International Tax Law

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This article reviews important international tax law developments during 2008 in the United States, Canada, and Japan.

I. Developments in United States

There were two important developments in 2008 in U.S. tax law affecting foreign nationals. On April 28, 2008, the U.S. Department of the Treasury released final regulations under Section 1446 of the Internal Revenue Code[1] respecting withholding requirements for foreign nationals within partnerships.[2] There were several modifications to the 2005 regulations, including changes in eligibility to certify losses and deductions to reduce withholding, relief for partnership's failure to withhold, and the certification procedure.

Also of note is the decision by the Third Circuit in *Swallows Holding, Ltd. v. Commissioner*,[3] which concerned the application of Treasury Regulation 1.882-4(a)(3)(i). That regulation sets out filing deadlines for foreign nationals to claim real property deductions.[4] Section 882 of the Internal Revenue Code[5] did not specify any time requirement for claiming the deductions but left to the Treasury and Internal Revenue Service the manner of claiming the deductions. The United States Tax Court (the lower court) held for the taxpayer and found that the regulation was unreasonable. The Third Circuit reversed, finding that the regulation was to be given deference under *Chevron USA, Inc. v. Natural Resources Defense Council, Inc.*[6] The *Swallows* case is considered significant not only for the particular determination regarding the Regulation, but also for the level of deference generally to be given to Treasury Regulations.

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1. I.R.C. § 1446 (West 2008).
2. Treas. Reg. § 1.1446 (as amended by T.D. 9394, 2008-21 I.R.B. 988).
3. Swallows Holding, Ltd. v. Comm'r, 515 F.3d 162 (3d Cir. 2008).
4. Treas. Reg. § 1.882-4(a)(3)(i) (1960).
5. I.R.C. § 882 (West 2008).
6. Chevron USA, Inc. v. Natural Res. Def. Council, Inc., 467 U.S. 837 (1984).

II. Developments in Canada

A. *GlaxoSmithKline Inc. v. The Queen*

In a lengthy judgment released on May 30, 2008, the Tax Court of Canada in *GlaxoSmithKline Inc. v. The Queen*[7] considered whether the price paid by the Canadian taxpayer to a related Swiss company for ranitidine hydrochloride (the active pharmaceutical ingredient in ulcer medication sold in Canada by the taxpayer under the brand name Zantac) was "reasonable in the circumstances" under subsection 69(2) of the Income Tax Act (Canada),[8] a predecessor provision to the current transfer pricing rules in Section 247 of the Act.

In conducting its transfer pricing analysis, the Court endorsed the ordering of methods set out in the OECD's Report on Transfer Pricing and Multinational Enterprises (the Transfer Pricing Guidelines), concluding that the comparable uncontrolled price (CUP) method was the preferred method for determining a reasonable price for the taxpayer's purchase of ranitidine unless there was no comparable transaction to that of the taxpayer. Under the CUP method, the appropriate transfer price is determined by reference to comparable transactions between an arm's length buyer and seller, which are representative of the market.

During the taxation years in question, two corporations in the Glaxo group carried out the primary manufacturing of ranitidine, one based in Singapore and the other in the United Kingdom. Ranitidine manufactured by these two companies was sold at a uniform price to one of two clearing companies in the Glaxo group, one based in Switzerland and the other in Asia. In turn, the clearing companies sold ranitidine for varying prices to companies in different countries. In the relevant years, the Glaxo group's transfer pricing arrangements allowed the Singapore manufacturer to earn gross profits of about ninety percent, which were not taxed in Singapore, on the sale of ranitidine to the Swiss clearing company, while the taxpayer was earning gross profits of about fifty-seven percent.[9] In many European markets, the Glaxo group entered into agreements with third party distributors who performed primarily marketing, detailing, and distribution functions. In determining the transfer price of ranitidine to such distributors, the Glaxo group used the resale price method to determine the appropriate price based on the distributors retaining a gross margin of sixty percent on their sales.[10]

As a preliminary matter in its analysis, the Court concluded that the pricing of ranitidine under the Supply Agreement between the taxpayer and the related Swiss company should be considered without regard to the Licensing Agreement under which the taxpayer paid a six percent royalty to another related company for the use of intangibles and services related to the sale of Zantac and other medications.[11] In the Court's view, the two agreements covered separate matters and could not be combined so as to ignore the distinct tax treatment flowing from each transaction. The Court also determined that it could rely on the 1995 version of the Transfer Pricing Guidelines even though it was

7. GlaxoSmithKline Inc. v. Her Majesty the Queen, [2008] D.T.C. 3957 (TCC) (under appeal to FCA.).
8. Income Tax Act (Canada), R.S.C., ch. 1 (1985) (5th supp.), as amended [hereinafter the Act].
9. *GlaxoSmithKline Inc.*, [2008] D.T.C. 3957, at ¶ 13.
10. *Id.* ¶ 47.
11. *Id.* ¶ 14.

released after the taxation years in question, as neither party to the appeal pointed to any inconsistencies between the 1995 and 1979 versions, and both parties had cited the 1995 version in their written submissions.[12]

Based upon a consideration of the expert evidence and the Transfer Pricing Guidelines, the Court concluded that third party manufacturers' sales of a generic version of the medication in Canada during the years in question were an appropriate comparable using the CUP method.[13] In doing so, the Court rejected the taxpayer's argument that its business circumstances were wholly different from those of the generic companies so as to render the generic companies' transactions not comparable to its transactions. There was no evidence that the price or value of ranitidine had any effect on the price of the medication produced, especially since the Glaxo group determined the pricing of ranitidine based on the ultimate price of the medication under the resale price method. Accordingly, the Court viewed "any difference in business strategy between the [taxpayer] and the generic companies [as relating] to the end selling price" of the medication rather than the purchase price of ranitidine and, thus, concluded that the taxpayer's business circumstances and strategies had no bearing on the transfer pricing issue.[14]

The Court also rejected the taxpayer's argument that the ranitidine manufactured within the Glaxo group and purchased by it was not comparable to the ranitidine purchased by the generic companies because of differences in the Glaxo group's good manufacturing practices (GMPs) and health, safety, and environmental standards.[15] Expert evidence indicated that the ranitidine purchased by the generic companies was chemically equivalent and bioequivalent to the Glaxo group's ranitidine and was approved for sale by the Health Protection Branch of Health Canada. Although the Court conceded that the Glaxo group's GMPs had some value in that they may have provided some comfort that its ranitidine had "minimal impurities and [was] manufactured in a responsible manner," they did not affect the comparability of the Glaxo group's ranitidine with the ranitidine purchased by the generic companies.[16]

The generic companies were an appropriate comparable for the following reasons: they operated and competed in the same economic market; there was no difference in substance between the ranitidine purchased by the generic companies and the taxpayer; they both purchased ranitidine at the wholesale level; they generally performed similar functions, i.e., "secondary manufacture, sales and distribution, and research and development"; and they performed very similar functions with respect to the ranitidine, i.e., purchasing bulk ranitidine from primary manufacturers, conducting secondary manufacturing in Canada, and carrying out marketing and distribution of the finished product.[17]

In contrast, the Glaxo group's European third party distributors were not an appropriate comparable using the CUP method (or the resale price method used by the taxpayer to support its purchase price of ranitidine) because the European markets and transactions differed significantly from the Canadian market and transactions, and it was not possible to compensate for the differences. For example, the Glaxo group had a monopoly in

12. *Id.* ¶ 83.
13. *Id.* ¶ 161.
14. *Id.* ¶ 90.
15. *Id.* ¶ 118.
16. *Id.*
17. *Id.* ¶¶ 120-30.

certain European countries that gave it the opportunity to charge high prices for third party sales of ranitidine. Moreover, generic drugs were available in the Canadian market at that time, but were not available in most European markets.[18] Also, the transactions between the Glaxo group and its European licenses generally included the purchase of ranitidine bundled with the use of intangibles for a single price, whereas the taxpayer had a separate supply agreement under which it paid a price for the purchase of ranitidine only.[19] The taxpayer also performed more functions and assumed more obligations than the European distributors, justifying a lower transfer price or a higher gross profit margin to the taxpayer under the resale price method.

In its analysis, the Court also found that the taxpayer had not satisfactorily established the transfer price paid by the Glaxo group's European distributors and provided no explanation for excluding certain potentially comparable distributors that had lower transfer prices. The taxpayer's position was not helped by the results of its transfer pricing analysis using the resale price method, as there was a wide range among the gross profit margins estimated for the included European distributors (from 45.8% to 82.4%) which, in the opposing expert's opinion, undermined the reliability of the analysis.[20]

Since the Court found that the generic companies were an appropriate comparable under the CUP method, the taxpayer's use of the European distributors as a comparable under the resale price method was rejected, as was its use of the transactional net margin method (TNMM) as a reasonableness check on the price paid by it for ranitidine.

Taxpayers who deal with transfer pricing issues in their businesses should take heed of the fact that in analyzing its first major transfer pricing case, the Court fully endorsed the Transfer Pricing Guidelines, including its recommended ordering of transfer pricing methods, its endorsement of traditional transaction methods over the profit-split method and the TNMM, and its preference for the CUP method over all other methods.

B. Other Canadian Tax Court Decisions

The Tax Court of Canada released two judgments on May 16, 2008: *American Income Life Insurance Company v. Her Majesty the Queen*[21] and *Knights of Columbus v. Her Majesty the Queen*.[22] These decisions provide valuable judicial insight with respect to the meaning of "permanent establishment" in the Treaty and with respect to the more general interpretation and application of this concept as it is used in OECD-type tax treaties.

The facts in each case are strikingly similar. The taxpayer, in each case, was a U.S.-based life insurer that solicited sales of life insurance policies to Canadians. In each case, the solicitations were made by Canadian-resident agents who were remunerated on a commission basis. Each sales agent was an independent contractor and was part of a geographically-based hierarchy of agents. Generally, the further up the hierarchy an agent was, the less his or her duties involved sales solicitation and the more his or her duties involved supervision and sales management. Typically, sales solicitation occurred at the prospective insured's home. The sales agent would explain the various insurance products

18. *Id.* ¶ 55.
19. *Id.* ¶ 138.
20. *Id.* ¶ 148.
21. Am. Income Life Ins. Co. v. Her Majesty the Queen, [2009] 2 C.T.C. 2114 (TCC.).
22. Knights of Columbus v. Her Majesty the Queen, [2009] 1 C.T.C. 2163 (TCC.).

available and assist the prospective insured in completing a life insurance application. The application was forwarded to the taxpayer's underwriting department. All underwriting activities, and all decisions with respect to accepting (with or without modification the insurance applied for based on the information in the application) or denying coverage were made by the taxpayer's employees in the United States. Each taxpayer was managed in the United States. Neither taxpayer had its own offices in Canada.[23]

In most cases, a prospective insured who provided the initial insurance premium to the sales agent was provided with limited temporary life insurance that took effect as of the time of the application, provided that the insured's coverage was approved (in the United States) as applied for, without modification. In other words, once the insured's application was approved "as is," the temporary insurance took effect on a retroactive basis from the time of the application.

Both taxpayers were regulated by the Office of the Superintendent of Financial Institutions (OSFI). Canada's insurance laws required each taxpayer to have a so-called "Chief Agent" in Canada, whose responsibilities included records management, serving as an attorney-for-service, and assisting OSFI in ensuring that various reserve-related and financial Canadian regulatory requirements were met.[24] Each taxpayer made extensive Canadian regulatory/financial filings with OSFI.

Each taxpayer took the position that it was not subject to tax in Canada on its business profits associated with the sale of insurance policies to Canadian insured's because they did not have a permanent establishment in Canada within the meaning of the Treaty. Canada's federal tax authority (the Canada Revenue Agency, or CRA) disagreed and assessed Canadian tax on the business profits it determined to be attributed to the Canadian business activities. CRA took the position that each non-resident insurer had a fixed base permanent establishment (either or all of the homes or offices of agents and Chief Agent) or a dependent agent permanent establishment (on the grounds that sales agents were not of independent status and concluded temporary or permanent insurance or other contracts on behalf of the insurer or that the Chief Agent concluded such contracts).[25]

Accordingly, the issues in each case were as follows:

- Did the taxpayer have fixed place permanent establishments within the meaning of Article V(1) of the Treaty?
- Did the taxpayer have dependent agent permanent establishments in Canada? In other words, did the taxpayer's dependent agents conclude contracts on behalf of the taxpayer, within the meaning of Article V(5) of the Treaty? And, if they did, were the agents "of independent status" within the meaning of Article V(7) of the Treaty?[26]

In each case, the Tax Court of Canada concluded that the taxpayer had no permanent establishment in Canada. Neither case was appealed by the Crown.

Throughout the judgments, the Tax Court referred to extrinsic evidence in order to give legal content to the concept of permanent establishment. That extrinsic evidence included review of the OECD Commentaries, because the Treaty is modeled on the

23. *Am. Income Life Ins. Co.*, [2009] 2 C.T.C. 2114, ¶¶ 3-24; *Knights of Columbus*, [2009] 1 C.T.C. 2163, ¶¶ 3-23.

24. *Knights of Colombus*, [2009] 1 C.T.C. 2163, ¶ 7.

25. *Id.* ¶ 47; *Am. Income Life Ins. Co.*, [2009] 2 C.T.C. 2114, ¶ 34.

26. *Am. Income Life Ins. Co.*, [2009] 2 C.T.C. 2114, ¶ 32; *Knights of Colombus*, [2009] 1 C.T.C. 2163, ¶ 1.

OECD's Model Convention, and the testimony of various experts in the *Knights of Columbus* matter. Extrinsic evidence has been determined to be particularly helpful in interpreting international tax treaties by the Canadian courts because, as previously pointed out by the Supreme Court of Canada, "[i]n interpreting a treaty, the paramount goal is to find the meaning of the words in question. This process involves looking to the language used and the intentions of the parties."[27] The testimony of the expert witnesses, in particular, was also found to be relevant and necessary to assist the Tax Court in determining the intentions of the drafters of the Treaty. Overall, the extrinsic evidence assisted the Tax Court in making several significant legal findings relating to the interpretation of the concept of permanent establishment, including the following:

- A fixed base permanent establishment will not exist unless all of the following are true:

  (i) there must exist a place of business;

  (ii) there must be a degree of permanence to that place of business; and

  (iii) the business of the non-resident (not the business of any agents in Canada) must be carried on through that place of business.[28]
- A dependent agent permanent establishment will not exist unless the following are true:

  (i) there is a person who habitually exercises authority to conclude contracts in the name of the non-resident; and

  (ii) that person is not an agent of independent status acting in the ordinary course of his or her business.[29]
- The types of contract that are relevant for determining whether an agent concludes contracts in the name of the non-resident are contracts that constitute the "business proper" of the non-resident.[30]
- In determining whether an agent is of independent status, a court must examine both legal independence and economic independence. Only an agent that is both legally and economically independent will be found to be an agent of independent status, and therefore not capable of constituting a dependent agent permanent establishment.[31]

There were two other matters in which the expert testimony was particularly helpful to the Tax Court. First, the Tax Court concluded that a fixed base permanent establishment will not exist if the non-resident does not have a "right of disposition" or "power of disposal" (the two phrases appear to have been used interchangeably) in reference to the Canadian premises in question.[32] The Tax Court (and the experts) appear to have had some difficulty in defining precisely what was meant by a right of disposition or a power of disposal. Ultimately, the Tax Court concluded that, "it comes down to. . .distinguishing the agents' business activities from the [non-resident's] business activities," and the in-

27. Crown Forest Indus. Ltd. v. Canada, [1995] 2 S.C.R. 802.

28. *Am. Income Life Ins. Co.*, [2009] 2 C.T.C. 2114, ¶ 34.

29. *Knights of Colombus*, [2009] 1 C.T.C. 2163, ¶ 49. The Court also pointed out that an agent cannot be engaged in certain preparatory or auxiliary activities, defined in Article V(6) of the Treaty.

30. *Id.* ¶ 49.

31. *Am. Income Life Ins. Co.*, [2009] 2 C.T.C. 2114, ¶ 74.

32. *Knights of Colombus*, [2009] 1 C.T.C. 2163, ¶¶ 33, 78.

quiry is to determine if a sufficient amount of the non-resident's business activities are being carried on from the Canadian premises in question.[33]

The second matter in respect of which the Tax Court relied on the experts' testimony related to the inference to be drawn from the absence of a so-called insurance clause in the Treaty. Many UN-type model treaties (and some treaties to which Canada is a party) contain clauses that deem a permanent establishment to exist in an insurance company context if the non-resident insures risks in the source jurisdiction or if premiums are collected from insured's in the source jurisdiction. The Treaty does not contain such a clause, and both taxpayers argued, relying on OECD Commentary, expert witness testimony, and U.S. jurisprudence, that the absence of such a clause in the Treaty permitted the Court to infer that the Treaty contemplates that a U.S. insurance company may conduct large-scale business in Canada without having a permanent establishment in Canada. The Tax Court agreed, noting that Canada "has had many opportunities over several years to add the insurance clause to the Canada-U.S. Treaty, but it has chosen not to do so," even though an insurance clause is included in some of Canada's other tax treaties.[34]

With this background, the Tax Court held that neither U.S. insurer had a permanent establishment in Canada. None of the agents' premises (homes or offices) constituted fixed base permanent establishments because it was the agents' businesses that were conducted from those premises, not the insurers' businesses. Neither insurer had a sufficient power of disposal over the agents' premises. Numerous factors (listed especially in the *American Income Life* case) pointed towards the conclusion that the agents' premises were used to conduct the agents' businesses of "soliciting sales" or "developing a hierarchy of agents."[35] Similarly, each Chief Agent's office was not a fixed base permanent establishment of the non-resident insurer–the Chief Agent conducted his own law or accounting business and fulfilled regulatory functions for the non-resident insurer in connection with that business.

Similarly, the Court found that neither insurer had dependent agent permanent establishments in Canada because the agents did not conclude contracts (that were part of the non-resident insurer's "business proper") on behalf of the non-resident insurer.[36] The Court concluded, relying on arguments made in the *American Income Life* case, that because the temporary insurance agreements were part of the underlying insurance policy of each insurer, and because the underlying insurance policy was concluded in the United States following the insurers' underwriting analysis, Canadian agents did not conclude contracts on behalf of the non-resident insurer by virtue of the agents' involvement in the temporary insurance agreements. In any event, on the facts, most or all of the agents were of independent status because they were legally and economically independent (again, numerous specific factors were listed in the *American Income Life* case). It did not matter that certain contracts (for example, agent agreements and the Chief Agents' signing authority over Canadian bank accounts) may have been concluded in Canada because those contracts were not part of the "business proper" of the non-resident insurer.

33. *Id.* ¶ 79.

34. *Id.* ¶ 84.

35. *Am. Income Life Ins. Co.*, [2009] 2 C.T.C. 2114, ¶ 53.

36. *Id.* ¶ 58; *Knights of Colombus*, [2009] 1 C.T.C. 2163, ¶ 50.

American Income Life and *Knights of Columbus* should be considered as welcome additions by international tax professionals in cross border planning where the meaning of permanent establishment and the scope of a source jurisdiction's capacity to tax the business profits of non-resident business enterprises under OECD-type treaties that contain similar "Permanent Establishment" and "Business Profits" provisions is involved. Taken together, the cases work to provide a comprehensive analysis of the legal and practical content of the permanent establishment concept. *Knights of Columbus* provides guidance as to the role of experts in tax treaty cases generally and as to the requirement that a non-resident enterprise must have a "power of disposal" over the premises in which the business activities are carried on for the premises to be considered a fixed base permanent establishment. *American Income Life* provides a practical checklist of specific factors that a court and taxpayers should consider in determining (i) whose business is being carried on at the premises in question for purposes of determining if there is a fixed base permanent establishment and (ii) whether an agent is sufficiently legally and economically independent to be considered an agent of independent status. Finally, in the insurance company context specifically, the cases may support the contention that, in circumstances where a tax treaty does not contain an insurance clause, a court may construe such an absence as implicit agreement by the treaty parties that an insurer resident in one contracting treaty state may conduct large-scale business in the other treaty state without attracting that state's income tax on business profits.

III. Developments in Japan

In January 2008, months before the full extent of its financial woes came to light,[37] the U.S. financial giant Citigroup, Inc. acquired the Japanese brokerage firm Nikko Cordial Corporation for approximately 530 billion yen (US$4.8 billion). The transaction marks the first time a foreign company has employed Japan's newly authorized cross-border triangular merger technique in an acquisition—a tax-deferred corporate reorganization long accepted and authorized by many other industrialized nations' laws, but neither legal nor tax-free under Japanese law until May 2007, following a long and public debate. Citigroup, a U.S. publicly traded corporation, which already had a presence in Japan

37. On Nov. 23, 2008, the U.S. Treasury Department agreed to bail-out financially distressed Citigroup, Inc., which had sustained hundreds of billions of U.S. dollars in losses since the worldwide credit crisis began in 2007 with the collapse of the U.S. subprime mortgage market. Under the 2008 rescue plan, the U.S. government will recapitalize Citigroup with US$20 billion and shoulder most of the losses the financial giant has accrued on its $306 billion portfolio. In exchange, the U.S. government will receive preferred Citigroup shares and warrants to buy Citigroup common stock. *See* David Ellis, *Citi Dodges Bullet*, CNNMONEY.COM, Nov. 24, 2008, http://money.cnn.com/2008/11/23/news/companies/citigroup/?postversion=2008112400. Citigroup had to make other concessions, such as cut-backs on executive compensation. Citigroup also announced plans in late 2008 to cut personnel at its Japanese subsidiaries. Specifically, employees at Citigroup's Japanese retail and wholesale brokerages will be asked to accept early retirement packages with incentive bonuses equal to nearly two times an employee's annual salary. With Japan's business environment deteriorating, Citigroup may be compelled to further restructure its operations in Japan and carry out additional reductions in its work force. The labor reductions are bound to trigger claims of "I told you so" by certain Japanese groups and opponents of the cross-border merger provision who had argued for more insular rules and warned of domestic labor troubles if the triangular merger technique became legal.

through its 100 percent owned subsidiary, Citigroup Japan Holdings Ltd.,[38] was seeking to expand and develop comprehensive financial services in Japan and East Asia by combining both brokerage and banking services at the retail level. This goal is especially welcome from Japan's perspective, as evinced by several massive Japanese legislative packages in recent years, all aimed at getting more Japanese individuals to shift their enormous collective savings out of low-interest deposits into higher-yielding investments.[39] With Citigroup's own losses from the collapse of the subprime mortgage market beginning to mount in 2007, Citigroup apparently chose this tax-deferred acquisition structure since it could use its own stock as acquisition currency, avoiding the necessity of a large cash expenditure.[40]

Although the battered U.S. financial services giant later announced, in April 2009, that the global financial meltdown was causing it to auction off large portions of its Japanese operations once seen as central to its growth—including the market trading divisions of Nikko Citigroup Ltd., along with the retail brokerage, Nikko Cordial Securities, Inc.[41]—Citigroup's original acquisition method will endure as a legal legacy, marking a fundamental turning point in Japan's international tax policy.[42]

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38. In the Spring of 2007, Citigroup Holdings launched a tender offer for Nikko shares in which it acquired 68 percent of Nikko's outstanding stock. Because most of Nikko's shares were already owned by the Japanese subsidiary of Citigroup, that subsidiary, as a Nikko shareholder, could be relied upon to approve the triangular merger. *See Citi Swallows Nikko via Tri-Merger*, NIKKEI WEEKLY, Oct. 8, 2007.

39. Between late June 2005 and 2006, when Japan passed several mammoth pieces of legislation aimed at expanding Japan's financial services and investments market, including the 2006 Financial Instruments and Exchange Law, and the Privatization Acts, nearly 51 percent of Japanese households' financial portfolios were held in cash and deposits, as opposed to just 18.5 percent in stocks, bonds, mutual funds, and investment trusts. By contrast, U.S. households' portfolios averaged 13.5 percent in cash and deposits and 53 percent in stocks, bonds, mutual funds, etc., while German households averaged thirty-five percent in cash and deposits and 33.4 percent in stock, bonds, mutual funds, etc. *See* FINANCIAL SERVICES AGENCY, JAPAN, NEW LEGISLATIVE FRAMEWORK FOR INVESTOR PROTECTION—FINANCIAL INSTRUMENTS AND EXCHANGE LAW 3 (2006), *available at* http://www.fsa.go.jp/en/policy/fiel/20061010.pdf. For an overview and circumspect analysis of Japan's sweeping Privatization Act, a major piece of legislation ostensibly aimed at opening up Japan Post—perhaps the world's largest state subsidized savings deposit institutions—to private and foreign competition over a ten-year period, *see* Pamela A. Fuller, *Asia and Pacific Law*, 41 INT'L LAW. 711, 717-26 (2007). For an overview of the 2006 Financial Instruments and Exchange Law, *see* Pamela A. Fuller, *International Investment and Development*, 42 INT'L LAW. 511, 518-23 (2008).

40. Unlike a direct merger, where the target is merged directly into the corporate acquirer, the structure employed by Citigroup is called a "triangular merger" by M&A and corporate tax attorneys because a subsidiary is used as an acquisition vehicle. Under terms of the triangular merger, Citigroup first transferred some of its own shares to its wholly owned Japanese subsidiary (Citigroup Holdings), which shares were then immediately transferred to Nikko in consideration for the exchange of all of Nikko's assets and liabilities. Nikko, in turn, transferred Citigroup's stock to its own shareholders who, in exchange, relinquished their shares in Nikko (the target). Nikko was then legally merged into Citigroup Holdings in May 2008. Following the transaction, Citigroup Holdings held all of Nikko's business assets and liabilities in corporate solution and continued to conduct the businesses formerly conducted by Nikko, including Nikko's former subsidiaries and unincorporated divisions. Citigroup Holdings continued as the wholly owned Japanese subsidiary of Citigroup. Many of Nikko's former shareholders became shareholders of the U.S. parent Citigroup, although any shareholders who objected to the deal had the option to receive cash instead of Citigroup shares.

41. *See Citigroup Considers Sale of Some Nikko Citigroup Ops*, NIKKEI, April 14, 2009.

42. Reversing its previous stance that its Japanese brokerage operations would not be put on the auction block, Citigroup Inc. announced in mid-April 2009 that it was leaning towards selling large parts of Nikko Citigroup Ltd., along with the retail brokerage Nikko Cordial Securities, as part of its restructuring efforts. On April 20, 2009, Japan's three largest banks—Sumitomo Mitsui Financial Group Inc., Mitsubishi UFJ Financial Group Inc. (MUFG), and Mizuho Financial Group Inc.—each submitted offers to buy Nikko Cor-

Over the past decade, Japan has been authorizing more and more tax-deferred corporate restructuring techniques, but none were permitted in the cross-border context. Rather, mergers and acquisitions between Japanese and foreign companies has been stymied by Japan's lack of transactional tools to achieve optimal structures for multinational corporations. For years, Japan's Commercial Code (the predecessor to the 2005 Companies Law) allowed direct mergers between two Japanese corporations, but direct mergers involving foreign corporations were not allowed. Likewise, the Commercial Code did not allow merging companies to use shares of a foreign corporation as consideration in the merger.[43]

Finally, on May 1, 2007, a controversial provision contained in the 2005 Companies Law[44] allowing Japanese companies to engage in cross-border triangular mergers with foreign corporations took effect after a long debate over the new rule's potential impact on foreign investment in Japan. Like the former Commercial Code, the 2005 Companies Law still does not permit a direct merger between a Japanese corporation and a foreign corporation, but it does sanction inbound triangular mergers—meaning that shares of the acquiring Japanese corporation's foreign parent can be used as consideration in the deal. Thus, under the provision, the parent of the surviving corporation can be a foreign entity, but both the merged target and the surviving corporation (i.e., the Japanese subsidiary into which the target is merged)[45] must be resident Japanese corporations, which means that the new law only facilitates inbound investment transactions.[46]

The Japanese government hopes that lifting the ban on cross-border triangular mergers will stimulate a higher level of foreign direct investment (FDI) into Japan, which level lags way below the inward FDI levels of other industrialized countries.[47] Because foreign cor-

dial Securities Inc. in a deal that is expected to total 400 to 500 billion yen. After it reviews the bids, Citigroup will grant preferential negotiating rights to one of the bidders, setting the stage for the final agreement. Because MUFG is Japan's largest banking group, it is seen as the leading candidate. *See SMFG, MUFG, Mizuho in Round 2 Nikko Cordial Bid*, NIKKEI, April 21, 2009; MUFG Seen as Front-Runner In Deal For Nikko Cordial, NIKKEI, April 21, 2009.

43. This policy was not on par with the laws of other industrialized countries, most of which sanction several tax-deferred methods of structuring cross-border corporate reorganizations involving foreign corporations. *See, e.g.*, U.S. Treas. Regs. §§ 1.367(a)-3(c) and 1.367(a)-3(d)(3), Example 5 (1998) (U.S). In a sense, Japan shares the same fears as far less developed countries, which are more reluctant to legalize tax-deferred share exchanges between domestic and foreign corporations due to fears of expropriation.

44. Kaisha Ho [Companies Law], Law No. 86 of 2005 [hereinafter *2005 Companies Law*]. The 2005 Companies Law integrated several statutes covering Japan's business entities, including rules applicable to their incorporation, governance, and power to flexibly engage in M&A transactions. For an overview, *see* Pamela A. Fuller *Asia and Pacific Law: Japan*, 40 INT'L LAW. 515, 521-23 (2006); Pamela A. Fuller, *International Mergers and Acquisitions: Japan*, 40 INT'L LAW. 311, 325-28 (2006).

45. American tax attorneys often refer to this structure, in which the target's corporate identity is dissolved, as a "forward triangular merger." A "reverse triangular merger," in which the target corporation survives, and the parent corporation's subsidiary dissolves, is a very popular U.S. acquisition technique, but it is not presently sanctioned under Japan's Companies Law, as amended.

46. A corporation is considered a resident of Japan if either its headquarters or principal office is located in Japan. For a more extensive explanation of these rules, including the potential for creating so-called dual resident companies, and their tax treatment, see Pamela A. Fuller, *The Japan-U.S. Income Tax Treaty: Signaling New Norms, Inspiring Reforms, or Just Tweaking Anachronisms in International Tax Policy?*, 40 INT'L LAW. 773, 791-93, 807-18 (2006).

47. In 2006, Japan's inward foreign direct investment (FDI) set a new record, increasing by 51.7 percent to US$45.6 billion. Both Japan's inward and outward FDI levels hit record peaks but resulted in a net capital investment outflow of US$6.8 billion, taking into account the balance of payments. In contrast, almost all

porations will be able to use their own stock as takeover currency, the new amendment makes it less expensive and easier for foreign corporations to acquire Japanese companies.

But the possibility that these acquisitive reorganizations might be too easy to execute has triggered fears that they might result in a wave of unfriendly foreign takeovers of Japanese companies. Although mergers must necessarily be negotiated by corporate boards and are not tantamount to hostile takeover bids,[48] Japan's powerful business lobby, the Japan Business Federation, also known as *Nippon Keidanren* (*Keidanren*), warned the provision could give potential acquirers the chance to sell a Japanese target's assets and fire its employees immediately after a merger. Apparently likening the potential effects of cross-border mergers to hostile acquisitions, the *Keidanren* convinced lawmakers to defer the effective date of the foreign merger provision by one year, to May 2007, in order to draft special provisions to restrict the acquisition technique's availability. Most foreign business interests and academics heavily criticized the proposed restrictions as too protective and also violative of Japan's international obligation to refrain from discriminating against foreign investors.[49] Ultimately, the Diet rejected the restrictions and on May 1, 2007, lifted the ban on cross-border triangular mergers without further extensions of the provision's effective date.

Cross-border triangular mergers, even if legalized, stood little chance of becoming popular acquisition vehicles in Japan if the target company's shareholders, who exchange their shares in the target corporation for shares in the foreign acquirer's parent corporation, were required to immediately recognize and pay tax on the shares they relinquished without the receipt of cash to pay that tax.[50] Prior to amendment, shareholders of a Japanese target could only defer tax on their exchanged shares if the acquiring company was another Japanese corporation.

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other industrialized countries recorded a net capital inflow of FDI in 2006. For example, the United States netted an FDI inflow of US$180.5 billion; the United Kingdom netted an FDI inflow of US$139.5 billion; France netted an FDI inflow of US$81 billion; and China netted an FDI inflow of US$78 billion. *See* Japan External Trade Organization, 2007 JETRO White Paper on International Trade and Foreign Direct Investment–Increasing Utilization of Asian FTAs and Growth Strategies for Japanese Companies 50 (Aug. 8, 2007), *available at* www.jetro.go.jp/en/stats/white_paper/. Because Japan's population is aging rapidly, Japan needs more inward foreign investment to sustain its gross domestic product. Former Prime Minister Koizumi had set a goal, in 2002, of doubling inward FDI by the year 2007. But it soon became clear that his goal was unrealistic, especially after the government decided to delay, by one year, the effective date of the 2005 Companies Law provision sanctioning cross-border forward triangular mergers. In late 2006, the government set a new goal of doubling inward FDI by the year 2010.

48. A triangular merger is an "extraordinary transaction" under Japanese law, which generally requires a two-thirds majority vote of both the target company's shareholders and the acquiring Japanese company's shareholders. While it is theoretically possible to get this level of approval without management's consent, it is highly unlikely, even in a U.S. corporation, much less in a Japanese one.

49. Arguably, Japan's international obligations as a member of the World Trade Organization require authorization of cross-border triangular mergers due to the "national treatment" principle—i.e., the obligation requiring contracting countries to accord to a person, item, or activity originating in another contracting country treatment that is no less favorable than the treatment accorded to a domestic person, item, or activity. *See* Final Act Embodying the Results of the Uruguay Round of Multilateral Trade Negotiations, Apr. 15, 1994, 33 I.L.M. 1125 (1994).

50. Technically, in a forward triangular merger, the target company's shareholders exchange their old shares in the target for new shares in the foreign parent corporation and take an exchanged tax basis in the shares received. In general, a target shareholder who receives only stock (i.e., or other "permissible consideration") in a so-called "tax-free corporate reorganization" may defer tax recognition until the shareholder subsequently sells or disposes of the shares received in a taxable transaction.

In late 2006, Japan's tax authorities decided that foreign triangular mergers should receive virtually the same favorable tax treatment as purely domestic mergers and amended the tax law accordingly. This means that the inherent built-in gains and losses in the target's assets, and the built-in gains and losses inherent in the target shareholders' stock, may be tax deferred so long as the triangular merger satisfies certain requirements, which are generally more stringent and protective than most industrialized countries' rules in that no transient subsidiaries may be used as acquisition vehicles.

In particular, tax deferral in cross-border triangular mergers is allowed only if the following four requirements are met:

1. the foreign parent must hold 100% of the Japanese acquiring corporation prior to the merger and not intend to quickly dispose of the shares once the merger is completed;
2. a substantial percentage of the consideration given to the target's shareholders must be stock in the foreign parent;
3. the Japanese acquiring corporation must not be a transient corporation and must be engaged in a Japanese trade or business prior to the merger; and
4. the Japanese target and the Japanese acquiring corporation must meet a separate business relationship test, intended to ensure that the acquiring corporation is a bona fide business and that the transaction has a legitimate business purpose.[51]

Japan's legalization of cross-border triangular mergers is an important step towards opening up the country's capital markets to foreign direct investment. Indeed, this newly authorized tax efficient structure has already helped attract one of the world's financial giants, Citigroup, to invest in Japan. Despite the credit crisis that rocked major banks and economies in 2008, this restructuring method is nonetheless bound to help Japan reach its short-term goal of doubling inward FDI by the year 2010 and its long-range goal of becoming more competitive in the international marketplace for capital. While this type of merger is not likely to be used in hostile acquisitions, it may be an excellent vehicle for a white knight—the potential acquirer chosen by a target's board to rescue it from an unwanted bidder's takeover attempt. This defensive use of foreign triangular mergers would be most welcome in Japan's current, rather insular, corporate environment, and highly ironic given that the transaction's Japanese detractors were so fearful these transactions would become a powerful offensive tool in the hands of hostile foreign acquirers.[52]

51. *See* Shorei [Ministry Ordinance], Int'l Tax Policy Div., Tax Bureau, Ministry of Finance, April 13, 2007 (setting forth conditions for tax deferral in cross-border triangular mergers).

52. In 2008, there is new evidence that Japanese companies are reviving their traditional defense against hostile takeovers by placing large blocks of stock in the hands of loyal, affiliated companies, which, as history as shown, can be relied upon to support incumbent corporate boards. Moreover, many Japanese companies are rushing to institute other anti-takeover devises, such as poison pills—stock acquisition rights that can typically be used to dilute the voting power of an unwanted suitor. For an analytical overview of these developments, as well as a summary of newly revised ministry sponsored Takeover Guidelines, see another article in this volume, Pamela A. Fuller, *International M & A and Joint Ventures*, 43 INT'L LAW. 367, 402-405 (2009).