced in FY2001.

4. Differences with the US System of Corporate Separations

Corporate separations in the US come in the 3 forms of spin-offs, split-ups, and split-offs (Figure 4). Spin-offs are not specified as part of company law, but as company reorganizations they are exempt from tax treatment if they meet certain criteria (Internal Revenue Code, Articles 355 and 368(a)(1)(D)).

A spin-off is where a company turns a division into a new subsidiary company and allocates the new company's shares to the parent company shareholders as dividends. Shareholders of the parent company receive shares in the new subsidiary pro rata, with there being practically no change in the overall amount held.

In split-offs, as with spin-offs, parent shares are exchanged for shares in the new subsidiary, but with split-offs the parent company decreases its equity capital against which the shareholders receive the shares of the new subsidiary.

In a split-up the parent company forms two or more new subsidiaries with which it exchanges shares, transfers all the assets necessary for the new companies to operate their businesses and then enters liquidation. In the distribution of the remaining assets of the parent company, the shares in the newly formed subsidiaries received as payment for the transferred assets are exchanged with shares in the parent from the parent shareholders.

The difference with Japan's system is that, in the case of corporate separations in Japan the shareholders of the splitting company can receive the shares in the newly formed company or the inheriting company directly, whereas in the US the shares are indirectly transferred through the parent company and paid out to its shareholders as dividends or as a disposal of residual assets. Corporate separations in Japan could be termed direct corporate separations, with spin-offs in the US as indirect corporate separations.

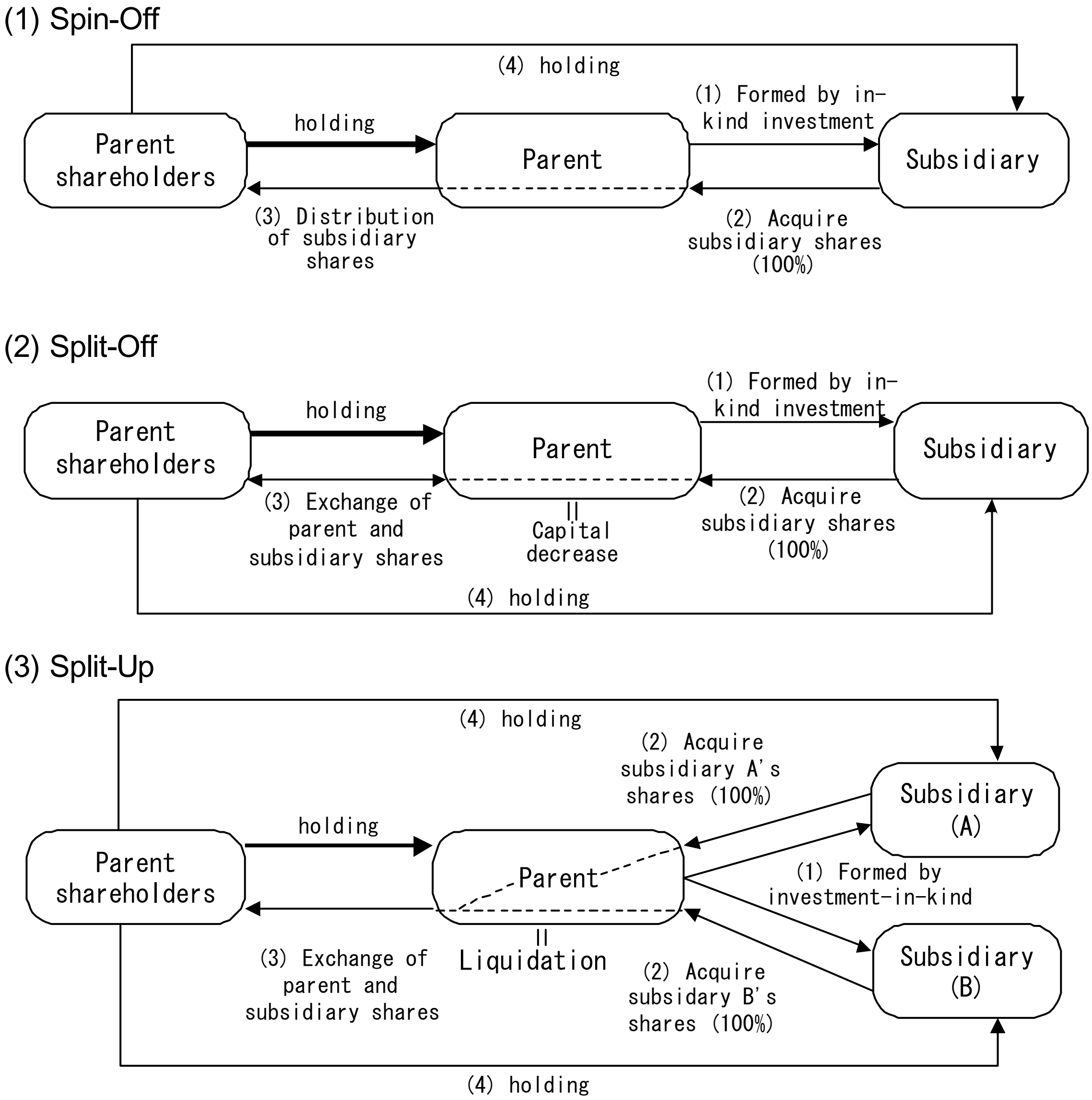
In order for US spin-off type corporate separations to be possible, it is necessary to allow the distribution of share holdings in another company, i.e. investments-in-kind. Under

7 For example, retirement benefits and advanced depreciation reserves are considered to belong to the transferred assets (objects and people) (retirement benefits reserves can be transferred in the case of an investment-in-kind, Corporate Taxation Fundamental Notification 11-5-23).

Japan's current legislation, distributions of profits to shareholders as a rule have to be paid in cash form (Commercial Code Articles 290, 293-5), and in exceptional circumstances own stock (stock split from capitalization of profits available for dividends (Commercial Code Article 290-2) – before the 1990 revisions to the Commercial Code this was termed share dividends), so paying of dividends-in-kind is not allowed. A split-off involves receiving shares in the subsidiary company against a reduction in equity capital. Since Japan's current legal framework allows an effective reduction in capital against payment in the form of subsidiary shares, this form of separation is in effect possible.

The indirect type splits above have not been covered in the current corporate separation legislation, and it is currently being investigated as to how far interpretation can allow these to be carried out.

Figure 4 Forms of Corporate Separation in the US



Source: NRI

5. Future Developments

Since the interim draft for the establishment of a corporate separation system was presented in July 1999, a number of corporate restructuring plans have been announced in anticipation of the passing of legislation by 1 January 2001, starting with the planned formation of the Mizuho Financial Group by the Industrial Bank of Japan, Dai-ichi Kangyo Bank and Fuji Bank.

With the establishment of a corporate separation system, it has not only become much easier to spin off divisions into new companies, but it has also made separations, the formation of new companies by the joint investment of several companies, and the splitting up of companies where there is a management conflict, a much smoother process. Further, a 'K' split enables the transfer of just the relevant division in return for receiving shares, instead of a merger of the whole company; it means an acquiring company can absorb a division from another company while paying for it with an equity issue instead of cash; and it makes it possible to transfer a division (where it seems as if the division would be better off merged with another company with similar operations) to another company, and by receiving shares in the acquiring company, still maintain a certain level of control as a shareholder.

However, the impact of the new legislation is being severely weakened by the fact that the introduction of the accompanying special tax measures and a consolidated tax system are being postponed, dampening any company's incentive to use corporate separations. Until Commercial Code revisions are implemented it will also remain unclear how the transfer of all rights and duties under an 'S' split to a new company, and creating a holding company, will affect the listing of the existing company, or the accounts treatment of companies carrying out corporate separations. Further, the timetable for Diet debate of the Commercial Code revisions to establish a corporate separation system has been falling behind.

For the time being it will be much simpler for companies to restructure using the systems for share exchange and share transfer for which the tax and exchange listing legislation is already properly established. Those types of corporate separations that have been carried out up to now, despite a certain amount of complexity, can be achieved by using the special measures under the Industrial Revitalization Law or methods such as business transfers which have certain tax advantages. Where what is called for is a more innovative and strategic type of business restructuring however, companies would be better off taking their time to plan ahead while waiting for the tax etc. measures to be passed before moving towards implementation.