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Japan Inbound Tax & Legal Newsletter

BEPS Enhanced Earnings Stripping Rules

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In Brief

Japan's revised earnings stripping rules, included in the 2019 tax reform enacted on 27 March 2019, introduce a number of major changes to align with recommendations under action 4 of the OECD BEPS project and further restrict the potential deductibility of interest for taxable years beginning on or after 1 April 2020. In particular, the new rules:

- Reduce the current 50% of "adjusted income" to 20% in computing interest expense disallowance;
- Modify the definition of adjusted income to exclude certain income, such as exempt dividends, which currently are included in the adjusted income calculation;
- Expand the scope of "harmful" interest expense to include third-party interest in addition to related party interest; and
- Revise the exceptions to the interest deduction limitation by introducing a new de minimis threshold for net interest expense of JPY 20 million or less, abolishing the current exclusion for interest paid to related parties (50% or less of total interest paid) and adding an exception for interest paid by group companies.

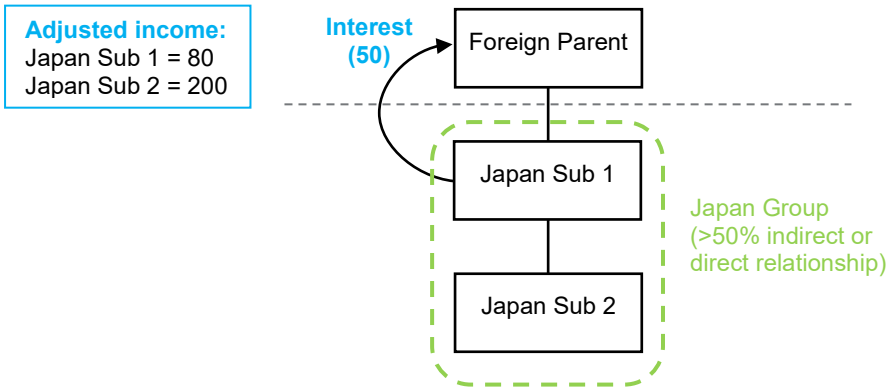
This alert highlights some of the significant changes, including the new group exception and the revised scope of harmful interest, and provides examples to show how the updated provisions potentially may impact foreign multinationals doing business in Japan.

1. New group exception

Under the 2019 tax reform, the earnings stripping rules will not apply to a Japanese group if the group's aggregated interest expense does not exceed 20% of the group's adjusted income.

For these purposes, a group refers to domestic companies with a common Japanese parent holding greater than 50% direct or indirect control. The new rules for group treatment will not apply to companies that have elected to be treated as a consolidated group for Japanese tax purposes; these companies will continue to apply the earnings stripping rules on a consolidated basis.

For multinationals with multiple subsidiaries in Japan, the new group exception may provide some relief for highly leveraged companies in structures generating sufficient income at the group level, as shown in the following example:



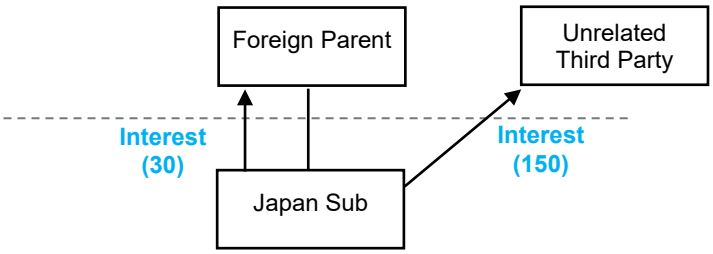
Current earnings stripping rules	
(a) Interest paid to foreign related party from Japan Sub 1	50
(b) Adjusted income for Japan Sub 1	80
(c) Deductible interest for Japan Sub 1 (adjusted income x 50%)	40
Disallowed interest for Japan Sub 1	10

New earnings stripping rules	
(a) Japan Group net interest expense	50
(b) Japan Group adjusted income	280
(c) Ratio of Japan Group net interest expense (a) ≤ 20% of Japan Group adjusted income (b)?	Yes
Disallowed interest	0

Where the group exception does not apply, group entities will be subject to the earnings stripping rules on a separate-entity basis.

2. Expanded scope of "harmful" interest expense

The new rules expand the scope of what is considered to be "harmful" interest expense subject to potential disallowance. Under the current system, only interest paid to related parties falls within the scope of the earnings stripping rules. However, the new rules also will apply to interest paid to third parties (except for interest taxable in Japan in the hands of the recipient, certain third-party bond interest, etc.). In certain cases, the new rules could create additional disallowed interest for Japanese companies, as shown below:



Current earnings stripping rules	
(a) Interest paid to foreign related party	30
(b) Interest paid to foreign unrelated party	150
(c) "Harmful" interest expense	30
(d) Adjusted income*	300
(e) Deductible interest: (d) x 50%	150
Disallowed interest (c) – (e)	0

New earnings stripping rules	
(a) Interest paid to foreign related party	30
(b) Interest paid to foreign unrelated party	150
(c) "Harmful" interest expense	180
(d) Adjusted income*	450
(e) Deductible interest: (d) x 20%	90
Disallowed interest (c) – (e)	90

*Net interest expense subject to earnings stripping rules (c) added back to taxable income to reach adjusted income (d).

It should be noted that the effects of this change may be limited. Existing structures with Japanese subsidiaries holding foreign unrelated third-party debt that is guaranteed by the overseas parent should not be impacted, since such structures generally are captured by the current earnings stripping rules. Similarly, Japanese subsidiaries borrowing locally from domestic third-party banks generally would not be affected as interest taxable in Japan will remain outside the scope of the new rules.

Deloitte's View

While overall the new earnings stripping rules will be more restrictive for companies with significant interest expense, there is potential for relief if sufficient income is generated in Japan at a group level. Similarly, the addition of unrelated third-party interest within the scope of the rules casts a wider net, but the impact may be mitigated if borrowing is done locally. However, the effects of the new rules are not limited to the examples provided above. For example, the exclusion of exempt dividends from adjusted income could mean a lower adjusted income for certain companies in Japan, which could increase the potential for disallowance. With time remaining until the new rules take effect on 1 April 2020, it is important for companies to evaluate their existing financing arrangements and consider the potential impact of the new rules to avoid any unexpected consequences.

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