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The Promotion of Foreign Direct Investment into Japan - The Measures' Impact on FDI Series

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The Promotion of Foreign Direct Investment into Japan - The Measures' Impact on FDI Series

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Maiko Wada *

Summary

- **At the occasion of delivering the fiscal year 2003 policy speech, Prime Minister Junichiro Koizumi proposed to double foreign direct investment (hereafter, FDI) stock into Japan within five years to revitalize the Japanese economy. Against this background, various measures aimed at promoting FDI into Japan have been investigated and implemented by the government and concerned ministries. A number of significant measures implemented in the most recent years to improve the investment environment include introducing a cross-border equity swap scheme and the Japanese version of the limited partnership (Japanese LPs). Consequently, there is a growing interest in examining how these measures could support a growth of FDI into Japan.**
- **The first scheme, cross-border equity swaps, involves using shares of a foreign company. This scheme implies that an existing foreign affiliated company operating in Japan initially acquires the shares of a foreign company (for instance, a foreign parent company). These shares will be used to pay for acquiring a Japanese company through either a triangular merger or through the creation of a subsidiary company. According to the *IMF Balance of Payments Manual, fifth edition (BPM5)*, the acquisition of the shares of a foreign parent company by a subsidiary is identified as a “reverse investment.” This transaction is recorded as an offsetting transaction to inward FDI received from the foreign parent company. For this reason, the likely result of cross-border equity swaps would record contraction of inward FDI flow series.**

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- In the second scheme, Japanese LPs combine the advantages of being free from the two-stage taxation and assuring limited liability. For this reason, Japanese LPs could be actively used in the future as an investment vehicle in the cases where investors would be unable to effectively assess the business situation and performance of investee companies in industries requiring the large initial investments, such as technology and R&D. The *Foreign Exchange and Foreign Trade Law (Foreign Exchange Law)* provides the statutory basis for the compilation of Japan's Balance of Payments (BOP) and International Investment Position (IIP), and the collection of data sources. Within this legal framework, investments by non-residents into Japanese LPs, which are not legal persons, are not defined as FDI into Japan. As a consequence, investments by non-residents into Japanese LPs are excluded from inward FDI flow and stock series.
- The current statistical treatment implies the following issues. [1] Because investments and collections of investments into Japanese LPs are not included in FDI into Japan, the impact of the introduction of this investment vehicle will not be accurately reflected in FDI series. [2] While this will depend on the volume of investments, strictly speaking, international comparisons with countries including investments into LPs in FDI series and Japan are difficult.
- Against this background, statistics compilers in Japan could possibly consider the inclusion of investments into Japanese LPs under FDI series within the current framework of the *Foreign Exchange Law*, provided that the capital participation is 10 percent or more. While giving due consideration to the reporting burden, statistics compilers in Japan should examine how to collect adequate data and reflect it in FDI series.

1. Introduction

Growing interest in FDI series. FDI constitutes long-term international investments primarily involving management control. As such, FDI not only affects country's international capital flows and stocks but also frequently impacts on its economic structure. As a result, FDI series are actively used in the analysis and perspective of international capital flows and stocks and economic structure, the formulation of economic policies, and the evaluation of the policy effects. In this connection, at the occasion of delivering the 2003 fiscal year policy speech, Prime Minister Junichiro Koizumi proposed to double FDI stock into Japan within five years to revitalize the Japanese economy. Against this background, various measures aimed at promoting FDI into Japan have been investigated and implemented by the government and concerned ministries. For example, a cross-border equity swap scheme and Japanese LPs were introduced to revitalize the Japanese economy, to strengthen competition through industrial and corporate re-organizations, and to enhance foreign capital into Japan. Currently, the possible impact of these measures on FDI into Japan is actively discussed.

This paper will outline the chronology of Japan's inward FDI promotion measures, before reviewing the measures introduced in the most recent years together with their corresponding statistical treatments. In particular, this paper will review a cross-border equity swap scheme and Japanese LPs, and will detail the impact of these two schemes on FDI series as recorded in the BOP¹ and IIP² based on the *BPM5*³ for statistics users' convenience.

2. Chronology of Japan's Inward FDI Promotion Measures

The inflow of foreign capital was in principle liberalized in 1980. Ever since, a series of inward FDI promotion measures have been investigated and implemented (Figure 1). Since the key determinant of FDI into Japan is the presence of real business opportunities in Japan, these measures were adopted to improve the overall investment environment, with a particular attention to the legal, tax and accounting systems.

The chronology of Japan's inward FDI promotion measures implemented since the 1980s can be summarized as follows.

¹ The BOP measures the flow of transactions between residents and non-residents during a given period of time.

² The IIP measures the stock of external assets and liabilities at a given point in time

³ The *BPM5* is the current international standard and provides internationally accepted guidelines for the BOP and IIP.

[1] 1980 - 1991 (69th Cabinet of Prime Minister Masayoshi Ohira - 77th Cabinet of Prime Minister Toshiki Kaifu⁴)

In the face of the growing current account surplus that reflected increasing exports to U.S., international investment liberalization policies were promoted to resolve Japan-U.S. structural issues.

This is exemplified by the following: the providing investment-related information, and the publication of the statement on “Declaration Concerning Openness to Foreign Direct Investment.”

[2] 1992 - 1999 (78th Cabinet of Prime Minister Kiichi Miyazawa - 84th Cabinet of Prime Minister Keizo Obuchi⁵)

Following the collapse of the bubble economy and the subsequent economic slowdown, a general framework was developed at the national level to facilitate the operations of foreign companies in revitalizing the Japanese economy and in promoting structural reform. During the second half of that period,⁶ active measures were also taken on the local and regional levels to enhance foreign capital.

At the national level, this is exemplified by the following: legislative measures designed to reduce the burden of initial costs facing foreign companies; the establishment of the Japan Investment Council (JIC) chaired by the Prime Minister; and improvements to the environment of M&A activities. At the local and regional levels, this is exemplified by the following: the host of “Regional Japan Investment Council”, and the providing information on industrial real estate throughout Japan.

[3] Since 2002⁷ (87th Cabinet of Prime Minister Junichiro Koizumi)

The continued stagnation of Japanese economy, and the declining birthrates and aging population would induce a continuous shrinkage of household savings, which provide funds for business investments. In the face of it, the government and concerned ministries agreed to cooperate in investigating and implementing a set of various measures to promote FDI into Japan. The goal is to double FDI stock into Japan (see table on the following page).

⁴ Term of office ended November 5, 1991.

⁵ Term of office ended April 5, 2000.

⁶ This refers to 1996 and thereafter. The 81st Cabinet of Prime Minister Tomiichi Murayama was in office until January 11, 1996 followed by the 82nd Cabinet of Prime Minister Ryutaro Hashimoto.

⁷ The discontinuity in the periods is due to the absence of significant inward FDI promotion measures during 2000 - 2001.

Chart 1: Chronology of Japan's FDI Promotion Measures since 2002

2002	<p>The statement on “Basic Policies for Economic and Fiscal Policy Management and Structural Reform 2002” was endorsed by the Cabinet. It indicated that “the Cabinet Office shall, in cooperation with concerned ministries, formulate specific measures aimed at reinforcing competitiveness by encouraging FDI into Japan and the brain gain during fiscal 2002, and shall systematically implement these measures in cooperation with concerned ministries.”</p> <p>The JIC Expert Committee was reinstated pursuant to the above Cabinet decision.</p> <p>Invest Japan Forum proposed to revitalize the Japanese economy through increasing FDI into Japan (referred to as “Third Opening of Japan”).</p>
2003	<p>Prime Minister Junichiro Koizumi proposed to double FDI stock into Japan (within 5 years) in his general policy speech.</p> <p>The JIC Expert Committee publicized the “Program for the Promotion of Foreign Direct Investment into Japan” containing the following specific measures:</p> <p>In the course of work on the modernization of the <i>Corporate Law</i>, examine a possible implementation of “the easing of rules on payment for merger etc.” as a permanent measure, which would enable <u>lifting the ban on cross-border equity swaps</u> to expedite the process of mergers and acquisitions by foreign companies.</p> <p>When liquidating stocks and loans owned by the Industrial Revitalization Corporation (IRC) and the Resolution and Collection Corporation (RCC), select the buyers through publicized procedures in a transparent, fair, and economically sound manner to encourage foreign companies to participate in the process of corporate revitalization.</p> <p>Create tax incentives in IT and R&D to reduce the tax burden of companies.</p> <p>Strive to improve transparency and reliability of corporate information by means such as observing actions corresponding to the international accounting standards to strengthen corporate governance.</p> <p>Post electronic reporting system on investment applications required by the <i>Foreign Exchange Law</i>.</p> <p>Clarify, simplify, and expedite administrative procedures by, for example, promoting the use of a “no action-letter” system to clarify interpretation of legislation.</p> <p>Improve basic proficiency in English and communication ability based on cross-cultural understanding of the Japanese people.</p> <p>To establish up the internationally competitive structure for attracting investments, the ministries and concerned agencies will investigate the structures and policies in other countries, and further implementation in Japan.</p> <p>Strengthen the providing information to foreign press, embassies, and consulates and publicizes the successful experiences involving FDI into Japan.</p> <p>Seek public support on the role and importance of FDI into Japan in the revitalization of the Japanese economy, through media and communication means.</p> <p>The JIC adopted the above program and publicized the statement on “Promotion of Foreign Direct Investment into Japan.”</p> <p>To implement the above program, a general contact information network (“Investment Japan”) was set up within the government and concerned ministries to facilitate information gathering by investors.</p> <p>The M&A Investigation Committee in the Economic and Social Research Institute of the Cabinet Office was established for the purpose of investigating the current status and specific issues pertaining to M&A activities of Japanese companies.</p>

2004	<p>The statement on “Three-Year Plan for Regulatory Reform and Promotion of Private Sector Liberalization” was endorsed by the Cabinet, containing proposals for the introduction of new investment vehicles, such as <u>Japanese LPs and Japanese limited liability companies (LLC)</u>.</p> <p>JIC Expert Committee summarized the status of program implementation during previous year.</p>
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Source: Compiled from the Statements of the JIC, etc.

3. Outline of Recent Measures to Improve the Investment Environment

The most recent measures to improve the investment environment include introducing a cross-border equity swap scheme and the Japanese LPs (see table below for outline of both schemes). In the fiscal year 2003 policy speech, Prime Minister Junichiro Koizumi proposed to double FDI stock into Japan within five years to revitalize the Japanese economy. To match this goal, the JIC Expert Committee that is an organ of the JIC chaired by the Prime Minister, and concerned ministries have been investigated and implemented a series of measures, among which both schemes. The following table presents an outline of both schemes, and their impact on investments into Japan from the perspective of the non-resident investors.

Chart 2: Outline of a Cross-Border Equity Swap Scheme and the Japanese LPs

	Cross-border equity swap scheme	Japanese LPs
Date introduced	April 2003	April 2004
Outline	Foreign companies are permitted to take capital participation in Japanese companies through cross-border equity swaps.	Permits the use of an investment vehicle being free from the two-stage taxation and assuring limited liability.
Features	In order to use shares of a foreign company to pay for acquiring a Japanese company, a foreign affiliated company operating in Japan must initially acquire the shares and use them through either a triangular merger or through the creation of a subsidiary company.	Expected to facilitate financing by Japanese companies.
Impact on investments into Japan	Several foreign companies point out the inconveniences, because tax-preferred measures are insufficient to enhance investments.	The promotion of investments in R&D type companies would create business opportunities in related fields. It follows that the Japanese LPs could promote investments in the long term.

A more detailed review of the two schemes is presented in the following pages.

(1) Introduction of a Cross-Border Equity Swap Scheme

Up until April 2003, cross-border equity swaps were not allowed⁸ in Japan. Since that date, new provisions open this option in response to strong demands for the introduction of a cross-border equity swap scheme⁹ and growing national awareness that expanding the range of payments (e.g., achieve greater flexibility in payment methods) for corporate re-organization and mergers was essential to the industrial revitalization. This resulted in the revision of the temporary legislation contained in the *Law on Special Measures for Industrial Revitalization (Industrial Revitalization Law)*, which aimed at revitalizing the industrial vitality by facilitating corporate restructuring. The revision admitted to use designated financial assets (cash or shares of other companies) as payments. In practical terms, the law opened the way to foreign companies to acquire outstanding shares of a Japanese company, conditional upon the certificate of the Minister of Economy, Trade and Industry in accordance with the provisions of the *Industrial Revitalization Law*.

Cross-border M&A activities have risen to high levels in Europe and U.S. since the mid-1990s as multinational corporations pursue economies of scale (Figure 2). In this context, cross-border equity swaps are used in cross-border M&A activities because they do not require a large amount of cash.¹⁰ In the case of Japan, it is possible that non-residents will increasingly use cross-border equity swaps to take capital participation in Japanese companies. For instance, in the medical and pharmaceutical industries where there is a growing interest in investing in Japanese companies, European and U.S. companies could take capital participation in Japanese companies that enjoy strong R&D potential or attractive product line-ups. Such acquisitions might be paid for either in cash by companies with large cash reserves, or through cross-border equity swaps with highly priced shares that reflect strong corporate performances (Figure 3).

⁸ A domestic equity-swap scheme was introduced by the August 1999 revision of the *Commercial Code* (enforced in October 1999). However, because the *Commercial Code* applies to companies incorporated under Japanese law, foreign companies were unable to use cross-border equity swaps when acquiring shares of a Japanese company under the *Commercial Code*.

⁹ Such demands were voiced by the Japan-U.S. Exchange Meetings based on “the Economic Partnership for Growth” agreed upon in the June 2001 Japan-U.S. summit meeting, the American Chamber of Commerce in Japan (ACCI), the European Business Community (EBC) and others.

¹⁰ Deals in which all payments were made through cross-border equity swaps account for a significant share of total cross-border M&A activities. In the acquisition of U.S. companies by European companies, the share is averaged slightly below 20 percent since 1997. In the acquisition of European companies by U.S. companies, the share is averaged slightly below 10 percent (compiled from Bloomberg). Given that payments are often made through a combination of cash, bonds and shares, the true weight of cross-border equity swaps can be said to be considerably higher.

However, cross-border equity swaps in Japan require triangular mergers or other complex schemes. This is because, in the case of Japan, the use of the shares of a foreign company for payments to the former shareholders of an acquired company requires following procedures: First, a foreign affiliated company operating in Japan has to acquire the status of a certified company.¹¹ The foreign affiliated company then either merges¹² with the acquired company (process referred to as a triangular merger), or the acquired company becomes a subsidiary company (process of acquisition) through the existing foreign affiliated company. Lastly, transferring the shares of the foreign parent company serves as a payment for the merger or acquisition.¹³ The revised *Industrial Revitalization Law* requires those procedures for the following reason. When a certified company (an acquiring company) undertakes an equity swap or merger in accordance with a certified plan, the law allows payments to former shareholders of an acquired company to be made through the transfer of designated financial assets (Article 12-9). However, because certification is restricted to companies incorporated in Japan, a foreign company cannot directly transfer its shares to the former shareholders of an acquired company.

The impact of cross-border equity swaps on FDI into Japan will depend on whether the investment scheme fits needs of investors. In this connection, it has been pointed out that cross-border equity swaps entail the following drawbacks for foreign companies.

[1] Cost of establishment of a foreign affiliated company

If a foreign company does not already operate a foreign affiliated company in Japan, it will have to set it up and bear the costs of its establishment and administration.

[2] Mandatory certification

A foreign affiliated company must be certified by the Minister of Economy, Trade and Industry under the provisions of the revised *Industrial Revitalization Law*.

Based on the awareness of the major impact of cross-border M&A activities on FDI, M&A Statistics are often used as supplementary information for FDI series. While there are some conceptual differences between them, time series display similarities (Figure 4).

¹¹ Companies must be certified under one of the following categories provided under the revised *Industrial Revitalization Law*: [1] self-restructuring plan (plan for improving productivity through business selection and concentration); [2] co-restructuring plan (joint plan by multiple number of enterprises for adjustment of excess capacity and improvement of productivity through business concentration, retrenchment or close down); [3] business transfer and restart plan (plan for utilizing the under-utilized resources of an existing company for improving efficiency in the business field of the existing company); and [4] pilot investment plan (plan for developing a domestic manufacturing base that is combined with R&D capabilities).

¹² In a triangular merger, either an acquiring or acquired company can be made a continuing entity. Hence, an acquired company, such as operating an industrial waste disposal business, could be a continuing entity (reverse triangular merger) in order to retain the existing business license.

¹³ In this case, the corporate laws, under which a foreign parent company is incorporated, must allow acquiring shares of a parent company by its affiliated company.

[3] Tax-related drawbacks

Under Japan's current tax system, cross-border equity swaps do not meet tax-deferred requirements¹⁴ and are frequently subject to capital gains taxes.¹⁵ Therefore, it is expected that the shareholders of an acquired company will not readily agree to equity swaps.¹⁶

Currently, to establish a cross-border equity swap scheme as permanent, the Corporate Law Subcommittee of the Legislative Council has included a measure for greater flexibility in payment methods¹⁷ in its "Draft Proposal on Modernization of

¹⁴ Under Japan's tax laws, equity swaps are considered to be a form of transfer of shares (the sale of shares held and the newly purchase of shares). As such, the capital gains or losses resulting from the swaps must be recognized. However, when equity swaps do not involve the actual payment and receipt of money; shares have been transferred to shareholders without tax-bearing capacity, payment of capital gains taxes can be deferred until the sale of the shares under certain conditions (when it is recognized that former shareholders maintain continued control, such as acquiring the shares of a newly established company through a merger in place of the shares previously held).

¹⁵ Current rules in major countries are as follows. In the U.S., U.K., France and others, capital gains taxes on equity swaps can be deferred under certain conditions. Germany does not provide for tax deferral, however, in most case profits from shares involved in equity swaps are exempted from income tax when requirements for long-term holding have been met.

However, it has been pointed out that if capital gains taxes are deferred on cross-border equity swaps, the scheme might be used in corporate inversions aimed at tax avoidance. For this reason, it has been argued that further discussion is needed on whether to allow tax deferral. Corporate inversion refers to the following type of transactions: [1] Japanese Company A establishes Company B as its subsidiary in the Caymans, Bermudas or other tax haven, [2] shares in Company A owned by resident shareholders are swapped with shares of Company B held by Company A, such that the parent-subsidiary relation between Companies A and B are reversed. By becoming a subsidiary of Company B domiciled in a tax haven, the Japanese Company A would take advantage of the low corporate tax rates in the tax haven, by reducing its taxable income in Japan.

¹⁶ When shares of a foreign company that is not listed on the Tokyo Stock Exchange are to be used in payment for acquisition, the former shareholders must open a "foreign securities transaction account" with a securities company in accordance with Agreement for Opening of a Foreign Securities Transaction Account.

¹⁷ Proposals for greater flexibility in payment methods were included in connection with deliberations on improving the efficiency of corporate management (lowering the minimum capitalization requirements, non-issuance of shares, etc.) and modernizing the language of company-related laws (Book II of the *Commercial Code*, the *Yugen Gaisha Law*, and the *Commercial Code Special Measures* specifying the audit and other matters related to joint-stock companies). This was in response to the view that improved convenience in payment for mergers would promote FDI into Japan and that this in turn could play an important role in raising the productivity of Japanese companies and improving the employment situation (Bills for legislative revisions are scheduled to be submitted to the ordinary Diet session of 2005). However, because these proposals are identical to the provisions of the revised *Industrial Revitalization Law*, foreign companies will remain barred from directly engaging in cross-border equity swaps.

In the Draft Proposal, the Ministry of Justice is also considering the creation of a new company form assuring limited liability of investors (Japanese LLC [provisional name]). Unlike the joint-stock company that provides for the separation of ownership and management, the Japanese LLC would be subject to partnership-type rules to organization's internal relations.

Corporation Laws” (October 2003) and is examined for the revision of the *Commercial Code*.¹⁸

(2) Introduction of Japanese LPs

Since April 2004, the use of Japanese LPs (limited partnerships for investment) has been allowed under the provisions of the *Limited Partnership Act for Investment (Limited Partnership Act)*. This legislative action was taken to match numerous demands¹⁹ to set up more flexible investment vehicles as a trigger for direct financing, in order to diversify merger methods with the purpose of using them to revitalize the Japanese economy. It followed that the *Law Concerning SME Limited Partnerships for Investment* was revised and replaced by the *Limited Partnership Act*. Japanese LPs were thus introduced as an investment vehicle.

Japanese LPs are relatively attractive as an investment vehicle and can be characterized as benefiting from:

[1] Tax advantage and limited liability

Since Japanese LPs are not legal persons and not taxable, they are not subject to the two-stage taxation (corporate taxes plus income taxes). Moreover, investors into Japanese LPs are assured with limited liability.

[2] Wider scope of investment choices

Unlike the *Law Concerning SME Limited Partnerships for Investment*, the scope of investment choices goes beyond unlisted small and medium enterprises (SMEs) to include major joint-stock companies and listed companies.²⁰

[3] Diversification of investment methods

Japanese LPs can contract monetary claims and corporate bonds in the course of investment. Japanese LPs can also extend loans.

[4] Simple means to raise capital

By accepting unlimited liability into Japanese LPs, investment banks and other entities that have proper capabilities to investigate and analyze the investment choices can

¹⁸ Household savings are viewed to decline continuously as a result of the aging population and declining birthrates. In light of this view, the government and concerned ministries are taking the position that systems need to be put in place to facilitate the inflow of foreign capital. There are some reports that a policy decision has been made to include measures in the fiscal 2006 tax reform to defer taxes under certain conditions, when the shares of foreign companies have been used to pay the former shareholders of an acquired company in an equity swap (*Nihon Keizai Shimbun*, October 19, 2004). Close attention should be given to progress toward revision of this system; as such a revision would reduce the above-mentioned tax drawbacks and would improve the convenience of cross-border equity swaps.

¹⁹ Such demands were made by the Council for Regulatory Reform, the Japan Keidanren, foreign affiliated companies and others.

²⁰ While there are not requirements concerning corporate scale (OTC registered companies are also eligible), as a rule, investment choices are restricted to Japanese companies.

reduce the information asymmetry between investors and investee companies, and can perform post-investment surveillance against moral hazards in investee companies.

Heretofore, various investment vehicles similar to Japanese LPs are available for investments into Japan for the purpose of making FDI. They include joint-stock companies and *yugen gaisha*, anonymous associations, voluntary partnerships, and SME investment partnerships.²¹ However, these schemes tend to have limited advantages. Specifically, impediments include the following. Joint-stock companies and *yugen gaisha* are subject to the two-stage taxation, anonymous associations have low standards for external disclosure, investors in voluntary partnerships are subject to unlimited liability, and SME investment partnerships are restricted to investments in unlisted SMEs and are also subject to restrictions on investment methods (Figure 5).

In contrast to this, Japanese LPs combine the advantages of assuring the management and distributing information of investee companies by unlimited liability partners, and the provision of large amounts of funds by limited liability partners. These elements explain that Japanese LPs could be actively used in the future as an investment vehicle in the following cases: where investors would be unable to effectively access the business situation and performance of investee companies intensive new technologies and R&D processes, where information asymmetry is believed to be significant and where the large initial investments are required, such as in information and communications, the development of new pharmaceuticals and bio-technology.

4. Statistical Treatments of Cross-Border Equity Swaps and Japanese LPs in the BOP and IIP

The statistical treatments of cross-border equity swaps and Japanese LPs in the BOP and the IIP are summarized below and some issues are identified.

(1) Treatment of cross-border equity swaps

The use of cross-border equity swaps is likely to be recorded as contraction of inward FDI flow in the BOP. This is because, under the provisions of the revised *Industrial Revitalization Law*, a foreign company using a cross-border equity swap to acquire a Japanese company must first transfer its shares to be used in the swap to its foreign affiliated company operating in Japan. Thereafter, the foreign affiliated company either merges with an acquired company or acquires it as its own subsidiary (thereby making the acquired company as a sub-subsidiary company of the foreign company). In this scheme, the shares of the foreign company are used to pay for acquiring a Japanese

²¹ These were specified under the provisions of the *Law Concerning SME Limited Partnerships for Investment*, the antecedent of the *Limited Partnership Act for Investment*.

company to the former shareholders. Thus, this acquisition process involves a cross-border capital transaction whereby the foreign affiliated company in Japan acquires the shares of its foreign parent company. However, the statistical treatment of this transaction offsets FDI into Japan made by non-residents (reverse investment [see note 1 in table]). Consequently, FDI flow into Japan in the BOP is recorded as a decrease by the amount of the foreign parent company's shares acquired by its foreign affiliated company in Japan.

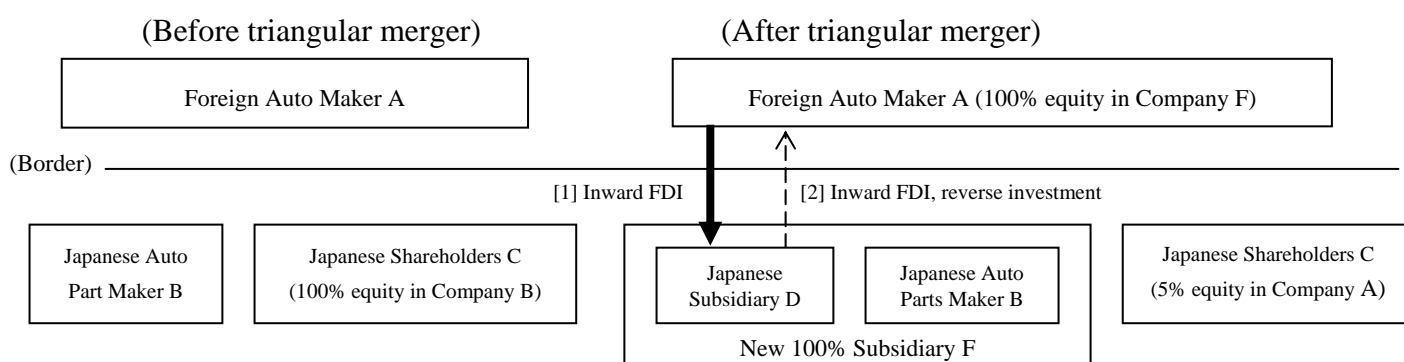
However, it is expected that the acquisition of the foreign parent company's shares by its foreign affiliated company in Japan will be financed through means such as new capital subscription or loans by the parent company. In this case, the capital outflow resulting from reverse investment will be matched by capital inflow resulting from new capital subscription or loans. Hence, the total impact on FDI flow into Japan in the BOP will be netted out (see note 2 in table).

Chart 3: Treatment of Triangular Mergers in the BOP

A triangular merger is outlined below. The acquisition of a Japanese company by a foreign company is recorded as follows in the BOP.

Assumptions: A foreign automobile manufacturer (Company A) acquires the shares of a Japanese auto parts manufacturer (Company B) from resident shareholders C and transforms Company B into a wholly owned subsidiary (Company F). To achieve this, the acquisition goes through the following steps:

- [1] Company A establishes a foreign affiliated company in Japan (Company D) [indicated by thick line in figure below]
- [2] Company D acquires the shares (5 percent of outstanding shares) of its parent Company A [indicated by dotted line in figure below]
- [3] Company B and Company D merge to create a new subsidiary (Company F), and the shares of Company A are used to pay for acquiring the shares of Company B. In this case, transaction [1] will be recorded as increase in inward FDI, while transaction [2] (reverse investment) will be recorded as decrease in inward FDI.²²



²² Similarly, if Company B becomes a subsidiary of Company D (a sub-subsidiary company of Company A), the acquisition of the shares of Company A (for use in payment) by Company D constitutes a “reverse investment.”

Description of Transactions	Statistical Treatment in the BOP
Foreign Auto Maker (Company A) establishes a foreign affiliated company in Japan (Company D) ([1])	Inward FDI: inflow of equity capital
To acquire shares of parent Company A, Company D raises funds using following methods:	
Case1: Company A acquires new shares issued by Company D	Inward FDI: inflow of equity capital
Case2: Company A loans funds to Company D	Inward FDI: inflow of other capital
Case3: Company A's foreign affiliate abroad (group's finance company) lends funds to Company D	Other investment (liabilities): inflow of loans
Case4: Company D borrows from domestic banks	Resident-resident transaction: not recorded in the BOP
Company D acquires the shares of Company A (5 percent of outstanding shares) ([2])	Inward FDI: outflow of equity capital (reverse investment)
Company B and D merge, and the shares of Company A are transferred to Japanese shareholders C in payment for acquisition of Company B by Company D	Resident-resident transaction: not recorded in the BOP

Notes: 1. Regarding a subsidiary's acquisition of claims against its parent company (extension of loans or acquisition of shares), when the subsidiary's capital participation in the parent company is less than 10 percent, the transaction offsets the FDI made by the direct investor and recorded as decrease in FDI (*BPM5*, para 371); it is referred to as a reverse investment. Therefore, the acquisition of the shares of Company A by Company D is recorded as an outflow of inward FDI.

2. When Company D raises funds for the acquisition of the shares of its parent Company A, equity swaps have the advantage of avoiding the need for cash in the acquisition. Therefore, the method used for fund-raising is likely to be the method used in Case 1 or Case 2. In Case 1, the acquisition of shares by Company D (capital outflow) offsets Company A's acquisition of new shares in Company D (capital inflow). In Case 2, the acquisition of shares by Company D (capital outflow) offsets Company A's loans to Company D (capital inflow).

The changes in the amount invested by non-residents into Japanese companies are following. [1] In a triangular merger, the amount invested in the new Japanese subsidiary (Company F: existing foreign affiliated company [Company D] added to the value of the acquired company [Company B]) is larger than the total in the existing company (Company D), FDI stock into Japan in the IIP will increase by the difference between the two amounts. [2] A scheme that results in the creation of a subsidiary company will not directly affect FDI stock into Japan in the IIP because there is no change in the amount invested in the directly owned existing company.

(2) Treatment of Japanese LPs

Investments into Japanese LPs are not included in inward FDI in Japan's BOP and IIP. The *Foreign Exchange Law* provides the statutory basis for the compilation of Japan's BOP and IIP and the collection of data sources. Within this legal framework,

investments by non-residents into Japanese LPs, which are not legal persons, do not constitute FDI into Japan (such as, acquiring shares or equity positions in a Japanese company <the *Foreign Exchange Law*, Article 26-2>). Consequently, even when the capital participation of non-residents into Japanese LPs is 10 percent or more, the investment is not recorded under FDI.²³

This statistical treatment implies the following issues. [1] Because investments and the collections of investments into Japanese LPs are not defined as FDI into Japan, the impact of the introduction of this investment vehicle on investments on FDI into Japan will not be accurately reflected in FDI series. [2] While this will depend on the volume of investments, strictly speaking, international comparisons with countries including investments in LPs in FDI series and Japan are difficult. These issues are discussed in some greater detail below.

[1] Difficulty in assessing investors' actual behavior

It is likely that, along with investments by non-residents into joint-stock companies and *yugen gaisha*, investments into Japanese companies through Japanese LPs will be increasingly used. Under the current statistical treatment, it is likely that FDI series do not accurately reflect the investment behavior of non-residents. If investments by non-residents into Japanese LPs with 10 percent or more capital participation were to be included in FDI, this would allow statistics users more accurately capture the inflow²⁴ of foreign capital into Japan for the purpose of management control, regardless of the form of investments.

In this connection, the *BPM5* defines FDI as “the category of international investment that reflects the objective of obtaining a lasting interest by a resident entity in one economy in an enterprise (author’s note: the direct investment enterprise receiving the investment) resident in another economy” (para 359). Furthermore, the direct investment enterprise is defined as “an incorporated or unincorporated enterprise in which a direct investor, who is resident in another economy, owns 10 percent or more of the ordinary shares or voting power or the equivalent” (para 362). Finally, “the term *enterprise* is inclusive of the terms *corporation*²⁵ and *quasi-corporation* (an unincorporated enterprise

²³ As in the case of investments in anonymous associations and voluntary partnerships, such investments are recorded under “Equity Securities” in “Portfolio investment (liabilities).” (Author’s note: they had been recorded under “Other” in “Other investment (liabilities)” at the release of the original Japanese-language version. The change was accompanied by the revision of the *Securities Transaction Law*.)

²⁴ It cannot be denied that even in cases where non-resident capital subscription into Japanese LPs is 10 percent or more, the purpose of the investments into Japanese companies through Japanese LPs could be for portfolio investment. Thus, due attention must be given to the possibility that not all investments into Japanese LPs are made for purposes of management control.

²⁵ “A corporation is a legal entity created for the purpose of producing goods or services for the market” (para 74).

that is operated as if it were a separate corporation with a complete set of accounts) as defined in the *SNA*” (para 74). With reference to “a separate corporation with a complete set of accounts,” the *BPM5* does not clarify what constitutes a separation of accounts, and the matter is left to the discretion of countries. However, because limited liability can at least be considered to be a condition indicating separation of accounts between investors and Japanese LPs, investments by non-residents into Japanese LPs with capital participation of 10 percent or more can be considered to constitute FDI into Japan under the *BPM5* recommendations.

[2] Difficulty in international statistical comparisons

In the U.S. where LPs are actively used, direct investment enterprises not only include corporations and branches with non-resident capital participation of 10 percent or more but also partnerships and sole proprietorships. Therefore, if Japan continues to exclude Japanese LPs from FDI series, bilateral comparison between Japanese and U.S. FDI series will become increasingly difficult as the investment method employed in FDI into Japan shifts toward Japanese LPs.

Against this background, statistics compilers in Japan could possibly consider the inclusion of investments into Japanese LPs and others²⁶ under FDI series within the current framework of the *Foreign Exchange Law*, provided that the capital participation is 10 percent or more. While giving due consideration to the reporting burden, statistics compilers in Japan should examine how to collect adequate data and reflect it in FDI series.

²⁶ In addition to Japanese LPs, the issue of whether investments in anonymous associations and voluntary partnerships should be included in FDI series must be considered.

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(Figure 1)

Chronology of Japan's inward FDI Promotion Measures

Investment promotion measures are indicated below with the following reference numbers: [1] measures related to changing the attitude toward accepting foreign capital (promoting a welcoming mind-set), [2] measures involving deregulating and simplifying investment procedures, [3] measures seeking the reduction of investment expenses and improving conditions for fund-raising. Additionally, measures not directly intended to promote FDI into Japan but which have some impact on investments by non-residents into Japan are indicated as “reference.”

1980	In connection with the revision of the <i>Foreign Exchange and Foreign Trade Control Law</i> (the former <i>Foreign Exchange Law</i> [promulgated in 1949]), the <i>Foreign Investment Law</i> was abolished; the introducing foreign capital and technology was liberalized in principle, provided prior notifications related to FDI into Japan. [2]
1984	The Japan Development Bank (currently the Development Bank of Japan, since it was merged with the Hokkaido-Tohoku Development Finance Public Corporation in 1999) launched the “Loan Program for Promoting Foreign Direct Investment in Japan.” [3] The Japan External Trade Organization (JETRO) started providing investment-related information to promote FDI into Japan. [2]
1990	The Hokkaido-Tohoku Development Finance Public Corporation launched the “Loan Program for the Internationalization of Local Companies.” [3] Following the final report of Japan-U.S. Structural Impediments Initiative negotiations, the government publicized the statement on “Declaration Concerning Openness to Foreign Direct Investment” indicating the decision to actively promote policies for openness to international investments. [1]
1992	The <i>Law on Extraordinary Measures for the Promotion of Import and the Facilitation of Foreign Direct Investment (Import and Inward Investment Law)</i> was promulgated to reduce the burden of initial costs facing foreign companies; tax incentives (tax provisions to extend the period for carry-over of deficit); loan guarantee by the Japan Development Bank. [3] The former <i>Foreign Exchange Law</i> was partially revised, and prior notifications related to FDI into Japan were replaced by ex-post reports related to FDI into Japan. This provision, however, excluded investments into industries related to national security and industries for which restrictions are internationally accepted. [2]
1993	The Foreign Investment in Japan Development Corporation was established jointly by the government and private sectors to provide comprehensive support services in order to facilitate operations of foreign affiliated companies in Japan. [2]
1994	The JIC was established; its members were Cabinet ministers under the chairmanship of the Prime Minister.

1995	<p>“Survey of Inward FDI Promotion Measures,” the study by a private research institution, was publicized.</p> <p>The JIC Statement on “The Promotion of Foreign Direct Investment in Japan” was publicized. [1]</p> <p>The <i>Import and Inward Investment Law</i> was extended through 2006. [3]</p>
1996	<p>“Survey of Improvement of Japan’s M&A Environment for Promoting Inward FDI,” the study by a private research institution, was publicized.</p> <p>The first Regional Japan Investment Council was held in Kita-Kyushu to promote FDI into outlying regions (thereafter regularly held, most recently in 2004 in Kyoto).</p> <p>The JIC Statements on “Promotion of Foreign Direct Investment into Japan” and “Development of Japan’s M&A Environment” were publicized. These included the following specific proposals and measures ([1] - [3]), calling for changes in private business practices and mind-set to facilitate strategic use of M&A activities.</p> <p>(</p> <ul style="list-style-type: none"> To actively implement M&A promotion and edification activities through the private sectors and the government cooperation; to provide information on cases of successful M&A; to facilitate business and industrial exchange using JETRO’s investment services. To establish one-stop M&A intermediation services in the Foreign Investment into Japan Development Corporation. To enhance status of M&A intermediation services as a business; to promote entry of new intermediation enterprises; to foster human resources with expert knowledge. To use the Office of Trade and Investment Ombudsman to receive complaints of foreign companies and others against the government. To launch the Japan Development Bank’s “Corporate Partnership Facilitation Loan Program” in fiscal 1996 for financing new capital investments undertaken by foreign affiliated companies that have completed M&A. To review the ban on holding companies within the scope of anti-monopoly policies and to implement necessary related measures; to discuss related systems (e.g., equity-swap and equity-transfer systems, corporate divestiture system, bankruptcy laws, and defenses against hostile M&A). <p>)</p>
1997	<p>“M&A Support and Development Initiatives: Survey of Bankruptcy Laws from the Perspective of Promoting M&A” and “Survey of Regional Inward FDI Promotion Measures by Foreign Countries,” studies by a private research institution, were publicized.</p> <p>Eligibility in the Japan Development Bank’s loan program for promoting FDI into Japan was expanded from companies with foreign capital participation exceeding 50 percent to those exceeding 33 percent. [3]</p> <p>The statement on “The Action Plan for Economic Structural Reform” was endorsed by the Cabinet including to strengthen FDI promotion measures and to study the improvement of environment for promoting inward M&A, in the international-related area among 15 new targeted areas for creation. FDI promotion measures are exemplified by the rectifying the high-cost situation, investment incentives, and the further liberalization of regulations against foreign participation. ([1] - [3])</p> <p>(Reference) Lifting of the ban on pure holding companies, simplification of merger procedures</p>
1998	<p>“Survey of Supportive Measures to Promote Inward FDI at the Regional Level,” the study by a private research institution, was publicized.</p> <p>The former <i>Foreign Exchange Law</i> was enacted committing to harmonize the pursuit of private profit and public good through market mechanism. [2]</p> <p>The Japan’s Regional Development Corporation established the Corporate Location Information</p>

	<p>Center in partnership with the Japan Industrial Location Center to provide information on 1,000 industrial locations throughout Japan. [2]</p> <p>The statement on “Three-Year Plan for the Promotion of Deregulation” was endorsed by the Cabinet, whereby committing to deregulate and adopt less stringent regulations, achieving international regulatory compatibility, and expediting regulatory procedures. [2]</p>
1999	<p>“Survey of Impact of Inward FDI on Regional Economies,” the study by a private research institution, was publicized.</p> <p>The statement on “Three-Year Plan for the Promotion of Deregulation” was revised. [2]</p> <p>The JIC Expert Committee, an organ of the JIC, publicized the statement on “Seven Recommendations for Promoting Foreign Direct Investment in Japan.” In response, the JIC publicized the statement on “Toward an Age of Diversified Ideas through Foreign Direct Investment in Japan,” proposing the following measures aimed at creating managerial and technological systems through the promoting FDI into Japan, the creation of jobs, generating greater benefits for consumers, and creating multi-faceted international economic relations. [1] - [3]</p> <p> { <ul style="list-style-type: none"> To realize the potential of foreign companies in outlying regions, local governments should promote the implementation of original initiatives reflecting the features of their particular regions (subsidies for attracting foreign affiliated companies, promoting partnerships with local universities aimed at gaining access to human resources, the provision of land and factory facilities through lease or rental arrangements); strengthen the system for providing regional information using the Internet and other means. To provide the better education for foreign children in public schools, and to support independent initiatives for the establishment and operation of international schools. To provide information on medical facilities in foreign languages and expand translation services. </p> <p>(Reference) Introduction of equity-swap and equity-transfer systems, enactment of the <i>Industrial Revitalization Law</i>, lowering the effective corporate tax rate from 49.98 to 40.87 percent.</p>
2000	<p>(Reference) Enactment of the <i>Civil Rehabilitation Law</i>, introduction of new consolidated accounting standards, application of tax-impact accounting.</p>
2001	<p>“Survey of Causes of Increased Inward FDI and Impact on the Japanese Economy,” the study by a private research institution, was publicized.</p> <p>The statement on “Three-Year Plan for Regulatory Reform” was endorsed by the Cabinet and thereafter revised in 2002 and 2003. [2]</p> <p>(Reference) Introduction of corporate divestiture system, introduction of mark-to-market valuation of all financial products excluding cross-shareholding.</p>
2002	<p>The follow-up to previous year’s study was publicized.</p> <p>The statement on “Basic Policies for Economic and Fiscal Policy Management and Structural Reform 2002” was endorsed by the Cabinet. It indicated that “the Cabinet Office shall, in cooperation with concerned ministries, formulate specific measures aimed at reinforcing competitiveness by encouraging inward FDI and the brain gain during fiscal 2002, and shall systematically implement these measures in cooperation with concerned ministries.” [1]</p> <p>The JIC Expert Committee was reinstated pursuant to the above Cabinet decision.</p> <p>The Invest Japan Forum proposed to revitalize the Japanese economy through increasing FDI into Japan (referred to as “Third Opening of Japan”). [1]</p>

	<p>(Reference) Publication of “Program for Financial Revival: Revival of the Japanese Economy through Resolving Non-Performing Loans Problems of Major Banks” by the Financial Services Agency, introduction of consolidated taxation system, enactment of the <i>Law Concerning SME Limited Partnerships for Investment</i>.</p>
2003	<p>“Survey of the Obstacles to Inward FDI,” the study by a private research institution, was publicized.</p> <p>Prime Minister Junichiro Koizumi proposed to double FDI stock into Japan (within 5 years) in his general policy speech. [1]</p> <p>The JIC Expert Committee publicized the “Program for the Promotion of Foreign Direct Investment into Japan” containing the following specific measures: [1] - [3]</p> <p>(</p> <ul style="list-style-type: none"> In the course of work on modernization of the <i>Corporate Law</i>, examine a possible implementation of “the easing of rules on payment for merger etc.” as a permanent measure, which would enable lifting the ban on cross-border equity swaps to expedite the process of mergers and acquisitions by foreign companies. When liquidating stocks and loans owned by the Industrial Revitalization Corporation (IRC) and the Resolution and Collection Corporation (RCC), select buyers through publicized procedures in a transparent, fair, and economically sound manner to encourage foreign companies to participate in the process of corporate revitalization. Create tax incentives in IT and R&D to reduce the tax burden of companies. Strive to improve transparency and reliability of corporate information by means such as observing actions corresponding to the international accounting standards to strengthen corporate governance. Post electronic reporting system on investment applications required by the <i>Foreign Exchange Law</i>. Clarify, simplify, and expedite administrative procedures by, for example, promoting the use of a “no action-letter” system to clarify interpretation of legislation. Improve basic ability in English and communication ability based on cross-cultural understanding of the Japanese people. To establish up the internationally competitive structure for attracting investments, the ministries and concerned agencies will investigate the structures and policies in other countries, and further implementation in Japan. Strengthen the providing information to foreign press, embassies, and consulates and publicizes the successful experiences involving FDI into Japan. Seek public support on the role and importance of inward FDI in the revitalization of the Japanese economy, through media and communication means. <p>)</p> <p>The JIC adopted the above program and publicized the statement on “Promotion of Foreign Direct Investment into Japan.” [1]</p> <p>To implement the above program, a general contact information network (“Investment Japan”) was set up within the government and concerned ministries to facilitate information gathering by investors.</p> <p>The M&A Investigation Committee was established in the Economic and Social Research Institute of the Cabinet Office for the purpose of investigating the current status and specific issues pertaining to M&A activities of Japanese companies.</p> <p>(Reference) The <i>Industrial Revitalization Law</i> revised, the <i>Corporate Rehabilitation Law</i> revised, mark-to-market accounting of cross-shareholdings introduced.</p>

2004	<p>“Survey of Factors Contributing to the Success and Failure of Foreign Companies in Japan,” the study by a private research institution, was publicized.</p> <p>The M&A Investigation Committee publicized the study on “Facilitating the Development of the M&A Activities of Japanese Companies.”</p> <p>The statement on “Three-Year Plan for Promotion of Regulatory Reform and Private-Sector Liberalization” was endorsed by the Cabinet, containing proposals for the introduction of new investment vehicles, such as Japanese LPs and Japanese LLC. [2]</p> <p>The JIC Expert Committee summarized the status of program implementation during previous year.</p> <p>(Reference) The <i>Law Concerning SME Limited Partnerships for Investment</i> was revised and replaced by the <i>Limited Partnership Act</i>.</p>
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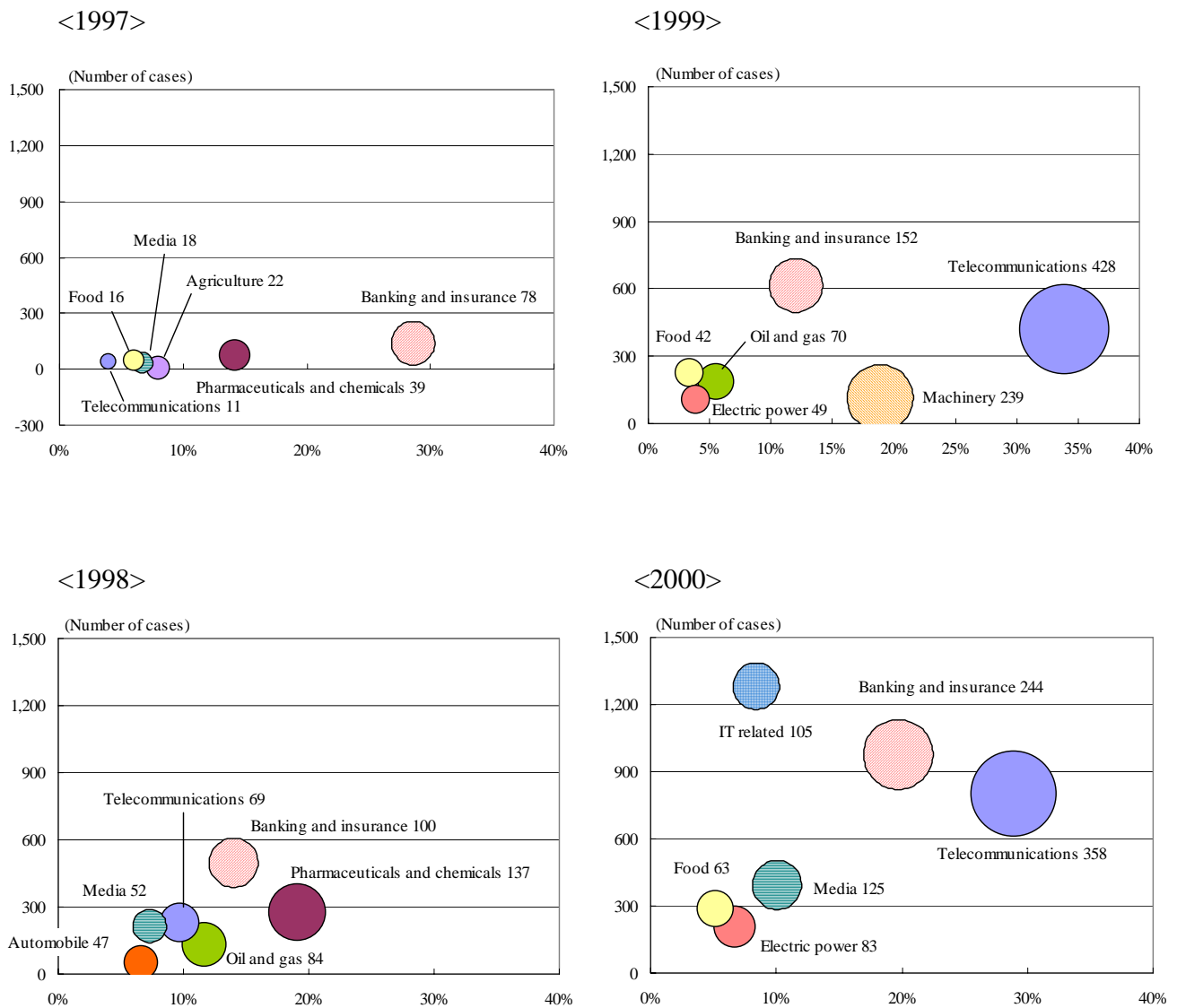
Sources: Compiled from *Measures for the Promotion of Inward FDI*, METI; *International Trade and Investment White Paper*, JETRO; the Statements of the JIC, etc.

Note: The above table contains measures that were not directly intended to promote FDI into Japan but which had some impact on investments by non-residents by improving the environment for investment and corporate activities.

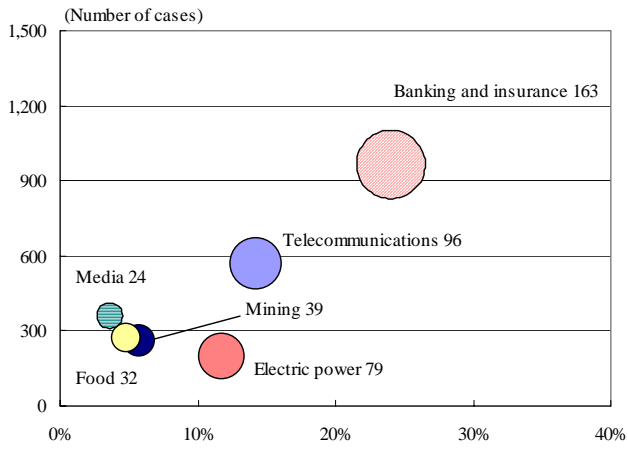
(Figure 2)

Cross-Border M&A Activities by Industry
(Vertical axis: number of cases; Horizontal axis: share in total amount;
Size of circle: amount [\$billion])

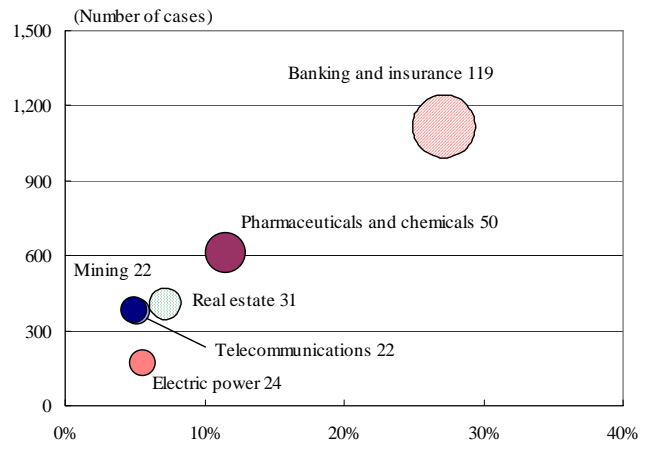
Circles approaching upper right-hand corner indicate higher levels of M&A activities; lower left-hand corner indicates lower levels of M&A activities. The figure for 2004 is annualized from data for January-November 2004. (Compiled from Bloomberg)



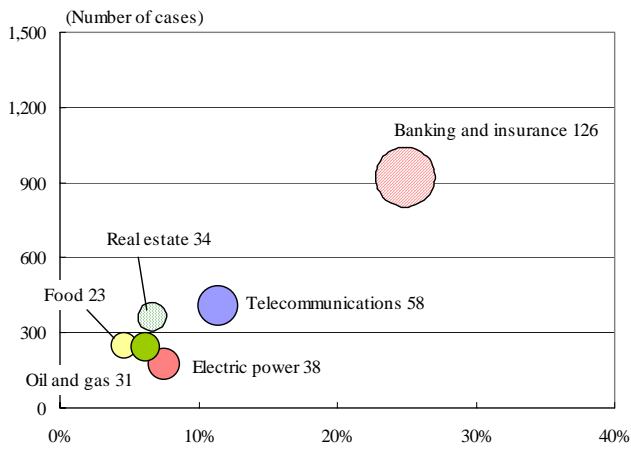
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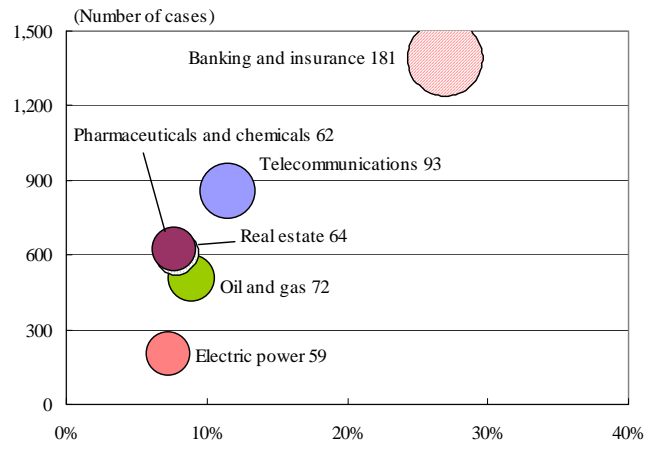
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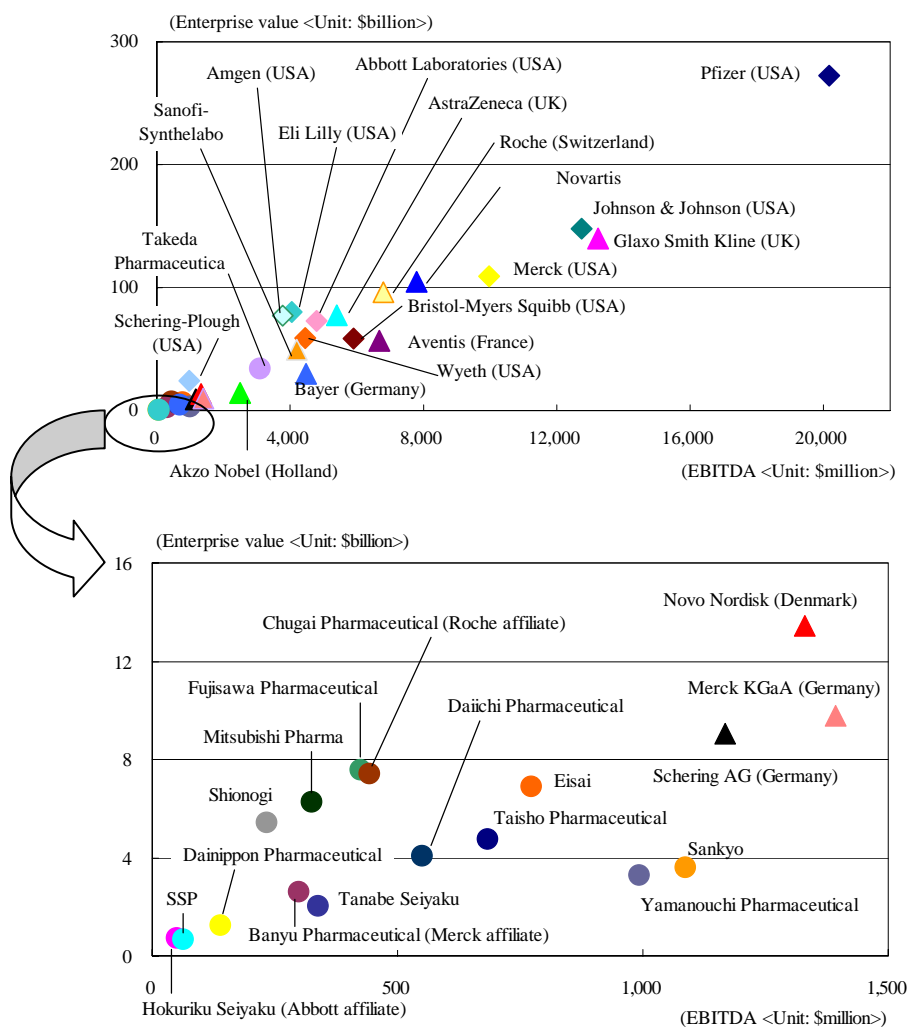


<2004 (Rough Estimate)>



(Figure 3)

Enterprise Value and Operating Cash Flow of Pharmaceutical Companies



- Notes: 1. Vertical axis indicates enterprise value (Unit: \$billion) and horizontal axis indicates EBITDA (earnings before interest, taxes, depreciation and amortization <Unit: \$million>). (Compiled from Bloomberg) EBITDA is obtained by adding depreciation and amortization in current term not involving cash-out to operating profit earned from core businesses, and thus provide a measure of cash flow from core businesses. Because it is not affected by tax rates and depreciation and amortization rates that differ among countries, EBITDA is usable for international comparisons of business performance. Companies approaching the upper right-hand corner are increasingly in a better position to launch acquisitions (companies in a stronger position to acquire others using equity swaps or cash on hand), and companies approaching the lower left-hand corner are increasingly prone to being acquired.
2. Diamonds indicate U.S. companies, triangles indicate European companies, and circles indicate Japanese companies.
3. Based on top 28 companies in Utobrain “2003 World Ranking of Major Pharmaceutical Manufacturers by Sales” and listed Japanese companies. (Settlement period for U.S. and European companies and Chugai Pharmaceutical and Hokuriku Seiyaku is December; all others are March [note that figures for Hokuriku Seiyaku are for December 2001, and March 2003 for Banyu Pharmaceutical]).
4. Yamanouchi Pharmaceutical and Fujisawa Pharmaceutical are scheduled to merge in April 2005 (new company to be named Astellas Pharma).

(Figure 4)

Differences between FDI Series and M&A Statistics

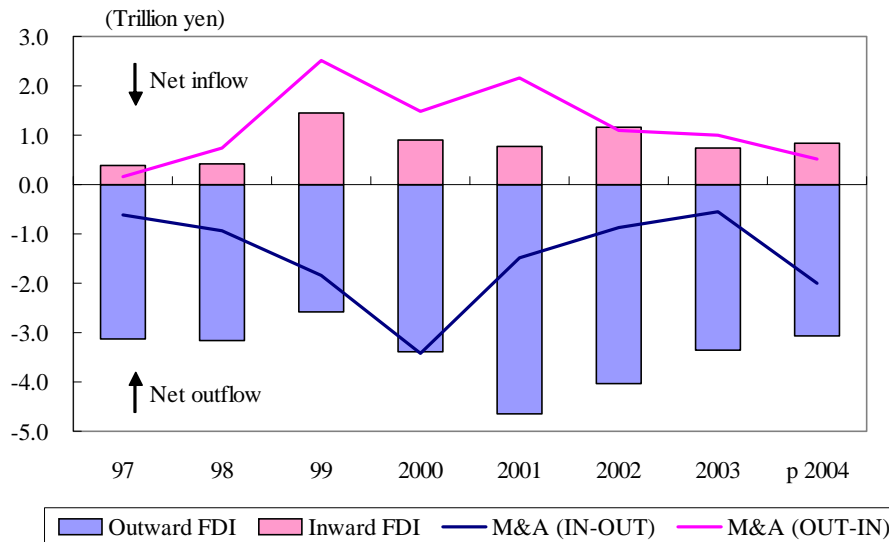
	FDI Series (BOP)	M&A Statistics
Methodology	<p>“Two-way, net basis” statistics covering cross-border capital transactions between residents and non-residents with capital participation of 10% or more.</p> <p>--- Cases on the right are: [1] a resident-resident transaction, [2] a nonresident-nonresident transaction, and [4] not involving a cross-border capital transaction are unrecorded, while [3] is recorded under “Other” in “Other investment.”</p> <p>Methodology is defined in the <i>IMF Balance of Payments Manual, fifth edition (BPM5)</i>, which is the international standard for the BOP and IIP, and in the <i>OECD Benchmark Definition of Foreign Direct Investment, third edition (BD3)</i>, which is the practical guideline for FDI. As such, statistics are generally consistent throughout the world.</p>	<p>“One-way, gross basis” statistics covering merger and acquisition by an investor against an enterprise who is resident in another economy.</p> <p>--- It includes [1] M&A financed by funds procured in a country of an acquired company, [2] M&A involving acquisition of shares from other non-residents, [3] acquisition of goodwill, industrial property rights, trademarks, etc., and [4] strategic business partnerships.</p> <p>There are no unified methodology and definitions, thus could differ among data providers.</p> <p>--- UK, Canada and others publish M&A statistics based on supplementary information undertaken in compiling FDI series (BOP). Data providers mostly consist of investigating and consulting companies.</p>
Item	<p>Three items: equity capital, reinvested earnings, and other capital.</p> <p>--- It includes non-M&A capital transactions, such as acceptance of newly-issued shares by existing company, reinvested earnings, and loans to existing company.</p> <p>Regional and industrial data are classified by direct investor, based on debtor/creditor principle.</p> <p>--- Case on the right is recorded as investment in Country C by direct investor of Country B. This tends to increase the volume of investments to and from the three Benelux countries with economic incentives for holding companies.</p>	<p>Amount used in M&A activities, number of M&A cases, etc..</p> <p>Regional and industry data categorized by ultimate investor.</p> <p>--- Example: Subsidiary in Country B of parent company in Country A acquires company in Country C. This is recorded as an investment in Country C from Country A where the ultimate parent company of the group is domiciled.</p>
Data Source	<p>Administrative reports (on cross-border remittances, etc.) submitted to statistics compilers, and surveys and reports undertaken for BOP statistical purposes.</p>	<p>Media information, IR materials, investigative reports, materials posted on websites of stock exchanges.</p>

Source: Compiled from various M&A statistics, the *BPM5* and *BD3*.

Note: As outlined above, FDI and M&A statistics are not necessarily consistent because [1] differences in methodology, [2] items and data sources differ among data providers.

The figure below depicts M&A trends in Japan. Japan's outward FDI frequently involves establishments and expansions of overseas production facilities by manufacturing industries, while inward FDI features the capital participation and acquisitions of Japanese companies. As such, inward FDI could be more strongly affected by M&A trends.

Trends in FDI Series (BOP) and M&A Statistics Involving Japanese Companies



Sources: *M&A statistics*, Recof: *Balance of Payments Monthly*, Bank of Japan

Note: Figures for 2004 were derived by annualizing the data for January-September. Because M&A statistics do not entail a concept of inflow/outflow, mergers and acquisitions of foreign companies by Japanese companies (M&A <IN-OUT>) was used here as outflow.

(Figure 5)

Main Features of Business Organizations Resembling Japanese LPs

	Form of Organization	Participant in management	Investor risk	Tax treatment	Other
Joint-stock companies, <i>yugen gaisha</i>	Established to engage in commercial transactions (<i>Commercial Code</i> , Articles 52 and 53; <i>Yugen Gaisha Law</i> , Article 1).	Ordinary shareholders, employees	Limited liability (O)	Company itself is taxable and is subject to the two-level taxation (corporate taxes + income taxes) (X).	Organizational flexibility on adjustment of economic interests, such as decision-making authority and allocation of profits, is lacking due to large number of laws and regulations (X).
Anonymous associations	Established based on anonymous association contract in which one party contributes funds to the other's business and two parties share the profits generated (<i>Commercial Code</i> , Article 535).	Proprietors	Proprietors have unlimited liability (X), partners have limited liability (O).	Association itself is not taxable, so taxation is passed through (O).	Established based on private law contracts between managers and partners and is lacking in external disclosure (X). Has organizational flexibility on adjustment of economic interests, such as decision-making authority and allocation of profits (O: hereinafter Feature A).
Voluntary partnerships	Established based on voluntary partnership contract in which parties agree to carry on a joint business by both contributing to the business (<i>Civil Code</i> , Article 667).	Partners	Unlimited liability (X)	Partnership itself is not taxable, so taxation is passed through (O).	Feature A (O)
Japanese LPs (limited partnership for investment)	Established based on limited partnership for investment contract in which parties agree to contribute to and carry on joint business (<i>Limited Partnership Act</i> , Article 3).	Unlimited liability partners	Unlimited liability partners have unlimited liability (X), limited liability partners have limited liability (O).	Partnership itself is not taxable, so taxation is passed through (O).	Subject to certain restrictions as being based on policy legislation (As such, investments are basically restricted to businesses of domestic companies and individuals.) (Δ). Feature A (O)
(Reference) U.S. LPs	Established as partnership of two or more persons carrying on joint business for commercial purpose as co-owners (<i>U.S. Uniform Partnership Act</i> , Article 2).	General partners	General partners have unlimited liability (X), limited partners have limited liability (O).	Partnership itself is not taxable, so taxation is passed through (O).	Feature A (O)
(Reference) Japanese LLC	Being considered for introduction as new corporate format assuring limited liability of investors, while applying partnership-type rules to organization's internal relations.	Scheduled to be partners	Scheduled to be limited liability (O).	Currently indeterminate as Legislative Council has no authority over tax matters. But because LLC is itself taxable, pass through of taxation may not be realized (X).	Organizational flexibility may be allowed on adjustment of economic interests, such as decision-making authority and allocation of profits (O).

- Notes: 1. Some exceptional provisions have been omitted for sake of simplicity.
2. Business organizations have been evaluated from the perspective of investors as follows: "O" indicates relatively advantageous feature; "X" indicates relatively disadvantageous feature.