Business Tax Law Newsletter

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Understanding the new earning-stripping rules

1. Introduction

The 2012 tax reform introduced new anti-tax avoidance rules - known as the ‘earning-stripping’ rules - which restrict a company [1] from deducting excessive interest payments to related parties that are inappropriate to its income. The new rules were introduced to address a problem which, the government believes, results in the erosion of the tax base.

Before this change was introduced, two rules were already in place to address the issue of tax avoidance through excessive interest payments:

- The transfer pricing rules disallow inappropriately high interest-rate payments in light of the arm’s-length rule.
- The thin capitalisation rules disallow deductions from taxable income interest payments to foreign related parties that exceed a 3:1 debt-equity ratio.

However, these rules do not necessarily restrict excessive interest payments that are inappropriately high compared to the company’s income, as transfer pricing does not disallow arm’s-length interest payments and thin capitalisation does not apply where the borrower has sufficient equity.

Recent tax treaties between developed countries tend to provide an exemption from taxation on interest in the source country. The government was concerned that if it entered into a tax treaty providing a general tax exemption on interest income, Japanese companies would increase their interest payments to foreign related parties that were eligible for tax treaty benefits. Therefore, the government decided to introduce rules on earning stripping, similar to those in the United States and some European jurisdictions, to prevent tax avoidance through interest payments that are inappropriate to income.

2. Net interest paid to related parties

The new rules restrict the deduction of the amount of net interest paid to related parties that exceeds 50% of the amount of adjusted income.

Net interest paid to related parties is calculated as the amount of interest paid to related parties minus the deductible amount of interest received.

The deductible amount of interest received is assessed on a pro rata basis, corresponding to the amount of interest paid to related parties. It is calculated as:

total interest received[2] x (total interest paid to related parties / total interest paid)

A person is a related party of a company if it:

- has 50% or more of a direct or indirect shareholding relationship with the relevant company (including through a company which shares a parent company with the relevant company);
- controls or is controlled by the relevant company through the appointment of directors or under a business or financial relationship; or
- provides funds to the relevant company with a guarantee or loan from a person covered by the two criteria above.

The interest subject to the earning-stripping rules includes interest equivalents, such as lease fees and discounts on commercial bills. However, it excludes:

- interest that is subject to Japanese taxation as taxable income of related parties, and
- interest related to repo transactions.

3. Adjusted income

Adjusted income is calculated by subtracting the amount of donations disallowed from the sum of:

- taxable income;
- net interest paid to related parties; and
- dividends excluded from taxable income, depreciation and bad debt loss.[3]

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4. Carry forward

The amount of interest disallowed to be deducted from taxable income under the earning-stripping rules can be carried forward for seven years, as the level of income and interest payments fluctuate depending on various factors that affect companies, such as market conditions.

5. Exemptions

The earning-stripping rules do not apply if:

- the amount of net interest paid to related parties does not exceed Y10 million; or
- the total amount of interest paid to related parties does not exceed 50% of the gross amount of interest paid.[4]

6. Application of related rules

The earning-stripping rules and other related anti-tax avoidance rules will apply as follows.

7. Thin capitalisation rules

If the amount of interest disallowed on the basis of the thin capitalisation rules exceeds the amount of interest disallowed on the basis of the earning-stripping rules, the thin capitalisation rules will be applied and the earning-stripping rules will not.

8. Controlled foreign company rules

If a Japanese resident company makes interest payments to a foreign subsidiary that is subject to the controlled foreign company (CFC) rules, and if both the CFC rules and the earning-stripping rules are applied, the interest payments could be subject to double taxation, since the Japanese resident company may not deduct interest payments from its taxable income while it consolidates the income of the foreign subsidiary under the CFC rules. Therefore, the relevant legislation provides for an adjustment in order to avoid double taxation by allowing the deduction of interest payments subject to double taxation under the earning-stripping rules.

9. Effective date

The earning stripping rules will apply to the business year starting on or after April 1 2013.

10. Comment

The new rules apply to a company that is not intending to avoid tax, but suffers a temporary decline in its income due to deteriorating performance. This adverse impact is mitigated to some extent by permitting the disallowed amount of interest to be carried forward for seven years; however, if the thin capitalisation rules are applied, the disallowed amount of interest cannot be carried forward.

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1 The earning stripping rules do not apply to an individual, although an individual could fall within the definition of a 'related party'.

2 The amount of interest received from related parties that are resident in Japan is excluded from the total amount of interest received, provided that if such related parties receive interest from Japanese resident unrelated parties, the total amount of interest received includes the lesser of:

- the amount of such interest received by the Japanese resident related parties from Japanese resident unrelated parties; and
- the amount of interest received by the company from Japanese resident related parties.

3 Adjusted income is subject to further adjustments.

4 The amount of interest paid to related parties and subject to Japanese corporate taxation is excluded.

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