ARTICLES

Liquidating Assets in Japan — New Law

Takayuki Furuhashi
Furuhashi & Associates, Tokyo

In 1998 the Japanese Government enacted a law to facilitate liquidation of assets. The so-called "SPC law" stipulates a special purpose entity that is used as a vehicle for assets, especially real estates' liquidation.

The purpose of this article is to give an outline of the law and a brief explanation of domestic and international tax implications provided in the Japanese tax laws.

I. Purposes and Meaning of the Law

The law to facilitate the liquidation of assets, the Liquidation of Specified Assets by Special Purposes Company (SPC) Law, came into force on September 1, 1998. An SPC is a corporation established in accordance with the law.

The purpose of the SPC law is to facilitate the liquidation of assets by securitisation of certain assets, whereby providing an investment opportunity for investors. In terms of the current economic situation in Japan, securitisation of real estate assists Japanese banks, with their huge volume of bad debts, to facilitate the movement of the stagnant flow of funds and to improve their capital position.

The law defines the functions and administration of an SPC and regulates specified securities issued by an SPC. According to the law, assets to be securitised are:

1. Real estates;
2. Loan credit, trade receivable, lease credit receivable, etc;
3. Beneficial interest in trust of 1. and 2. above.

Securities to be issued are classified as:

1. Preferred stock;
2. Bond;
3. Commercial paper.

According to the law, "Liquidation of Specified Assets" will be realised; first by issuing specified securities to investors, then with those funds, acquiring "Specified Assets" from an originator, and thirdly, managing and selling those assets. In those transactions an SPC is supposed to obtain an income to pay dividends to investors, to pay interest and to repay loans to creditors.

II. Incorporation Requirements for an SPC

An SPC is incorporated subject not to the Japan Commercial Code but to the SPC law. As such, requirements of the corporation structure and paid-in capital are eased as follows, compared to Joint Stock Companies.

1. Minimum paid-in capital is 3 million Yen (10 million Yen for a joint stock company and 3 million Yen for a limited liability company).
2. Minimum number of directors is one (three or more directors are required for a joint stock company and one or more for a limited liability company).
3. A board of directors is not required (same as for a limited liability company).
4. Minimum number of statute auditors is one.
5. A board of statute auditors is not required.

However, an SPC is not allowed to merge with other corporations.

To be eligible for SPC treatment in the law, an SPC must satisfy certain statutory requirements. These requirements generally mean that an SPC is not allowed to control and manage the purchased assets (a third party should assume those functions). There are some restrictions on disposition of the assets and funds raised by a loan, except those defined in the law.

The Assets Liquidation Plan stipulates the term of the plan, issuance and redemption of specified securities, acquisition of specified assets, management and disposition of specified assets, etc.

III. Domestic Taxation

In this section, first we consider taxation for an SPC, then for investors for domestic tax law purposes.

A. Taxation of an SPC

Although an SPC may take the form of a corporation, for Japanese Special Taxation Measures Law purposes it is treated as a conduit through which incomes will be passed to the interest holders or beneficiaries, provided certain statutory requirements are met. These requirements (as discussed later in more detail) are essentially that an SPC is a corporation en-

 Copyright © 1999 by The Bureau of National Affairs, Inc.

titled to a deduction for the amount of dividends distributed to the interest holders.

An SPC must distribute 90 percent or more of its distributable income. Thus, any income earned by an SPC and distributed to its beneficiaries is taxed only at the beneficiaries' level, thereby avoiding any double taxation to which the SPC would otherwise be subject. Unlike a partnership, however, only the net income of an SPC is passed through. Losses remain at the entity level and cannot be used by the investors. Every tax year, the SPC must satisfy certain requirements provided as follows.

1. Corporate test

(a) An SPC must be registered, as provided for in Article 3 of the SPC law.

(b) SPCs issuing specified securities must fall into one of the following categories:

(i) Aggregate issue price of bonds of 100 million Yen or more is publicly offered to 50 or more investors or bonds are offered only to qualified institutional investors set forth in the Securities and Exchange Law of Japan.

(ii) Preferred stock is publicly offered to 50 or more investors.

(iii) Preferred stock is offered only to qualified institutional investors.

(c) Other requirements set forth in the SPC law.

2. Distributable income test

(a) SPC business operations are subject to an assets liquidation plan.

(b) An SPC must not engage in other businesses other than provided in the assets liquidation plan.

(c) An SPC entrusts management and disposition of specified assets to other organisations or creates a trust by transferring specified assets to the trust.

(d) As of the end of a business year, an SPC is not a family corporation setting forth in corporate income tax law. (However, if the requirements in Section III.A.1.(b)(i) above are met, family corporation is acceptable. In this case family corporation tax rules are applied to the corporation. Family corporation is a corporation of which 50 percent or more of the shares are directly or indirectly held by three shareholders or less.)

3. Distribution requirements

An SPC must distribute 90 percent or more of its distributable income as a dividend to investors. In order for the dividend to be deductible, the details of the calculation of the dividend-paid deduction must be attached to annual tax returns of the SPC.

4. Other tax advantages

Land surtax on capital gains realised through the sale of land by an SPC is exempted. Registration tax and real estate acquisition tax, which are taxes imposed on acquisition of land, are reduced to half (effective for acquisitions made until March 31, 2000). Special land holding tax is exempted.

B. Taxation for Investors

Incomes earned by investment in an SPC are classified as mainly interest income, dividend income and gains from the sales of interest. As for corporate investors, interest is subject to a 20 percent (15 percent is a national tax, 5 percent is a local tax) withholding tax. The withholding tax may be credited against national income tax and local tax. As for individual investors, interest is taxed separately from other income and is subject to a final 20 percent withholding tax at source.

Dividends distributed by an SPC are subject to a 20 percent withholding tax on the gross amount of the dividends for both corporate and individual investors. The withholding tax may be credited against national income tax for corporate investors. However, a dividend-received deduction is not available for corporate investors and a tax credit for dividends is not available for individual investors, since double taxation regarding dividends does not incur because of dividend-paid deductions at the level of an SPC.

Concerning individual investors, gains from the sales of interest in an SPC are taxed separately from other income at a rate of 20 percent, plus 6 percent inhabitant tax.

In general, land surtax is imposed on capital gains incurred by the sale of interest in a corporation, of which 70 percent or more assets consist of land. However, if the above requirements in Section III.A.1.(b) are met, the sales of interest in an SPC is exempted from land surtax.

As for corporate investors, the gains from the sales of interest are taxed at the standard corporate tax rate of 34.5 percent (for corporations capitalised at 100 million Yen or less, the rate is 25 percent if the taxable income is 8 million Yen or less).

IV. International Tax Issues for an SPC and Investors

In this section we consider the tax implications for a foreign investor's investment in an SPC.

A. Thin Capitalisation Rule

In case a foreign-related controlling company holds bonds in an SPC, the thin capitalisation rule must be considered. The rule limits the deduction for interest expense for companies with foreign-related party debt if the debt-to-equity ratio exceeds 3:1.

In general, the foreign-related controlling company is a company which holds, directly or indirectly, 50 percent or more of the interest in a controlled company.

The rule does not allow the non-deductible interest to be deducted in future tax years. In addition, even if interest is not deductible for the rule purposes, 10 percent (reduced rate by tax treaty) withholding tax imposed on the interest paid.

ARTICLES

B. Foreign Tax Credit

Japanese-resident companies may be entitled to claim a foreign tax credit against both national tax and inhabitant tax for foreign income taxes paid. Creditable foreign income taxes for the companies include direct tax credit and indirect tax credit.

In general, the foreign tax credit limitation is calculated using the following formula:

Japanese corporate tax × Foreign-source income ÷ Worldwide taxable income

As far as the SPC is concerned, the worldwide taxable income is to include the dividend-paid deduction, thereby avoiding international double taxation at the level of the SPC.

C. Treaty Taxation

Japan currently has income tax treaties with approximately 46 countries. Most treaties reduce the tax rates on Japan-source income, such as dividends, interest, royalties, personal services, and ocean and air transportation. In general, the treaties reduce the tax rates only when income is not attributable to a non-resident's permanent establishment. Some of the provisions that affect the foreign corporations investing in the SPC are as follows.

1. Dividend income

Dividends are subject to a 20 percent withholding tax if paid to non-residents. This rate may be either exempt or subject to a lower rate of tax of 5–15 percent. For instance, in the Japan-France tax treaty, a 0 percent rate applies if the recipient of the dividends is a corporation owning at least 15 percent of the payer and is an "eligible resident" provided for in Article 10 of the treaty.

2. Interest income

Interest income is also subject to a 15 percent withholding tax if paid to non-residents (a non-resident is not subject to local inhabitant tax of 5 percent). This tax may be exempt or subject to a lower rate of tax of 10 percent. For example, in the Japan-Pakistan tax treaty, interest on debentures or loans is exempt(Article 8 of the treaty).

3. Gains from sales of stock

In most instances, a foreign corporation with no permanent establishment in Japan is not taxed on its gains arising from the sales of stock in a domestic corporation except when:

(a) the gains arise from cornering stocks of the corporation; and

(b) the gains are incurred by the sales of 5 percent or more of the stock of the controlled companies (a corporation of which 25 percent or more is owned by a transferor in the past three tax years preceding the tax year in which the transfer was made).

However, whether it is taxed or not for treaty taxation purposes varies with each tax treaty, for instance in the Japan-U.S. tax treaty, in general, the gains are exempt in Japan even if the gains arise from the transactions in (a) and (b) above. On the other hand, in the Japan-U.K. tax treaty, the gains arising from the transactions in (a) and (b) above are subject to corporate income tax in Japan.

Foreign investors, therefore, should carry out careful research with regard to tax treaties with Japan. Treaty taxation for the gains in terms of corporate income tax — in the case where the gains are not attributable to a permanent establishment and in the case where there is no permanent establishment — are as follows.

1. Taxation subject to domestic tax law since tax treaties do not provide for treatment of the gains: Canada, Thailand, Pakistan, India, Korea, Australia, etc.

2. Tax imposed in the country where securities are transferred: Sweden, Egypt, etc.

3. Tax imposed only on the gains incurred by the sales of the stock of controlled companies: Austria, United Kingdom, etc.

4. Tax not imposed in case the gains are not attributable to a permanent establishment or there is no permanent establishment in Japan: United States, Germany, Brazil, Denmark, etc.

5. Tax imposed in a transferor's resident country: Indonesia, Netherlands, Ireland, Italy, etc.

***Takayuki Furuhashi** of Furuhashi & Associates, Tokyo, Japan. Furuhashi & Associates is a member of MacIntyre Sträter International Limited (MSI), a worldwide association of independent professional services firms. For more information on MSI or to learn how to become a member, please contact Charles Hornor (Director) on +44 171 404 1000 (phone), +44 171 404 0000 (fax) or e-mail at: chornor@msi-network.com*

 Copyright © 1999 by The Bureau of National Affairs, Inc.