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A Study on the relationship of accounting with taxation in merger, etc. — Using recent cases as reference topics—

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The author who has been engaged in merger and business transfer of many companies including the companies listed on the First Section of the Tokyo Stock Exchange, specifically discuss on exchange of stocks and stock transfer in merger and acquisition or merger-like actions, using the recent cases as reference materials. Even for organizational restructuring of a domestic corporation, it is necessary to take into consideration the influence of tax laws of foreign countries, as there is the so-called triangle relationship among the Commercial Law (Company Law), the accounting standards based on the Securities Exchange Law and the Tax Law[1], plus the U.S. financial accounting standards and other international accounting standards which must be given a due consideration because of increasing numbers of foreign stock holders in Japan.

Keywords: corporate restructuring, purchase method, pooling-of-interests method acquisition business entity, business combination, merged corporate body, enterprise engaged in combination, carry-over deficits, goodwill, U.S federal taxation, transfer of stock, M&A, reorganization, deferred tax, exchange of voting stocks

I Review of the relationship between accounting treatment and tax system for corporate restructuring

(1) Characteristics of Purchase Method and Pooling-of-Interests Method

FASB141 and International Accounting Standards 22 have recently abandoned the pooling-of-interests method to unify the methods into

only the purchase method. The purchase method has the following characteristics.

" i. Relative voting rights after business combination in a company which has been combined – Acquisition business entity is a company where the owner stays or a company receiving a bigger portion of voting stocks.

ii. Presence of large portion by minority interests when other owners or groups of organized owners have some important portion of voting rights – An acquisition business entity is a combination enterprise in which a large portion of minority interests in the acquired business entity is typically held by a single owner or some groups of organized owners.

iii. Composition of the controlling body in a combined enterprise – An acquisition business entity is a combination enterprise, in which its owners or its controlling body has a capability of controlling or ruling most of voting stocks held by the controlling body of the acquiree.

iv. Composition of senior administrative management of the combined enterprise – An acquired business entity is a combined enterprise, in which the senior administrative management of the acquirer is controlling that of the acquiree.

v. Period of exchange of controlling equity – An acquisition business entity is a combined enterprise, in which other combined enterprises or business entities pay a premium on the market value of the capital equity." [2]

In Japan, for business combination, acquisition and equity are two different economic realities. As acquisition is a method to control the other enterprise, the purchase method will be applied, while when a certain requirement is met in acquisition, it has been approved to adopt the pooling-of-interests method. By judging the continuation of equity from the two controllable aspects, namely kind of consideration and control, if all the following requirements are met, it shall be judged

that the equity continue, and for such combination in business, it has been determined to apply the pooling-of-interests method.

" i. All the equivalents paid for a business combination shall be the voting stocks.

ii. The ratios of the voting rights which have been held as a whole after the combination by the stockholders who belonged to each enterprise engaged in combination shall be equal.

iii. There shall be no certain fact indicating a control relationship other than ratios of voting rights." [3]

The characteristic in this case is that, by the purchase method, a surviving

company purchases an extinguishing company at a fair value (current value) to hold a controlling right upon it. Contrary to this method, based on the pooling-of-interests method, a surviving company is on an equal footing with an extinguishing company, which allows continuation of management, involving no relationship of control and non-control between the two parties concerned. Therefore, this is a merger making it possible for the surviving company to accept the asset of the extinguishing company at its book value.

(2) Eligible tax system or non-eligible tax system ?

Under the tax system for corporate reorganization, a matter of concern for enterprise lies in the aspect of whether the tax system is eligible or non-eligible.

Such eligible merger is defined to be one of the following applicable cases:

"(a) A merging corporate body has a relationship of holding directly or indirectly all the issued stocks of the merged one.

(b) If the merging corporate body and the merged one have an equity relationship of holding over 50% and less than 100% of the stocks, which shall be one of the following: i. roughly more than 80% of the

total number of the employees who were counted immediately prior to the merging are expected to continue their jobs in the merging corporate body. ii. The major business of the merged corporate body is expected to be continued by the merging one.
(c) It is a merger for the purpose of undertaking a mutual business by both the merging corporate body and the merged one: i. The stocks of the merged corporate body which have been issued at the time of merger are expected to be continuously held by the merging one. ii. It is the condition corresponding to (i) and (ii) of (b). In case of an eligible merger, in addition to the above requirements, there is another requisite, in which any asset other than the stocks of the merging corporate body shall not be provided to the stock holders, etc. of the merged corporate body." [4]

The below-mentioned differences will arise, depending on an eligible merger or a non-eligible merger.

First, for the merger of bodies established under domestic law, if it is a non-eligible merger, the assets, etc. will be valuated at current values, whereas, if for an eligible merger, the merged corporate body has transferred its assets to the merging one, the transfer of assets, etc. is regarded to have been done at book values, from which no capital gains or losses accrue, resulting in no taxation relationship.

Secondly, for a non-eligible merger, no transfer of carry-over deficits is not allowed, whereas for an eligible merger, the transfer of carry-over deficits of the merged company is allowed.

(3) Accounting and taxation prior to the establishment of tax system for corporate reorganization.

Treatment of carry-over deficits and assets valuation in merger under the Corporation Tax Law, before the provisions of an eligible merger and a non-eligible merger on the tax system of corporate reorganization were established, was as follows;

First, for a merged corporate body, "an amount of loss subject to the provisions of Article 57 and Article 58 of the Corporation Tax Law

(on carry-over, etc. of an amount of loss in the business year when a blue return form is submitted) which is not calculated in deficits of the merged corporate body within the business year, to which the date of merger belongs, shall not be included in the calculation of deficits of each business year of the transferee corporation." [5] If the carry-over deficit of a merged corporate body is allowed to be deducted, the net balance of the income of a transferee corporation will be aggregated with the deficit of a merged corporation in the profit-and-loss calculation. This may cause tax evasion, making it easy to purchase a deficit corporation.

Secondly, regarding the treatment of a carry-over deficit of a transferee corporation, the acquisition of a non-deficit corporation by a deficit corporation is called a reverse merger, because deduction of the carry-over deficit of a merged corporation is not permitted to be transferred. This reverse merger is accepted under the corporation tax law only when there are some reasonable, economic reasons. If a merger is solely intended to avoid taxes, it may be valid on the Commercial Law, but there is a judicial precedent[6] which rejected the merger on the Corporation Tax Law.

Thirdly, before the tax system for corporate reorganization was established, even when , for an insolvent company having carry-over deficits, a surviving company has accepted the assets of an extinguishing company at current values in order to dissolve the liabilities in excess of assets, there is an approved method, in which no tax is levied on the transferred amount of valuation profit up to the amount of excess liabilities. This demonstrates consistency in treatment of accounting and taxation. Therefore, for the amount of assets to be accepted at merger, which must be appraised by the below-current value principle, and if there were carry-over deficits in a merged corporate body, a latent profit of asset (land) was first entered in the calculation prior to the entry of a goodwill, and then the goodwill was entered in the calculation[7]. The amount of such goodwill was entered at a level just below the taxation level.

(4) Relationship between Purchase Method · Pooling-of-Interest Method and Taxation-eligibility · Taxation-non-eligibility

I will review below to see if there is consistency in the relationship between the purchase method · the pooling-of-interests method and the eligible merger · the non-eligible merger under the tax law, in accounting for valuation of the amount transferred into the balance sheet from a merged corporation (extinguishing company) to a merging corporation.

First, if the asset is entered at current value by the purchase method, it will be a tax-non-eligible merger, while, if entered at book value by the pooling-of-interests method, it will be a tax-eligible merger. I wonder if consistency between the above two cases can be recognized. Or, as in the case of valuation of consolidated financial statements by book values, the accounting treatment and the tax system for corporate reorganization are two different things. Therefore, it will be a point in dispute whether a tax effect accounting as a means to connect the above two should be adopted or not. In this respect, regarding transfer of assets and losses by an eligible merger, even if a merged corporation enters valuation profits in a separate amount in order to dissolve deficits, the profits and losses from this transfer do not accrue. On the other hand, even if a merging corporation enters an appraised amount being different from book values for assets to transfer, it will be a transfer at book values, provided that the requirements for an eligible merger are met[8].

Therefore, even when the accounting treatment to transfer assets at current values by the purchase method is performed, the merger, from the taxation point of view, is ① a merger, in which cash and other assets are not granted for adjusting a merger ratio, which means a merger via only new stocks, and ② it is a transfer of business at book values, provided that the relationship of 100% stock holding and the relationship of over 50% to less than 100% stock holding as the requirements of the interested party as well as the requirements of merger for a mutual business are met. Then, as discrepancy between accounting and taxation occur, a tax effect accounting will become necessary.

Secondly, in case of an eligible merger, even though a merging corporation enters the amount corresponding to the whole or part of the carry-over deficit of a merged corporation as a goodwill in accounting treatment, the said goodwill shall not be treated as a transfer[9]. Consequently, although a goodwill is entered in the balance sheet, the discrepancy between accounting and taxation requires a tax-effect accounting method.

(5) Review on Goodwill of Merged Corporation with Liabilities in excess of assets

The problem is whether or not goodwill can be entered in the merged corporation.

In accountancy for goodwill, the excess earning power capitalization method or the expected earnings discount method will be usually used. However, in case of a merged corporation, operating or recurrent profits are in most of the cases negative due to a slump in sales, making it impossible to enter goodwill. Therefore, it will present a problem if a deficit company is allowed to argue goodwill. On this issue, a judicial precedent which did not approve such entry describes that "as goodwill indicates all the facts having intangible, proprietary values which are able to gain corporate earnings exceeding those of other enterprises, based on its long-standing tradition and social credibility, condition of business location, existence of special business relations, exclusivity of all these elements, etc., and as excess earning power in future cannot be expected, it is not reasonable to enter any amount of goodwill." [10] In this court decision, an excess earning power constitutes a criterion for judgment.

On the other hand, "there was a case which approved goodwill based on the valuation of the right of a navigation service route held by a deficit merged corporation. This case proves that, even without excess earning power if the said corporation has legal goodwill, goodwill of location and hidden profits of assets, these constitute the criterion for judgment. For a transferee of business, such goodwill becomes an acquisition for value, but the basis for calculation is necessary, and more over a person concerned in business must take

the burden of proof." [11] For instance, in case of a non-merged company, an accumulation method of multiplying a gross profit (for half an year) of each customer shop by the number of the customers to produce the amount of goodwill can be considered. For this case, a hidden profit of land should not be entered as a transfer to goodwill, but be entered at current values. In this case, for a non-eligible merger, the straight-line method within 5 years[12] is permitted for the entry of goodwill as well as its depreciation. Thus, advantages in taxation are obtained.

(6) Relevant Matters of Flexibility of Merger Consideration and Tax System

Under the company law in case of acquisition, it is usual to grant the stocks of the surviving company to the stockholders of the extinguishing company, but it also stipulates a flexible method of admitting the grant of cash and other assets other than the stocks as consideration for acquisition. For this method, the following problems may occur:

First, as a condition for an eligible merger, granting assets other than the stocks of a merging corporation (surviving company) to the stockholders (extinguishing company), etc. should not be allowed. Therefore, if such grant except the stocks is made, the merger becomes a non-eligible one, which will be subject to taxation.

Secondly, in Japan both the purchase method and the pooling-of-interests method are admitted. When there occurs a relationship of controlling and being controlled, continuity is then disrupted. As a result, a flexibility in merger consideration may apply under the purchase method, but it may be understood that, under the pooling-of-interests method, such flexibility will affect a ratio of voting rights and therefore shall not be admitted.

Thirdly, in case of granting cash other than stocks of the existing company, it has been pointed out that the stocks will be granted to the parent company, while cash will be given to minority stockholders, losing the balance of minority stockholders' equity. This means that, if

only based on appraisal of the corporate values of both companies prior to the merger, the minority stockholders of the extinguishing company calculate the amount of consideration for acquisition, such stockholders have to accept the appraised value prior to the merger, hence all the synergy effect can be exclusively absorbed by the surviving company (=majority stockholders)[13].

Fourthly, in the U.S., granting cash is called a Cash Out Merger. There is a judicial precedent of the court decision for Singer vs. Magnavox Co, the Delaware Supreme Court decided that a justifiable purpose in business was required for the large stockholders and directors to perform the cash grant[14].

(7) Review of Acquisition Merger

- Astellas Pharma. Inc. (Merger of Yamanouchi Pharmaceutical Co., Ltd. and Fujisawa Pharmaceutical Co., Ltd.)

The surviving company, ex Yamanouchi Pharmaceutical Co., Ltd.(new corporate name: ASTELLAS Pharma.Inc.) merged with the extinguishing company, ex Fujisawa Pharmaceutical Co., Ltd. on April 1, 2005[15]. The characteristics of this merger is as follows:-

First, the ratio of stock allotment was one stock of Fujisawa against 0.71 stock of Yamanouchi (new name after the merger: Astellas Pharma.Inc.) Instead of issuing new stocks for the merger with Fujisawa, Yamanouchi allotted its treasury stocks (29,000,000 stocks, total disposal amount ¥98,260 million), but did not make any allotment to the treasury stocks held by Fujisawa.

Secondly, the capital to be increased was 0, and the capital reserves in the amount of ¥59,897 million were derived from the excess amount in accordance with Section 1-5 of Article 288-2 of the Commercial Law deducting profit reserves ¥6,464 million, and retained profits such as voluntary reserves, etc. ¥210,782 million. The reason why the said capital was 0 is that the treasury stocks were given.

Thirdly, by this merger, the asset liabilities transferred from Fujisawa were the current assets in the amount of ¥208,829 million, the fixed assets ¥282,675 million, the total assets ¥491,505 million, the current liabilities ¥95,067 million, the fixed liabilities ¥7,252 million, the total liabilities ¥102,320 million which were shown in the individual financial statements of Fujisawa dated March 31, 2005. As these amounts were based on the book values, it can be seen that their accounting treatment was done by the pooling–of-interests method.

Fourthly, regarding the second requirement for an eligible merger (joint enterprise), both companies were similar in conducting pharmaceutical business. After the merger, this business has been continuing, and all the employees of Fujisawa were transferred to the merging company. When compared with equality in the size of the business prior to the merger, the merged company (Fujisawa) is supposed to be 1, and then the merging company (Yamanouchi) is 1.27 in sales, 2.26 in the capital amount and 1.12 in the number of employees, all of which were within a factory of 5[16]. For special officers (directors), 3 persons from Yamanouchi and 4 from Fujisawa have been appointed.

II Management Consolidation by Exchange of Stocks

For corporate reorganization by way of stock acquisition, there are stock exchanges, stock transfer and takeover bid of stocks. As this corporate reorganization does not influence at all the financial position of the company concerned, there is a characteristic of no need of taking a procedure for protection of creditors.

(1) Management consolidation by exchange of stocks

As the form of merger, such direct merger as observed in a surviving company (merging company) and an extinguishing company (merged company) has not been adopted, but recently a merger-like organizational action of forming a wholly-owned relationship of a parent company and its subsidiary company through exchange of stocks between both companies (Article 767 of the Company Law) is taking place[17]. Specifically, exchange of stocks is conducted in a

manner that a specific parent company (P Company) grants to the stockholders of a specific subsidiary company (S 1 Company) the stocks of P Company in exchange of the stocks of S 1 Company, thus holding the whole stocks of S 1 Company. This method is to make a wholly-own subsidiary company not through the process of merger.

First, for exchange of stocks, if the limit of increased capital amount stipulated in the Article 357 of the Company Law exceeds the increased capital amount of the wholly-owned parent company, the excess amount becomes capital reserves[18], which corresponds to the amount of the net assets of a company to become the wholly-owned subsidiary multiplied by the exchange ratio of stocks to be transferred to a company to become the wholly-owned company by exchange of stocks of the total number of the issued stocks, less the amount of grant for the exchange of stocks and the book values of the treasury stocks to be granted[19]. Needless to say, earning reserves and retained reserves of the wholly-owned company are not transferred.

Secondly, for the stocks of a wholly-owned company to be granted to a wholly-owned parent company, there are two methods, by which the net assets of the wholly-owned subsidiary should be valued either at the amounts in the books or at the stock prices.

Thirdly, the company to become a wholly-owned parent company is allowed to transfer its treasury stocks to the stockholders of the company to become a wholly-owned subsidiary. In this case, however, the total number of the stocks to be transferred, classes of stocks and the number of stocks by classes should be described in a stock exchange control[20]. In this case, as in the merger, an approval should be obtained by a special decision at the shareholders' meeting.

The point of dispute in the above case is whether or not it is necessary to enter the capital amount at the time of new stock issue. By the revision of the Commercial Law made in 2001, it has been decided that "the provision to stipulate the total amount of face values of par value stocks as the lowest limit for the increased capital of the company to become a wholly-owned company, the successor

company and the existing company in the case of stock exchanges, business divestures by absorption and mergers by absorption, and the provision to stipulate both the total amount of face values of par value stocks to be issued and the amount of non-par value stocks to be issued which should be multiplied by ¥50,000, as the lowest limit, for the capital amount of the company to become a wholly-owned company in the case of stock transfer, newly-established divestures and newly-established mergers and founded companies, were deleted. Therefore, in the former case, it has become possible not to increase the capital, and for the latter case, it has become possible to fix the minimum capital amount to be ¥10 million." [21] Thus, entry of the capital is not necessarily required.

(2) Tax system for stock exchanges, etc.

First, there is a special case of taxation on the succeeded book value of exchanged stocks. In the case that exchange of stocks and transfer of stocks ("exchange of stocks, etc.") are performed, when the requirements that the amount received by a specific parent company from the stocks of its specific subsidiary company is below the book value of the stockholders of the specific subsidiary company, and that the amount of new stock value to be issued for the transfer of stocks by a wholly-owned parent company is over 35% are met, deferment of taxation on capital gains obtained from transfer of the book values of the stocks of the specific subsidiary company shall be approved[22].

Secondly, taxation takes place when a specific parent company grants the treasury stocks by way of exchange of stocks. When a corporation established under domestic law assigns the treasury stocks, its amount of equivalent value for the assignment as the amount corresponding to the book value immediately prior to the assignment of the treasury stocks will be calculated for capital gains or losses. Therefore, the capital gains or losses will not accrue by assignment of the treasury stocks[23]. This is because the transfer of the treasury stocks to the wholly-owned subsidiary is stipulated in the Commercial Law.

(3) Management consolidation by way of exchange of stocks, etc. – Review on the case of Konica-Minolta

(i) Historical background

In the case of management consolidation of Konica and Minolta as well, they did not take a form of merger, but exchange of stocks. As a first step, they exchanged stocks to make Konica as the wholly-owned parent company and Minolta as its wholly-owned subsidiary company, and after their integrated holding company under the firm name of Konica-Minolta holding Co., Ltd. At the time of stock exchange, Konica newly issued 174,008,969 common stocks to the stockholders of Minolta at the exchange ratio of 0.621 common stocks of Konica-Minolta Holding Co., Ltd. (wholly-owned parent company) per common stock of Minolta(wholly-owned subsidiary company), but no payment for stock distribution was made[24].

(ii) Characteristic

First, as the stocks for consideration of acquisition in stock exchange was issued at current value, the calculation for the increased capital surplus accrued from the stock exchange is based on 280,207,681 stocks ×0.621 ×¥843=¥146,580,840. The increased amounts of capital reserves and surplus by the stock exchange correspond to the premium on stocks. Since these are capital transactions, profits and losses do not accrue[25].

Secondly, the incremental capital amount at issue of the new stocks following the stock exchange of Konica Minolta was 0, and the incremental capital reserves were ¥146,706 million. The reason why Konica Minolta Holdings (ex Konica) did not have any increase in the capital is due to the revision of the provision on capital of the Commercial Law made in 2001, as above explained.

Thirdly, as the valuation method for assets and liabilities of the consolidated subsidiary company was based wholly at current value, the consolidated adjustment account in the amount of ¥98,716 million accrued, and this amount was depreciated in equal installment for 20 years, about ¥5,000 million per year[26].

(Parent Company: Konica Minolta Holdings)[27]

Number of	Apr.1,'03	Aug.5,'03	Sep.30,'03
Issued Stocks	357,655,368		531,664,337
Incremental Issued Stocks via Stock Exchange (Stocks)		174,008,969	
Capital (¥Mil)	37,519		37,519
Capital Increment via Stock Exchange		0	
Capital Reserves (¥Mil)	78,883		157,501
Incremental Capital Reserves via Stock Exchange (¥Mil)		78,158	
Other Capital Surplus (¥Mil)	459		68,564
Other Incremental Capital Surplus via Stock Exchange		68,548	
Capital Surplus	79,342		226,065
Incremental Capital Surplus via Stock Exchange		146,706	

III Reorganization via Stock Transfer

(1) Merger-like organizational behavior via stock exchange

A company is allowed to transfer stocks in order to establish its wholly-owned parent company[28]. By setting up the company to become a wholly-owned company it is intended to establish at once a relationship among a company establishment, a wholly-owned parent company and a wholly-owned subsidiary company.

First, this is an establishment of a holding company by investment in kind of the stocks of a subsidiary company, which is a merger-like organizational behavior, due to its effect similar to merger.

Secondly, the capital of a wholly-owned parent company is the amount described in the management integration agreement proposed at the stockholders meeting, and the value of the subsidiary company is equal to the sum of the net assets of all the wholly-owned subsidiary companies.

Thirdly, the capital reserves of a wholly-owned company to be established are the amount deducting the sum of the capital and the amount to stock distribution from the sum of the net assets of the wholly-owned company at the date of stock transfer. However, there are different theories on the net asset value of this wholly-owned subsidiary company. One theory is that "assessing the existing, net assets of the company to become a wholly-owned subsidiary at the date of stock exchange, as in the case of assessing the asset value to be transferred from the extinguishing company in merger, will contribute to the development of fair accounting practice." [29] Another theory is that," at the time of stock exchange to make the company with excessive liabilities a wholly-owned subsidiary, it is allowed to reappraise the assets of this subsidiary, and, as a result, if the status of excessive liabilities can be dissolved, the stock exchange is possible." [30] According to the fair accounting practice in the former case, the net assets will be in book values in the balance sheet, and in the latter case it will be at current values. Instead of the latter theory adopting the method of current values for reappraisal of the assets by stock exchange, another method for assisting an insolvent company such as going to the rescue of a stagnant subsidiary company of the parent company should be first adopted.

(2) Tax System on Stock Transfer

First, for the case that the stocks of a corporate stockholder of a wholly-owned company are transferred to its wholly-owned parent company, if a wholly-owned parent company accepts the net assets of its wholly-owned subsidiary company at book values and makes them the value of the stocks of this subsidiary company[31], and if the value of new stocks granted by the wholly-owned parent company in stock exchange is over 95% of the total amount of new stocks granted, cash and other assets, — if these above requirements are met, there shall be no profit and loss from the transfer of stocks of the subsidiary company[32].

Secondly, in the case when the stocks of individual stockholders of a wholly-owned parent company accepts the net assets of its wholly-owned subsidiary company and make them a value of the stocks of

the subsidiary company[33], and if the value of new stocks granted by the wholly-owned parent company in stock exchange is over 95% of the total amount of new stocks granted, cash and other assets, — if these above requirements are met, there shall be no profit and loss from the transfer of stocks of the subsidiary company[34].

(3) Review on Management Integration via Stock Transfer – Daiichi Sankyo Co., Ltd. (Integration of Sankyo and Daiichi Pharmaceutical Co., Ltd.)

(i) Historical Background

Management integration via stock transfer is a procedure to establish a wholly-owned parent and subsidiary relationship by transferring stocks of the existing companies (Sankyo Co., Ltd. and Daiichi Pharmaceutical Co., Ltd.) from their stockholders to Daiichi Sankyo Co., Ltd. (holding company) on September 28, 2005. In exchange for obtaining stock certificates of Sankyo Co., Ltd. and those of Daiichi Pharmaceutical Co., Ltd. the newly established, wholly-owned parent company issues the new stocks corresponding to these above stocks to be granted to the ex stockholders of the two companies. Consequently, Sankyo Co., Ltd. and Daiichi Pharmaceutical Co., Ltd. become the wholly-owned subsidiary of Daiichi Sankyo Co., Ltd.

First, the class of stocks to be issued by the wholly-owned parent company at the time of stock transfer is a common stock with 771,498,064 stocks in number. This number was counted, based on the issued stocks of both companies i.e., the wholly-owned subsidiary as of March 31, 2005. The ratios of stock transfer were one (1) stock of Daiichi Sankyo Co., Ltd. for 1 common stock of Sankyo Co., Ltd., and 1,159 stocks of Daiichi Sankyo Co., Ltd. for Daiichi Pharmaceutical Co., Ltd. Therefore, the total number of new stocks is the sum of 439,498,765 issued stocks of Sankyo at the calculation base date of number of stocks multiplied by 1 and of 286,453,235 issued stocks of Daiichi multiplied by 1,159[35].

Secondly, the capital amount of the wholly-owned parent company

is ¥50,000 million, and the amount of its capital reserves is the amount deducting the sum total of the capital and stock grant from the total amount of net assets of both companies, i.e., the wholly-owned subsidiary, valued at the date of stock transfer, thus yielding ¥1,085,384 million[36].

Thirdly, after establishment of the holding company (Daiichi Sankyo Co., Ltd.) this stock transfer has been intended to reach the second stage of reorganization for integrating the ethical pharmaceutical business of the two companies i.e. the wholly-owned subsidiary, into Daiichi Sankyo Co., Ltd. in April 2007 as a goal. The issue is whether or not this procedure will be applicable to the organizational change stipulated in U.S. IRC.

IV Review on the Relationship between the Summary Method of Merger in Japan and the Reorganization Method in U.S.

(1) Characteristic of Reorganization in U.S.

The taxation system in the U.S. has the laws and regulations controlling tax business on M&A transactions involving corporations in the U.S. The core lies in the basic framework to cover selling and purchasing corporations, and to evaluate the results of tax on federal income generated by companies, stockholders, etc. Generally speaking in the U.S. irrespective of the country where income is generated, tax is levied on corporations merged under the law, covering the source of income to all the kinds of net income[37]. Therefore, the Federal income tax in the U.S. is a great concern to international corporations having a high ratio of American stockholders.

For reorganization in the U.S., there are basically Type A, Type B, Type C, Type D and Type E[38].

① Essential points and characteristic of Type A reorganization[39].

Type A reorganization is subject to the law governing mergers in each State, by which all the assets and liabilities of a target company

shall be transferred to an acquiring company. Therefore, the target company will be merged in the acquiring company, together with the stockholders of the target company who receive the stocks of the acquiring company. This is to satisfy the request of continued holding of equities, depending on the objectives written in private letters.

Thus, since stockholders of the merged company accept the value to be replaced by the stocks of the acquiring company at receipt of its common stocks, the treatment is non-taxable. However, in reference to gains, tax will be levied on either dividends in boots (cash except stocks) or capital gains[40].

An acquiring company, in principle, adopts a carry-forward approach for the assets of an acquired company[41]. Therefore, it will be treated as non-taxable, but boots (cash except stocks) will be required to increase the book values of the assets to receive[42]. Also, carry-over deficits will be brought in the acquiring company[43].

② Essence and characteristic of Type B reorganization [44]

In Type B reorganization, an acquisition company (acquiring company) acquires at least 80% of the voting stocks simply by way of stock exchanges of the acquired company(acquiree company), which means stock exchanges.

As a method of acquisition, the acquisition company acquires the stocks of the acquired company either by a stock acquisition agreement with the acquired company or by offering the request of stock exchange in accordance with the provision under the regulation of take-over bid in the Securities Act of 1934, for the case of an acquired company owned by tender.

After the establishment of the stock exchange, the acquired company becomes a subsidiary of the acquiring company.

In respect of tax, the stockholders of the acquired company are non-taxable[45]. Also, the acquirer uses a carry-over base[46] for the

stocks of the acquired company. Therefore, the acquirer is non-taxable[47].

③ Essence and characteristic of Type C reorganization [48]

In Type C reorganization, the acquisition company (business-assigned company) substantially acquires all the assets of the acquired company (business-assigning company) simply by exchange of voting stocks of the acquisition company. This is the case of business transfer and business takeover.

To begin with, an acquiring company acquires specific assets and specific liabilities of an acquired company in accordance with the acquisition agreement. Then, the acquired company goes into liquidation, receiving from the acquisition company the stocks which must be distributed to the stockholders[49].

In respect of tax, the acquired company is non-taxable[50]. As the stockholders of the acquired company use the replacement base method for the stocks of the acquisition company which they receive[51], their acceptance of the stocks of the acquisition company is non-taxable[52].

Because the acquirer uses a carry-over base method for the assets of the acquired company[53], the acquirer is treated as non-taxable[54]. Moreover, as the acquiring subsidiary carries forward the property of other taxes of the acquired company, the carry-over deduction of deficits is allowed[55].

④ Essence and characteristic of Type D reorganization[56]

In Type D reorganization, it is a transaction for a company (company to be apportioned) to substantially transfer all the assets to another company (controlling company). The company to be apportioned immediately after the transfer or its stockholders or combination is under the control of the controlling company. Apportionment by the company to be apportioned to the stockholders of the stocks or

securities of the company under control should be restricted under the provisions of the domestic Revenue Act[57]. In accordance with the reorganization plan, stocks received or securities received, as in the same manner for other properties, are portioned. As the company to be apportioned is taken away of its assets, the company is liquidated. This is subject to the provision of company split.

(2) Reorganization and deferred tax

For review on whether or not the difference between the purchase method in accounting treatment and reorganization will be an object of tax effect accounting, it is necessary to know the basic stance of U.S. Federal Income Taxation on reorganization.

Under the U.S. Federal Income Tax System, not only merger, but also stock acquisition and property acquisition are treated uniformly.

What is noteworthy on the basis of this taxation theory is that acquisition forms of merger has been basically recognized a sale of other dispositions of property since the start of registration (1918). Stipulating corporate acquisition including mergers as sale or other dispositions of properly in the same text has attached a great deal of importance to the nature of consideration of money, stocks, securities, etc. Such being the case, it should be noted that paper transactions as a reason for tax deferment fall upon the case of consideration of stocks even for acquisitions and property other than mergers. As a result, tax deferment should have been expanded to these forms of corporate acquisition[58], requiring tax effect accounting.

(3) Taxation relationship of U.S. Stockholders

If either at least 75% of a foreign company's gross income is passive under the U.S. Federal income tax, or less than 50% of its asset value holds the assets contributing to production, this income will be classified a Passive Foreign Investment company in a given taxation year[59]. One part of gross passive incomes of a foreign personal holding company consists of the following:

"(A) dividend, interest, royalty, rent, pension, (B) Excess gains or

loss from sale or dispositions of chattels, (C) commodity transaction (forward delivery which is similar to transactions in futures), (D) gains of foreign currency." [60] In this case, stockholders in the U.S. of a passive foreign investment company is allowed to postpone the payment of taxes until disposition of the stocks. However, the tax amount and the interest due to deferment must be paid, or they must make an income tax return by combining their own income with their shares for the retained earnings of the passive foreign investment company[61].

(4) Review on Management Integration of Daiichi Sankyo Co., Ltd.

Transfer of stocks by the stockholders of the former companies (Sankyo Co., Ltd and Daiichi Pharmaceutical Co., Ltd.) to the newly established Daiichi Sankyo Co., Ltd. is a procedure to create a wholly-owned parent-subsidiary relationship. The newly-established Daiichi Sankyo Company issued new stocks corresponding to the certificates of stocks acquired from Sankyo Co., Ltd. and Daiichi Pharmaceutical Co., Ltd. and delivered to the old stockholders of the said two companies. As the result, these two companies have become wholly-owned subsidiaries of Daiichi Sankyo Co., Ltd., to which the Daiichi Sankyo company group just correspond.

Firstly, Sales of Daiichi Sankyo shares by *Daiichi and Sankyo* may adversely affect the market price of Daiichi Sankyo shares. In order to comply with the Commercial Code of Japan, Daiichi and Sankyo will need to dispose of the Daiichi Sankyo shares they will receive in the joint share transfer as holders of one another's shares within a reasonable time after the joint share transfer. As of March 31, 2005, Daiichi held 2,602,000 shares of Sankyo common stock and Sankyo held 2,864,000 shares of Daiichi common stock. Based on the agreed exchange ratio, and assuming no change in such shareholding, Daiichi will own approximately 0.3% and Sankyo will own approximately 0.4% of the shares of common stock of Daiichi Sankyo immediately following the joint share transfer.These shares may be disposed of in market transactions through the Tokyo Stock Exchange or other securities exchanges on which Daiichi Sankyo's shares will

be listed, reacquired by Daiichi Sankyo through non-market share repurchases, or through other legally permissible methods. Although Daiichi and Sankyo intend to engage in orderly dispositions of their Daiichi Sankyo interests, any share dispositions may adversely affect prevailing market prices of Daiichi Sankyo shares.

Japan's unit share system imposes restrictions on the rights of holders of shares of Daiichi Sankyo common stock that do not constitute a "unit". Pursuant to the Commercial Code of Japan and certain related legislation, the proposed articles of incorporation of Daiichi Sankyo provide that 100 shares of Daiichi Sankyo common stock will constitute one "unit". The Commercial Code imposes significant restrictions and limitations on holders of shares that constitute less than one unit. In general, such holders do not have voting rights, and the transferability of such shares is significantly limited. Under the unit share system, holders of shares constituting less than one unit have the right to require the issuer to purchase their shares. In addition, Daiichi Sankyo's articles of incorporation will provide that a holder of less than a unit of Daiichi Sankyo shares may request that Daiichi Sankyo sell to such holder such amount of shares which will, when added together with the shares constituting less than one unit, constitute one unit of shares, as long an Daiichi Sankyo has treasury stock to sell upon such request.

Rights of shareholders under Japanese law may be more limited than under the laws of other jurisdictions. The articles of incorporation, Share Handling Regulations and Regulations of the Board of Directors of each company, and the Commercial Code of Japan, govern the affairs of Daiichi Sankyo, and will govern the affairs of Daiichi Sankyo. Legal principles relating to such matters as the validity of corporate procedures, directors' and officers' fiduciary duties and shareholders' rights may be different from those that would apply if any such company were a non-Japanese company.

Shareholders' rights under Japanese law may not be as extensive as shareholders' rights under the laws of other countries or jurisdictions within the United States. You may have more difficulty in asserting your rights as a shareholder than you would as a shareholder of a corporation organized in another jurisdiction. In addition, Japanese courts may not be willing to enforce liabilities

against Daiichi Sankyo in actions brought in Japan which are based upon the securities laws of the United States or any U.S. state.

The U.S. federal income tax consequences of the joint share transfer are uncertain, and Daiichi Sankyo intends to take the position that the joint share transfer is a taxable exchange unless it notifies U.S. holders of shares in Daiichi or Sankyo otherwise. The joint share transfer agreement between Daiichi and Sankyo contemplates the integration of the prescription pharmaceutical operations of the companies in or around April 2007. In light of this intention to pursue a subsequent business combination, the joint share transfer and the subsequent business combination may be treated for U.S. federal income tax purposes as forming a single integrated transaction. However, because the form of the subsequent business combination has not been chosen, the U.S. federal income tax consequences of the overall transaction cannot presently be determined. As soon as practicable after the form of the subsequent combination of Daiichi's and Sankyo's operations is chosen, Daiichi Sankyo intends to consider whether the joint share transfer and the subsequent business combination, viewed as and integrated transaction, qualify as a tax-free "reorganization" for U.S. federal income tax purposes with respect to Sankyo shareholders and (separately) with respect to Daiichi shareholders. Daiichi Sankyo also undertakes to notify U.S. holders of Sankyo or Daiichi shares who participate in the joint share tansfer of its conclusion in this regard. Before such notification, however, Daiichi Sankyo intends to take the position that the joint share transfer is a taxable exchange. There can be no assurance that the Internal Revenue Service, or the IRS, or a court will agree with Daiichi Sankyo's position. See "Taxation—United States Tax Consequences—The Joint Share Transfer" beginning on page 192. Each U.S. shareholder of Daiichi or Sankyo is strongly urged to consult its own tax advisor concerning the U.S. federal income tax consequences of the transaction and the proper reporting of the transaction on its tax return.

Even if the joint share transfer is to be treated as a step in an integrated transaction qualifying as a "reorganization" for U.S. federal income tax purposes with respect to Daiichi or Sankyo shareholders, Daiichi Sankyo may not be able to notify U.S. holders of this

conclusion until 2007. As soon as practicable after the form of the subsequent combination of Daiichi's and Sankyo's operations is chosen, Daiichi Sankyo intends to consider whether the joint share transfer and the subsequent business combination, viewed as an integrated transaction, qualify as a "reorganization" with respect to Sankyo shareholders and (separately) with respect to Daiichi shareholders. Daiichi Sankyo will also undertake to notify U.S. holders of Sankyo or Daiichi shares who participate in the joint share transfer of its conclusion in this regard. However, there can be no assurance that the IRS or a court will agree with Daiichi Sankyo's position. Moreover, notification regarding Daiichi Sankyo's position may not be made until shortly before the date of the subsequent integration of the prescription pharmaceutical operations of the companies as currently contemplated. See "Taxation—United States Tax Consequences" beginning on page 192. Each U.S. shareholder of Daiichi or Sankyo is strongly urged to consult its own tax advisor concerning the U.S. federal income tax consequences of corporate events relating to the companies subsequent to the joint share transfer and the proper reporting of the joint share transfer on its tax return[62].

Secondly U.S. holders of shares in Daiichi or Sankyo may be subject to adverse tax consequences if either Daiichi or Sankyo is or has been considered a passive foreign investment company, or a PFIC, for U.S. federal income tax purposes. Under U.S. federal income tax law, a foreign corporation is classified as a PFIC for a given taxable year if either at least 75% of its gross income is passive income, or at least 50% of the value of its assets is attributable to assets that produce or are held for the production of passive income. Each of Daiichi and Sankyo believes that it has not been a PFIC for each of the years ended March 31, 2004 and 2005, although there can be no assurance in this regard. Neither Daiichi nor Sankyo has made a determination whether it has been a PFIC for fiscal years prior to 2004. Specifically, based on the composition of its income and value of its assets (including goodwill), Daiichi believes that in the year ended March 31, 2004, (i) no more than 1% of its gross income was passive income and (ii) the average percentage of its assets, by value, which produce passive income or are held for the production of

passive income was more than 40% but less than 50%. At this time, Daiichi is unable to determine the actual percentage of its passive income or passive assets in the year ended March 31, 2005. However, Daiichi believes that, for purposes of determining whether it was a PFIC in the year ended March 31, 2005, such percentages are similar to the corresponding percentages in the year before. Based on the composition of its income and value of its assets (including goodwill), Sankyo believes that for each of the years ended March 31, 2004 and 2005, (i) no more than 7% of its gross income was passive income and (ii) the average percentage of its assets, by value, which produce passive income or are held for the production of passive income was more than 40% but less than 50%. Neither Daiichi nor Sankyo can give assurance regarding to the above calculations, however, because of difficulties associated with determining the fair market value of their respective assets. If Daiichi or Sankyo is or has been a PFIC, and if the joint share transfer is a taxable exchange for U.S. federal income tax purposes with respect to Daiichi or Sankyo's U.S. shareholders (which is the position Daiichi Sankyo intends to take unless it notifies such U.S. holders otherwise), then such holders of Daiichi or Sankyo, as applicabele, may be subject to adverse tax consequences. See "Taxation—United States Tax Consequences—Passive Foreign Investment Company" for further information. A transaction that would otherwise qualify as a tax-free reorganization with respect to a shareholder will not so qualify if the acquired corporation is or was a PFIC, during the period in which such shareholder had held its stock, and the acquiring corporation is not a PFIC after the transaction. Under this rule, if either Daiichi or Sankyo is or has been a PFIC at any time, the exchange of Daiichi or Sankyo shares for Daiichi Sankyo shares may be deemed a taxable disposition of PFIC shares, even if the joint share transfer would otherwise be considered as forming a part of a tax-free reorganization for U.S. federal income tax purposes. A taxable disposition of PFIC shares may result in adverse tax consequences. See "Taxation—United States Tax Consequences—Passive Foreign Investment Company" for further information.

U.S. holders of Daiichi Sankyo shares will be subject to adverse tax consequences if it is considered a PFIC for U.S. federal income tax purposes. Based on the projected composition of Daiichi Sankyo's

income and value of its assets, including goodwill, we do not believe that Daiichi Sankyo will be a PFIC for the current taxable year and we do not expect that it will become one in the future. However, PFIC status is a factual determination that is made annually. Accordingly, it is possible that Daiichi Sankyo may become a PFIC in the current or any future taxable year due to changes in valuation or composition of its assets. If Daiichi Sankyo were to be considered a PFIC, U.S. holders of Daiichi Sankyo shares would generally be subject to special rules and adverse tax consequences with respect to certain distributions made by Daiichi Sankyo and on any gain realized on the sale or other disposition of Daiichi Sankyo shares. Such U.S. holders might be subject to a greater U.S. tax liability than might otherwise apply and incur tax on amounts in advance of when U.S. federal income tax would otherwise be imposed. A U.S. holder of Daiichi Sankyo shares might be able to avoid these rules and consequences by making an election to mark its shares to market. See "Taxation—United States Tax Consequence—Passive Foreign Investment Company" for further information[63].

(Conclusion)

Based in the cases of organizational changes such as mergers, etc. which are taking place rapidly in recent Japan, the author took up and discussed the accounting issues, but in this paper the author did not take up the issues on exchange ratio of merger, sale of assets, problems of insolvent company, TPO, etc., as these have been discussed in other papers. For further information, please refer to his published papers shown in the reference.

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Remarks

1. Since in this paper the author discussed both aspects of accounting and tax laws, such pair words as continuing company vs. extinguishing company

in accounting, and acquiring company vs. acquired company in tax laws were used.

2. FASB, FASB Statement No.141 *Business Combinations* ,par17
3. From the Statement of Opinion on Accounting Standard related to Business Combinations
4. See 8-12, 2-62 and 63, Article 2 of Corporation Tax Law
5. Basic Circular Notice No. 4-12-18 of the former Corporation Tax Law
6. Court Decision dated February 21, 1972 and Court Decision dated June 19, 1985
7. Basic Circular Notice No. 4-2-8 of the former Corporation Tax Law
8. Article 62-5 of Corporation Tax Law and Article 123-3 of Enfercement Ordinance of the Corporation Tax Law
9. Basic Circular Notice No. 12, 2-1-1, of the Corporation Tax Law, [Commentary] : 1.
10. "Meaning of Goodwill in the Corporation Tax Law dated July 3, 1976 of the Supreme Court", "The Hanrei Jiho" No. 831, p. 29-30
11. Sadao Maki, Manager of Examination Department, The National Tax Administration Agency: "Court Decision on Goodwill" dated March 27, 1976"
12. The Ministerial Ordinance on Depreciable Life of Depreciable Assets: Annexed List No. 3, Intangible Depreciable Assets
13. Yukei Fujita "Definition of flexibility and making a subsidiary in reorganization consideration" in "Jurist" No. 1267 (4.15, 2004), p. 104.
14. Kazushi Shibata, "On flexibility of merger consideration in the draft of the Guideline on modernization of corporate legal systems" in "The Horitzujiho", Vol. 76, No.4 (April 2004) p. 32
15. The figures are from the financial statement of Astellas Pharma Inc.
16.

	Sales(¥Mil)	Capital Amount(¥Mil)	No. of Employees
Yamanouchi Pharmaceutical Co., Ltd.	349,969(1.27)	100,490 (2.26)	4,007 (1.12)
Fujisawa Pharmaceutical Co., Ltd.	275,752(1)	44,291 (1)	3,570 (1)

The above figures were prepared by the author, from the financial statement of Astellas Pharma. Inc

17. The Company Law
18. The Commercial Law, Section 2 - ① – 2 of Article 288
19. The Commercial Law, Article 357

20. The Commercial Law, Article 356
21. Koji Harada, keita Hatada and Daisuke Kooriya. “Commentary of Revised Commercial Law related to the review of acquisition regulations, etc. of treasury stocks. (The second of three volumes)” in “The Shoji Homu”, No. 1607, p. 91
22. The Special Taxation Measures Law, Article 67-9, The Enforcement Ordinance of the Special Taxation Measures Law, Article 39-30 (1): The provisions are different, depending on the number of stockholders of a subsidiary with less than 50 or more than 50.
23. The Corporation Tax Law, Article 61-2 ①, ⑤
24. The important subsequent event in the financial statement of Konica Minolta
25. This accounting treatement is (Debit) Stocks of the Subsidiary (current value) / (Credit) Capital surplus.
26. The figures was prepared by the author, with reference to the financial statement of Konica Minolta Holdings.

    Subsidiary: Konica Minolta Holdings Co., Ltd. (Old Minolta), as of March 31, 2003.

    Total numbers of issued stocks 280,207,681 stocks (100% owned by the parent company Konica Minolta Holdings)

    Current Assets ¥127,815 million, Fixed Assets ¥141,381 million. Total Assets ¥269,196 million

    Current Liabilities ¥125, 397 million, Fixed Liabilities ¥57,420 million, Total Liabilities ¥182,818 million.

    Capital Amount ¥25,832 million, Capital Surplus ¥60,546 million, Total Capital ¥86,378 million

    Parent Company: Konica Minolta (consolidated B/S) as of March 31, 2004

    Current Assets ¥535,769 million, Fixed Assets ¥433,820 million, Total Assets ¥969,589 million.

    Current Liabilities ¥484,842 million, Fixed Liabilities ¥148,076 million, Total Liabilities ¥632,919 million

    Equity of Minority Stockholders ¥1,242 million, Capital ¥335,427 million

27. Capital Surplus has been inc reasing ¥75,158 million, by Stock Exchange.
28. The Commercial Law, Article 364
29. Yasushi Maeda “Commentary of the outline of the draft law revising a part of the Commercial Law, etc. [The first of three volumes], in The Shoji-homu

No. 1517, p. 16

30. Koji Harada,"Commentary on Revised Commercial Law of 1999 related to the exchange of Stocks, etc."[the first of three volumes] in The Shoji-homu No. 1536, p. 12
31. The Enforcement Ordinance of the Special Tax Measurements Law, Article 39-30 ①, stipulating different provisions for less tha 50 stockholders and for more than 50 stockholders of a subsidiary.
32. The Special Tax Measurements Law, Article 67-9
33. The Enforcement Ordinance of the Special Tax Measurements Law, Article 25-13 ② 2, stipulating different provisions for less than 50 stockholders and for more than 50 stockholders of a subsidiary.
34. The Special Tax Measurements Law, Article 37-14
35. More exactly, the total number of the stocks is the total number of issued stocks at the calculation base date of the stocks deducted by the numbers of the treasury stocks which Sankyo and Daiichi disposed of after the following day, and added by the number of the common stocks newly issued by execution of stock option.
36.

	Net Assets	Dividends	Officers' remuneration	Balance of Net Assets
Sankyo	727,993	10,737	82	717,174
Daiichi	415,020	6,710	100	408,210

37. Internal Revenue Code(IRC) Sec.11
38. Sammuel C. Thompson, JR Corporate taxation through the Lens of Mergers Sc Acquisitions included cross — border transaction. Carolina Academic Press, 2005 pp. 98-109
39. IRC Sec. 368 (a)(1)(A) Direct merger
40. It will be determined under IRC Sec. 356.
41. It will be determined under IRC Sec. 362.
42. It will be determined under IRC Sec. 1032
43. It will be determined under IRC Sec. 381.
44. IRC Sec. 368 (a)(1)(B) Stock for Stock Reorganization
45. It will be determined under IRC Sec. 354.
46. It will be determined under IRC Sec. 362 (b)
47. It will be determined under IRC Sec. 1032.
48. IRC Sec. 368 (a)(1)(c) Direct Stock for asset reorganization
49. IRC Sec. 368 (a)(2)(H)
50. It will be determined under IRC Sec. 361
51. It will be determined under IRC Sec. 358.
52. It will be determined under IRC Sec. 354.
53. It will be determined under IRC Sec. 362 (b).
54. It will be determined under IRC Sec. 1032.

55. It will be determined under IRC Sec. 381.
56. IRC Sec. 368 (a)(1)(D)
57. It will be restricted under IRC Sec. 354, 355 and 356.
58. Tadatsune Mizuno, “Legal Structure of the U.S. Corporation Tax – Taxation Theory of Corporate Transaction” published by Yuhikaku in 1988, p. 329
59. IRC Sec. 1297 (a)
60. IRC Sec. 954 (c)
61. IRC Sec. 1291 (a)(b)(c)
62. Sankyo Inc, Securities and Exchange Commission Form F-4 Registration Statement under The Securities Act of 1933 pp. 20-21.
63. ibid. pp. 21-22.

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