ACC Association of Corporate Counsel

Tax on corporate lending and bond issues in Japan: overview

Tsuyoshi Ito, Norihiro Ubukata and Takatomo Terasaki
Nishimura & Asahi

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TAX AUTHORITIES

1. What are the main authorities responsible for enforcing taxes on finance transactions in your jurisdiction?

The main authority responsible for enforcing national taxes is the National Tax Agency (NTA) (*Kokuzei-cho*) which is an external body of the Ministry of Finance. The NTA is responsible for assessing and collecting internal taxes (*Articles 18 and 19, Act for Establishment of the Ministry of Finance*).

The NTA has:

- One head office.
- 11 regional taxation bureaus (*Kokuzei-kyoku*).
- One Okinawa regional taxation office.
- 524 tax offices (*Zeimu-sho*).

The tax offices are front line administrative offices responsible for assessing and collecting national taxes, although the regional taxation bureaus also levy and collect taxes directly from large taxpayers. The regional taxation bureaus and the tax offices generally have the closest contact with taxpayers.

The main authorities responsible for local taxes are the governors of each local government. However the responsibilities of each governor are delegated to the tax department of its local government so that, in practice, local taxes are enforced by a tax department of each local government (*Articles 2, 3 and 3-2, Local Tax Act (LTA)*and *Article 149(iii), Local Government Act*).

Pre-completion tax clearances

2. Is it possible or necessary to apply for tax clearances or obtain guidance from the tax authorities before completing a finance transaction?

Circumstances for obtaining clearance

There is no tax clearance system from the tax authority, however, in certain cases the taxpayer can submit an enquiry before a transaction to request a written response from the NTA about whether it will be subject to taxes. This advance enquiry to the NTA functions in practice as a tax clearance. A taxpayer can generally request a written response from the NTA if the following conditions are satisfied:

- The taxpayer conducted, or will conduct, a certain transaction by itself.
- The taxpayer provides necessary information and materials for the transaction.
- No clear interpretation has been revealed by other written rulings.

Mandatory or optional clearance?

Submitting an advance enquiry is optional.

Procedure for obtaining clearance

The taxpayer requesting a written response must consent to the public disclosure of its enquiry and to the response from the NTA being publicly available, and file an application with the regional taxation bureau or the tax office that covers the place of tax payment.

A taxpayer can also obtain informal guidance on the tax treatment of a particular transaction through informal consultation with tax officers at regional taxation bureaus or tax offices. This informal guidance may provide some comfort for the taxpayer. When requesting informal guidance, general practice is to disclose the taxpayer's identity and detailed information about the transaction.

Disclosure of finance transactions

3. Is it necessary to disclose the existence of any finance transactions to the tax authorities?

Circumstances where disclosure is required

There are no general requirements to disclose the existence of a finance transaction to the tax authority when the transaction closes. However, taxpayers must submit records of payments to the tax authorities (including the identities of recipients and payment details), such as interest, dividends, salaries, remunerations, certain fees and real estate rental fees. Generally, taxpayers must submit required payment records by the end of January of the next year. In a tax audit, a tax officer can request a taxpayer to disclose the existence and contents of finance transactions to examine whether the taxpayer's tax filing is legitimate and appropriate. The taxpayer must generally comply with a request from the tax officer for this information.

In addition, a company that seeks various tax deductions, exemptions or other benefits relating to finance transactions may be required to file documents that show an outline or details of the finance transaction to obtain the deduction, exemption or benefit. In relation to the filing, the company may have to disclose the existence of a finance transaction.

Under the attributable income principle that comes into effect the fiscal year commencing on or after 1 April 2016, where a domestic corporation's income is attributable to its permanent establishment in a foreign jurisdiction, the corporation must prepare documents evidencing the internal transaction with its permanent establishment in the foreign jurisdiction. As for a foreign corporation, if the income derived from a transaction with a third party is attributable to the foreign corporation's permanent establishment in Japan, the foreign corporation must prepare a

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document to evidence that the income is attributable to the permanent establishment.

In the Base Erosion and Profit Shifting (BEPS) Action Plan report (*Action Plan 13*), the OECD/G20 recommended adopting a new transfer pricing documentation rule that will require large-size multinational enterprises to file a master file, a country-by-country report and a local file with the relevant tax authorities. In the master file, the ultimate parent company of a multinational enterprise must provide and explain an outline of any intergroup finance transactions.

Manner and timing of disclosure

The timing of disclosure is either on request from the tax officer or when a company seeks and applies for tax deductions, exemptions or other benefits. The manner of disclosure is usually to provide the related documents. As for the master file, the ultimate parent company must submit the master file by the 1st anniversary of the end of its fiscal year.

TAXES ON CORPORATE LENDING/BORROWING

Taxes potentially chargeable on amounts receivable

4. What are the main corporate taxes potentially chargeable on interest and other amounts receivable under a loan?

Interest and other amounts receivable under a loan usually constitute taxable income of the corporation. The main corporate income taxes are:

- National corporation tax.
- Local inhabitants' tax.
- Local enterprise tax.
- Local corporation special tax.

Local inhabitants' tax and local enterprise tax are imposed by each local government according to the Local Tax Act and ordinances made by each local government, and therefore can vary.

National corporation tax

Key characteristics. National corporation tax is imposed on the taxable income (or net income) (*shotoku*) of domestic corporations, foreign corporations and other entities treated as corporations for Japanese tax purposes. Foreign corporations and other foreign entities are only liable to pay national corporation tax on income from sources in Japan. Domestic corporations must pay tax on all taxable income from domestic and foreign sources.

Calculation of tax. A corporation's taxable income for each accounting period is generally calculated by subtracting deductible expenses from gross income. Interest and other amounts receivable under loans are classified as gross income.

Triggering event. A corporation is liable to pay corporation taxes to the extent that it has earned taxable income during each accounting period.

Applicable rate(s). The normal national corporation tax rate is 23.4% for the fiscal years commencing on or after 1 April 2016 and 23.2% for the fiscal years commencing on or after 1 April 2018. A reduced rate of 15% applies to the first JPY8 million of taxable income earned by small or medium-sized companies for fiscal years between 1 April 2015 and 31 March 2017. Small or medium-sized companies are companies with stated capital of JPY100 million or less, except for certain companies such as wholly owned subsidiaries of large-sized companies.

Local inhabitants' tax

Key characteristics. Local inhabitants' tax consists of tax on a per capita basis, and tax on a corporate tax basis.

Calculation of tax. In general, the amount of tax on a per capita basis ranges from JPY70,000 to JPY3.8 million per year, based on the capital amount of a corporation and the number of employees. Tax on a corporation tax basis is calculated based on the amount of the national corporation tax.

Triggering event. A corporation is liable to pay local inhabitants' tax for each accounting period.

Applicable rate(s). The current tax rate is generally 12.9% (the prefectural rate is 3.2% and the municipal rate is 9.7%) and will be reduced to 7.0% (the prefectural rate will be 1.0% and the municipal rate will be 6.0%) for the fiscal year commencing on or after 1 April 2017 (*Articles 51(1) and 314-4(1), LTA*), although some prefectures impose a slightly higher rate (for example, a corporation with its head office in Tokyo is subject to rates from 12.9% to 16.3%) for fiscal years commencing on or after 1 October 2014. In addition, the applicable tax rate for a corporation with its head office in Tokyo will be reduced by amendment of the Tokyo Metropolitan Tax Ordinance.

Local enterprise tax

The rates and calculation of local enterprise taxes generally differ depending on the amount of the stated capital of a corporation (*Article 72-2, LTA*).

If the stated capital amount of a corporation is over JPY100 million, a local enterprise tax for the fiscal year 1 April 2015 to 31 March 2016 will be imposed on the basis of (*Article 72-24-7(1), LTA* and *Article 2, Act on Interim Measures concerning the Local Corporation Special Tax*):

- A value-added factor (of 0.72%) on the amount of the added value.
- A capital factor (of 0.3%) on the stated capital amount.
- An income factor (that ranges from 1.6% to 3.1% at a progressively increasing rate) on the taxable income.

A local enterprise tax for fiscal years on and after 1 April 2016 will be imposed on the basis of:

- A value-added factor (of 1.2%) on the amount of the added value.
- A capital factor (of 0.5%) on the stated capital amount.
- An income factor (that ranges from 0.3% to 0.7% at a progressively increasing rate) on the taxable income.

If the stated capital amount of a corporation is JPY100 million or less, local enterprise tax is only imposed under the income factor, at a progressive tax rate from 3.4% to 6.7% (*Article 72-24-7(1) LTA,* and *Article 2, Act on Interim Measures concerning the Local Corporation Special Tax*).

In addition, insurance companies and electrical and gas suppliers calculate this tax based on their income (*Article 72-24-7(2), LTA*).

Local corporation special tax

In 2008, the Japanese government created a local corporation special tax in exchange for reducing the local enterprise tax, to redress the tax income gap between local governments and redistribute tax income among local governments. The amount of the local corporation special tax is generally (*Article 9, Act on Interim Measures Concerning the Local Corporation Special Tax and Article 7, Act for Partial Amendment to LTA (Law No 2 of 2015)*):

- For the fiscal year of 1 April 2015 to 31 March 2016, 93.5% of the income factor tax amount of the local enterprise tax, if the stated capital amount of a corporation is over JPY100 million. For fiscal years on or after 1 April 2016, 414.2%.
- 43.2% of the amount of the local enterprise tax, for other corporations.

Local corporation tax

In 2014, in order to redress the tax income gap among local governments, the Japanese government created a new local corporation tax in exchange for reducing the local inhabitants' tax. The tax is 10.3% on the amount of corporation tax for fiscal years commencing on or after 1 October 2014.

Effective tax rate

The effective tax rate on taxable income for a corporation in Japan is generally about 29.97% (the rate is a little different in some prefectures).

Tax treaties and domestic law

The government has entered into tax treaties and conventions with many countries. When a tax treaty is applied to a transaction and there are differences between the tax treaty and domestic law, generally the tax treaty will apply.

This chapter sets out Japanese domestic rules, regulations and procedures. Tax treaties vary from country to country, and apply many exemptions and reduced tax rates, as well as requirements that would otherwise apply under domestic law.

Tax reliefs available for borrowing costs

5. What corporate tax reliefs are available for borrowing costs (including interest and other amounts payable under a loan)?

Borrowing costs, including interest and other amounts payable under a loan, are generally deductible expenses. A borrower can deduct these costs from gross income when calculating taxable income for the accounting period. If interest on a loan is lower than the fair market rate, donation taxes can be imposed on the lender, while the borrower can only deduct the actual amount of interest paid (not the fair market rate of interest).

There is a thin capitalisation rule in cross-border transactions, which can limit the amount that a Japanese corporate borrower can deduct as interest and other amounts from its gross income for tax purposes.

Generally under this rule, if the average balance amount of loans and other credits and debts that a foreign controlling shareholder provides (by itself and through third parties) exceeds three times the amount of its equity share, interest and other debt costs payable to it relating to the excess debt are not deductible from taxable income of the Japanese corporation, unless the average balance amount of all debt bearing interest does not exceed three times the amount of the shareholders' equity (*Article 66-5(1), Act on Special Measures Concerning Taxation* (ASMCT)).

Instead of this three-times-multiple standard, a Japanese corporation can use other debt-to-equity ratios found to be appropriate compared with similar companies of the same size that conduct the same business.

For fiscal years commencing on or after 1 April 2013, the Japanese earnings stripping rule applies. Under this rule, if interest and other debt costs payable to certain controlling persons (and not subject to Japanese income tax or corporation tax) exceed 50% of the statutory base income amount, such excess is generally not deductible (*Article 66-5-2(1), ASMCT*). However any non-deductible excess may be carried forward for 7 fiscal years and deducted until the 50% threshold has been reached (*Article 66-5-3(1), ASMCT*).

If both this rule and the thin capitalisation rule described above are applicable, the larger non-deductible amount will apply (*Article 66-5(4), 66-5-2(7), ASMCT*).

Tax payable on the transfer of debt

6. What corporate, transfer, stamp or other taxes are payable on the transfer of a debt under a loan?

Corporation tax

A lender's gain from the transfer of a loan is taxable income subject to corporate taxes (*see Question 4*). The gain is generally calculated by deducting the base cost of the transferred loan from the sale price of the transferred loan.

Similarly, if a lender makes a loss on the transfer of a loan, the loss is generally deductible from its taxable income. The price of the transferred loan must be at fair market value, considering various factors including valuation of collateral, status and conditions of the borrower's assets and business. Overpricing or underpricing can trigger donation tax issues.

A borrower is generally not liable to pay tax when the lender transfers the loan.

Stamp tax

Stamp tax is imposed on an agreement to transfer a loan, and both the transferor and the transferee are jointly liable to pay stamp tax. An original agreement (or its amending agreements) to transfer a loan incurs a fixed JPY200 stamp tax on each document, regardless of the amount of the loan.

Withholding tax

7. Is there withholding tax on interest or any other payments under a loan?

When withholding tax applies

No withholding tax is imposed on interest or any other payments under a loan payable to Japanese residents or Japanese domestic corporations.

Interest under a loan payable to non-residents or foreign corporations is subject to Japanese withholding tax, provided the source of interest is from Japan. The source of interest is generally deemed to be from Japan when the borrower conducts its business in Japan and uses funds provided under the loan for business in Japan. Lenders should be aware that source rules under a tax treaty can override Japanese source rules.

Applicable rate(s) of withholding tax

The rate of withholding tax on interest is 20.42% unless a reduced rate or exemption under a tax treaty applies (*Articles 161, 162, 212 and 213, Income Tax Act (ITA), Article 28, Act on Special Measures for Securing Financial Resources Necessary to Implement Measures for Reconstruction Following the Great East Japan Earthquake (ASMRGEJE)*).

Exemptions from withholding tax

No withholding tax is imposed on interest under a loan payable to a non-resident or a foreign corporation that has a permanent establishment in Japan where the interest is attributed to the permanent establishment in Japan, if the non-resident or foreign corporation obtains a certificate from the relevant tax office and presents the certificate to the borrower before any payments of interest (*Articles 180 and 214, ITA*), although this interest is subject to Japanese income tax or corporation tax imposed on the non-resident or the foreign corporation.

In addition, no withholding tax is imposed on interest paid by a financial institution on a deposit or a loan recorded in a special international financial transactions account (as set out in the Foreign Exchange and Foreign Trade Act) to a foreign corporation (*Article 7, ASMCT*).

Other exemptions from withholding tax or a reduced rate of withholding tax on interest payments may be available if the lender benefits from a tax treaty.

For a comparative summary of withholding tax on interest, see table, *Withholding tax requirement on interest on corporate debt, and the key exemptions*, in this global guide.

Guarantees

8. Do any particular tax issues arise on the provision of a guarantee?

A commission or charge payable from a borrower to a guarantor in relation to a guarantee is generally deductible from the borrower's taxable income, and is taxable income of the guarantor.

If a guarantor is a foreign corporation without a permanent establishment in Japan, guarantee commissions or charges payable to the guarantor are not Japan-source income. As a result, the guarantor is not liable to Japanese tax on the income from guarantee commissions or charges.

In the context of the thin capitalisation rule (*see Question 5*), loans and other debts guaranteed by a foreign controlling shareholder are treated as loans from the foreign controlling shareholder. Deduction of interest paid on these loans and other debt, as well as guarantee commissions and charges, may be restricted by the thin capitalisation rule (*Article 39-13(13) and (15), ASMCT Enforcement Order*). Please note that if a guarantor is a controlling person under the Japanese earnings stripping rule (*see Question 5*), then guarantee commissions or charges payable to such guarantor are subject to the limits on deduction (*Article 39-13-2(3)(i), ASMCT Enforcement Order*)

BOND ISSUES

9. For corporate taxation purposes, are bonds treated any differently from standard corporate loans?

Withholding tax

In contrast to interest payments under a loan (*see Question 7*), interest on bonds (including national government bonds, local government bonds or bonds issued by Japanese corporations) paid to a Japanese resident or a Japanese corporation is subject to national level withholding tax at 15.315% (*Articles 23, 181, 182, 212 and 213, ITA and Article 28, ASMRGEJE*). Only Japanese individual residents are subject to local withholding tax of 5% in addition to the above income withholding tax (*Article 71-6, Local Tax Act (LTA)*).

Interest on bonds paid to a non-resident or a foreign corporation is subject to withholding tax at 15.315% (*Articles 161, 212 and 213, ITA* and *Article 28, ASMRGEJE*) if it is Japan-source income. Even when a non-resident or a foreign corporation has a permanent establishment in Japan, no exemption from the withholding tax under Article 180 or Article 214 of the ITA is available.

Corporate bondholders

Bonds are classified as securities for corporation tax purposes. If a Japanese company holds corporate bonds for the purpose of making profits on market movements on a short-term basis, it must assess corporate bonds on a market value basis at the end of its accounting period, and recognise any changes in value as income or loss for that period (*Article 61-3, Corporation Tax Act (CTA)*).

Interest on bonds paid to a Japanese domestic corporation constitutes taxable income of the domestic corporation and is subject to corporate income taxes. Amounts that have been withheld as withholding taxes are deducted from the amount of corporate income taxes that the domestic corporation would have to pay.

Corporate issuers

For corporate issuers, the tax consequences of issued bonds are basically the same as those for corporate loans (*see Questions 4* and *5*).

Interest on bonds paid to bondholders is generally a deductible expense for tax purposes.

Expenses incurred to issue bonds can, at the option of the taxpayer, be expensed in the accounting year in which they are incurred, or capitalised and deducted in the following years (*Article 64(1)(i), CTA Enforcement Order*).

The difference between the amount received for the issuance of a bond and its face amount is recognised as a profit or loss in an equal amount over the total months of the redemption period of the bond, on a straight-line method (*Article 136-2(1), CTA Enforcement Order*).

Taxes payable on the issue and/or transfer of a bond

10. What stamp, transfer or similar taxes are payable on the issue and/or transfer of a bond?

Stamp tax on the issuance of bonds

The issuance of physical bond certificates is subject to stamp tax at the following rates:

- JPY200 for a bond certificate of up to JPY5 million.
- JPY1,000 for a bond certificate of more than JPY5 million to JPY10 million.
- JPY2,000 for a bond certificate of more than JPY10 million to JPY50 million.
- JPY10,000 for a bond certificate of more than JPY50 million to JPY100 million.
- JPY20,000 for a bond certificate of more than JPY100 million.

The bond issuer is liable to pay the stamp tax. The stamp tax is only triggered when the issuer issues a physical bond certificate. No stamp tax is imposed when the issuer issues corporate bonds without physical bond certificates, such as issuing bonds under a book-entry system.

Stamp tax on transfer of bonds

Bond transfers are not subject to stamp tax.

Exemptions

11. Are any exemptions available?

Exemption from Japanese income/corporation tax

Subject to certain requirements set out in the ASMCT, non-residents and foreign corporations are entitled to be exempted from income tax and corporation tax on interest on and profits from redemptions of the following (*Articles 5-2, 5-3, 6, 41-13 and 67-17, ASMCT*):

- Corporate bonds that were issued outside Japan and the interest paid outside Japan.
- Japanese government bonds or local government bonds issued in the book-entry system in Japan.
- Corporate bonds issued in the book-entry system in Japan.

For individuals, profits from the transfer of government bonds or bonds issued by Japanese corporations are exempt from income tax (*Article 37-15, ASMCT*).

Exemption from withholding tax

Interest on corporate bonds that are issued in the Japanese book-entry system and recorded in the transfer accounts of financial institutions that have a business office in Japan, or corporations with a stated capital of JPY100 million or more, is exempt from withholding tax (*Article 8, ASMCT* and *Articles 3-3(7), (8) and (9), ASMCT Enforcement Order*).

Interest on bonds received by securities investment trusts or pension trusts is exempt from withholding tax (*Articles 176 and 180-2, ITA*).

PLANT AND MACHINERY LEASING

Claiming capital allowances/tax depreciation

12. What are the basic rules for enabling the lessor or lessee of plant and machinery to claim capital allowances/tax depreciation?

Japanese tax law generally recognises lease transactions in which the lessor holds ownership of the assets and leases the assets to the lessee. Therefore, the lessor can claim a tax allowance for depreciation of the leased assets.

However, if a lease transaction meets both the following requirements, the leased asset is treated as a finance lease when the leased asset is transferred from lessor to lessee (*Article 64-2, CTA*):

- The contract of the lease cannot be cancelled during the lease term (non-cancellable).
- The lessee can effectively enjoy economic benefits arising from the asset, and is substantially obliged to pay for expenses incurred due to use of the asset (full-payout).

Under a finance lease, the lessee is treated as the buyer of the leased asset and, as a result, can claim a tax allowance for depreciation relating to the asset. The lessor recognises the excess of the lease payments over the cost of the leased asset as income.

A lease transaction entered into before 1 April 2008 is recognised as a finance lease for tax purposes (that is, the leased asset is treated as if it were sold to the lessee) if it satisfies one of the following conditions or its equivalent (title transfer conditions), in addition to the two conditions set out above (*Article 21, Supplementary Provisions of the 2007 amendments to CTA Enforcement Order (Law No. 83 of 2007)*):

- The leased asset will be transferred to the lessee at no charge or for a nominal charge during or at the end of the lease period.
- The lessee has the right to purchase the leased asset at a significantly low price during or at the end of the lease period.
- Considering the type, intended purpose and installation circumstances of the leased asset, only the lessee is expected to use the asset throughout its useful life or it is hard to identify the leased assets.
- Considerable differences between the lease period and the statutory useful life of the asset allow a remarkable decrease of corporation tax or income tax of the lessee or the lessor.

If a lease is not treated as a finance lease, the lessor can claim a tax allowance for depreciation on the leased asset.

Rate of capital allowances/tax depreciation

13. What is the rate of capital allowances/tax depreciation; does it depend on the type of assets?

The rate (useful life) and method of tax depreciation depends on the type and the acquisition date of the asset.

The lessee in a finance lease which satisfies one of the title transfer conditions (*see Question 12*) (title transfer finance lease) must depreciate the leased asset using the same method as other depreciable assets that are acquired by the lessee. A lessee in a finance lease other than a title transfer finance lease must depreciate the leased asset using the straight-line lease period method (*Article 48-2(1)(vi), CTA Enforcement Order*).

Lessees not carrying on business in the jurisdiction

14. Are there special rules for leasing to lessees that do not carry on business in your jurisdiction?

In lease transactions entered into before 1 April 2008 that satisfy the non-cancellable and full-payout requirements (*see Question 12*), if the lessee is a non-resident or a foreign corporation, the lessor must use the former straight-line foreign lease period method to calculate depreciation. In this formula, the acquisition price minus the estimated residual value is depreciated using the straight-line method (*Article 48(1)(vi), CTA Enforcement Order*).

If a lease transaction was entered into on or after 1 April 2008 and satisfies the non-cancellable and full-payout requirements, that lease transaction is treated as a finance lease. Therefore, the lessee is treated as the buyer of the leased asset and can claim tax depreciation relating to the asset. The lessor recognises the excess of the lease payments over the cost of the leased asset as income (*see Question 12*).

If a lease transaction does not satisfy the non-cancellable and full-payout requirements and was entered into on or after 1 April 2008, the lessor must depreciate the leased asset using the same method as ordinary depreciable assets, even if the lessee is a non-resident or a foreign corporation.

Leases of assets to entities that are not Japan-resident are generally exempt from Japanese consumption tax (*Article 7, Consumption Tax Act*).

Taxation of rentals

15. How are rentals taxed?

If a lease transaction is recognised as a finance lease for tax purposes, the lessee generally treats the rent payments that it makes as instalment payments of the purchase price for the leased asset and interest on them. The lessor treats the rent payments that it receives as the collection of accounts receivable and interest on them related to the sale of the leased asset by deferred payments.

If a lease transaction is not deemed to be a finance lease (and is treated as an ordinary lease), rent payments by the lessee are usually deductible from taxable income and rental payments received by the lessor are generally taxable income of the lessor.

Rulings and clearances

16. Is a ruling or clearance necessary or common?

No ruling or clearance is necessary (*see Question 2*).

RESTRUCTURING DEBT

Unpaid or deferred interest or capital

17. What is the tax treatment of the borrower and the lender if interest or capital is unpaid or deferred?

Lender

The lender must generally recognise interest income on an accrual basis, even if the borrower does not actually pay the interest to the lender (*Corporation Tax Basic Circular (CTBC) 2-1-24*). However, the lender can recognise interest income on a cash basis if one of the following applies (*CTBC 2-1-25*):

- Any interest payable during the six months from the last date of the accounting period is unpaid to the lender and, other than that interest, little or no interest is paid to the lender for that six months, due to the borrower's insolvency or other reasonable reasons regardless of the lender's demand to the borrower.
- In relation to the borrower, procedures under the Corporate Reorganisation Act begin.
- Risk of loss of all or a considerable portion of a loan arises, because the borrower's insolvency continues for a reasonable period and there is no expectation of an upturn in the business or assets condition of the borrower, or other similar reasonable reasons.
- On determination of approval under the Corporate Reorganisation Act by a creditors' meeting or other similar reason, the collection of all or a considerable portion of the loan is extended over about two years.

Borrower

The borrower is not subject to tax if interest, capital or principal is unpaid or deferred. If the lender waives the borrower's debt capital or principal, the borrower must recognise the amount of debt waived as taxable income (*see Question 18*).

Debt write-off/release and debt for equity swap

18. What is the tax treatment of the borrower and lender if a loan is:

- **Written off or released (wholly or partly)?**
- **Replaced by shares in the borrower (debt for equity swap)?**

Write-off or release of a loan

Bad debt loss. The lender can deduct the entire amount of the write-off or release of a loan under a borrower's legal bankruptcy procedure or reasonable out-of-court workout procedure (*CTBC 9-6-1*). Further, when it becomes clear to the lender that the entire amount of the loan is uncollectable in light of the borrower's inability to repay and the borrower's asset situation, the lender can deduct all the amount of the write-off. Before any deduction, the lender must first dispose of, and make collections based on, any collateral that secures repayment of the loan (*CTBC 9-6-2*).

If a parent company has to write off or release a loan to its subsidiary in connection with, for example, the winding-up or sale of the subsidiary, and the parent company has a material reason to do so, so that the parent company may incur additional losses without the write-off or release, the parent company can also deduct the write-off or release of the loan to the subsidiary (*CTBC 9-4-1*).

In these cases, the borrower is deemed to receive debt-waiver income (that is, deemed to have received income equivalent to the debt that is released) which is taxable income. In certain cases (for example, under the Corporate Reorganisation Act), the borrower can use net operating losses that have already expired to offset debt-waiver income.

Bad debts reserve. Before the enactment of the 2011 tax reform, any lender that established a bad debts reserve account was allowed to deduct the credited amount to a bad debt reserve account from taxable income, subject to certain restrictions and limitations under the CTA (*Article 52, CTA*). However, in taxpayers' fiscal years commencing on or after 1 April 2012, this deduction is only available to:

- Small- or medium-sized companies.
- Banks, insurance companies or other similar companies.
- Certain companies holding certain monetary claims, including those arising from a lease treated as finance lease (*see Question 12*).

Nonetheless, as an interim measure, companies classified as neither small- or medium-sized or banks, insurance companies or similar can deduct the following bad debt reserve amounts (*Articles 13 and 19, Supplementary Provisions of the 2011 amendment to CTA (Law No. 114 of 2011)*):

- For the accounting period 1 April 2012 to 31 March 2013: 75% of the deductible amount before the reform.
- For the accounting period 1 April 2013 to 31 March 2014: 50% of the deductible amount before the reform.
- For the accounting period 1 April 2014 to 31 March 2015: 25% of the deductible amount before the reform.

Debt-for-equity swap (DES)

A DES is generally carried out through a contribution-in-kind, in which the creditor contributes debt of the borrower in exchange for receiving shares in the borrower. A DES where a corporation directly or indirectly holds all the issued shares of the other corporation is usually tax-qualified (*see below*). In other DESs, requirements to be tax-qualified are hard to satisfy.

Both of the following apply if the DES is classified as a tax-qualified contribution-in-kind:

- The lender acquires the borrower's shares at a price equal to its book value of the loan (*Article 62-4, CTA*). Therefore, the lender is not subject to corporate tax for the DES.
- The borrower receives the loan at the lender's book value. If the lender's book value is equal to the face value of the loan, the borrower is also not subject to corporation tax for the DES.

Both of the following apply if the DES is not tax-qualified:

- The lender acquires the borrower's shares at a price equal to the fair market value of the loan. If there is a difference between the book value and the fair market value of the loan, the lender recognises (that is, reports for corporation tax purposes) a gain or loss equal to the difference. In this case, the loss is only thought to be tax deductible for tax purposes if the DES is based on a reasonable turnaround plan.
- The borrower receives the loan at the fair market value of the loan. If the fair market value of the loan is lower than the face value of it, the borrower must recognise the difference as debt-waiver income.

SECURITISATION

19. Briefly explain the key features of the tax regime applicable to securitisations, including details of any specific tax rules that apply or issues that arise in relation to securitisations.

The tax regime and tax issues on securitisations vary depending on securitisation schemes and structures. This answer looks at general tax aspects of:

- A *Tokumei Kumiai* (TK) agreement, which is commonly used for securitisation of real estate.
- A *Tokutei Mokuteki Kaisha* (TMK), which is a special corporation designed for securitisation vehicles.

TK structure

A TK agreement is a bilateral agreement between a business operator (*eigyo-sha*) and a silent partner (*tokumei-kumiai-in*) under the Commercial Act of Japan. A silent partner (usually an investor) contributes (or agrees to contribute) cash or other assets into the business operator, in exchange for participating in profits and losses of the business (TK Business) of the business operator. A TK is not a legal entity but a bilateral agreement between a business operator and a silent partner. All titles, assets, rights and obligations of the TK Business belong to the business operator.

The business operator is liable to pay tax on the TK Business. However, the profits of the TK Business allocated to the silent partner are deductible from the taxable income of the business operator, while the losses of the TK Business allocated to the silent partner must be added to the taxable income of the business operator (*CTBC 14-1-3*). Distribution of profits under a TK agreement is subject to withholding tax at the rate of 20.42% (*Articles 161, 174 and 210 to 213, ITA and Articles 26 and 27, ASMRGEJE*).

TMK structure

A TMK is a corporation established under the Law Concerning Liquidation of Assets (Securitisation Law), and is classified as a domestic corporation for tax purposes and therefore subject to corporate tax similar to ordinary corporations in Japan, but is entitled to enjoy some preferable tax treatment.

Deduction for dividends. The main feature of a TMK is that a TMK can claim a deduction for dividends payable to shareholders in calculating taxable income, if the following requirements are satisfied (*Article 67-14, ASMCT*):

- Relating to the TMK structure itself:
  - the TMK is established and registered under the Securitisation Law;
  - one of the following requirements is met:
    - the TMK has issued bonds through a public offering, and the amount of the bonds is JPY100 million or more;
    - the issued bonds are subscribed for only by certain categories of institutional investors (defined in the ASMCT and its ordinance), such as banks, securities companies and insurance companies;
    - the preferred shares (*Yusen Shussi*) of the TMK are subscribed for by 50 or more investors;
    - the preferred shares are subscribed for only by institutional investors.
  - its asset securitisation plan specifies that more than 50% of each series of preferred shares and certain subordinated equity shares are offered in Japan.
- Relating to the TMK in each accounting year when the TMK claims a deduction for dividends, all the following are met:
  - the TMK conducts its securitisation business in accordance with its asset securitisation plan and does not conduct other business;
  - the TMK has entrusted the specified assets (which generally means underlying assets of the securitisation) in a trust account, or delegated management and disposal of the specified assets to the third party;
  - the TMK is not a certain type of family corporation (defined in Article 2(x) of the CTA) at the end of the accounting year;
  - the amount of dividends relating to the accounting year exceeds 90% of the earnings available for dividends for that accounting year;
  - the TMK is not an unlimited liability shareholder in any general partnership corporation (*Goumei Kaisha*) or any limited partnership corporation (*Goushi Kaisha*);
  - the TMK does not own any assets other than the specified assets set out in its asset securitisation plan and other necessary assets to conduct its securitisation business;
  - if the TMK owes loans, the lenders are institutional investors described above and not subordinated equity shareholders in the TMK.

Real estate tax. A TMK also enjoys reduction of real estate taxes. Real estate acquisition tax is imposed on a real estate buyer. In calculating real estate acquisition tax, the tax base of buildings and land which a TMK acquires under its asset securitisation plan before 31 March 2017 is reduced to two-fifths of normal taxable base, when 75% or more of the specified assets that the TMK owns are buildings and land (and their equivalent) (*Article 11(3), Supplementary Provisions of the LTA* and *Article 7(3), Supplementary Provisions of LTA Enforcement Order*).

Registration and licence tax is imposed on a person who seeks to register ownership of real estate, or mortgages on them. The rate of registration and licence tax on the transfer of buildings and land that the TMK acquires under its asset securitisation plan before 31 March 2017 is reduced to 1.3% of the price of the real estate, as long as certain requirements set out in the ASMCT are satisfied (*Article 83-2, ASMCT*).

FOREIGN ACCOUNT TAX COMPLIANCE ACT (FATCA)

20. Has your jurisdiction entered into an intergovernmental agreement (IGA) to implement FATCA, or does it intend to enter into an IGA to implement FATCA?

Japan entered into an IGA, the "Statement of Mutual Cooperation and Understanding between the US Department of the Treasury and the Authorities of Japan to Improve International Tax Compliance and to Facilitate Implementation of FATCA", on 11 June 2013. This IGA is in line with the Model 2 IGA released by the IRS.

The principal terms of the IGA are as follows:

- A foreign financial institution in Japan is not required to execute an FFI Agreement with the IRS.
- Each Japanese financial institution that registers and implements the requirements of an FFI Agreement should be treated as complying with the requirements of, and as not subject to withholding under, the US FATCA.
- The United States should not require a Japanese financial institution to withhold tax under the US FATCA with respect to an account held by a recalcitrant account holder, or to close such an account, as long as:

- the Japanese financial institution carries out the necessary due diligence and reporting required by the IGA; and
- the account information of non-consenting holders requested by the IRS is provided with the IRS through the Japanese NTA.

21. Have there been any particular difficulties in light of your jurisdiction's domestic legislation with implementing the FATCA requirements?

Implementing the FATCA requirements raised issues related to the Personal Data Protection Act in Japan and to the confidentiality obligation owed by financial institutions. To reconcile these issues with FATCA requirements, the IGA provides a framework for inter-government information exchange. Specifically:

- A Japanese financial institution is not required to report individual account information but instead required to report aggregate account information held by non-consenting US persons.
- The US authority will request that the Japanese authority provide it with information regarding account information that the non-consenting US persons hold, under the information exchange clause in the Japan-US tax treaty.
- Under domestic Japanese laws, the Japanese authority obtains the requested information from the specified Japanese financial institution, and provides it to the US authority. The Japanese financial institution will provide relevant information to the Japanese authority in accordance with Japanese domestic laws.

22. Are there any provisions of your jurisdiction's IGA and/or domestic implementing legislation, if any, that are more onerous than the US FATCA requirements?

There are no such more onerous provisions.

BANK LEVIES

23. Are there any bank levies or similar taxes imposed specifically on financial institutions?

There are no bank levies or similar taxes imposed specifically on financial institutions in Japan.

24. On what are any such levies or taxes charged?

Not applicable (*see Question 23*).

Exemptions

25. At what rate(s) are the levies or taxes charged?

Not applicable (*see Question 23*).

26. Are there any thresholds or exemptions?

Not applicable (*see Question 23*).

REFORM

27. Please summarise any proposals for reform that will impact on the taxation of finance transactions.

In the 2014 tax reform, the attributable income principle (Authorised OECD approach) was adopted by the Japanese Government which means only income attributed to a permanent establishment in Japan is subject to Japanese income tax. The attributable income principle came into effect from the fiscal year commencing on or after 1 April 2016.

On 29 March 2016, the Japanese Diet approved the tax reforms for the fiscal year of 2016. The reforms are primarily intended to reduce the effective tax rate of corporate income tax, to encourage economic growth and to archive a fair distribution of the tax burden by way of expanding the corporate tax base, and to respond to aggressive tax planning and tax avoidance based on discussions under the BEPS project. These reforms include adopting a new three-layer transfer pricing documentation rule.

Japan and Taiwan signed a double tax agreement (DTA) on 26 November 2015. Although the relevant domestic laws and regulations have been approved by the Japanese Diet and the Ministry of Finance, they have not yet come into effect. Under the DTA, a reduced tax rate of 10% on dividends and interest will be applicable for transactions between Japan and Taiwan. In the 2016 tax reform, reduced VAT rates for foods and newspaper subscription fees, and some technical amendments for invoice systems, have been adopted and will come into effect the fiscal year commencing on or after 1 April 2017, simultaneously with the VAT hike to 10%. However, Prime Minister Shinzo Abe recently announced that the VAT hike and reduced VAT rates will be postponed until October 2019.

ONLINE RESOURCES

National Tax Agency (*www.nta.go.ip/foreign_language/index.htm*)

Description. This is the official website of the National Tax Agency. However, it should be noted that the National Tax Agency takes no responsibility for any consequences, including damage, that arises out of or in connection with the use of any information available in this website.

Japanese Law Translation Database System (*www.japaneselawtranslation.go.jp/?re=02*)

Description. This website is managed by the Ministry of Justice and provides some unofficial English translations of certain Japanese laws and regulations. The translations published in this website need to be used solely as reference material.

Practical Law Contributor profiles

Tsuyoshi Ito

Nishimura & Asahi (Nagoya Office)
T +81 52 533 2591
F +81 52 581 0327
E t_ito@jurists.co.jp
W www.jurists.co.jp/en

Qualified. Japan, 2000; New York, US, 2008

Areas of practice. Tax; finance transactions.

Recent transactions

- Representing a Japanese corporation at the National Tax Tribunal concerning assessment of a withholding tax on a securitisation transaction and winning a final judgment ordering the cancellation of the tax assessment.
- Representing a Japanese bank in tax litigation concerning repurchase agreement transactions and winning a final judgment at the Supreme Court of Japan for a recovery of JPY6.3 billion.

Takatomo Terasaki

Nishimura & Asahi (Tokyo Office)
T +81 3 6250 6802
F +81 3 6250 7200
E t_terasaki@jurists.co.jp
W www.jurists.co.jp/en

Qualified. Japan, 2015.

Areas of practice. Tax; corporate.

Norihiro Ubukata

Nishimura & Asahi (Tokyo Office)
T +81 3 5562 8500
F +81 3 5561 9954
E n_ubukata@jurists.co.jp
W www.jurists.co.jp/en

Qualified. Japan, 2007.

Areas of practice. M&A; general corporate; tax.