

2006 Tax Reform on Thin Capitalization Rule

I. Thin Capitalization Rules

Where a foreign affiliated Japanese corporation (or a Japanese branch of a foreign corporation) doing business in Japan raises financing, it is considered that such a corporation might attempt to reduce its own tax burden by borrowing from its foreign affiliate and seeking to deduct the interest instead of raising funds by equity investments. The interest paid to the foreign parent would be subject to Japanese withholding tax but would not be subject to Japanese corporate tax.

In order to limit such decreases of its tax base, Japan has established Thin Capitalization Rules. If the annual average balance of debt to a foreign controlling shareholder (the foreign parent corporation) exceeds the tax statutory limitation, the excess interest expense paid or payable to the foreign parent corporation is not deductible. The 2006 tax reform expands the applicable scope of the Thin Capitalization Rules by including loan transactions not only from the foreign parent corporation but also from third parties if the loans are guaranteed by the foreign parent corporation. Aside from this, a special measure for a certain type of *repo* transaction is established whereby the debt from the certain *repo* transaction is excluded from the debt subject to Thin Capitalization Rules.

This article provides a basic overview of the Thin Capitalization Rules which have been in effect so far, and reviews the amendments made to the Thin Capitalization Rules under the 2006 tax reform.

I. Basic Overview of Thin Capitalization Rules

Following is a basic overview of Thin Capitalization Rules in Japan:

- (1) If the annual average of the balance of interest-bearing debt to the foreign parent corporation exceeds three times the capital contributed by the foreign parent corporation, the interest on the excess debt is not allowed as a deduction for tax purposes.

- (2) An alternative to the debt-to-equity ratio of 3 to 1 above is to use a reasonable debt-to-equity ratio of a Japanese domestic corporation doing a similar type of business and of a similar size under a similar situation.

II. 2006 Tax Reform in respect to Thin Capitalization Rules

Following are amendments made to the Thin Capitalization Rules under the 2006 tax reform:

1. Scope of Debts and Interests subject to Thin Capitalization Rules Widened

Prior to the tax reform, when a foreign affiliated Japanese corporation entered into a loan agreement with a third party such as a bank with the guarantee provided by its foreign parent corporation, such loan transactions were not subject to the Thin Capitalization Rules. However, loan agreements with a third party are now subject to the Thin Capitalization Rules where the loan is guaranteed by the foreign parent corporation and in some other similar cases.

Debts and interests subject to new Thin Capitalization Rules are set out as below:

- (1) Debt, interest and/or guarantee fees where a foreign affiliated Japanese corporation borrows money from a third party with the guarantee by its foreign parent corporation
- (2) Debt, interest and/or bond borrowing fees where a foreign affiliated Japanese corporation borrows money from a third party which is secured by bonds (including a bond repurchase transaction and cash collateralized bond borrowing transaction) borrowed from its foreign parent corporation
- (3) Debt, interest, guarantee fees and/or bond borrowing fees under the combination of (1) and (2) above

The interest, guarantee fees and/or bond borrowing fees which are subject to Japanese corporate tax on the recipient side are excluded from the scope of the interest subject to Thin Capitalization Rules.

2. Calculation of Amount to be Disallowed under Thin Capitalization Rules

(Please note that the following explanation and graphic chart are for illustrative purposes.)

Application to a particular company would require a more detailed feasibility study referring to the tax law and regulations in connection with Thin Capitalization Rules.)

Firstly, debts subject to Thin Capitalization Rules are classified into the following three categories:

- (1) Debt to the foreign parent corporation
- (2) Debt to an offshore third party that is guaranteed by the foreign parent corporation and interest on which is not subject to the Japanese corporate tax (e.g., borrowing from the foreign third party) (“debt to offshore third party guaranteed by foreign parent corporation”)
- (3) Debt to an onshore third party that is guaranteed by the foreign parent corporation and interest on which is subject to the Japanese corporate tax purposes (e.g., borrowing from the domestic third party (including a Japan branch of foreign corporation)) (“debt to onshore third party guaranteed by foreign parent corporation”)

In these categories, interest paid or payable to the foreign parent corporation regarding debt (1) above, interest, guarantee fees and/or bond borrowing fees regarding debt (2) above and guarantee fees and/or bond borrowing fees regarding debt (3) above are subject to the Thin Capitalization Rules.

Secondly, the amount to be disallowed for tax purposes is calculated based on two cases set out as below, in which A, B, C, a, b and c mean:

A: sum of (1) and (2)

B: amount of A less three times the capital contributed by the foreign parent corporation

C: amount of (3)

a: sum of interest and guarantee fees and/or bond borrowing fees incurred on the debt of (1) and (2)

b: interest, guarantee fees and/or bond borrowing fees incurred on B

c: guarantee fees and/or bond borrowing fees incurred on the debt of (3)

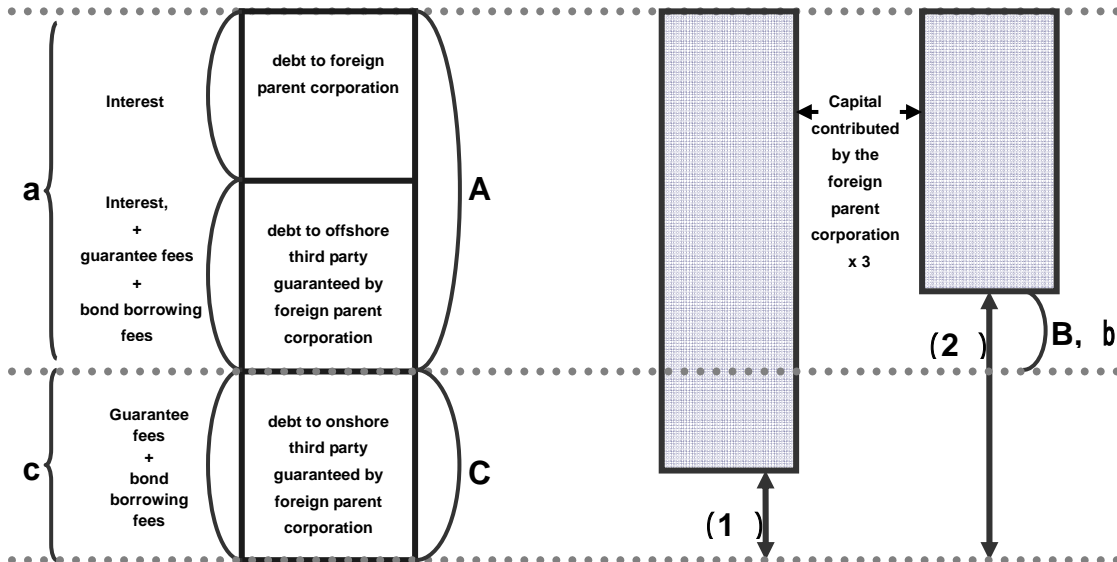
- i) If the sum of (1) and (2) is not more than three times the capital contributed by the foreign parent corporation

$$c \times \frac{(A + C) - \text{Three times the capital contributed by the foreign parent corporation}}{C}$$

- ii) If sum of (1) and (2) exceeds three times the capital contributed by the foreign parent corporation

$$b + c \left(\begin{array}{l} A:B = a:b \\ b = a \times B \div A \end{array} \right)$$

The calculation above is presented in a graphic chart below.



3. Special Measure for bond repurchase transaction and cash collateralized bond borrowing transaction (“Repo”) Transaction

A *repo* transaction prevailing in a short-term financial market in Japan is treated as a financing transaction for tax purposes. Accordingly, if such a *repo* transaction is made with the foreign parent corporation to raise financing from the foreign parent corporation by pledging bonds such as JGB for collateral, the *repo* transaction is subject to the Thin Capitalization Rule.

If bonds borrowed or purchased in one *repo* transaction are then lent or sold in another *repo* transaction to the foreign parent corporation or a third party lender guaranteed (by

the foreign parent) (“specified repurchase transaction”), such debts to the foreign parent corporation may be owed for financing brokerage rather than own financing. Such back-to-back *repo* transaction with the foreign parent corporation and third party lender whereby the borrowing position clearly corresponds to the lending position in the hands of the foreign affiliated Japanese corporation is excluded from application of the Thin Capitalization Rules. To apply this special *repo* rule, the normal threshold of the annual average balance of interest-bearing debt to the foreign parent corporation (debt-to-equity ratio) is reduced from 3:1 to 2:1 therefore the deductibility requirement is harder to satisfy. However, even in this case, it is possible to use the debt-to-equity ratio of a comparative corporation.

4. Effective Date

The new Thin Capitalization Rules apply from the fiscal year ending after April 1, 2006. However, the new Thin Capitalization Rules in respect of debt, interest and guarantee fees where a foreign affiliated Japanese corporation makes third party borrowing with the guarantee of its foreign parent corporation apply from the fiscal year commencing after April 1, 2006 (the transitional treatment). Therefore, e.g., if the fiscal year end of a foreign affiliated Japanese corporation is December 31, the whole new Thin Capitalization Rules will apply from the fiscal year ending December 31, 2007.

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