April 2012

Japan tax alert

Ernst & Young Shinnihon Tax

Japan's 2012 tax reform adopted; new earnings stripping provision and extension of R&D credit

Executive summary

On 30 March 2012, the Japanese Diet passed 2012 tax reform bill (2012 Tax Reform). The 2012 Tax Reform was promulgated on 31 March 2012, and the provisions in the 2012 Tax Reform are generally effective on 1 April 2012 unless otherwise specified.

The 2012 Tax Reform contains the following key provisions for corporations:

- Introduction of earnings stripping provisions; and
- A two-year extension for an additional R&D tax credit.

New earnings stripping provision

The new earning stripping provision limits the deductibility of interest expense incurred on loans directly with a non-Japanese related party and those that are guaranteed by related parties.[1] The provision aims at curbing Japanese corporate taxpayers' base erosion through interest expense payments made to a non-Japanese related party. The term "interest expense" for purposes of this provision includes guarantee fee payments but excludes the payments if a recipient is subject to Japanese corporate tax. A disallowed portion of the interest expense is in excess of 50% of taxable income before net interest payments to related parties, depreciation expenses, and other adjustments (Adjusted Income).

1 The term "related party" includes foreign and Japanese domestic related/controlling party and a domestic or foreign guarantor.

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Japan's prior thin capitalization rules placed a limitation on the deductibility of interest expense based on a 3:1 debt-to-equity ratio. The new provision, however, applies when the debtor company claims an excessive interest expense deduction against its income, even if the debtor company were to satisfy the 3:1 debt-to-equity ratio. The amount disallowed is the higher of the amount computed under the thin capitalization or this new provision.

A current disallowed amount may be carried forward for seven years for future use when the taxpayer's net interest expense is less than 50% of the Adjusted Income.

Two-year extension for an additional R&D tax credit

Under the current rules, a Japanese corporation can claim an R&D tax credit up to a 40% of their total corporate tax liability. This represents a combination of (1) a "base" maximum credit of 30% of total tax liability (20% plus a temporary available credit of 10%), and (2) an additional maximum "temporary" credit of 10% of the total tax liability.

Current tax law provisions reduce the maximum "base" credit from 30% to 20% and repealed the 10% additional "temporary" credit for taxable years beginning on or after 1 April 2012. The 2012 Tax Reform extends the 10% additional "temporary" credit for two more years.

As stated above, the provisions in the 2012 Tax Reform are generally effective on 1 April 2012, but the earnings stripping provisions have a later effective date and only applicable to fiscal years beginning on or after 1 April 2013. A Japanese consumption tax rate increase is not part of the 2012 Tax Reform but the bill has been submitted separately to the Japanese Diet for further discussion.

Implications

Multinational companies need to begin reviewing potential impact of the earnings stripping rules and assess if corrective actions are required, in order to mitigate the impact of the new rules by the effective date.

Comments or general inquiries regarding this tax alert may be directed to our Corporate Communications team at tax.marketing@jp.ey.com.

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