Asia Pacific Tax Newsalert

A Washington National Tax Services (WNTS) Publication

Japan

February 1, 2012

Japan's 2012 tax reform proposals include earnings stripping rules

On December 10, 2011, the Japanese Cabinet released the 2012 tax reform proposals, which include new earnings stripping rules that would limit the deductibility of related party interest expense. The Diet (parliament) will discuss the annual tax reform legislation and it is expected to take effect April 1, 2012. The new earnings stripping rules discussed below are scheduled to be effective for tax years beginning on or after April 1, 2013.

New earnings stripping rules

Current system

Japan currently limits interest expense deductions in two situations: where an "excess" interest rate is charged to related parties, and where "excess" debt exists between related parties. Under the proposed earnings stripping rules, Japan also focuses on the deduction of excess related party interest payments. These three issues related to interest expense, and Japan's corresponding tax law measures, are summarized in the chart below.

Issues	Corresponding Japanese Tax Law
Excess interest rate	Transfer pricing
Excess related party debt	Thin capitalization rules
Excess interest expense payments	Proposed earnings stripping rules

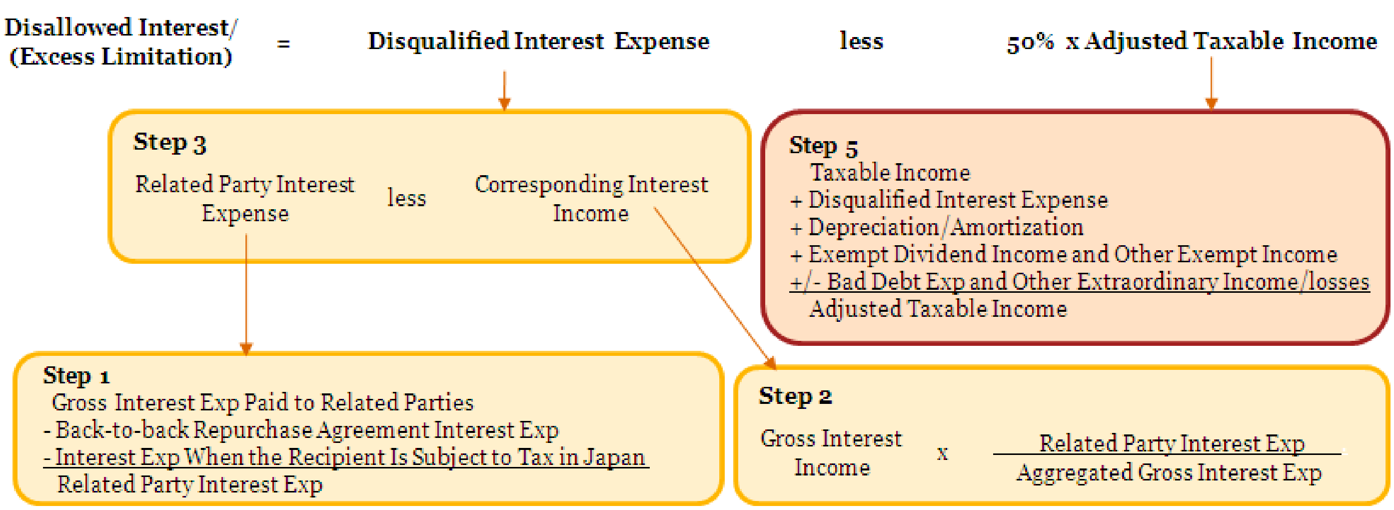
The transfer pricing rules prevent a related party from charging an excess interest rate. Thin capitalization rules restrict the use of excess related party debt by limiting the deductibility of interest expense incurred by a loan funded or guaranteed by a foreign related party. Where the debt-to-equity ratio exceeds 3:1, the thin capitalization rules expressly disallow the interest deduction on the excess debt. The new earnings stripping rules would apply concurrently with the transfer pricing and thin capitalization rules. When both the earnings stripping rules and thin capitalization rules apply, disallowed interest expense would be the greater of the amount calculated under each rule.

Overview

The proposed earnings stripping rules would operate similarly to the US earnings stripping rules by limiting the deduction of interest paid to a foreign related party not subject to tax in Japan, and by generally disallowing deductions of disqualified interest expense in excess of 50% of adjusted taxable income. While containing these structural similarities with the US rules, the proposed earnings stripping rules differ in a few important respects. First, under the proposed rules, interest expense is still subject to the limitation even if such payment is subject to the withholding tax, and interest expense includes guarantee fees incurred for a third-party loan guaranteed by a related party. Additionally, while the US rules permit disallowed interest to carry forward indefinitely, the Japanese rules only allow a seven-year carryforward. Finally, the proposed rules do not use the debt-to-equity ratio as a safe harbor test (which applies to the existing thin capitalization rules described above). Instead, they adopt a de minimis rule.

Calculation

The following diagram summarizes the calculations for the proposed earnings stripping rules. The detailed calculations follow immediately below. Note that the rules are still in proposal form and thus subject to change before enactment.



Step 1 - Calculate related party interest expense

Related party interest expense is calculated as follows:

Gross interest expense paid to related parties
Less: Back-to-back repurchase agreement interest expense
Less: Interest expense when the recipient is subject to tax in Japan
Equals: Related party interest expense

For this purpose, a related party is defined as a person connected through 50% or more direct or indirect equity ownership, a person controlling a borrowing corporation in substance, or a third party lender whose debt is guaranteed by such related party.

Unlike the US earnings stripping rules, even if the withholding tax is imposed on the interest payment, such interest income is considered not subject to the Japanese corporate tax. Therefore, interest expense is still subject to the new earnings stripping rules and can be disallowed even when the withholding tax applies.

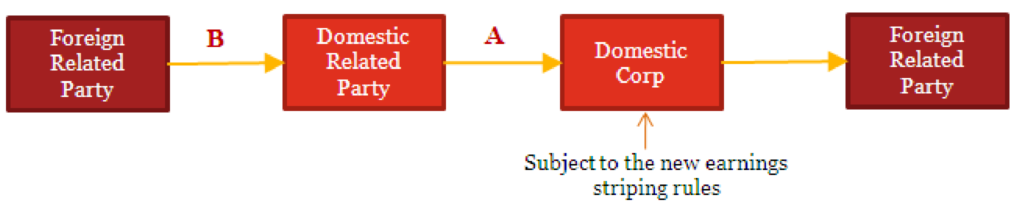
Another difference from the US earnings stripping rules is that interest expense paid to related parties includes guarantee fees. Therefore, the deduction of guarantee fees can be disallowed under the new earnings stripping rules.

Step 2 - Calculate corresponding interest income

Corresponding interest income is interest income attributable to related party interest expense and is calculated in proportion to the aggregated gross interest expense as follows:

$$\text{Gross interest income} \times \frac{\text{Related party interest expense}}{\text{Aggregated gross interest expense}}$$

Gross interest income does not include domestic related party interest income (amount **A** in the chart below), which is basically interest income received by a related person subject to corporate tax in Japan. Domestic related party interest income consists of interest income amounts received from a related party that is a Japanese resident, a domestic corporation, or a non-resident individual or foreign corporation with a permanent establishment ("PE") in Japan (domestic related parties). However, gross interest income does include interest income that domestic related parties receive from a non-resident individual or foreign corporation without a PE in Japan (amount **B** in the chart below). The inclusion amount is limited to domestic related party interest income (amount **A**). In summary, in the chart below, gross interest income of Domestic Corp excludes amount **A** but includes amount **B** up to the amount of **A**.



Note that the above calculation is performed without regard to interest expense or income related to back-to-back repurchase agreements.

Step 3 - Calculate disqualified interest expense

Disqualified interest expense equals related party interest expense (from Step 1) less corresponding interest income (from Step 2), as shown below:

Related party interest expense (from Step 1)
Less: Corresponding interest income (from Step 2)
Equals: Disqualified interest expense

Step 4 - De minimis rule

The new earnings stripping rules would not apply if one of the following conditions is met:

1. Disqualified interest expense (from Step 3) is less than 10 million yen (approximately US $125,000), or

2. Related party interest expense is not more than 50% of the aggregate gross interest expense.

However, for condition #2 above, the aggregate gross interest expense does not include related party interest expense when the recipient is subject to corporate tax in Japan.

Step 5 - Calculate adjusted taxable income

If the de minimis rule does not apply, adjusted taxable income would be calculated in order to determine the amount of disallowed interest expense. Similar to the US earnings stripping rules, this calculation starts with taxable income modified by various adjustments as shown below:

	Taxable income
Plus:	Disqualified interest expense (from Step 3)
Plus:	Depreciation/amortization
Plus:	Exempt dividend income and other exempt income
Plus/less:	Bad debt deduction and other extraordinary income and losses
Equals:	Adjusted taxable income

Step 6 - Calculate disallowed interest expense

Disqualified interest expense in excess of 50% of adjusted taxable income would be disallowed under the new earnings stripping rules. Disallowed interest expense could be carried over for seven years and could be deducted in a year when an excess limitation arises, i.e, when disqualified interest expense is less than 50% of adjusted taxable income. The deductible amount of the previously disallowed interest expense is limited to the amount of excess limitation.

	Disqualified interest expense (from Step 3)
Less:	Adjusted taxable income (from Step 5) x 50%
Equals:	Disallowed interest /(excess limitation)

Other miscellaneous rules

For taxpayers electing to file a consolidated return, the above rules would apply as if the consolidated group were a single taxpayer. However, intragroup dividend income exempt from the consolidated taxable income should not be an adjusting item when calculating adjusted taxable income.

Under the proposed rules, both the Japanese controlled foreign corporation ("CFC") rules and the new earnings stripping rules could apply concurrently. In that case, disallowed interest expense paid to a CFC is reduced by the CFC's income subject to tax in Japan.

In the case of a tax-free merger or complete liquidation of a wholly owned subsidiary, any excess limitation of the target company or the subsidiary will be carried over to the acquiring company or the parent company.

Conclusion

If enacted, the new rules would warrant additional analysis when a US multinational company (US MNC) places debt into Japan. For example, if a US MNC loans funds to a new Japanese subsidiary in order to acquire a Japanese company, the new earnings stripping rules may apply if the new subsidiary does not generate sufficient adjusted taxable income (from Step 5) to offset the interest expense. However, the new entity might not be subject to these new rules if it elects a consolidated filing with a target acquired in a stock acquisition.

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