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# Going Public in Japan: United States and Japanese Tax Consequences

by  
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## INTRODUCTION

Spurred by low interest rates and declining inflation, the United States stock market trebled in value between 1982 and October 19, 1987.<sup>1</sup> The bull market constantly set records for the volume of stocks traded and the selling price of stock. The Dow Jones Average moved from 1,000 in 1982<sup>2</sup> to 2,660 in October 1987.<sup>3</sup> Less publicized, but more dramatic than the Wall Street phenomena, was the growth of foreign stock markets. Foreign stock markets collectively out-performed the U.S. stock markets in all but one of the last ten years.<sup>4</sup>

In response to the collapse of the U.S.' stock market, many foreign stock markets also declined. The Paris Stock Exchange, for example, experienced a twenty-five percent decline in value. The London market similarly had a

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1. See generally Morgenson, *A Checklist for Stock Market Prognosticators*, FORBES, May 4, 1987, at 110.

2. Laderman, *What the Rally Really Means*, BUS. WK., Feb. 2, 1987, at 58.

3. Wall St. J., Oct. 15, 1987, at 64, col. 1. On October 19, 1987, the New York Stock Exchange collapsed. The Dow Jones Industrials closed on that day at 1738, the largest one-day decline in the history of the stock market. Since October 19, 1987, the stock market has stabilized. The Dow Jones Industrial Average was up to 1924 on February 4, 1988 (a twenty-seven percent decrease from October 1987). Wall St. J., Feb. 5, 1988, at 42, col. 3. See also Laderman, *Better Keep Those Seat Belts Fastened*, BUS. WK., Nov. 9, 1987, at 38.

4. Carey, *Climbing the Wall of Worry*, FIN. WORLD, Sept. 8, 1987, at 30.

twenty-nine percent decline in value. However, of the major markets, the market that was least affected by the stock market collapse was the Tokyo Stock Exchange, whose value declined by only fourteen percent.<sup>5</sup> As of February 15, 1988, the Nikkei index on the Tokyo Stock Exchange was only 6.3 percent below its October 1987 high.<sup>6</sup>

Of the major foreign stock markets, the "hottest" has been the Japanese stock market. Shortly before October 19, 1987, a single company on the Tokyo Stock Exchange was valued higher by investors than the entire market capitalization of all Australian companies combined.<sup>7</sup> However, the best basis for comparing the U.S. and Japanese stock markets is the price-earnings ratio [hereinafter PER] obtained by companies in an initial public offering [hereinafter IPO]. Companies have sold their stock for up to twenty times earnings on the U.S. stock market.<sup>8</sup> In sharp contrast, companies have obtained sixty to seventy times earnings for their stock on the Japanese stock market.<sup>9</sup>

Attracted by the strong yen and the high PER, two American companies have already cashed in on the "hot" Japanese stock market by taking successful Japanese businesses public. Avon, Inc. recently generated about \$216 million in proceeds from the IPO of forty percent of its Japanese operations.<sup>10</sup> Even more astounding is the fact that Avon took its Japanese operation public after the October stock market collapse. Shaklee, Inc. is the only other U.S. company to date to take its Japanese subsidiary public. Shaklee realized about \$80 million in proceeds from its IPO.<sup>11</sup>

These U.S. companies, through the sale of their stock holdings, unlocked many years of investment in their Japanese operations and obtained other business advantages which in Japan are only available to public companies.<sup>12</sup> Shaklee and Avon, in selling the stock of their Japanese subsidiaries now,

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5. Riemir, *Trouble From Tokyo to Timbuktu*, BUS. WK., Nov. 9, 1987, at 50. See *Share Prices Plunge Across Asia, Europe, as U.S. Decline Stuns Equities Markets*, WALL ST. J., Oct. 20, 1987, at 50, col. 1.

6. *Odd Lots*, San Francisco Chronicle, Feb. 25, 1988, at C1, col. 1.

7. Morgenson, *supra* note 1, at 110.

8. See *Equity's Hot, Debt's Not. Beginning of the End?*, FIN. WORLD, Sept. 22, 1987, at 55.

9. See Francis, *Investors Have Done Well, but the Market Is Walking on Air*, Christian Sci. Monitor, Aug. 31, 1987, at 14, col. 1. Avon received approximately sixty-two times 1986 earnings on its initial public offering [hereinafter IPO]. *Avon Stock Trades in Japan*, N.Y. Times, Dec. 7, 1987, § D (Financial Desk), at 5, col. 2.

10. *Avon Stock Trades in Japan*, *supra* note 9.

11. Investment Planning Department, Japan Associated Finance Co., Ltd. (JAFCO), Information Bulletin, IPOs of Foreign Affiliated Companies in Japan, app. at 1 (June 1987) [hereinafter *IPOs of Foreign Affiliated Companies in Japan*] (available in English at the offices of the International Tax & Business Lawyer).

12. Even after the 1987 stock decline, Toshihide Tanaka, general manager for IPOs at Nomura Securities and lead manager for the Avon offering, said, "[e]veryone thinks now is still a good time to go public." Holden, *Avon Calling—at the Tokyo Exchange*, BUS. WK., Dec. 14, 1987, at 116.

have taken advantage of the strong yen and, thus, have maximized their profits from the stock sale. Additionally, they have protected themselves from possible future decline in the yen's value, which could diminish the profit on a future stock sale. It is anticipated that other U.S. companies will try to achieve these same benefits by taking their own Japanese operations public.<sup>13</sup>

The sluggish rebound of the U.S. stock market (compared with the strength of the Japanese market) makes the Japanese stock market an excellent alternative for investing and selling stock. To assist companies contemplating such a move, this article reviews both the business considerations and the U.S. and Japanese tax considerations that a U.S. company taking its Japanese operations public should keep in mind. The article follows the chronological sequence of a U.S. company's decision to go public, the market registration process, incorporation, and the tax consequences of incorporating the subsidiary and selling its stock.

For illustrative purposes, this article will use the following case profile. A U.S. company [hereinafter U.S.Co.] operates a branch in Japan.<sup>14</sup> The branch has sold U.S.Co. products in Japan for twenty years. U.S.Co. decides to incorporate the Japanese branch, creating NEWCO. NEWCO's current net worth is \$60 million and it has annual operating income of \$20 million. Investment bankers have advised U.S.Co. that NEWCO can be taken public in Japan for fifty times earnings (i.e., \$1 billion). This article assumes that U.S.Co. has a zero tax basis in its NEWCO stock. Thus, U.S.Co. would realize a gain of \$250 million on the sale of twenty-five percent of its stock in the IPO.

## I.

### THE DECISION TO GO PUBLIC

U.S.Co.'s decision to take its Japanese branch public requires a balancing of the rewards and the risks. The primary reward is taking advantage of the strong Japanese stock market by selling NEWCO's stock for up to sixty to seventy times earnings. Other advantages of having a Japanese public company include the ability to increase company visibility, to hedge against the declining dollar, to attract the best Japanese college graduates, to retain the finest employees through the use of a stock ownership program, to access

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13. A third company, Baskin-Robbins, Inc. offered fourteen percent of its Japanese joint venture with Fujiya Co. to the Japanese public at thirty-eight times earnings. The offering generated net proceeds of about \$36 million. See Holden, *supra* note 12; Wood, *Allied Lyons in Japanese Share Offer*, FIN. TIMES, Nov. 19, 1987, § 1 (U.K. Company News), at 26; *Allied Lyons Sees Potential in Far East*, Reuters BC Cycle, Jan. 25, 1988.

14. The case profile assumes that U.S.Co. has operated in Japan through a branch because until 1973 Japan did not allow foreign companies to own more than fifty percent of a Japanese corporation and had complex controls on foreign investment. Consequently, most U.S. companies operated in Japan as a branch. See J. ABEGGLEN & G. STALK JR., *KAISHA, THE JAPANESE CORPORATION* 221, 223 (1985).

lower lending rates, to more easily obtain licenses and permits, and to promote the sale of NEWCO products through the reliability and credibility that a public company provides.<sup>15</sup>

The major risk in taking NEWCO public is the possibility of a Japanese stock market decline before the initial stock offering. Most economists, however, expect Japan to continue to be a world economic power well into the twenty-first century. In the aggregate, the Japanese stock market in the future will most likely continue to reflect the country's economic prowess and financial liquidity. The strength of the Japanese stock market is exemplified by its resurgence after the October 19 Wall Street stock market collapse.

Other risks include shareholder lawsuits, public exposure of NEWCO's trade secrets or intangibles, and the possible loss of profit margins due to public disclosure of NEWCO's financial statements. These risks are mitigated by various factors. In Japan, shareholder lawsuits are rare, due to a high level of shareholder loyalty.<sup>16</sup> Also, the public disclosure of trade secrets can be minimized through licensing agreements with U.S.Co.

A final risk is that U.S.Co. may incur the current tax and legal costs in setting up NEWCO but, due to delays in getting NEWCO listed on the exchange, may not have sufficient cash to pay these costs. This risk stems from market requirements that companies wanting to be listed have two years of audited financial statements.<sup>17</sup> However, through careful business and tax planning, U.S.Co may be able to minimize this risk.

## II.

### THE REGISTRATION PROCESS

The process of going public in Japan is very different from the process in the United States. The most important distinction is the Japanese authorities' paternalistic concern for the securities which the average Japanese person is allowed to purchase. In Japan, "soundness" rather than disclosure is the standard of administrative approval. U.S. companies should consider these differences at each step of the registration process.

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15. See generally *IPOs of Foreign Affiliated Companies in Japan*, supra note 11, at appendix (interview with Mr. Kimiaki Matsushita, President, Shaklee Japan K.K.).

16. *Id.* at 5; Bowen, *Why the Japanese Seem to be Eight Feet Tall*, FORTUNE, July 16, 1979, at 179.

17. Japanese Securities Dealers Association [hereinafter JSDA] rules require two years of audited financial statements. In practice, two years may mean less than two full years. Two accounting periods may be sufficient to meet the rules' requirement. Usually, this will require twenty-four months of financial statements. However, the JSDA has made exceptions to this policy. For example, Avon, Inc. went public with financial statements covering twelve and eleven month accounting periods. There is an indication that an even shorter overall "two year" period may be permissible. See *Rules of OTC Issues and Publishing of Quotations*, art. 6(5) (Rules of Fair Practice, JSDA No. 2, June 18, 1976); *Detailed Rules of OTC Issues and Publishing of Quotations*, sched. 1 (June 18, 1976) (available in Japanese at the offices of the *International Tax & Business Lawyer*).

*A. Selection of an Investment Banker*

The selection of a Japanese investment banker is an important decision in ensuring NEWCO's successful registration. The investment banker performs four key roles. First, he assesses the project's feasibility under the current registration regulations of the stock exchange where NEWCO will be listed. Second, he negotiates NEWCO's registration with the Ministry of Finance and the Japanese Securities Dealers Association [hereinafter JSDA]. Third, he sets the initial price at which the stock is traded. Finally, the investment banker undertakes the sale of the stock in the IPO.<sup>18</sup>

*B. Selection of a Stock Exchange*

Japan has eight stock exchanges: Tokyo, Osaka, Nagoya, Kyoto, Hiroshima, Fukuoka, Niigata, and Sapporo. The Tokyo Stock Exchange is the largest. In addition to the eight exchanges, Japan has a booming over the counter [hereinafter OTC] market. The OTC market is a private, free stock market modeled on the National Association of Securities Dealers Automated Quotations [hereinafter NASDAQ] market in the United States.<sup>19</sup>

Most U.S. companies wanting to take their Japanese subsidiary public should use the OTC market. OTC registration is advantageous because it is designed for smaller businesses and has less restrictive registration requirements than the other stock exchanges.<sup>20</sup> For example, an application for listing on the Tokyo Stock Exchange requires the approval of the Ministry of Finance. In contrast, an OTC registration application can be approved by the JSDA.<sup>21</sup> Since NEWCO is a small business, this article will discuss the OTC listing process.

*C. General Requirements for OTC Registration*

A company wanting to go public in Japan must meet certain established structural criteria regarding number of shares outstanding, minimum earnings per share, and minimum assets per share.<sup>22</sup> These requirements vary by exchange, with the OTC market being the most liberal and the Tokyo Stock Exchange the most stringent. A comparison of the requirements for going public in each exchange is set forth below:

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18. The major Japanese investment bankers are Nomura Securities, Daiwa Securities, Nikko Securities, and Yamaichi Securities. See Glasgall, *Japan on Wall Street*, BUS. WK., Sept. 7, 1987, at 82. U.S. companies admitted to the Tokyo Stock Exchange include Merrill Lynch, Morgan Stanley, and Salomon Brothers.

19. *IPOs of Foreign Affiliated Companies in Japan*, *supra* note 11, at 9.

20. *Tokyo Report: OTC Registrations Boom*, JiJi Press Ticker Service, Sept. 7, 1986, at 37.

21. The JSDA Board of Directors approves the over the counter [hereinafter OTC] registration. See *Rules of OTC Issues and Publishing of Quotations*, *supra* note 17, art. 7.

22. See *IPO of Foreign Affiliated Companies in Japan*, *supra* note 11, at 9-10 (a good source detailing the OTC registration criteria). See also *Rules of OTC Issues and Publishing of Quotations*, *supra* note 17, art. 6.

CRITERIA FOR GOING PUBLIC<sup>23</sup>

	Tokyo Stock Exchange	OTC Exchange
1. Stock issued	Minimum six million shares before IPO	Minimum two million shares at the time of registration
2. Minimum net assets	¥1 billion	¥200 million
3. Net assets per share	¥100	No requirement
4. Minimum profit		
3 yrs. before IPO	¥200 million	No requirement
2 yrs. before IPO	¥300 million	No requirement
1 year before IPO	¥400 million	Positive
5. Minimum profit per share	¥20 before tax	¥10 before tax
6. Dividend	Before IPO: Required After IPO: Minimum ¥5	No Requirement
7. Minimum period since establishment	Five years	No requirement
8. Number of stockholders	1,000 at time of listing	200 at time of registration
9. Shares to be offered	No requirement	More than the total of 150,000 shares plus 7.5 percent of shares outstanding
10. Pricing shares at time of IPO	Shares valued at less than ¥10 million: 800,000; ¥10 million — ¥20 million: 1,000,000 ¥20 million — ¥30 million: 1,200,000	¥4 million: 60,000 ¥4 million — ¥6 million: 180,000; ¥6 million or more: 100,000

In addition to the above criteria, an OTC listing requires two underwriters.<sup>24</sup> One acts as the lead manager and the other as a co-manager.

The most difficult requirement for a U.S. company which is incorporating its Japanese branch is the JSDA prerequisite of two years of independent financial statements for NEWCO.<sup>25</sup> This requirement serves as a listing period to see how the newly incorporated entity operates as an independent

23. *IPO of Foreign Affiliated Companies in Japan*, supra note 11; *Rules of OTC Issues and Publishing of Quotations*, supra note 17, art. 6.

24. *Rules of OTC Issues and Publishing of Quotations*, supra note 17, art. 4(1).

25. See *Detailed Rules of OTC Issues and Publishing of Quotations*, supra note 17, sched. 1.

company. Besides NEWCO's financial statements, the listing rules require the submission of the audited financial statements of a significantly related company (i.e., U.S.Co.).<sup>26</sup>

As part of the application process, NEWCO's management will have to submit various documents to the JSDA.<sup>27</sup> The major documents to be submitted include both short and long range business plans. These plans should analyze in detail the benefits public listing will bring NEWCO in Japan and throughout the world. Furthermore, NEWCO will have to demonstrate that substantive internal controls are in place. If NEWCO does not meet this condition, the JSDA may delay the offering's arrival on the market.

Recently, the Ministry of Finance issued a pronouncement detailing the conditions for allowing a Japanese subsidiary of a foreign parent to go public. Its objective is to protect the investor through full disclosure. The conditions are: 1) the immediate parent, whether a holding company or not, must be registered on a public stock exchange; or 2) if the foreign parent's stock is not publicly traded, the Japanese subsidiary must be completely independent.<sup>28</sup>

Since many parent companies will not be publicly traded companies themselves (nor hold their Japanese operations through a holding company), they will rely on the second alternative of the pronouncement. Thus, the newly incorporated subsidiary company will be required to be as independent as possible from the parent company.<sup>29</sup> This article will assume that

26. *Id.*

27. Partial List of Documents to be Submitted for OTC Registration

- A. Securities Report for Registration Application containing:
  - i. Application for over the counter dealing in the company's shares;
  - ii. Pledge;
- B. Two years of audited financial statements;
- C. Operating reports for the three preceding years;
- D. Articles of Incorporation;
- E. Corporate registration;
- F. Corporate brochure, product pamphlets, and other printed matter;
- G. Registration Application containing:
  - i. Board of Director minutes;
  - ii. Rules and regulations of the company, including those concerning general accounting, cost accounting, auditing, retirement allowances, lending, and share transactions;
  - iii. Copies of the operating reports and corporate tax returns;
  - iv. Operating reports for the preceding three years;
- H. Corporate data sheet;
- I. List of principal shareholders and distribution of shareholders;
- J. Specimen share certificates;
- K. Operating plan;
- L. Letter of intent from the securities company sponsoring the application;
- M. Report of analysis of the company applying for registration and report on examination;
- N. Schedule for public offering of shares;
- O. Report on sale and public offering;
- P. Report of sales schedule for shares to be offered for sale.

*Detailed Rules of OTC Issues and Publishing of Quotations, supra* note 17, sched. 1.

28. *See IPOs of Foreign Affiliated Companies in Japan, supra* note 11, at 9-10.

29. The criteria for independence is established by oral agreement among the JSDA members and may include that: (1) NEWCO's management be independent from U.S.Co.;



NEWCO is independent from U.S.Co. and qualifies under the second alternative.

#### D. Pricing the Issue

The investment banker plays the leading role in setting the price of the initial NEWCO offering. Market conditions also play an important, but not definitive, role in the new issue pricing. The investment banker selects companies that are comparable to NEWCO and then evaluates them by using a formula which equally weighs and compares earnings per share, assets per share, and dividends per share of those companies against NEWCO. The formula's output will be the IPO price of NEWCO's shares, which is generally twenty to thirty percent below the market price of the first unregulated trade after the IPO.

The OTC market requires new companies to offer for sale more than 150,000 shares plus 7.5 percent of the outstanding shares.<sup>30</sup> Secondary offerings can be made one year later. The rule forces NEWCO to make a business decision: it can either sell the minimum amount of shares in the first offering and then wait a year to sell the remaining shares undiscounted in a second offering or, if NEWCO fears that, during that year, a market decline will cause the share prices to fall lower than the discounted price, sell a greater number of shares in the first public offering. This article assumes that NEWCO wants to take advantage of the current strength of the Japanese market so that, despite the regulatory discount, it will offer twenty-five percent of its stock in the IPO.

#### E. Private Placement

To strengthen NEWCO's stock for the public listing, and to create a market for its shares, NEWCO may want to consider placing some of its stock privately.<sup>31</sup> However, JSDA will not accept a company's application to list on the OTC market if some of the company's new shares were issued to

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(2) NEWCO's products and technology be independent from U.S.Co.; and (3) NEWCO's finances be independent from U.S.Co. *Resolution of the Board of Directors of JSDA*, Nov. 29, 1983, Regarding Review of the Special Disclosure Items on Business Operation Enclosed in the Registration Statement.

Independence, however, is a subjective test. To strengthen NEWCO's facts and circumstances in favor of independence, U.S.Co. and NEWCO may, for example, establish royalty agreements for the use of U.S.Co.'s technology or rewrite supply or customer contracts in the name of either U.S.Co. or NEWCO.

30. *Rules of OTC Issues and Publishing of Quotations*, *supra* note 17, art. 9(2).

31. Note, however, that Avon's IPO was so well-received that its offering was fully subscribed to on the first day of a three day offering period. This success would indicate that it may not be necessary to privately place stock before the IPO. *Avon's Japanese Unit IPO Fully Subscribed*, Reuters BC Cycle, Dec. 2, 1987.

third parties during the six month period preceding the fiscal year-end that occurs prior to the OTC application date.<sup>32</sup>

### III. FORMATION OF NEWCO

#### *A. In General*

The legal and tax consequences of taking a company such as NEWCO public can vary, depending upon the current structure of U.S.Co.'s Japanese operations and the proposed make-up of the company which will be taken public. For example, U.S.Co.'s existing Japanese operations may be kept in various Japanese entities or they may be owned by various foreign holding companies. U.S.Co. may want to consolidate these operations in NEWCO to create a company which will command a greater PER. In such cases, U.S.Co. may need to undertake a major reorganization to consolidate the assets in NEWCO as a directly owned subsidiary of U.S.Co.

Time is of the essence in taking NEWCO public. Thus, we assume that U.S.Co. will have to form NEWCO without the benefit of an Internal Revenue Service ruling. In addition, the Japanese Department of Revenue will not issue rulings on such transfers. Consequently, U.S.Co. must rely on the opinion of tax counsel as to the tax consequences of forming NEWCO.

#### *B. Overview of Incorporation*

Key steps in incorporating the Japanese branch of U.S.Co. include the following: 1) submitting NEWCO's articles of incorporation and application for registration to the Ministry of Justice,<sup>33</sup> 2) reporting the transfer of the branch's assets to the Fair Trade Commission,<sup>34</sup> 3) rewriting distribution, supply and licensing agreements in NEWCO's name,<sup>35</sup> and 4) notifying the branch's creditors and debtors of the transfer.<sup>36</sup> While ownership of NEWCO shares does not have to be registered with any public authority, a report to the Minister of Finance, filed through the Bank of Japan, is required when the ownership of stock in a Japanese corporation is transferred to a foreign entity.<sup>37</sup>

In anticipation of listing NEWCO's stock, U.S.Co. should give careful consideration to NEWCO's name. For example, by making reference in NEWCO's name to its primary business (i.e., NEWCO Computer Company),

32. Internal Regulation of the Operating Committee of the JSDA, item 1, issued June 12, 1980, enacted January 1, 1981.

33. SHŌHŌ (Commercial Code of Japan), Law No. 48 of 1899 [hereinafter SHŌHŌ], art. 57.

34. There is a thirty-day waiting period from the time the Fair Trade Commission receives the report until the business transfer may be made. ANTIMONOPOLY AND FAIR TRADE MAINTENANCE, Law No. 54 of 1947 arts. 15-16.

35. See SHŌHŌ, *supra* note 33, arts. 16-21.

36. MINPŌ (Civil Code of Japan), Law No. 89 of 1896 and Law No. 9 of 1898, art. 467.

37. THE FOREIGN EXCHANGE AND FOREIGN TRADE CONTROL LAW, Law No. 228 of 1949, as amended art. 22, para. 1, item 3.

U.S.Co. could create important product identification with NEWCO's stock. This connection will attract Japanese investors when the stock is publicly listed.

U.S.Co. should also give consideration to NEWCO's capitalization. Specifically, there is a direct relationship between the listing price of NEWCO's stock and the par value of the stock. Older Japanese companies generally issued shares at ¥50 par value. Newer Japanese corporations are required to have a ¥5000 par value. Logically, the number of people willing or able to purchase a stock with a higher listing price will be smaller than the number willing or able to purchase a lower listed stock. Therefore, in order to attract a larger market for its shares, a company like NEWCO may want to consider merging with a pre-existing corporation whose shares have a ¥50 par value.<sup>38</sup>

#### IV. TAX CONSEQUENCES OF INCORPORATING A JAPANESE BRANCH

##### A. Japan

Under Japanese tax laws, U.S.Co.'s contribution of its branch's assets to NEWCO is a taxable transfer to U.S.Co., unless a special nonrecognition rule applies.<sup>39</sup> The special rule is contained in article 51 of the Corporation Tax Law.<sup>40</sup>

Article 51 provides for a tax free incorporation if the following conditions are satisfied:

- 1) U.S.Co. must own at least ninety-five percent of NEWCO;
- 2) NEWCO must be a new Japanese corporation;
- 3) The book value of the NEWCO assets must not exceed the book value of U.S.Co.<sup>41</sup>

If U.S.Co. contributes its branch's assets to NEWCO, U.S.Co. is required to appraise the assets.<sup>42</sup> The appraisal process could be costly and require an inordinate amount of time. As an alternative, U.S.Co. can incorporate NEWCO and contribute to it a sum of cash equal to the net value of the branch's assets. NEWCO can then purchase the assets from U.S.Co. Under article 51, U.S.Co.'s contribution of cash followed by NEWCO's

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38. This is a suggestion of the securities companies from a practical business standpoint. Almost all of the par value of stocks listed on Japanese stock exchanges is ¥ 50.

39. JAPANESE CORP. TAX LAW, Law No. 34 of 1965, as amended art. 51.

40. *Id.*

41. JAPANESE CORP. TAX LAW ENFORCEMENT ORDER, art. 93; JAPANESE CORP. TAX LAW, *supra* note 39, art. 51.

42. SHŌHŌ, *supra* note 33, arts. 172, 173.

purchase of the branch's assets qualifies for nonrecognition so long as NEWCO is a wholly-owned subsidiary of U.S.Co.<sup>43</sup>

One inherent risk of incorporating a branch which will be taken public is that article 51 may not apply if the purpose of incorporation is the sale of assets disguised as a sale of stock. But, according to an influential tax official, article 51 should not be interpreted to impose tax liability on U.S.Co. for transferring the shares of NEWCO in a business environment where the purpose of the transfer is not for tax avoidance reasons.<sup>44</sup> The transfers, however, should be made after the end of the year in which the investment in kind or the alternative cash investment and subsequent transfer of assets (liabilities) takes place. Also, in order to avoid having the NEWCO shares be considered assets of a branch which is a permanent establishment in Japan, U.S.Co. should transfer the NEWCO shares from the branch's books to U.S.Co.'s books in the United States.

Other considerations in an article 51 transfer include the following: 1) the value of NEWCO shares must equal the book value of the branch's assets;<sup>45</sup> 2) if U.S.Co. makes a non-cash contribution of property, certain branch reserves, such as bad debt or price fluctuation reserves, cannot be transferred tax-free;<sup>46</sup> 3) the branch's basis in the assets transferred will carry over from NEWCO; 4) the branch's retained earnings cannot be transferred tax-free to NEWCO. But, since the retained earnings have been taxed previously by Japan, there is no additional tax liability for U.S.Co. when it dissolves the branch.

Assuming U.S.Co. meets the conditions of article 51, NEWCO will be formed free of any Japanese tax consequences. This result will be especially important if substantially appreciated property is transferred from the branch.

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43. JAPANESE CORP. TAX LAW, *supra* note 39, arts. 51, 142. See also JAPANESE CORP. TAX LAW ENFORCEMENT ORDER, *supra* note 41, arts. 93, 188, para. 1, item 3.

44. Watanabe, *Zeimu Sodan*, ZEIMU TSUSHIN, July 23, 1979, No. 1589. Japan does not offer the equivalent of U.S. private letter rulings or revenue rulings. Instead, the opinions of tax officials are used as guidance on how the government might tax a transaction.

45. JAPANESE CORP. TAX. LAW, *supra* note 39, art. 51, para. 1; JAPANESE CORP. TAX REGULATION, 10-7-6, 10-7-10.

46. JAPANESE CORP. TAX REGULATION, 10-7-4(1). One important consideration is the treatment of pension reserves. Those reserves may be on the branch's books and may cover those employees who will work for NEWCO. NEWCO generally cannot take the pension reserves when the branch's assets are contributed to NEWCO.

The deductible provision for retirement reserve is calculated at the smaller of: (1) the increase of the necessary amounts of required reserve from the date of transferring employees to the end of the first fiscal year of the new corporation, or (2) forty percent of the necessary amount of required reserve at the end of the first year.

If this basic rule is applied, as the first factor is always de minimis, most of the reserve may not be deductible. So, the special treatment for calculating the deductible amount allows the new corporation to provide for the reserve as if the new corporation continues the employment of the parent company's branch employees. Thus, approximately forty percent of the necessary amount would be deductible by the new corporation.

B. United States

The major U.S. tax risk of incorporating U.S.Co.'s Japanese branch is that U.S.Co. could be forced to recognize gain on appreciated assets transferred to NEWCO.<sup>47</sup> The risk is magnified by the fact that U.S.Co. could incur an immediate U.S. tax cost and not have the proceeds from the sale of NEWCO stock in the IPO available to pay the tax until two years after forming NEWCO. U.S.Co. can avoid this risk by incorporating its Japanese branch so as to qualify under the nonrecognition provision of section 351, as limited by section 367, of the Internal Revenue Code [hereinafter I.R.C.]

1. Section 351

Under section 351,<sup>48</sup> U.S.Co. recognizes no gain or loss on the contribution of its branch assets to NEWCO if: 1) the transfer of assets is solely in exchange for NEWCO stock; and 2) U.S.Co. controls at least eighty percent<sup>49</sup> of the voting power and eighty percent of all classes of stock immediately after the transfer.

The second requirement that control be "immediately after the transfer" may be difficult to satisfy because of U.S.Co.'s plan to sell twenty-five percent of NEWCO's stock in a public sale. The Internal Revenue Service could apply a step transaction doctrine to argue that the transfer of assets is really a disguised sale and thus deny nonrecognition of gain treatment for the transfer of the branch's assets. This risk may be increased if, prior to the transfer of the branch assets, NEWCO has binding commitments with underwriters to dispose of NEWCO stock in the IPO.<sup>50</sup>

Case law interpreting the "immediately after requirement" is well-developed. In general, the cases hold that momentary and transitory control does not satisfy the control requirement if the loss of control was due to a binding commitment at the time of transfer.<sup>51</sup> If there is no binding commitment, the courts look to the intent of the parties to determine whether the transfer of assets and subsequent sale of stock were mutually interdependent steps of a unitary transaction and, therefore, denied nonrecognition treatment.<sup>52</sup>

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47. Generally, Internal Revenue Code [hereinafter I.R.C.] section 1001 requires a taxpayer to recognize gain or loss on the sale or exchange of property. The transfer of property to a corporation in exchange for stock is treated as a sale or exchange within the meaning of section 1001(a). Section 1001(a) requires the transferor to realize gain or loss equal to the difference between the adjusted basis of the property given up (i.e. the branch's assets) and the value of the stock received. Section 1001(c) provides that the gain is not recognized if the transaction comes within one of the nonrecognition provisions of the I.R.C.

48. I.R.C. § 351 (1986).

49. *Id.* § 368(c).

50. See *American Bantam Car Co. v. Commissioner*, 11 T.C. 397 (1948), *aff'd per curiam*, 177 F.2d 513 (3d Cir. 1949), *cert. denied*, 339 U.S. 920 (1950)(non-binding commitment with underwriters to dispose of stock did not disqualify petitioner from nonrecognition).

51. *Manhattan Bldg. Co.*, 27 T.C. 1032, 1042 (1957); *Hazeltine Corp. v. Commissioner* 89 F.2d 513 (3d Cir. 1937); *Intermountain Lumber Co.*, 65 T.C. 1025 (1976).

52. *Intermountain Lumber Co.*, 65 T.C. 1025, 1032 (1976).

NEWCO will receive nonrecognition treatment because it does not fit under the mutually interdependent test for two reasons. First, in Japan, no negotiations with the investment bankers or the JSDA can occur until NEWCO is formed. Any commitments to sell the NEWCO stock generally occur between NEWCO's formation and the NEWCO IPO (two auditing periods later). Second, there may be independent business reasons for the transfer (e.g., consolidating U.S.Co.'s Japanese operations).

Assuming the requirements of section 351 are satisfied, no gain or loss will be recognized by U.S.Co. on the transfer of its branch's assets to NEWCO.<sup>53</sup> U.S.Co.'s basis in its NEWCO stock will equal its tax basis in the assets it contributes to NEWCO.<sup>54</sup> NEWCO's basis in the assets it receives will be equal to U.S.Co.'s basis in the assets.<sup>55</sup>

## 2. Section 367

Section 367<sup>56</sup> applies to all exchanges involving the transfer of property to a foreign corporation pursuant to a section 351 transfer. If the requirements of section 367 are not satisfied, then NEWCO is denied corporate status for purposes of using the tax-free transfer provisions of the Internal Revenue Code. Consequently, the failure to satisfy section 367 can result in the recognition of gain by U.S.Co. on the transfer of appreciated branch assets to NEWCO.

The general rule of section 367 is that U.S.Co. is denied nonrecognition treatment on the transfer of its branch assets to a foreign corporation (i.e., NEWCO).<sup>57</sup> Section 367 provides three exceptions to this rule: 1) if, pursuant to a section 351 transfer, U.S.Co. transfers stock of a foreign corporation which is a party to the exchange or reorganization to a foreign corporation;<sup>58</sup> 2) any transfer exempted by the Treasury Regulations;<sup>59</sup> or 3) the transfer of property to a foreign corporation for use by the foreign corporation in the active conduct of a trade or business outside the United States.<sup>60</sup>

The transfer by U.S.Co. to NEWCO should qualify under the third exception,<sup>61</sup> since NEWCO will use the U.S.Co. branch's assets to continue the

53. It is possible that the section 351 transfer of branch assets may be a technical "type C" reorganization in I.R.C. section 368(a)(1)(C). See B. BITTKER & J. EUSTICE, *FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS* ¶ 3.19 (5th ed. 1987).

54. I.R.C. § 358(a)(1) (1986).

55. *Id.* § 362(a). Since NEWCO is not paying cash in addition to its stock, the rules relating to the receipt of "boot" under I.R.C. section 356 do not apply. Likewise, since the branch liabilities assumed by NEWCO do not exceed the basis of the assets transferred, the assumption-of-liability rules of I.R.C. section 357 do not apply.

56. I.R.C. § 367 (1986).

57. *Id.* § 367(a)(1).

58. *Id.* § 367(a)(2).

59. *Id.* § 367(a)(5).

60. *Id.* § 367(a)(3).

61. See *Treas. Reg.* § 1.367(a)-2T (1987), and especially § 1.367(a)-2T(b) (1987) (explanation of what constitutes the active conduct of a trade or business outside the United States). I.R.C. section 367(a)(3)(c) places a limitation on the trade or business exception in the case of the

trade or business in Japan previously conducted by the branch. Since the third exception applies, U.S.Co. can avoid section 367 recognition of gain on the transfer of the branch's assets to NEWCO.

Section 367 provides special rules for the transfer of intangibles. Generally, outbound intangible transfers under sections 351 and 361 are deemed sales at a contingent price to the foreign corporate transferee. Gain is also recognized ratably, under section 367(d), as U.S. source ordinary income.<sup>62</sup> This article assumes that no intangibles will be transferred to NEWCO. Thus, section 367(d) does not apply to U.S.Co.'s section 351 transfer of its branch assets to NEWCO.

## V.

### TAX CONSEQUENCES OF THE SALE OF NEWCO STOCK

#### A. Japan

In general, Japanese Corporation Tax Law taxes a foreign corporation (i.e., U.S.Co.) when it transfers the shares of a Japanese corporation (i.e., NEWCO) if two conditions are met: 1) the foreign corporation owns or owned twenty-five percent or more of the total shares of the Japanese corporation at any time during the current and preceding two years; and 2) the foreign corporation transfers five percent or more in the current year.<sup>63</sup> This law applies even if U.S.Co. does not have any permanent establishment in Japan.

Since U.S.Co. owns 100 percent of NEWCO and will be selling twenty-five percent of its stock in the IPO, the sale will subject U.S.Co. to tax in Japan unless a nonrecognition provision applies. Article 16 of the United States-Japan Tax Convention<sup>64</sup> exempts U.S.Co. from Japanese taxation on the NEWCO stock sale. Generally, under the United States-Japan Tax Convention, gains derived from the sale of capital assets by a U.S. corporation are exempt from tax by Japan.<sup>65</sup>

However, if U.S.Co. has a permanent establishment in Japan and the property giving rise to the gain (i.e., NEWCO's stock) is effectively connected with that permanent establishment, then the gain will be taxable in Japan.<sup>66</sup>

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transfer of assets of a foreign branch with previously deducted losses. See Treas. Reg. § 1.367(a)-6T(c)(2) (1987) (explanation of the branch loss recapture rules).

62. B. BITTKER & J. EUSTICE, *supra* note 53, at ¶ 17.42.

63. JAPANESE CORP. TAX LAW, *supra* note 39, art. 141, item 4; CORPORATION TAX LAW ENFORCEMENT ORDER, art. 187, para. 1.C.

64. Convention on Double Taxation of Income, Mar. 8, 1971, United States-Japan, 23 U.S.T. 967, T.I.A.S. No. 7365.

65. *Id.* art. 16, 23 U.S.T. 967, 994, T.I.A.S. No. 7365, at 28.

66. *Id.* art. 16(3). The Japanese tax authorities have not announced that they will apply article 16, paragraph 3 to gains arising from transfer of shares which were issued by a Japanese corporation whose principal assets consist of real property located in Japan. This treatment exempting gain from the transfer of shares in a real property holding corporation from Japanese tax should be contrasted with that of the U.S. Internal Revenue Service. The I.R.S. has concluded that the Foreign Investment in Real Property Tax Act [hereinafter FIRPTA], which

If the NEWCO stock is placed on the branch's books and not directly relocated to the parent's books prior to the stock's sale, the stock sale could be subject to Japanese taxation.<sup>67</sup> If, as in our case, the NEWCO stock is placed directly on U.S.Co's books, then the gains generated from the sale of NEWCO stock should be exempt from Japanese tax because the gains are not effectively connected with the permanent establishment in Japan.<sup>68</sup> The relocation of the shares of NEWCO from the branch in Japan to the U.S.Co. home office should not constitute a taxable "sale" or "transfer" for Japanese income tax purposes. Thus, before the shares of NEWCO are sold, they could be relocated from U.S.Co.'s permanent establishment in Japan to its home office without any taxation on the appreciated value of the shares. This could be accomplished by recording NEWCO's stock on the financial statements of U.S.Co. and not on the books of the Japanese branch.

Assuming the stock of NEWCO is not effectively connected to a permanent establishment in Japan, article 16 of the United States-Japan Income Tax Convention exempts U.S.Co. from taxation in Japan on its sale of NEWCO shares in the IPO.

## *B. United States*

### *1. Characterization of gain*

U.S.Co. is subject to taxation in the United States on the gain resulting from the sale of NEWCO stock. The amount of the gain is the difference between the sale price of the stock and U.S.Co.'s tax basis in the stock.<sup>69</sup> Normally, the character of the gain on the sale of stock is capital.<sup>70</sup> However, under section 1248, the gain will be recharacterized as a dividend to the extent of the pro rata amount of the undistributed earnings and profits of NEWCO at the date of the sale of stock.<sup>71</sup> The determination of the source of the gain will vary depending on how the gain is characterized.<sup>72</sup>

### *2. Characterization for sourcing of gain*

The source of the gain on the sale of NEWCO stock is determined under section 865 for the capital portion of the gain and section 861 for the dividend portion of the gain. The general rule of section 865 is that income on the sale

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makes taxable such a transfer of shares in a real property holding corporation, has superceded the above treaty provision.

67. I.R.C. § 864(c) (1986).

68. *Id.*

69. *Id.* § 1001.

70. *Id.* § 1221.

71. *Id.* § 1248. For example, if U.S.Co. sells twenty-five percent of NEWCO stock, then an amount of the gain equal to twenty-five percent of NEWCO's undistributed earnings and profits will be recharacterized as dividends. See 1 R. RHOADES & M. LANGER, *INCOME TAXATION OF FOREIGN RELATED TRANSACTIONS* § 3.06 (1987) (an excellent discussion of section 1248).

72. I.R.C. §§ 861, 865 (1986).



of personal property, including stock, is sourced based on the taxpayer's residency.<sup>73</sup>

Section 865(f) provides a special rule for the sale of stock in a foreign affiliate which, if satisfied, sources the gain as foreign sourced. The requirements of section 865(f) are: 1) U.S.Co. must sell the stock of a foreign affiliate (i.e., U.S.Co. must own eighty percent or more of NEWCO); 2) NEWCO must be engaged in the active conduct of a trade or business; and 3) the sale of NEWCO stock must occur in the foreign country (i.e., Japan) in which NEWCO derived more than fifty percent of its gross income for the three years preceding the year of sale.

Since U.S.Co. owns 100 percent of NEWCO and sells NEWCO's stock on the OTC in Japan, where NEWCO has actively conducted its trade or business, the capital portion of the gain on the sale of NEWCO stock is foreign sourced.<sup>74</sup>

The dividend portion of the gain on the sale of NEWCO stock is sourced pursuant to the residency of the payor.<sup>75</sup> The Tax Reform Act of 1986 [hereinafter TRA] provides that if the gain on the sale of shares in a foreign corporation by a U.S. shareholder is recharacterized under section 1248(a) as a dividend, then the gain is sourced pursuant to the source provisions governing dividends.<sup>76</sup> Since NEWCO's residence is Japan, the dividend portion of U.S.Co.'s gain on the sale of NEWCO stock is derived from a foreign payor and is foreign sourced.

### 3. Categorization of gain for foreign tax credit limitations

Although U.S.Co. will not be subject to Japanese tax, it will be deemed, only for foreign tax credit purposes, to have paid some Japanese tax under I.R.C. section 902(a). For this reason, U.S.Co. could use the foreign tax credit to lower its U.S. tax liability on the sale of NEWCO stock. Under section 902(a), U.S.Co., because it received dividends from NEWCO, is

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73. *Id.* § 865(a).

74. Section 865(f), as read in conjunction with section 1504(a), requires U.S.Co. to own eighty percent of NEWCO. This can impact U.S.Co.'s decision on the proper amount of stock to sell in the IPO. If U.S.Co. sells twenty-one percent of NEWCO in the IPO, any gain on the stock sold in the second public offering would be considered U.S. source income because, at the time of the sale, U.S.Co. owned less than eighty percent (instead of foreign sourced if less than twenty percent of NEWCO was sold in the IPO). Thus, either U.S.Co. should sell less than twenty percent of NEWCO's stock in the IPO or all of the shares that U.S.Co. wants to sell (e.g., twenty-five percent of NEWCO shares), under section 865(f), in order to retain foreign source income status for the extra five percent of the stock. *Id.* §§ 865(f), 1504(a).

75. By choosing the residence of the payor, the Tax Reform Act of 1986 [hereinafter TRA] substantially revised the rules for determining the source of capital gain on the sale of tangible property. Tax Reform Act of 1986, Pub. L. No. 99-514, 100 Stat. 2085 (1986). The law prior to the TRA sourced the gain where title to property passes. See Treas. Reg. § 1.861-7 (1987).

76. See *General Explanation of the Tax Reform Act of 1986*, 74 Stand. Fed. Tax Rep. (CCH Special 24) at 922 (May 8, 1987). I.R.C. section 861(a)(2) provides that a dividend is foreign sourced if the foreign corporation paying the dividend had, during the three previous years, no more than fifty percent of its gross income during the three previous years considered effectively connected with the conduct of a U.S. trade or business. See Treas. Reg. § 1.861-3(a)(3) (1982).

deemed to have paid a portion of NEWCO's tax liability.<sup>77</sup> The amount of Japanese tax deemed paid by U.S.Co is "the same proportion [of NEWCO's taxes] . . . as the amount of such dividends bears to such foreign corporation's undistributed earnings."<sup>78</sup> The dividend is a quarter of NEWCO's earnings.<sup>79</sup> Thus, U.S.Co. is deemed to have paid a quarter of NEWCO's tax, which U.S.Co. can use for foreign tax credit purposes.

Once the source of the gain from the sale of NEWCO stock is determined, the TRA requires U.S.Co. to determine the category (or categories) in which the income is to be classified for foreign tax credit purposes.<sup>80</sup> The new law creates separate credit limitations for passive income, high withholding tax interest, financial services income, shipping income, and dividends from controlled section 902 corporations.<sup>81</sup> As with the sourcing rules, the determination, for foreign tax credit purposes, of the income category for gain from the NEWCO stock sale is made separately for the capital and dividend portion of the gain.

The determination of the category which the gain belongs to is very important. Generally, the higher Japanese tax rates will produce excess "active basket" foreign tax credits on the dividend portion of the NEWCO stock sale. Also, U.S.Co. may have other general foreign credits from its other operations. These other general foreign credits may expire or not be used if U.S.Co. is unable to generate "active basket" income in order to use the excess "active basket" foreign tax credits generated from the NEWCO stock sale. For purposes of this article, U.S.Co. is assumed to have no foreign tax credits other than those generated from the NEWCO stock sale.

The TRA provides a "look through" concept for determining into which category the dividend portion of the NEWCO stock sale gain is placed.<sup>82</sup> This means that NEWCO's earnings generating the dividend must be placed into categories under the new rules. The dividend itself is then classified into different categories in the same proportion as NEWCO's income. Since NEWCO's income is generated entirely by the active conduct of a trade or business, its income would be in the "active basket." Therefore, applying the "look through" concept, the entire section 1248 dividend would be "active

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77. See I.R.C. § 1248 (1986).

78. *Id.* § 902(a).

79. See *supra* note 71 and accompanying text on section 1248.

80. The TRA made substantial changes to the foreign tax credit limitations provisions. The changes were enacted to restrict a taxpayer's ability to average high and low foreign tax credits. The new limitations are generally in addition to those of pre-1986 section 904(d) which prevented taxpayers from averaging foreign tax rates on other income classes that may be easily resourced or that are generally subject to abnormally high or low foreign tax. I.R.C. § 904(d) (1986). See *General Explanation of the Tax Reform Act of 1986*, *supra* note 76, at 852.

81. I.R.C. § 904(d) (1986).

82. The Committee Reports explain that the look through rules apply to any gain treated as a dividend under section 1248. See *Tax Reform Act of 1986, Law and Controlling Committee Reports*, 72 Stand. Fed. Tax Rep. (CCH Special 23) ¶ 8201 (Oct. 25, 1986).

basket" income for foreign tax credit purposes. This is advantageous to U.S.Co.

To determine the income category into which capital gain from the NEWCO stock sale is placed requires a reading of the TRA committee reports. Most likely, the TRA will treat the capital gain income as "passive basket" income.<sup>83</sup> This conclusion is based on the fact that "passive basket" income is defined to include foreign personal holding company [hereinafter FPHC] income.<sup>84</sup> The committee reports state that FPHC income includes gain from the sale of stock of a controlled foreign corporation (such as NEWCO).<sup>85</sup> In addition, the House Committee Report states that "passive income also generally includes gain from the sale or exchange of property of a kind giving rise to dividend" (i.e., stock).<sup>86</sup>

Prior to August 1987, one possible argument for placing non-dividend income in the "active basket" was that the sale of part of the stock in the Japanese public market is not a capital gains transaction. However, Temporary Regulations issued in August of 1987 clarify that the sale of the stock of a controlled foreign corporation is a capital transaction.<sup>87</sup> Likewise, the Supreme Court has reviewed the *Corn Products* doctrine<sup>88</sup> and has held that the sale of a subsidiary's stock is a capital transaction.<sup>89</sup> Given the Temporary Regulations and the Supreme Court's holding, the non-dividend gain is probably passive income.

The problem of splitting the \$250 million gain from the IPO between passive and active income is illustrated as follows. Assume that, prior to the sale of its stock on the OTC, NEWCO has \$20 million in taxable income. The Japanese tax on this income will be \$11.6 million. As a result, NEWCO retains \$8.4 million in earnings and profits prior to the sale of stock on the OTC.<sup>90</sup> For U.S. tax purposes, U.S.Co. would report taxable income of \$252.9 million. Of that total, \$250 million are the proceeds of the NEWCO stock sale, which sum can be further subdivided into the capital gains and

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83. The section 904 proposed regulations take the position that the capital gain portion resulting from the sale or exchange of a NEWCO type stock is considered passive income. For a general discussion, see Joyce, *The 1986 TRA Changes to the Section 904 Limitation—Part I*, 16 TAX MGMT. INT'L J. 347 (1987).

84. I.R.C. § 904(d)(2)(A) (1986).

85. *Tax Reform Act of 1986, Law and Controlling Committee Reports, supra* note 82, ¶ 8221.

86. *Id.* ¶ 8201.

87. Temp. Treas. Reg. § 1.904 (1987).

88. *Corn Products Refining Co. v. Commissioner*, 350 U.S. 46 (1955) (futures contracts entered into as an integral part of taxpayer's business, even as a hedge against a price increase in needed raw materials, rather than as a speculative transaction, result in ordinary, not capital, gain or loss).

89. *Arkansas Best Corp. v. Commissioner*, 56 U.S.L.W. 4229 (1988), *aff'g* 800 F.2d 215 (8th Cir. 1986).

90. The \$8.4 million earnings and profits is computed as follows: taxable income of \$20 million multiplied by the Japanese tax rate of fifty-eight percent equals \$11.6 million of Japanese tax. The taxable income of \$20 million less the Japanese tax of \$11.6 million equals the earnings and profits of \$8.4 million.

dividends categories. There will be \$247.9 million in the capital gains category, which will be "passive basket" income, and \$2.1 million in the dividends category, which will be "active basket" income.<sup>91</sup> The other \$2.9 million in taxable income results from I.R.C. section 78, which recharacterizes a portion of the Japanese tax paid by NEWCO as a dividend to U.S.Co.<sup>92</sup> Thus, the \$2.1 million dividend and the \$2.9 million "gross up" dividend give U.S.Co. \$5 million total in dividends, which will all be "active basket" income.

The U.S. tax on the \$252.9 million gain before credits would be \$85,986,000. U.S.Co. will have \$247.9 million of "passive basket" income and \$5 million of "active basket" income. Although under section 902(a) U.S.Co. will be deemed to have paid \$2.9 million in Japanese tax, assuming no other foreign source income, the "active basket" limitation would be \$1.7 million [ $(\$5 \text{ million}/\$252.9 \text{ million total income}) \times \$85,986,000$ ].<sup>93</sup> Thus, U.S.Co. will have \$1.2 million in excess "active basket" tax credits (plus any other foreign tax credits from other sources).

In summary, there are no Japanese income tax consequences on the sale of NEWCO stock in the IPO. The United States will tax the gain at the thirty-four percent tax rate. Part of the gain will be capital gain and part will be recharacterized as a dividend under section 1248. For foreign tax credit purposes, the gain will be foreign sourced and part of the gain will be "passive basket" income and part "active basket" income. The NEWCO stock sale, however, will probably cause U.S.Co. to have excess foreign tax credits due to the higher Japanese tax rates and the lack of "active basket" income. Likewise, the stock sale will not produce any additional "active basket" income for U.S.Co. to use against any of its other excess foreign tax credits.

### CONCLUSION

With proper planning, U.S.Co. has cashed in on the "hot" Japanese stock market by selling twenty-five percent of its Japanese operations for a gain of \$250 million. In addition, U.S.Co. has strengthened its remaining stock interest in NEWCO by creating a public company which is more competitive with other public companies in the Japanese marketplace. Finally,

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91. See *supra* note 71 and accompanying text. Section 1248 deems U.S.Co. to have received as a dividend the same proportion of the undistributed profits and earnings that the percent of NEWCO stock it sells bears to the total amount of stock. Since Newco has \$8.4 million in undistributed earnings and profits and U.S.Co. has sold twenty-five percent of that stock, they are deemed to have received \$2.1 million in dividends from the sale.

92. See I.R.C. § 78 (1986). Section 78 recharacterizes as dividend "an amount equal to the taxes deemed to be paid by such corporation under section 902(a)." Under section 902(a), U.S.Co. will be deemed to have paid twenty-five percent of NEWCO's Japanese tax liability of \$11.6 million. Thus, under section 78, U.S.Co. is deemed to have received \$2.9 million in dividends from NEWCO.

93. The Foreign Tax Credit limitation is set out in I.R.C. section 904(a) and is expressed in the following equation: foreign source taxable income divided by total worldwide taxable income multiplied by U.S. tax on worldwide taxable income.

U.S.Co. has repatriated its investment in its Japanese assets while the yen is strong. Thus, U.S.Co. maximized its profits on the sale of its branch's assets and protected itself from any future devaluation of the yen.

Through the formation of NEWCO, these benefits have been achieved with little or no U.S. or Japanese tax consequences. The risk of the Japanese market taking a significant downturn in the near future has been minimized by careful planning to ensure that the registration and initial public offering of NEWCO stock is accomplished as quickly and efficiently as possible. Lastly, advance tax planning has ensured that the gain on the sale of NEWCO stock is not taxed in Japan and that the U.S. tax consequences are minimized through utilization of all available foreign tax credits. Given the benefits of being a public company in Japan, more U.S. companies like U.S.Co., Shaklee, Inc., and Avon, Inc. should consider taking their Japanese operations public in Japan.