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Japan Tax Bulletin

Limitation on deductions for interest payments

September 2019

As previously reported in our April Japan tax bulletin, the earnings stripping rule was revised by the 2019 tax reform to reflect the recommendations of the final report on Action 4 of BEPS Project. There are two sets of rules which apply to Japanese legal entities the earnings stripping rule and the thin capitalisation rule. Both disallow interest paid to foreign related companies for Japanese legal entity (e.g.: KK, GK).

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

1. *Earnings stripping rule*

Under the earnings stripping rule, net interest paid to related parties and third parties (interests paid to third parties were not subject to the rule before the 2019 tax reform)by a corporation exceeding 20% (50% before the 2019 tax reform) of its adjusted income is disallowed. Net interest paid to related parties and third parties means the amount of interest payments to related parties, which are not subject to Japanese income taxes.
The 2019 tax reform will be applied for fiscal years beginning on or after 1 April 2020.

1.1 Related parties

(i) Ownership

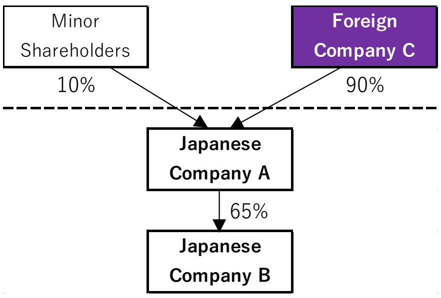
Related parties include:

- entities which own directly or indirectly, 50% or more of the shares of the taxpayer,
- entities which are owned directly or indirectly 50% or more of the shares by the taxpayer, and
- an individual who owns directly or indirectly 50% or more of the shares of 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 substantially control or are controlled by the taxpayer through operating transactions, finances, concurrent posting of directors etc.

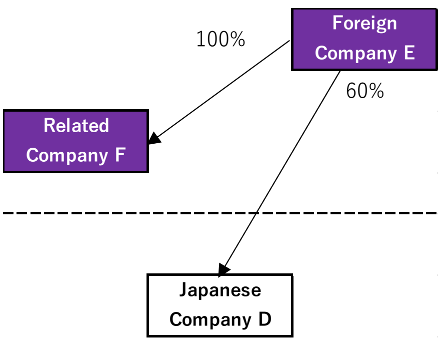


(i) Japanese Company A

The foreign company C directly owns 90% of the shares of the Japanese company A. The foreign company C is a related party of Japanese company A.

(ii) Japanese Company B

The foreign company C indirectly owns 65% of the shares of the Japanese company B. The foreign company C is a related party of Japanese company B.



(iii) Japanese Company D

The foreign company E directly owns 60% of the shares of the Japanese company D. The foreign company E is a related party of Japanese company D. Related Company F is also a related party of Japanese company D because the foreign company E directly owns 50% or more of the share of both Japanese company D and the related company F.

1.2 Adjusted income

Adjusted income is taxable income with certain addbacks and deductions. For example, disallowance of donations and deduction of tax. Further to the 2019 tax reform, the following provisions must now be applied when calculation the adjustable income.

- Domestic dividends exclusion from taxable income
- Foreign dividends exclusion from taxable income
- Disallowance of deductions for income tax credited against corporation tax

1.3 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 20% limit is not reached.

1.4 Exemption thresholds

The criteria of exemption thresholds will be changed and expanded as follows by the 2019 tax reform.

(i)	Net Interest Payment ≦ JPY20,000,000
(ii)	$\dfrac{\text{Net Interest Payments of Japanese group - Net Interest Income of Japanese group}}{\text{Adjusted Income of Japanese group - negative amount of Japanese group}} \leqq 20\%$

2. *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 both the tests are met and 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, the interest is disallowed.

2.1 Foreign controlling shareholder

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

(i) Directly or indirectly owns 50% or more of the outstanding shares of the subject corporation,

(ii) Has 50% or more of its outstanding shares directly or indirectly owned by a same person that also directly or indirectly owns 50% or more of the outstanding shares of the subject corporation, or

(iii) 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.

2.2 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.

2.3 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.