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Important points of DES to improve the financial condition of overseas subsidiaries

Takashi Kurematsu, Manager
Grant Thornton Taiyo Tax Corporation

Japanese corporations are developing their business abroad both in developed countries and emerging countries in these days of the borderless age. Not only major corporations, but also many small and medium-sized enterprises have set up their bases abroad. Whilst doing so, some Japanese corporations face difficulties as follows: their overseas business is not going as well as they had planned; they need to improve the financial status of their overseas subsidiaries; even worse, they are considering closing overseas operations or some have already withdrawn.

As a remedy to rescue overseas bases that have been caught in financial difficulties, there is a useful financial approach other than the waiver of debt and additional capital contributions. The debt-to-equity swap or commonly called "DES," converts loans that overseas subsidiaries borrowed from their parent companies to equity. However, there are some important issues from the viewpoint of taxation when you actually implement cross-border DES scheme, so please be advised to consider the possible taxation consequences in advance.

1. Corporate reorganization under the Japan taxation system

Under the Japan taxation system, in principle the value of a capital contribution in kind is based on its market value, but there is an exception. If it is a qualified capital contribution in kind that meets certain requirements, the value of the contribution is calculated based on its book value. When transferring a certain level of domestic assets or liabilities to a subsidiary overseas, such a transaction shall not be deemed as a qualified capital contribution in kind. Thus, cross-border DES in this form shall be deemed a non-qualified capital contribution in kind, and the value of the transferred assets is calculated based on their market value when a Japan parent company enters into a DES transaction with a subsidiary overseas.

In the event of any difference between the market value of the transferred assets and their book value, the difference shall be included in taxable profit, as a gain from the transfer of assets, when calculating corporate income tax (or shall be deducted from taxable profit as a loss from the transfer). In fact, losses from transferring assets arise when DES transactions take place, because parent companies in Japan often do so in order to turn around the financial status of their distressed overseas subsidiaries. Consequently, the market value of transferred assets becomes lower than their book value.

Though there is no specific regulation or law that stipulates the way to calculate the market value of assets that are subject to DES, the National Tax Agency (Japan) indicated its view on this issue in a written response dated February 22, 2010 to answer the inquiry below from the Ministry of Economy, Trade and Industry (METI). (Inquiry about taxation rules: how to appraise assets that are subject to DES when deciding whether to apply for the Enterprise Revival Tax System)

(1) Referring to a balance sheet that present a real picture of the business (= actual BS)
Carrying out asset valuations by capital/liability item in order to prepare an actual BS that presents a real picture of the business, first of all. Then, appraising assets that are subject to DES based on the actual BS. Calculating an amount of debt payable under a mutual agreement between the creditor and the debtor.

(2) Market value of the assets that are subject to DES
If the debt is larger than the amount of debt payable calculated in accordance with (1) above, such an excess amount cannot be converted into equity under the DES scheme. Thus, the market value of the assets that are subject to DES shall be appraised based on the amount of debt payable that is calculated in a rational manner.

The above mentioned response of National Tax Agency seems to indicate that it accepts the view described in “DES (Debt Equity Swap) Study Group Report,” a reference material provided by METI. The report explains the steps to be taken to appraise market value of assets as follows:
(i) Deciding revival claims that are calculated in a rational manner
(ii) Dividing the debt into assets retained and assets subject to DES based on (i)
(iii) Deciding the market value of the assets subject to DES

2. Concerns from the viewpoint of taxation on donations

As stated in 1., when a Japanese corporation enters into a DES transaction with its subsidiary overseas, a loss from transferring assets can arise because the DES transaction is deemed a non-qualified capital contribution in kind.

Bear in mind that the transaction in this case is deemed a donation to a foreign affiliated person, which

may result in excluding the loss in full from deductible expenses, unless there is a reasonable and probable cause, e.g. the DES transaction was taken in accordance with a rational corporate revival plan to prevent the distressed subsidiary overseas from going into bankruptcy. A decision on whether or not National Tax Agency accepts a revival plan as a rational one depends on the situation on a case by case basis. For instance, is the DES amount is sufficient enough to turn the distressed subsidiary around? Has the parent company continued monitoring the improvement of the financial status of the subsidiary since the execution of the DES scheme? This is how National Tax Agency comprehensively makes a decision

3. Concerns from the viewpoint of foreign exchange gains/losses

Foreign exchange rules in Japan stipulate the following principles: short-term receivables/payables in a foreign currency are translated into Japanese yen at the exchange rates at the end of the fiscal year. Long-term ones are translated at the exchange rates at the settlement date; therefore, foreign exchange gains/losses arise whenever receivables or payables are realized.

For example, suppose a Japanese corporation provided a long-term foreign currency loan to its overseas subsidiary when the foreign currency was weak. Then, the parent company entered into a DES transaction with the subsidiary that was mired in a poor performance. In this case, the market value of the long-term foreign currency loan has shrunk. If the DES transaction is executed under the condition that the foreign currency is strong, the value of the loan is converted into more Japanese yen. This means that the parent company acquires the subsidiary's share at a higher price in Japanese yen than the amount of the original loan. As described above if a loss arises from converting the loan to capital and the loss is deemed a donation, it would be non-deductible for tax purposes.

*Here is how it works:

Assume a parent company lent 10 US dollars to its subsidiary when USD 1 is equivalent to JPY 100. If the both parties enter into a DES transaction when 1 dollar is 120 yen (appreciation of foreign currency), the loan of 10 dollars is valued at 1,200 yen in equity of the subsidiary. In this case, if the market value of the debt is valued at 5 dollars, which is translated into 600 yen; the DES transaction results in a loss of 400 yen. On the other hand, when a foreign currency becomes weak against Japanese yen, for instance, 1 dollar is 80 yen, the same debt is translated into 400 yen (USD 5 * JPY 80 = JPY 400), which results in a loss of 600 yen. If there is any risk that a loss from transferring assets is deemed a donation, appreciation of the foreign currency against Japanese yen may result in mitigating the risk.

4. Concerns from the viewpoint of consumption tax

Transactions of a capital contribution in kind are equivalent to transactions of transferring assets in kind. Though they fall into non-taxable sales when calculating consumption tax, an amount equivalent to 5% of the transfer value shall be added to the non-taxable sales when calculating the taxable sales ratio.

As explained above, DES transactions are usually executed to improve financial conditions of distressed

subsidiaries overseas. Under these circumstances, the market value of a capital contribution in kind, which is deemed a non-taxable sale, is most likely to have become significantly worse. Thus, a possible monetary impact on consumption tax seems to be limited.

5. Possible concerns that may arise abroad

All the concerns and issues described above are related to parent companies in Japan. Below are taxation concerns about countries and regions (hereinafter referred to as "the Country"), where subsidiaries overseas get involved in DES transactions. Specifically, there are some concerns that have to be checked with local tax authorities as follows: 4

(i) Suppose that the Country found the DES transaction a transaction of transferring assets that took place in the Country. Is there any possibility if the Country holds the parent company in Japan liable for any tax?
(ii) What if the Country sees that the subsidiary overseas entered into a capital transaction? In that case does the Country impose income tax on the subsidiary for because of such a capital transaction?
(iii) Whether gains arising from extinguishment of the debt are included in corporate income or not?

Author: Takashi Kurematsu, Manager
Grant Thornton Taiyo Tax Corporation
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(Edited and issued by) The Bank of Tokyo-Mitsubishi UFJ, Ltd.
Global Business Division
(Contact persons) Hiroaki Kitamura
(E-mail) hiroaki_2_kitamura@mufg.jp

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