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Thin Capitalization Tax Rules Finally Applied in Court—Tokyo District/High Courts Deny Tax Deductibility of Interest Paid to a Non-resident Investor

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Introduction:

The thin capitalization tax rules (the "Thin Capital Rules" or the "Rules") were incorporated into our tax statute[1] in 1992. Then no cases appeared in courts for almost three decades. Recently, however, a new case appeared in the Tokyo District Court[2] and on appeal, the Tokyo High Court[3]. These cases reached similar conclusions on the issue of how a "foreign controlling party[4]" should be recognized that has the power to determine business directions of the borrower.

Legal framework:

The Thin Capital Rules were introduced to prevent abuse of tax deductions with respect to interest paid on a loan made by a non-resident investor that controls a Japanese business operator. The policy of these Rules is straightforward; in a situation where the controlling investor determines how to lend or provide capital to a domestic business operator, the investor can, in its discretion, determine the allocation of money between debt and capital, and if it lends, the borrower as someone controlled by the investor can deduct the interest payment (if it weren't for the Rules.) The Japanese tax authorities then would miss the opportunity to collect tax income from the borrower for the interest amount due to the deduction taken. Thus, the Rules disallow deductibility of interest payment in these circumstances.

The Rules apply only to loans made by a non-resident because if the loan is made by a domestic party, the tax authorities can recover the commensurate tax on the interest paid to the lender, where if it is a non-resident, the authorities miss the opportunity to collect the tax because the taxpayer is no longer within Japanese jurisdiction. In the core, the government deems these circumstances to be highly prone to manipulation due to the lack of the arms'-length relationship.

Facts of the Case:

1. The plaintiff corporation borrowed 16.4 billion yen from an individual investor during June 30 to July 4 of 2011, and filed tax returns for two years incorporating tax deductions taken for interest paid to the investor.

2. The investor/lender was a Japanese individual resident until June 4 of 2011 (he converted his residency to Singapore on July 5). The plaintiff secured a large percentage of its funds for its operation from the investor/lender. The tax authorities challenged the tax filings, arguing that

1.47 billion yen of interest payment must be disqualified as deductible expenses under the Rules.

3. The plaintiff sued the government alleging that (a) the investor/lender doesn't qualify as a "foreign controlling party" due to the advances made while he was a resident; and (b) the investor/lender doesn't control the borrower as a matter of fact based on the circumstances, and sought reversal of the tax finding.

Issues:

Does the investor/lender qualify as a "foreign controlling party" as set forth in the relevant tax statute[5] as a requirement for the application of the Rules?

a. When is the "foreign status" recognized; at the time of the advance or the time of interest payments?

b. Does this investor/lender have a "controlling power" over the plaintiff's business under the facts?

Decision:

The determination of a "foreign status" must be made over the entire duration of the loan and not at the timing of an advance. If we don't operate on this interpretation, the Rules would be easily circumvented by the lender making an advance and then relocating to a foreign country thereafter. Nor does the statutory provision require the non-resident status at the time of a relevant advance.

The "control" requirement will be examined by reviewing the following circumstances of the borrower as a whole: (a) dependency on the lender for transactions; (b) dependency on the lender for financing; (c) the lender's influence through appointment of the borrower's directors; and (d) other similar facts indicating the lender's ability to control the business direction of the borrower. Under the current facts, the plaintiff's lending accounted for 60%-75% from the lender, showing that he provided a dominant portion of the necessary capital as the Enforcement Order directs to examine. Although the lender at the time of advance no longer had shareholding relationship over the borrower, his influence in areas (a)-(d) continued to be pronounced. On these grounds, we conclude that the investor/lender constituted a "controlling party" as defined in the statute. Thus, the deductibility is denied.

Discussion:

These decisions clarify how the Rules are applied under the statutory requirements of the foreign lender and his controlling status. Considering the policy of the Thin Capital Rules, the courts' discussions are persuasive.

The timing of determining a foreign status is straightforward and was as expected.

The controlling status is more controversial in that it is a combination of various factors. If we pay attention to the guiding principle of the "lack of arms'-length relationship", however, the analysis is usually not so convoluted. In this case, the investor/lender was the dominant decision-maker over the borrower in almost all areas, other than the fact that he was no longer a shareholder. There were various factors ((a)-(d) discussed above) showing the lack of the arms'-length relationship.

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If you have any questions concerning these developing issues, please do not hesitate to contact the following Paul Hastings Tokyo lawyer:

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[1] Act on Special Tax Treatments (Law No. 26 of 1957, as amended), Article 66-5.

[2] Tokyo Dist. Ct. September 3, 2020, Hanji 2473-18.

[3] Tokyo High Ct. July 7, 2021, Hanji 2502-12.

[4] The statutory provision uses the term "foreign controlling shareholder, etc." Para 5, Subpara. 1 of the above article.

[5] The Act on Special Treatments of Taxation, Article 66-5, Para 5.