

Japan Tax & Legal Inbound Newsletter

Earnings stripping rules and the potential impact on asset deals in Japan

September 2021, No. 70

In Brief

In the context of certain leveraged acquisitions, companies should consider the deductibility of interest under the earnings stripping rules and the potential impact on asset deals in Japan. In particular, when an acquired entity recognizes significant amounts of goodwill in the course of a pre-closing carve-out process, the amortization of the goodwill may reduce the adjusted taxable income of the entity.

This newsletter provides an overview of the Japanese earnings stripping rules and the potential impact on asset deals in Japan.

1. Overview of Japanese earnings stripping rules

The following is an overview of the earnings stripping rules:

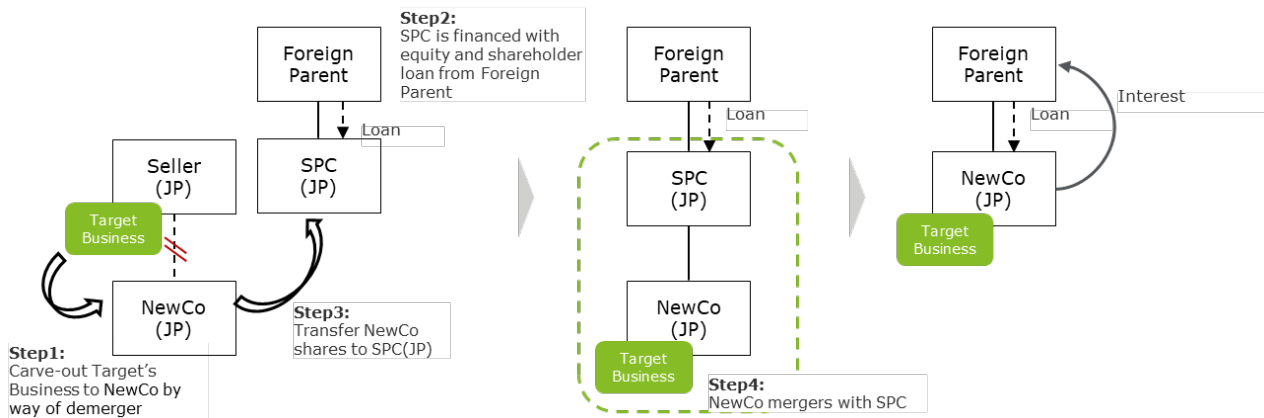
- Prior to the 2019 tax reform, the earnings stripping rules restricted deductions for net interest expenses that exceeded 50% of a Japanese company's adjusted taxable income ("Tax-EBITDA"). Pursuant to the 2019 tax reform, the 50% threshold was lowered to 20%.
- "Net interest expenses" are defined as the sum of the interest on loans (excluding interest that is fully subject to Japanese corporate income tax) less the sum of certain interest income.
- Tax-EBITDA is calculated using the following formula:

| |
|---------------------------|
| Taxable income |
| +) NOL deduction |
| +) net interest payment |
| +) depreciation expenses |
| +) bad debt losses, etc. |
| Tax-EBITDA |

- If both thin capitalization and earnings stripping rules apply, the rules that result in the largest amount of nondeductible interest will apply.
- Disallowed interest expenses may be carried forward and deducted from taxable income in the succeeding seven fiscal years.
- There are certain exceptions to the earnings stripping rules. A de minimis rule applies in the event that (1) net interest expenses are JPY 20 million or less or (2) the sum of interest expenses of a domestic group exceeds the sum of 20% of the Tax-EBITDA of such group.

2. Potential impact on commonly seen asset deals in Japan

In cases where a foreign company ("Foreign Parent") acquires the business ("Target Business") of a Japanese company ("Seller"), the following transaction steps are commonly seen in practice:



The demerger at Step 1 generally should be treated as a taxable demerger as there is no existing business at NewCo at the time of the demerger. In the event that the demerger is treated as a taxable demerger, if the fair market value (FMV) of Target Business is greater than the FMV of identifiable assets and liabilities to be succeeded by way of the demerger, such difference may be treated as goodwill and amortized over 60 months at NewCo.

For Japanese tax purposes, a merger in a 100% controlling relationship generally should qualify as a nontaxable merger as long as boot is not delivered to the shareholders of the merging company. Therefore, the merger between NewCo and SPC at Step 4 generally should qualify as a nontaxable demerger for Japanese tax purposes and all assets and liabilities (including goodwill) of the merging company may be transferred to the succeeding company on a carryover basis.

It should be noted that the amount of goodwill amortization is not added back in the Tax-EBITDA calculation and, accordingly, net interest expenses may easily exceed 20% of Tax-EBITDA if a significant amount of goodwill amortization is recognized as illustrated in the example below:

Assumptions

- ✓ Demerger is performed at the beginning of the year.
- ✓ Upon the demerger, goodwill is recognized in the amount of JPY 2,500 million.
- ✓ No limitation on interest deductibility under thin capitalization rules, transfer pricing rules, etc.

| NewCo(JP) Adjusted income | | |
|---------------------------|----------------------------------|------------|
| 1 | Sales | 2000 |
| 2 | Expenses(Interest) | (200) |
| 3 | Expenses(Others) | (1000) |
| 4 | Amotization of Goodwil | (500) |
| 5 | Adjusted(Interest) | 200 |
| 6 | Tax-EBITDA (1+2+3+4+5) | 500 |

| Earnings Stripping Rules | |
|--|-----|
| a. NewCo's net interest expenses | 200 |
| b. 20% of Tax-EBITDA on NewCo | 100 |
| C. Disallowed interest expenses (a.-b.) | 100 |

As a result, JPY 100 million of the net interest expenses are not deductible under the earnings stripping rules, and such disallowed interest expenses may be carried forward and deducted from taxable income in the succeeding seven fiscal years (up to 20% of Tax-EBITDA), which may increase after 60 months as the goodwill would have been fully amortized.



Deloitte's View

In cases where a foreign company finances the acquisition of a Japanese business in an asset deal using a shareholder loan, the interest on the shareholder loan could be disallowed under the earnings stripping rules pursuant to the 2019 tax reform.

In addition to the earnings stripping rules, interest on shareholder loans at Newco may be disallowed under thin capitalization rules, transfer pricing rules, etc. Accordingly, due consideration should be given to the debt-to-equity ratio, various loan terms (e.g., interest rate, currencies, maturities, etc.), future income projections, acquisition value of the business, post-merger integration strategies (e.g., upstream versus downstream merger) to ensure there are no unexpected consequences related to the interest on acquisition indebtedness.

Newsletter Archives

To see past newsletters, please visit our website: www.deloitte.com/jp/tax-legal-inbound-newsletter.

Subscribe to Japan Tax & Legal Inbound Newsletter and tax@hand app

To automatically receive future newsletters, please email japan_taxlegal_inbound@tohmatu.co.jp and register by providing your name, company, position, and email address. Click [here](#) to download our tax@hand app to view newsletters and other content on your mobile device.

Contacts

Deloitte Tohmatsu Tax & Legal Inbound Client Services Team

Not all facts and circumstances are covered in this newsletter. If you have any questions regarding your specific situation, please contact one of the tax professionals at our Deloitte office in Tokyo at japan_taxlegal_inbound@tohmatu.co.jp or visit our website: www.deloitte.com/jp/tax-legal-inbound-services.

| Jun Sawada, Inbound Client Services Leader | |
|--|---------------------------|
| Business Tax Services | Sunie Oue, Partner |
| | David Bickle, Partner |
| Indirect Tax Services | Fumiko Mizoguchi, Partner |
| Global Employer Services | Russell Bird, Partner |
| Transfer Pricing | Samuel Gordon, Partner |
| Tax Management Consulting | Sreeni Menon, Director |
| International Tax and M&A | Masato Iwajima, Partner |
| Financial Service Industry | Yang Ho Kim, Partner |
| | Kai Hielscher, Partner |
| Tax Controversy | Yutaka Kitamura, Partner |
| Legal | Kaori Oka, Partner |
| Immigration | Kumiko Kawai, Partner |
| Payroll and Social Benefits Processing | John Dorff, Partner |
| Family Consulting | Michael Tabart, Partner |
| email to: japan_taxlegal_inbound@tohmatu.co.jp | |

Issued by

Deloitte Tohmatsu Tax Co.

Marunouchi-Nijubashi Building, 3-2-3 Marunouchi, Chiyoda-ku, Tokyo 100-8362, Japan

Tel: +81 3 6213 3800

email: tax.cs@tohmatu.co.jp

Corporate Info: www.deloitte.com/jp/en/tax

Deloitte Tohmatsu Group (Deloitte Japan) is a collective term that refers to Deloitte Tohmatsu LLC, which is the Member of Deloitte Asia Pacific Limited and of the Deloitte Network in Japan, and firms affiliated with Deloitte Tohmatsu LLC that include Deloitte Touche Tohmatsu LLC, Deloitte Tohmatsu Consulting LLC, Deloitte Tohmatsu Financial Advisory LLC, Deloitte Tohmatsu Tax Co., DT Legal Japan, and Deloitte Tohmatsu Corporate Solutions LLC. Deloitte Tohmatsu Group is known as one of the largest professional services groups in Japan. Through the firms in the Group, Deloitte Tohmatsu Group provides audit and assurance, risk advisory, consulting, financial advisory, tax, legal, and related services in accordance with applicable laws and regulations. With more than 10,000 professionals in over 30 cities throughout Japan, Deloitte Tohmatsu Group serves a number of clients including multinational enterprises and major Japanese businesses. For more information, please visit the Group's website at <http://www.deloitte.com/jp/en>.

Deloitte refers to one or more of Deloitte Touche Tohmatsu Limited ("DTTL"), its global network of member firms, and their related entities (collectively, the "Deloitte organization"). DTTL (also referred to as "Deloitte Global") and each of its member firms and related entities are legally separate and independent entities, which cannot obligate or bind each other in respect of third parties. DTTL and each DTTL member firm and related entity is liable only for its own acts and omissions, and not those of each other. DTTL does not provide services to clients. Please see www.deloitte.com/about to learn more.

Deloitte Asia Pacific Limited is a company limited by guarantee and a member firm of DTTL. Members of Deloitte Asia Pacific Limited and their related entities, each of which are separate and independent legal entities, provide services from more than 100 cities across the region, including Auckland, Bangkok, Beijing, Hanoi, Hong Kong, Jakarta, Kuala Lumpur, Manila, Melbourne, Osaka, Seoul, Shanghai, Singapore, Sydney, Taipei and Tokyo.

Deloitte is a leading global provider of audit and assurance, consulting, financial advisory, risk advisory, tax and related services. Our global network of member firms and related entities in more than 150 countries and territories (collectively, the "Deloitte organization") serves four out of five Fortune Global 500® companies. Learn how Deloitte's approximately 312,000 people make an impact that matters at www.deloitte.com.

All of the contents of these materials are copyrighted by Deloitte Touche Tohmatsu Limited, its member firms, or their related entities including, but not limited to, Deloitte Tohmatsu Tax Co. (collectively, the "Deloitte Network") and may not be reprinted, duplicated, etc., without the prior written permission of the Deloitte Network under relevant copyright laws.

These materials describe only our general and current observations about a sample case in accordance with relevant tax laws and other effective authorities, and none of Deloitte Network is, by means of this publication, rendering professional advice or services. Before making any decision or taking any action that may affect your finances or your business, you should consult a qualified professional adviser. The opinions expressed in the materials represent the personal views of individual writers and do not represent the official views of Deloitte Network. No entity in the Deloitte Network shall be responsible for any loss whatsoever sustained by any person who relies on this publication.

Member of
Deloitte Touche Tohmatsu Limited

© 2021. For information, contact Deloitte Tohmatsu Group

