

# Japan Tax Bulletin

## Restrictions on interest expense deduction

**March 2016**

There are two sets of rules which disallow interest paid to foreign related companies. One is the thin capitalisation rule and the other is the earnings stripping rule. Both rules are targeted rules under BEPS Action 4. A fixed ratio approach where the general deduction of interest expense is restricted to a certain percentage of EBITDA under BEPS Action 4, has not been introduced.

### 1. Thin capitalisation rule

When a Japanese corporation pays interest to a foreign controlling shareholder and both the following ratios exceed 3:1, a portion of the interest paid is disallowed:

- The average total interest bearing debt amount compared to the equity amount
- The average interest bearing debt amount from foreign related shareholders compared to the equity amount attributable to foreign controlling shareholders

If the tests are met, the portion of interest paid to the foreign controlling shareholder which is attributable to the amount of borrowing in excess of three times the shareholder's equity, is disallowed.

#### 1.1 Foreign controlling shareholder

A foreign controlling shareholder is a non-resident or a foreign corporation that:

- Owens directly or indirectly 50% or more of the outstanding shares of the subject corporation,
- Has 50% or more of its outstanding shares owned directly or indirectly by a same person that also owns directly or indirectly 50% or more of the outstanding shares of the subject corporation, or
- Has substantial control over part or all of the business policy of the subject corporation through transactional, financial or personnel affairs connected to the subject corporation.

#### 1.2 Average interest bearing debt amount

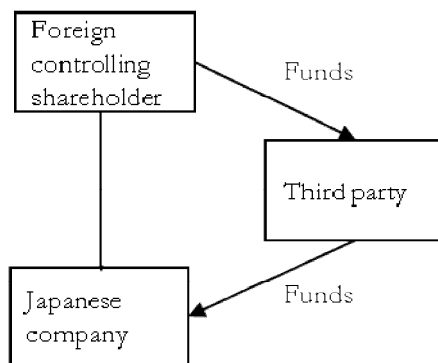
The average interest bearing debt amount is the average book value of interest bearing debt balances. The average may be the daily average or monthly average. However, the average of the beginning balance and the ending balance of a year cannot be used.

#### 1.3 Interest expense

The thin capitalization rules do not apply to interest which forms part of the taxable income in Japan of a non-resident or foreign corporation. The rules only apply when the income is exempt from taxation or taxed at reduced rates.

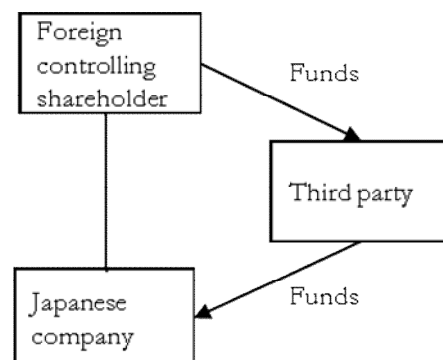
#### 1.4 Back-to-back loan and other arrangements

Interest expenses on a loan provided through a third party under the following arrangements are subject to the thin capitalisation rule:



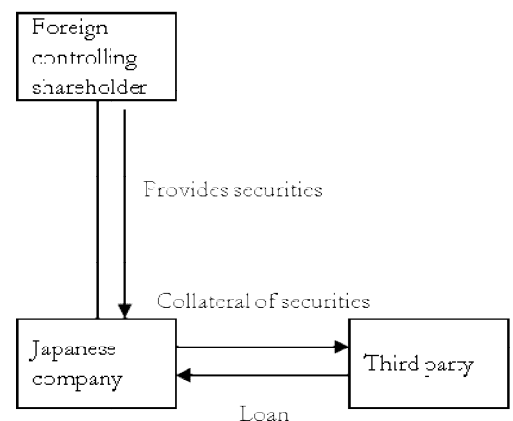
##### (i) Back-to-back loan

A foreign controlling shareholder provides funds to a Japanese company through a third party.



##### (ii) Securities collateral loan

A Japanese company obtains a loan from a third party, using securities provided by a foreign controlling shareholder as collateral.



### 2. Earnings stripping rule

Under the earnings stripping rule, net interest paid to related parties by a corporation exceeding 50% of its adjusted income are disallowed. Net interest paid to related parties means the amount of interest payments to related parties, which are not subject to Japanese income taxes.

#### 2.1 Related parties

##### (i) Ownership

Related parties include:

- entities which own directly or indirectly, 50% or more of the interest in the taxpayer,
- entities which are owned directly or indirectly 50% or more by the taxpayer, and
- an individual who owns directly or indirectly 50% or more of the interest in the taxpayer.

Additionally, a third party that provides funds under a guarantee from related parties or a back-to-back loan arrangement, is treated as a related party.

##### (ii) Substantial control

Related parties also include entities which control substantially or are controlled by the taxpayer through operating transactions, finances, concurrent posting of directors etc.

### 2.2 Adjusted income

Adjusted income is taxable income with certain addbacks and deductions. Taxable income is the taxable income of a year before applying certain provisions such as the disallowance of donations, exclusion of dividends received, deduction of tax losses etc. Items added back include net interest paid to related parties, deductible depreciation and deductible bad debt losses. Deductions include attributable income under the CFC rules.

### 2.3 Carry forward

Net interest paid that has been disallowed under the earnings stripping rules can be carried forward for 7 years and deducted from taxable income in business years when the 50% limit is not reached.

### 2.4 Applicability of the thin capitalisation rule and the earnings stripping rule

Where both the thin capitalisation rule and the earnings stripping rule are applicable, the rule which disallows the greater amount is applied.

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