2021 Japan Tax Reform Proposals News Flash

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In brief

On 10 December 2020, the ruling parties in Japan published their 2021 Tax Reform Proposals ("2021 Tax Reform Proposals"). It is expected that most of the items contained in the 2021 Tax Reform Proposals will be passed into law in March 2021.

A summary of the major items contained in the 2021 Tax Reform Proposals is set out below. A more detailed analysis of the 2021 Tax Proposals will be provided in a subsequent Japan Tax Update.

In detail

Corporate Tax

1. Measures to increase the industrial competitiveness of companies

a) Tax incentive for investment in digital transformation

Consistent with the Suga administration's emphasis on digital transformation, from the effective date (date to be determined) of the revised Industrial Competitiveness Enhancement Act (ICEA) through 31 March 2023, companies that have a certified "Business Adaptation Plan" (tentative name) and that make an investment in digital transformation (i.e., in new, or the expansion of, software and machinery or equipment to be installed in connection with software) according to and necessary for the Plan, can choose either a special first-year depreciation deduction or a tax credit for such investment. Costs that qualify for the additional deduction or credit include the costs of acquiring machinery and equipment that is necessary to run the software.

b) R&D tax incentive

The following amendments are proposed to R&D tax credit.

(1) Where sales in the current year have decreased by 2% or more compared to the base year*, and where the amount of R&D expenditure has increased compared to the base year*, the maximum permitted R&D tax credit will be increased by 5% to 30% of corporate tax payable.
*The last fiscal year ended before February 1, 2020.

(2) The R&D tax credit "ratio curve" will be revised to give more incentive for corporations to increase R&D expenditure. After the amendment, the percentage by which R&D expenditure must increase from the prior year, to maintain the same percent of R&D expenditure eligible for credit, will be increased. Further, the lower end of the range of

percent of R&D expenditure eligible for credit will be reduced from 6% to 2% (the upper end of 14% will not change).

(3) The current special R&D tax credit for companies achieving a certain ratio of current year R&D expense to average sales over the past 3 years will be extended by 2 years.

(4) The definition of qualified R&D expenses is expanded to include the cost of acquisition of software used in-house to provide cloud services to customers.

(5) The scope of open innovation facilities that qualify for the R&D tax credit will be expanded.

All of the above provisions will be effective for fiscal years beginning on or after 1 April 2021.

c) Increased salary tax incentive

The increased salary tax incentive for large companies will be relaxed by abolishment of the requirement for investment in fixed assets.

At the same time however, the incentive will be tightened to focus on increases in salaries and training costs for new employees. While the current requirement that all employees' gross salary in the current year exceeds that of the previous year remains in effect, eligibility for the incentive will also require that the rate of increase from the previous year in the amount of salary paid to new employees be 2% or more.

The available tax credit will be 15% of the amount of salary paid to new employees, increased by 5% (to 20%) where there is an increase in education and training expenses of 20% or more compared to the previous year. (Under the current law, the additional credit requires an increase in education and training expenses of 20% or more over the average for the prior two years.)

All of the above provisions will be effective for fiscal years beginning on or after 1 April 2021.

d) Relaxation of the loss carry forward deduction limitation

Companies that are certified under the revised ICEA within one year from its effective date (date to be determined), adopt a Business Adaptation Plan, and make an investment in digital transformation or business restructuring during fiscal years beginning before 1 April 2026 (a "qualified investment"[1]), are entitled to a special loss carry forward deduction. That is, such companies will be able to carry forward and deduct, in the year of the qualified investment, up to 100% of any tax loss incurred as a result of the COVID-19 pandemic for a fiscal year that includes any part of the period 1 April 2020 to 1 April 2021, inclusive. This effectively allows taxpayers to carry forward such tax loss from two fiscal years[2]. However, the amount of the special loss carry forward that can be deducted in the year of the qualified investment will be limited by the amount of the qualified investment. Thus, such special loss carry forwards are not subject to the ordinary limit on the use of tax carry forward losses, which is 50% of taxable income. Special provision is made for taxpayers with a fiscal year ending between 1 February 2020 and 31 March 2020, inclusive, such that they may choose either their fiscal years ending in 2020 and 2021 or their fiscal years ending in 2021 and 2022 from which losses will be carried (the two fiscal years must be consecutive).

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[1] Investment to support business recovery by increasing productivity (with target ROA, ROI, etc.), business restructuring, or change of business model including investment in DX.

[2] By way of example, a taxpayer with a 31 December fiscal year end would be able to carry forward losses under this rule for fiscal years ending 31 December 2020 and 31 December 2021, both of which include periods falling between 1 April 2020 and 1 April 2021.

e) Carbon neutrality investment incentive

Upon certification under the revised ICEA, including adoption of a Business Adaptation Plan, special accelerated depreciation of 50% of acquisition cost or a tax credit of 5% of acquisition cost, which is increased to 10% if carbon emission is substantially decreased, will be available ("substantially decreased" yet to be defined under the ICEA). This incentive will be available for assets acquired from the effective date of the revised ICEA (date to be determined) through 31 March 2024.

f) Measures to promote domestic M&A activity

To stimulate investment and help revitalize the economy, especially in the post-COVID-19 era, certain provisions of the ICEA have been eliminated and incorporated into the Companies Act, although with greater flexibility than under the ICEA, in order to promote domestic M&A activity. These provisions relate to share-for-share acquisitions and will enter into effect on 1 March 2021. The newly introduced share-for-share exchange scheme (*kabushiki koufu*) is summarized as follows:

(1) Share-for-share exchanges of less than 100% but more that 50% of the capital of the acquired company will now be permitted (although increasing the equity percentage of an existing subsidiary will not be permitted). Both the acquiring and the acquired companies must be Japanese Limited Liability Corporations (*kabushiki kaisha*) (although the shareholders of the acquired company may be a foreign corporation or a non-resident).

(2) An inspector's investigation will no longer be required.

(3) A special resolution by the shareholders of the acquired company will no longer be required.

(4) The obligation of the acquiring corporation to compensate the acquired corporation's shareholders for a decline in the acquired corporation's share price between the date of the agreement and the actual date of the share swap will no longer be required.

In order to align with the revisions to the Companies Act, as described above, changes were also made to the tax law. Under the provisions of the ICEA due to expire on 31 March 2021, taxation of capital gains arising from disposition of shares in a share-for-share exchange can be deferred until the acquired shares are disposed of, where:

(a) The acquiring company has obtained advance approval from the Ministry of Economy, Trade and Industry (METI) for a special business restructuring plan for the acquisition, as prescribed in the ICEA;

(b) The acquisition was accomplished through a share-for-share exchange only, i.e., no cash (boot) was paid; and

(c) The share-for-share exchange was to acquire 50% of more of the target company or to increase the equity percentage in an existing subsidiary.

The 2021 Tax Reform will make the following additions to the tax law with respect to deferment of tax in share-for-share exchanges, without a time limit as previously existed under the ICEA:

(i) The tax deferment described above will no longer require approval from METI.

(ii) Up to 20% of the consideration for the disposed shares may be cash or cash equivalents.

(iii) Tax deferral will be permitted on the portion of the consideration that is in the form of shares (i.e., any gain attributable to boot will not qualify for tax deferral).

If a foreign company is a shareholder of the acquired corporation, the above deferral measures will be applicable to the extent that the shares of the acquiring corporation exchanged for the shares of the acquired corporation are held after the exchange by a permanent establishment of the foreign corporation in Japan.

The effective date of the above measures will be provided in the amended tax law.

g) Measures to promote international financial hubs

In order to promote Japan, and in particular Tokyo, as an international financial hub the restrictions on deductibility of performance-linked remuneration paid to directors will be relaxed for unlisted, non-family controlled companies whose main business is investment management. A number of requirements will still need to be met; however, the requirement to disclose the calculation method for such performance-linked remuneration in a listed company's securities report will be replaced with a requirement to disclose the calculation method on the homepage of the Financial Services Agency. This change will be effective for a fixed term of five fiscal years beginning with fiscal years beginning on or after 1 April 2021.

h) Tax incentives for large corporations

Large corporations are currently restricted in the amount of R&D tax credit or other tax incentives they may utilise, i.e., they must satisfy certain additional requirements, such as an increase in taxable income year on year. These restrictions will be extended for a further three years through to fiscal years beginning on or before 31 March 2024 and will also be extended to cover new tax incentives introduced, such as the carbon neutral investment incentive.

2. Tax proposals related to SMEs, regional revitalisation, etc.

a) R&D tax incentive

R&D tax incentives for SMEs will be revised in the following areas:

(1) Where sales in the current year have decreased by 2% or more compared to the base year, and the amount of R&D expenditure has increased compared to the base year, the maximum permitted R&D tax credit will be increased by 5%, to 30% of corporate tax payable.

(2) Where the R&D expenditure in the current year also exceeds 10% of average sales for the past three years, the maximum permitted R&D tax credit will be increased by a further 10%, to 40% of corporate tax payable.

(3) The current special regulations providing for an additional credit of up to 10% of corporate tax payable depending on the ratio of current year R&D expenditure to average sales for the past three years will be extended by two years.

All of the above provisions will be effective for fiscal years beginning on or after 1 April 2021.

b) The special reduced tax rate for SMEs will be extended for two years.

c) Investment tax incentive

The SME investment tax incentive and the SME productivity tax incentive will be extended by two years. The commercial, service industry, agriculture, forestry and fisheries revitalization tax incentive will be integrated into the SME investment tax incentive.

d) Regional investment tax incentive

The range of applicable industries eligible for the regional investment tax incentive will be broadened, but the target investment criteria will be tightened. The application period will be extended by 2 years.

e) Increased salary tax incentive

Under the increased salary tax incentive for SMEs, the current requirement is that (1) the amount of salary paid to employees exceeds the previous year, and (2) the amount of salary paid to existing employees increases by 1.5% or more from the previous year. The tax incentive will be extended for two years, however (1) and (2) will be combined into a single requirement that the amount of salary

paid to employees increases by 1.5% or more from the previous year. These changes will be effective for fiscal years beginning on or after 1 April 2021.

f) Investment incentive to promote M&A

Under the current open innovation investment incentive, SMEs that invest in Innovative Corporations, are entitled to a special income deduction. The government wants to stimulate SME M&A activity further, for consolidation of management resources, through SME acquisition of other SMEs. Accordingly, an SME acquiring another SME will be permitted to deduct up to 70% of the acquisition cost in the year of acquisition. This change will be effective from fiscal years beginning on or after 1 April 2021.

3. International taxation

a) Electronic filing of treaty benefit applications

Electronic filing of treaty benefit applications will be permitted, providing the taxpayer satisfies the necessary requirements, such as quality of scanned documents, etc. This change will be effective for applications filed on or after 1 April 2021.

b) Earnings stripping rules

For fiscal years ending on or after 31 March 2021, the calculation of interest expense under the earnings stripping rules will be relaxed, as follows.

(1) Interest expense arising on reserves for certain insurance contracts will be excluded from the interest expense calculation of the insurer.

(2) Distributions from bond investment trusts will be included in the net interest calculation (to offset against interest expense).

c) Interest deduction by PEs

Where capital on the accounting books of a permanent establishment (PE) in Japan is less than the capital attributed to the PE for Japanese tax purposes, interest expense attributable to such deficient capital is non-deductible in the calculation of the PE's attributable income. Under the 2021 tax reform, negative interest-bearing debt will be included in the total amount of debt for the calculation of non-deductible interest expense.

d) Double taxation adjustment of tax withheld in foreign countries

Effective for tax years beginning on or after 1 April 2021, the amount of foreign withholding tax that will be permissible as either a deduction or a credit will be revised. The amount eligible for deduction or credit will become identical; i.e., the portion of the foreign withholding tax that is imposed on income that is also subject to Japan corporate income tax (and therefore, to double taxation) under the controlled foreign corporation rules.

4. Improvements to tax administration

The following changes are proposed to tax administration processes, many of which arise out of the Suga administration's current focus on digitalization of government processes.

a) Abolition of requirement for wet seals

It will no longer be necessary to seal hard copy tax returns or other forms submitted to the tax authorities. This will align the process for hard copy submissions with the existing process for electronic submissions (which do not require sealing). This change will be effective for tax documents filed on or after 1 April 2021.

b) Rules relating to electronic maintenance of books and records

The current rules relating to maintenance of books and records digitally will be significantly relaxed to the benefit of taxpayers. Changes include:

(1) The pre-approval system will be abolished;

(2) The requirements and procedures necessary for scanning and maintaining data digitally will be significantly relaxed; and

(3) Additional measures will be put into place to prevent fraudulent activities by taxpayers by increasing the penalty tax.

These changes will be effective on or after 1 January 2022.

c) Tax agents

Given the increase in cross border transactions, the tax authorities will now have the power to appoint a tax agent for non-resident taxpayers, where the non-resident taxpayer has not already done so. This change will be effective for requests or appointments by the tax authorities made on or after 1 January 2022.

Local Tax

Property tax on land

Current regulations that allow local governments to reduce the taxable basis of land for property tax purposes will be continued through fiscal years beginning 1 April 2021 and ending 31 March 2024.

Individual Tax

1. Individual Income Tax

a) Income tax credit for housing loans

The income tax credit period of 13 years for housing loans for individuals who acquire a qualified residence will continue to be available; however, the required move-in date to the new residence has been extended to the end of 2022. To avail of this credit, the contract should be signed between 1 October 2020 and 30 September 2021 for individuals purchasing newly constructed properties and between 1 December 2020 and 30 November 2021 for individuals purchasing resale properties.

b) Carried interest received by individual fund managers

Carried interest received by individual fund managers through partnership funds will be taxed as capital gain on the sale of shares at the rate of approximately 20%, rather than as income taxation (where progressive rates of up to 55% are applicable), as far as the carried interest distribution ratio is reasonably determined.

c) Retirement income

In order to ensure fair taxation of retirement income, the 50% exclusion on the portion of retirement income exceeding 3 million yen (net of the retirement income deduction) will not apply to employees whose length of service is five years or less.

2. Inheritance and Gift Tax

To promote the employment of highly-skilled foreign workers in Japan, inheritances and gifts received by non-resident foreigners or foreigners residing in Japan for a short period on a Table 1 visa (includes work related visas) from other foreigners residing in Japan on a Table 1 visa, where the assets are located outside of Japan will not be subject to Japanese inheritance or gift tax regardless of the period of the deceased/donor's' residence in Japan.

Let’s talk

For a deeper discussion of how this issue might affect your business, please contact:

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