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Japan's Proposed Earnings Stripping Rules

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On December 10, 2011, the government of Japan released its tax reform proposal for fiscal 2012. Subject to approval by the Diet, the proposal is expected to come into effect on April 1.[1] This article provides a brief summary of the earnings stripping rules and some other items in the proposal that may be of interest.

Summary

Current Thin Capitalization Rules

Under Japanese tax law, deductions of interest payments by Japanese companies to foreign controlling shareholders are subject to thin capitalization rules, which disallow excess interest payments if the debt-to-equity ratio of the Japanese subsidiary exceeds 3 to 1,[2] with no carryforward available for the taxpayer. The thin capitalization rules disallow deductions of interest payments to foreign controlling shareholders, foreign entities under common control with the interest payer,[3] foreign persons having effective control over the interest payer, and lenders to the interest payer funded or guaranteed by such shareholders, entities, or controlling persons, but do not disallow deductions of interest payments to other related persons, such as subsidiaries of the interest payer not under common control with the interest payer. Thus, for example, a Japanese resident company can easily strip its Japanese earnings without being caught by the thin capitalization rules by establishing a subsidiary[4] in a low-tax jurisdiction[5] from which a loan is made to the resident interest payer parent and to which interest is paid on the loan by that parent. The adoption of the earnings stripping rules is presumably aimed at combating these types of tax planning structures. (See figure.)

Earnings Stripping Rules

General

The earnings stripping rules will disallow current deductions on the excess of net interest payments to related persons over 50 percent of the adjusted taxable income, with such excess being allowed to be carried

[1] Some parts of the 2012 proposal are expected to come into effect on different dates.

[2] A different threshold debt-to-equity ratio may apply under exceptional circumstances.

[3] A foreign entity is under common control with the interest payer if 50 percent or more of the outstanding shares in each of the entities are owned by the same shareholder.

[4] The subsidiary must not be under common control with the Japanese resident company in order to avoid triggering thin capitalization rules. For instance, the structure will not work if Shareholder A wholly owns the Japanese resident interest payer that wholly owns the subsidiary. In that case, the Japanese resident interest payer and the subsidiary are treated as being under the common control of Shareholder A, and thus interest payments from the Japanese resident interest payer to the subsidiary will be subject to thin capitalization rules.

[5] The entire scheme should be carefully structured so as not to trigger Japanese controlled foreign corporation rules.

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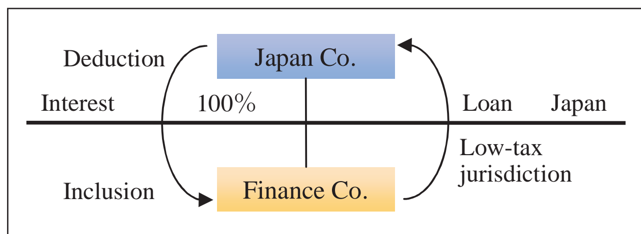

forward for up to seven tax years. Unlike the U.S. earnings stripping rules, there is no debt-to-equity ratio test in the Japanese rules.

Definitions

According to the proposal, net interest payments to related persons is the excess of interest payments to related persons over interest received from related persons corresponding to such interest payments.

Interest payments include interest, the interest portion of lease payments, and guarantee fees paid to related guarantors regarding borrowings. However, the proposal makes it clear that interest on repo transactions is excluded from the definition of interest payments to related persons to the extent that the borrowing clearly corresponds to the lending. Also, interest payments that are subject to Japanese corporate taxes in the hands of the recipients are excluded from the definition of interest payments to related persons; therefore, the earnings stripping rules target only cross-border income shifting.

The phrase ''related persons'' refers to:

- persons owning directly or indirectly 50 percent or more of the shares of the subject entity;
- persons 50 percent or more of whose shares are owned directly or indirectly by the subject entity;
- persons having effective control over the subject entity; and
- unrelated lenders to the interest payer receiving guarantees from any of the above.

Interest received includes interest and the interest portion of lease payments. The amount of interest received that will be deducted from interest payments will be computed by the following formula:

$$\left\{\begin{matrix}\text{(Gross interest received)} - \\ \text{(Repo interest received)}\end{matrix}\right\} \times \frac{\text{(Interest paid to related persons)}}{\text{(Gross interest paid)} - \text{(Repo interest paid)}}$$

For this purpose, the gross interest received does not generally include interest received from related persons that are tax residents of Japan.[6] However, if such tax residents receive interest from unrelated persons or nonresidents, that interest will be included in gross interest received to the extent of the amount of interest received from related tax residents.

Adjusted taxable income will be computed based on the amount of taxable income of the current tax year, adjusted by adding back net interest payments to related persons, depreciation allowances, and received dividends excluded from taxable income, subject to further adjustments on extraordinary items. Although the proposal is silent regarding negative taxable income before adjustment, to avoid disallowance, taxpayers could create sufficient adjusted taxable income by receiving extra dividends from its subsidiaries.

Seven-Year Carryforward

Interest deductions disallowed under the earnings stripping rules can be carried forward up to seven tax years and can be used to offset taxable income to the extent that 50 percent of the adjusted taxable income exceeds net interest payments to related persons in the relevant tax year.

De Minimis Rules

The earnings stripping rules will not apply if:

- net interest payments to related persons do not exceed ¥10 million (about $129,898) for the relevant tax year; or
- interest payments to related persons do not exceed 50 percent of gross interest paid for the relevant tax year.[7]

Relationship Between the Rules

If both the earnings stripping rules and the thin capitalization rules apply, the greater of the disallowed amount under the earnings stripping rules and the disallowed amount under the thin capitalization rules will be disallowed for the relevant tax year.

If both the earnings stripping rules and the CFC rules[8] apply to interest paid to a foreign subsidiary of the subject company, the disallowed amount under the earnings stripping rules will be reduced to the extent that such amount is subject to current inclusion in taxable income of the subject company under the CFC rules.

Carryover

Disallowed interest deductions under the earnings stripping rules in the hands of the disappearing corporation can be carried over to the surviving corporation for a qualified merger or liquidation of a disappearing

[6]The term ''tax resident'' refers to resident individuals, domestic corporations, and nonresident individuals or foreign corporations with a permanent establishment in Japan.

[7]For this purpose, gross interest paid does not include interest payments that are subject to Japanese corporate taxes in the hands of related recipients.

[8]Unlike the U.S. subpart F rules, which adopt an income approach, Japanese CFC rules adopt an entity approach, under which income of a low-taxed subsidiary is taxed currently to its parent company if the former is subject to an effective tax rate of 20 percent or less.

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corporation wholly owned by the surviving corporation provided that the entire assets of the disappearing corporation are distributed.

Implications for Financial Statements

Deferral of interest that has been expensed in financial statements will result in recognition of a deferred tax asset under Japanese generally accepted accounting principles. Thus, companies in this situation should assess the recoverability of the asset and the need for a valuation allowance — based on a reasonable prediction of when it can deduct the interest for tax purposes — when preparing annual financial statements.

Effective Date

According to the proposal, the earnings stripping rules are expected to come into effect from the tax year starting on or after April 1, 2013.

Higher Taxes for Corporate Directors

Under current Japanese tax law, lump sum retirement benefits (severance pay and other payments made at the end of one's employment) are taxed at significantly lower rates compared with ordinary wages. Specifically, unlike ordinary wages, which are fully taxed at progressive tax rates after the applicable standard deductions, only half of the difference between the lump sum retirement benefit and the applicable standard deduction is taxed separately from regular income at progressive tax rates. High-earning corporate directors (including foreign expats) have used this to reduce their overall tax burden by shifting some of their wages to lump sum retirement benefits. The proposal will make this commonly used tactic unavailable for corporate directors who have served for less than five years at the time of retirement. The same proposal was made for fiscal 2011 but was not approved by the Diet, presumably because of political turmoil after the earthquake of March 11, 2011. This new rule is expected to apply from the 2013 calendar year.

Reporting Requirement

Individuals resident in Japan for tax purposes with aggregate foreign asset holdings of ¥50 million (about $649,446) on an actual value basis as of the end of each calendar year are required to file a report describing their foreign asset holdings by March 15 of the following calendar year. Some penalty taxes will be reduced in the case of reassessment of income tax or inheritance tax regarding the relevant asset if such asset has been included in the report. The reporting requirement will become effective January 1, 2014. Noncompliance with this reporting requirement is punishable by imprisonment of up to one year or a fine of up to ¥500,000 (about $6,495), effective January 1, 2015.

Expats meeting the definition of tax resident for Japanese purposes should be aware of this new reporting requirement. Expert advice should be sought from appropriate tax attorneys (*bengoshi*) regarding evaluation of residency status.[9] ◆

[9]On February 18, 2011, the Supreme Court, the highest court in Japan, reversed a lower court decision and ordered the tax authorities to refund approximately ¥200 billion (about $2.6 billion) to a taxpayer. This was the second largest taxpayer victory in Japan's history. The court found that the taxpayer had been domiciled not in Japan but rather in Hong Kong at the time at issue. The Supreme Court stated in its decision that a domicile (*ju-sho*) for tax purposes is identical to the concept as found in the Civil Code. Japanese tax law is designed in such a way that it heavily relies on concepts adopted from the legal areas of private law and commercial law, and courts routinely find them to be identical.

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