Debt Push Down more restricted by the Earnings stripping rule

In M&A transactions, a debt push down is a tax planning technique to reduce taxable income of the target company after acquisition. The earning stripping rule implemented in 2012 restricts the availability of debt push down when acquiring a Japanese company.

1. **Debt Push Down**
   A typical debt push down can be depicted as follows:

   - A foreign investor sets up an acquisition vehicle in Japan.
   - The foreign investor provides the acquisition vehicle with acquisition funds by equity and loan. The loan equity ratio is less than 3:1 to avoid the thin capital rule.
   - The acquisition vehicle acquires 100% interests in the target company.
   - The acquisition vehicle and the target company elect to file a consolidated tax return.
   - The interest expenses the acquisition vehicle pays to the foreign investor can be deducted from the profit of the target company on the consolidated tax return.

2. **Earnings stripping rule**
   The earnings stripping rule is applied from a business year beginning after March 31, 2013. Under the earnings stripping rule, net interest paid to related parties that exceeding 50% of the taxpayer’s adjusted income are disallowed. Net interest paid to related parties means the amount of interest payments to related parties, which are not subject to the Japanese income taxes.

   **Related party**

   **Ownership**
   Related parties are entities which own or are owned directly or indirectly 50% or more interests in the taxpayer or an individual who owns directly indirectly 50% or more interests in the taxpayer. Further, a third party funds provider under guarantee by related parties is treated as a related party.

   **Substantial control**
   Related parties include entities which substantially control or are controlled the taxpayer through operating transactions, finances, concurrent posting in directors etc.

   **Adjusted income**
   Adjusted income is calculated by
   - taxable income
   - + tax loss deduction
   - + exempt dividends
   - + net interests paid to related parties
   - + deductible depreciation
   - + deductible bad debt loss
   - - Disallowed donation.

   **Carry forward**
   Disallowed net interests paid to related parties are carried forward to succeeding 7 years and deducted from taxable income in business years when 50% of adjusted income is

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1 Interest expenses on a loan from foreign controlling shareholders are disallowed where both a general debt equity ratio and a related party debt equity ratio exceed 3:1. Disallowed interest expenses are interest expenses attributed to a portion of the loan exceeding 3:1.
larger than the net interests paid to related parties in those years.

**Consolidated return**

Where a taxpayer files a consolidated tax return, net interests paid to related parties and adjusted income are calculated on consolidated basis. Where an acquired company in a consolidated group is profitable, interest expenses exceeding 50% of adjusted income will be disallowed. As such, the leverage effect will be reduced.

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