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# KPMG Japan tax newsletter

## Japanese Earnings Stripping Rules



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Japanese tax law historically has had two sets of rules to restrict interest deductions; the transfer pricing rules (for interest at a higher rate compared to the arm's length principle) and the thin capitalization rules (for interest on excessive debt compared to capital), but until recently there has been no rule to restrict interest payments that are excessive compared to income. Taking into account rules in other developed countries, Japanese earnings stripping rules were introduced under the 2012 tax reform with the aim of preventing tax avoidance by limiting the deductibility of interest paid to related persons where it is disproportionate to income.

The Japanese earnings stripping rules will be applicable for fiscal years beginning on or after 1 April 2013 in order to provide one year for the new rules to become broadly known and allow taxpayers time to review their funding schemes.

While our earlier newsletter “Outline of the 2012 Tax Reform Proposals” (issued on 14 December 2011) included an overview of the new rules, we have set out further details in this newsletter.

## I. OUTLINE OF THE RULES

The Japanese earnings stripping rules will disallow deductions for Net Interest Payments to Related Persons in excess of 50 percent of Adjusted Taxable Income. Any disallowed amounts may be carried forward for 7 fiscal years and deducted in a fiscal year in which Net Interest Payments to Related Persons do not exceed 50 percent of Adjusted Taxable Income until the 50 percent of Adjusted Taxable Income threshold is reached.

## II. LIMITATION ON DEDUCTIONS FOR EXCESSIVE INTEREST PAYMENTS

When a company’s Net Interest Payments to Related Persons exceed 50 percent of Adjusted Taxable Income in a fiscal year, the excess portion (i.e. the following amount) is disallowed:

$\text{Net Interest Payments to Related Persons} - \text{Adjusted Taxable Income} \times 50\%$
↑
$(\text{Interest Payments to Related Persons} \\ \text{less Eligible Interest Income})$

### 1. Adjusted Taxable Income

The term ‘Adjusted Taxable Income’ means taxable income (calculated by not applying the provisions described in (1) below and treating all donations paid as tax deductible expenses) with an add back of items described in (2) below. Note that while ‘taxable income’ can be negative, ‘Adjusted Taxable Income’ cannot.

#### (1) Main provisions not applied in calculating Adjusted Taxable Income

- deduction for domestic dividends received
- foreign dividends exclusion
- certain valuation losses
- disallowance of deductions for income tax/foreign tax credited against corporation tax
- deduction of carried-forward tax losses
- income deductions for designated companies in International Strategic Comprehensive Special Zones
- deduction of dividends paid by tax qualified special purpose companies
- thin capitalization rules
- earnings stripping rules

#### (2) Items to be added back in calculating Adjusted Taxable Income

- Net Interest Payments to Related Persons
- tax deductible depreciation
- tax deductible bad debt losses

## 2. Related Persons

The term 'Related Person' means any person described in (1) and (2) below:

### (1) Any person with a specified relationship

If a person (both an individual and a company) has a specified relationship with a company, that person is treated as a Related Person of the company. The criteria for determining whether there is a specified relationship for both individuals and companies are very similar. Where the person is a company, a specified relationship is defined as follows:

- (a) a relationship between two companies in which one company owns directly or indirectly 50 percent or more of the total outstanding shares in the other company
- (b) a relationship between two companies in which the same person owns directly or indirectly 50 percent or more of the total outstanding shares in both companies
- (c) a relationship between two companies in which one company can, in substance, engage in decision making regarding the other company's business affairs due to shared directors, substantial business transactions, financing, etc.

### (2) Certain third parties

- (a) a third party who provides a loan to a company under a back-to-back loan arrangement with a Related Person of the company as described in (1)
- (b) a third party who provides a loan to a company guaranteed by a Related Person of the company as described in (1)
- (c) a third party who provides a loan to a company by taking bonds the company has borrowed from a Related Person as described in (1) as collateral
- (d) a third party (A) who lends bonds to a company which are guaranteed by a Related Person of the company as described in (1), and a third party (B) who provides a loan to the company by taking the above bonds as collateral

## 3. Interest Payments to Related Persons

The term 'Interest Payments to Related Persons' means interest paid by a company to its Related Persons, excluding payments subject to income tax/corporation tax in Japan. Note that 'subject to income tax/corporation tax' broadly means declared as taxable income in a Japanese tax return, and thus interest paid to a Related Person who is a non-resident individual/foreign company not having a permanent establishment in Japan is included in Interest Payments to Related Persons, regardless of whether Japanese withholding tax is imposed on the interest.

#### 4. Eligible Interest Income

Eligible Interest Income for a fiscal year is calculated as follows:

$$\text{Total Interest Income} \times \frac{\text{Total Interest Payments to Related Persons}}{\text{Total Interest Payments}}$$

If a company receives interest from a Domestic Related Person (a Related Person who is a Japanese resident individual/Japanese company or a non-resident individual/foreign company having a permanent establishment in Japan), the lower of the following is deemed to be the interest received from that Domestic Related Person and included in the Total Interest Income in the above formula:

- Interest Income of the company from that Domestic Related Person
- Interest Income of that Domestic Related Person from a person who is neither the company nor another Domestic Related Person

The purpose of this rule is to close a loophole whereby a company provides a loan to a Domestic Related Person for the purposes of: (i) reducing its Net Interest Payments to Related Persons amount; and (ii) reducing taxable income for the Domestic Related Person.

#### 5. Interest Payments and Interest Income

The scope of Interest Payments and Interest Income for the purpose of the earnings stripping rules is as follows:

##### (1) Interest Payments

- interest payments
- discounts on bills/notes
- the interest portion of finance lease payments (where total lease payments under the arrangement are JPY10 million or more)
- redemption losses on bonds
- guarantee fees and bond borrowing fees paid to Related Persons in the cases described in 2(2)(b)(c)(d) above
- amortization of premiums on securities having a maturity date or a fixed redemption price
- other payments whose economic characteristics are equivalent to interest

##### (2) Interest Income

- interest income
- discounts on bills/notes
- the interest portion of finance lease income
- accumulation of discounts on securities having a maturity date or a fixed redemption price
- other income whose economic characteristics is equivalent to interest

## 6. Special Rule for Repo Transactions

Where bonds borrowed under a cash-secured bond lending transaction (genkin-tanpotsuki-saiken-taishaku-torihiki) or purchased under a bond gensaki transaction (saiken-gensaki-torihiki) are lent under another cash-secured bond lending transaction or sold under another bond gensaki transaction to a Related Person, interest income and interest payments through these transactions will be excluded in calculating the extent of deductible interest payments.

This rule has been set out taking into account the fact that financial institutions provide loans to other financial institutions in Japan by using funds borrowed from their Related Persons outside Japan under the above transactions. Measures to mitigate any adverse impacts caused by the above transactions are also provided for in the thin capitalization rules.

## III. DE MINIMIS RULES

A company falling under either of the following cases in a given fiscal year will not have disallowed interest pursuant to the Japanese earnings stripping rules in such fiscal year provided the relevant schedules are attached to its tax returns and documents relating to the calculation of excess interest are retained.

(a)	Net Interest Payments to Related Persons	≤	JPY10 million
(b)	Interest Payments to Related Persons	≤	Total Interest Payments <sup>(*)</sup> x 50%

(\*) Excluding interest paid to Related Persons where the interest is subject to Japanese income tax/corporation tax.

## IV. DEDUCTIONS OF DISALLOWED INTEREST PAYMENTS

When a company's Net Interest Payments to Related Persons are less than 50 percent of Adjusted Taxable Income for a given fiscal year, disallowed interest payments incurred in the past 7 years are deductible in such fiscal year up to the 50 percent threshold provided certain conditions are satisfied, e.g. relevant schedules are attached to the tax returns for all fiscal years from the fiscal year in which the oldest disallowed interest payments were incurred.

There are also rules allowing for assumption of disallowed interest payments under certain circumstances. If a company with disallowed interest payments is the liquidating entity in a tax qualified merger, the disallowed interest payments can be assumed by the surviving company. Additionally, where a company with disallowed interest payments in a 100 percent group has been liquidated and its value of residual assets is finalized, the disallowed interest payments will be assumed by its Japanese shareholders in accordance with their proportional shareholding.

## V. INTERACTION WITH OTHER RULES

### 1. Thin Capitalization Rules

If both the earnings stripping rules and the thin capitalization rules are applicable in a fiscal year, only the larger of the disallowed amounts under either will be applied. As there is no carry forward of the disallowed amount under the thin capitalization rules, recognizing disallowed interest under the earnings stripping rules may be preferential for taxpayers, as they may be eligible to take a deduction for the disallowed amounts in the future.

The main differences between the earnings stripping rules and the thin capitalization rules are as follows:

		Earnings stripping rules	Thin capitalization rules
(a)	Target transactions	Interest payments to foreign related persons which are excessive when compared to income	Interest payments to foreign shareholders in place of dividends (i.e. excessive debt compared to equity)
(b)	Recipients of interest subject to restrictions	Foreign related persons (including foreign subsidiaries)	Foreign shareholders (including foreign sibling companies but not foreign subsidiaries)
(c)	Disallowed interest	The portion of Net Interest Payments to Related Persons which exceeds 50% of Adjusted Taxable Income	The portion of gross interest applicable to debt which exceeds three times the amount of capital
(d)	Carryforward rule	Disallowed interest payments may be carried forward for 7 years.	No carryforward available.

### 2. Anti-Tax Haven (CFC) Rules

Under the anti-tax haven rules, when a Japanese parent company holds a foreign subsidiary located in a low tax jurisdiction (i.e. a controlled foreign company, hereafter 'a CFC') and the relevant exemption conditions are not met, all or part of the income of the CFC is treated as income of the Japanese parent company and taxed in Japan.

Interest paid by a Japanese parent company to its CFC that is disallowed under the earnings stripping rules may result in double taxation since the disallowed amount could be treated as income of the Japanese parent and taxable in Japan. Thus, special measures to prevent such double taxation have been provided for, as set out below. (Note that measures are provided for two separate cases depending on the timing of the potential double taxation since income of a CFC for a fiscal year should be taxable in the fiscal year of its Japanese parent company which includes the day 2 months after the end of the fiscal year of the CFC under the anti-tax haven rules.)

	Fiscal year of the Japanese parent company in which income of the CFC is aggregated	Special measures to prevent double taxation
(a)	The fiscal year following the fiscal year in which the Japanese parent company paid interest to the CFC	Disallowed interest related to the CFC in the previous year is allowed in the current fiscal year (to the extent of CFC income subject to aggregate taxation).
(b)	The fiscal year in which the Japanese parent company paid interest to the CFC	Total disallowed interest in the fiscal year (as calculated prior to application of this rule) is reduced by the amount of disallowed interest related to the CFC (to the extent of income of the CFC subject to aggregate taxation).

### 3. Consolidated Tax Return Filing System

When the consolidated tax return filing system is elected, the earnings stripping rules will be applied on a group basis and not on a stand-alone entity basis. The following points should be noted for companies belonging to a tax consolidated group:

- When a company receives a dividend from another company and both companies belonged to the same tax consolidated group throughout the dividend calculation period, the domestic dividend received deduction rule will be applied in calculating the tax consolidated group's Adjusted Taxable Income.
- Interest received from other companies in the same tax consolidated group will not be included in the calculation of Eligible Interest Income.
- Total Interest Payments under the de minimis rule and Interest Payments to Related Persons do not include Interest Payments to entities within the same tax consolidated group.

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