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Japan Tax Bulletin

Cross-border intercompany debt forgiveness

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A foreign parent company may lend money to a loss-making Japan subsidiary for many reasons, including for the purpose of improving its working capital position. If the loan is unlikely to be repaid, the foreign parent company may consider forgiving the debt. There are a couple of tax issues that should be considered before proceeding.

1. *Taxable gains*

The forgiveness of the debt would give rise to taxable income in the Japan subsidiary. Assuming the subsidiary is loss making, it would usually have tax losses available to offset against the taxable income recognized. However, there are a couple of restrictions for utilizing brought forward tax losses:

(1) 50% restriction
Tax losses can be carried forward for 10 years and offset against up to 50% of each year's taxable income for a blue tax return filer. A blue tax return filer is a taxpayer who has filed an election to be one and is required to maintain books and records to calculate taxable income correctly.

(2) SME rule
An SME (Small or Medium-Sized Enterprise) can offset carried forward tax losses against 100% of current year taxable income. An SME is a corporation whose stated capital is JPY100 million or less, unless 100% owned directly or indirectly by a corporation whose stated capital is JPY500 million or more.

(3) Pre-acquisition losses
If the foreign parent acquired a tax loss holding company, the tax losses incurred in business years prior to the year when the acquisition took place may be disallowed and cannot be carried forward if the underlying business of the Japan subsidiary changed significantly, directors and employees of the Japan subsidiary changed significantly, or other conditions are met.

2. *Withholding tax*

The intercompany debts may include accrued interest payable. Domestic withholding tax is due on interest paid to a foreign company. The term "payment" for the purposes of withholding tax is much broader than actual payments and includes the capitalization of the accrued loan interest into the principal or any other transactions or acts which extinguish the debt.

Where interest payable is calculated on a compound basis, the Japan subsidiary may already have a withholding obligation.

Upon the forgiveness of a debt, as the intercompany debts are extinguished withholding tax should be calculated on the accrued interest portion, if any, and paid to the tax office. However, where the Japan subsidiary is insolvent (having negative net equity balance) and it is expected that the Japan subsidiary cannot repay the intercompany debt, the withholding deduction is not be required.

3. *Debt for equity swap*

Instead of forgiving intercompany debts, the foreign parent may consider transferring the intercompany debts to the subsidiary' s capital account. Under Company law, it is possible for a company' s creditors to contribute monetary claims to the company in exchange for the company's stocks (a capital contribution-in-kind).

For tax purposes, a capital contribution in kind is classified as tax-free qualified or non-tax-free qualified. Where a 100% domestic parent company makes a contribution-in-kind to its subsidiary, the transaction is usually tax-free qualified, i.e. the shareholder and the subsidiary do not recognize gains or losses. However, if a foreign parent transfers overseas assets to its 100% Japan subsidiary as a capital contribution, the transaction is treated as non-tax-free qualified capital contribution-in-kind. The location of the contributed assets is determined with reference to the location of the business premises where the assets are attributable to. Therefore, monetary claims to the Japan subsidiary are treated as located overseas unless they are attributable to the foreign parent's PE in Japan.

Where a capital contribution of monetary claims to a 100% subsidiary is treated as non-tax-free qualified, the parent company and the subsidiary would recognize gains or losses for the difference between the fair value and the acquisition cost of the monetary claims.

The fair value of monetary claims is usually equal to or lower than their face value. Where a subsidiary is financially troubled and it is expected that the subsidiary cannot repay the debt in full, the fair value of the monetary claims would be lower than their face value.

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As long as the subsidiary is solvent (i.e. its net equity balance is positive), it is assumed that the subsidiary would be able repay the debt in full if it were to sell all of its assets. In this case, the fair value of the monetary claims is not lower than their face value.

On the other hand, if a subsidiary is insolvent, the subsidiary would be required to recognize taxable gains for the difference between the fair value and the acquisition cost of the monetary claims.

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