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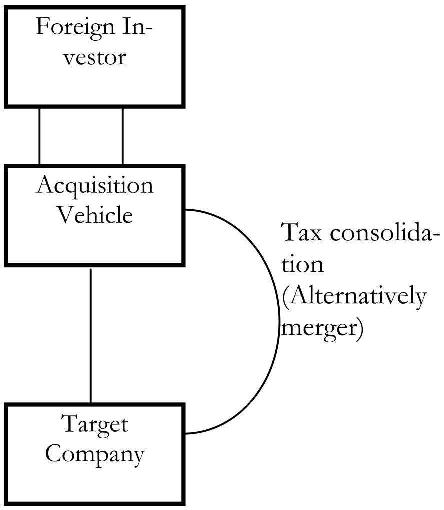
Debt Push Down more restricted by the Earnings stripping rule

In M&A transactions, a debt push down is a tax planning technique to reduce taxable income of the target company after acquisition.. The earning stripping rule implemented in 2012 restricts the availability of debt push down when acquiring a Japanese company.

1. *Debt Push Down*
   A typical debt push down can be depicted as follows:



- A foreign investor sets up an acquisition vehicle in Japan.
- The foreign investor provides the acquisition vehicle with acquisition funds by equity and loan. The loan equity ratio is less than 3:1 to avoid the thin capital rule[1].
- The acquisition vehicle acquires 100% interests in the target company.
- The acquisition vehicle and the target company elect to file a consolidated tax return.
- The interest expenses the acquisition vehicle pays to the foreign investor can be deducted from the profit of the target company on the consolidated tax return.

2. *Earnings stripping rule*
   The earnings stripping rule is applied from a business year beginning after March 31, 2013. Under the earnings stripping rule, net interest paid to related parties that exceeding 50% of the taxpayer's adjusted income are disallowed. Net interest paid to related parties means the amount of interest payments to related parties, which are not subject to the Japanese income taxes.

Related party

Ownership
Related parties are entities which own or are owned directly or indirectly 50% or more interests in the taxpayer or an individual who owns directly indirectly 50% or more interests in the taxpayer. Further, a third party funds provider under guarantee by related parties is treated as a related party.
Substantial control
Related parties include entities which substantially control or are controlled the taxpayer through operating transactions, finances, concurrent posting in directors etc.

Adjusted income
Adjusted income is calculated by
taxable income
+ tax loss deduction
+ exempt dividends
+ net interests paid- to related parties
+ deductible depreciation
+ deductible bad debt loss
- Disallowed donation.

Carry forward
Disallowed net interests paid to related parties are carried forward to succeeding 7 years and deducted from taxable income in business years when 50% of adjusted income is

[1] Interest expenses on a loan from foreign controlling shareholders are disallowed where both a general debt equity ratio and a related party debt equity ratio exceed 3:1. Disallowed interest expenses are interest expenses attributed to a portion of the loan exceeding 3:1.

larger than the net interests paid- to related parties in those years.

Consolidated return

Where a taxpayer files a consolidated tax return, net interests paid to related parties and adjusted income are calculated on consolidated basis. Where an acquired company in a consolidated group is profitable, interest expenses exceeding 50% of adjusted income will be disallowed. As such, the leverage effect will be reduced.

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