December 2011

ANDERSON MŌRI & TOMOTSUNE

AM&T

アンダーソン・毛利・友常 法律事務所

Japan Tax Newsletter

Tax Reform Proposals for 2012 Issued on December 10, 2011 by the Japanese Cabinet

Introduction of a New International Taxation Regime Called "Excessive Interest Payment Taxation"

* * * * * * * * * *

I. Introduction

On December 10, 2011, the Japanese cabinet made public the tax reform proposals for 2012. Among the various tax reform proposals, a very important anti-tax avoidance scheme in the area of international taxation is included, which is a new regime called "Excessive Interest Payment Taxation" (*Kadai Shiharai Rishi Zeisei*; hereinafter, "EIPT"). If this EIPT is implemented, capital strategies of international companies having subsidiaries in Japan would be substantially affected. Set out below is a summary of the current EIPT. Assuming that the EIPT is actually enacted, it is meant to apply to a corporation's business year commencing on or after April 1, 2013.

II. Outline of the EIPT

The purpose of the EIPT, according to the tax reform proposals, is to prevent tax avoidance using tax deductible interest payment between associated enterprises, the amount of which is disproportionately large as compared to the amount of income of the payor.

(A) Restriction of Interest Deduction

EIPT restricts the deduction of interests paid to an associated enterprise, where the amount of net interest payment by a corporation to its associated enterprises exceeds 50% of the amount of the corporation's adjusted income, by disallowing the deduction of net interest payment in excess of the 50% threshold.

(B) Associated Enterprises

Interest payments may be subject to the EIPT if they are paid to "associated enterprises", which term includes (1) an enterprise that directly or indirectly holds 50% or more of the equity interest of the corporation, (2) an enterprise that substantially controls the corporation, and (3) a third party whose loan to the corporation is guaranteed by enterprises described in (1) or (2). The term "associated enterprises", however, does not include a company that is subject to corporate income taxation in Japan with respect to the interest payment it receives from a payor corporation.

(C) Amount of Net Interest Payment to Associated Enterprises

The amount of net interest payment to associated enterprises will be calculated based on the total interest payments to its associated enterprises (including the interest portion of financial lease fees and guarantee fees paid to associated enterprises) less the total interest received from its associated enterprises.

In calculating the net interest payment, interest payment to an associated enterprise will exclude interest payments to a recipient that is subject to Japanese corporate income taxation with respect to such interest payments. Therefore, interest paid to Japanese business entities will not be subject to the EIPT. This new legislation appears to be primarily targeted at Japanese companies controlled by foreign shareholders.

(D) Amount of Adjusted Income

The amount of "adjusted income" is calculated by certain additions such as depreciation and amortization, and deductions such as bad debt loss to and from the taxable income (including capital gains).

(E) Exemptions from the EIPT

The EIPT will not be applicable where (1) the amount of net interest payment to associated enterprises in a business year is JPY 10 million or less; or (2) the aggregated amount of the interest payment to associated enterprises is 50% or less of the total interest payment in a business year. In applying exemption (1), the total interest payment will exclude interest payments to associated enterprises that are subject to Japanese corporate income taxation.

(F) Carry-over of Disallowed Interest Deduction under the EIPT

If a portion of interest deduction is disallowed because of the application of the EIPT, such disallowed interest may be carried forward for seven (7) business years and may be deducted from the payor's income in a business year that falls within the seven-year period, if in such business year the amount of the net interest payment to associated enterprises is less than 50% of the amount of the adjusted income, only to the extent of the balance of the amount of net interest payment to associated enterprises less 50% of the amount of adjusted income.

(G) Other Provisions

The EIPT legislation will include, among other things, provisions on the application of the EIPT to companies subject to the consolidated tax return, and provisions to reconcile EIPT with rules on thin capitalization taxation and CFC taxation.

(H) Non-discrimination Clause of Tax Conventions

If the EIPT is introduced to the Japanese tax code as intended in the tax reform proposals, there may be an issue as to whether the EIPT is compatible with the non-discrimination clauses contained in most double taxation conventions that Japan has entered into with approximately 50 countries and territories. As described in (C) and (E) above, the EIPT will apply to a Japanese company, the shares of which are held by its ultimate foreign parent company, that borrows money from its parent or foreign affiliates, whereas the EIPT will not apply to a Japanese company, the shares of which are held ultimately held by a Japanese parent company, that borrows money from its parent or domestic affiliates. One may argue that this difference does not violate the non-discrimination clauses because the difference does not come from the residency of the shareholder but the residency of the lender or the guarantor. It is questionable, however, if this explanation is sufficiently convincing. At this time, there has been no official announcement from the Japanese government as regards this issue and the specific details of the EIPT are yet to be made public.

* * * * *

This newsletter is authored by Takashi Tezuka of Anderson Mori and Tomotsune.

* * * * *

Contact Information:

Should you wish to receive further information or advice regarding the above-mentioned matters, please contact Takashi Tezuka.

Takashi Tezuka
Associate
Email: takashi.tezuka@amt-law.com
Telephone: 03-6888-1166