

Japan Tax Bulletin

Financial support for a subsidiary in financial distress

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It is common that a parent company provides a financially distressed subsidiary with financial support in the form of debt forgiveness, sales price discounts or interest-free loans etc. Such financial support is usually treated as a “donation” for tax purposes and its deductibility for tax purposes is restricted. However, when there are rational reasons for a parent company to support its financially distressed subsidiary, the support is not treated as a donation and is fully tax deductible.

1. *Donations for tax purposes*

Article 37(7) of the Corporation Tax Law defines donations for tax purposes as follows:

“The amount of a donation as prescribed in the preceding paragraphs, irrespective of the donation having been made as a donation, contribution, gift, or under any other name, is to be the amount of monies in the case where a domestic corporation has made a gift or the gratuitous conveyance of monies or other assets or economic benefits (excluding expenses for advertising or providing samples or other equivalent expenses, and those deemed to be entertainment and social expenses, reception expenses, and welfare expenses; the same applies in the following paragraph), the value of the assets other than monies as of the time of the gift, or the value of the economic benefits as of the time of the conveyance.”

Donations for tax purposes are a gift or the gratuitous conveyance of monies or other assets or economic benefits and are much broader than the ordinary meaning of donations. The deduction of donations for tax purposes, except for those made to governments or public interest corporations/trusts, is limited to:

$$[(\text{Stated capital amount} + \text{capital reserve amount}) \times \text{the number of months in a fiscal year} / 12 \times 0.25\% + \text{taxable income} \times 2.5\%] \times 1/4.$$

The rationale behind the limit on the deduction of tax purpose donations is that tax purpose donations have the nature of both business expenses and the appropriation of profit, and as such, the amount up to the limit is deemed to be business expenses.

2. *Rational reasons for financial support to a financially distressed subsidiary*

The tax authority has released Corporation Tax Law Basic Circulars (“CTLBC”) on financial support to a financially distressed subsidiary which is not treated as a donation for tax purposes.

CTLBC 9-4-1

“Where a corporation has assumed obligations or borne other losses or waived claims (hereinafter referred to as “loss bearing” in 9-4-1) for its subsidiary in relation to the dissolution of its subsidiary, transfer of management control over the subsidiary etc., if there are rational reasons for bearing the loss including the case where it is clear from social conventions that a parent company would suffer a larger loss in the future unless it bears the loss, the amount of economic benefits provided through bearing the loss, shall not fall under the amount of the donation.”

A subsidiary includes a company a parent has not only capital ownership but also a business relationship through operating transactions, human resources, financial transactions etc.

CTLBC 9-4-2

In the event that a corporation lends money its subsidiaries at interest free or an interest rate lower than the ordinal interest rate, or waives monetary claims, if there are rational reasons for providing interest-free loans etc. including cases where they were made in accordance with a reasonable reorganization plan unavoidable to prevent bankruptcy of a subsidiary, the amount of economic benefits provided through such interest-free loans etc. shall not fall under the amount of donations.

According to CTLBC 9-4-1 and 9-4-2, a gift of assets or provision of economic benefits for free to a subsidiary under normal operations is treated as a donation for tax purposes. As there is no consideration paid for a gift of assets or provision of economic benefits for free, they are treated as donations for tax purposes. Where a gift of assets or a provision of economic benefits for free are made to a subsidiary in dissolution, transfer management control, bankruptcy etc., such transactions can protect the investment value from further decrease or avoid bearing further losses. It is generally understood that protecting investment value or avoiding bearing further losses, is a form of consideration for a gift of assets or provision of economic benefits for free, and so therefore under these circumstances the transactions are not treated as donations for tax purposes.