2021 Japan Tax Reform: incentives to promote corporate transformation and encourage growth

Issue 179, June 25, 2021

In brief

In order to promote corporate transformation and encourage growth in the post COVID-19 environment, the Japanese government is revising the Industrial Competitiveness Enhancement Act (ICEA). In connection with this, the 2021 Tax Reform introduces certain special tax measures designed to promote the new objectives and focus areas of the ICEA.

This newsletter explains the structure of the revised ICEA, as well as outlines the tax measures that are provided for each of the three areas of focus of the ICEA. The revised bill of the ICEA was approved in the Diet on 9 June 2021, although the effective date is not yet determined.

Details of all the overall 2021 Tax Reform Proposals can be found here in print:
https://www.pwc.com/jp/en/taxnews/pdf/jtu-20201214-en-169.pdf
and here in webcast:
https://www.pwc.com/jp/en/seminars/2021-japan-tax-reform.html

In detail

Overview of ICEA

The purpose of the ICEA is to promote the industrial competitiveness of corporate Japan in the medium to long term, in response to significant social and economic upheavals over the past few years, but most particularly in the wake of COVID-19. The ICEA aims to achieve this objective by promoting adaptation of existing businesses to the new post-COVID-19 business environment, by promoting development of new markets, or by promoting growth in existing markets. One of the ways of achieving these goals is through tax incentives and other forms of financial support.

In order to be eligible for the tax incentives (or other financial support) under the ICEA, a taxpayer must prepare a Business Adaptation Plan (BAP) in compliance with the provisions of the ICEA and based on a resolution of the taxpayer's Board of Directors. The BAP should describe the goals of the business, outline the plan, explain the plan's implementation timeline, and describe the management policy in relation to the plan. Once prepared, the taxpayer applies to have the BAP certified under the ICEA by the Ministry of Economy, Trade and Industry (METI). Certification will be granted if the BAP appears appropriate in light of the ICEA guidelines, if it can be implemented smoothly and reliably, and if the improvement in productivity or increase in demand as a result of the business adaptation under the BAP is expected to be sustainable in light of the market circumstances. Once certified, the BAP will be made publicly available, and the certified business can then take advantage of the incentives that relate to its particular BAP.

The ICEA has three different areas of focus. Details of these three areas, the relevant BAP for each, and the associated tax incentives are outlined below. All of these BAP are independent of each other, and taxpayers wishing to take advantage of more than one category of tax incentive must file a separate BAP application for each category. The tax incentives are available to blue form tax filers only.

1. Information Technology BAP - to promote increased digitalisation

The Information Technology BAP is focused on promoting investment in information technology, i.e., digital transformation (DX). Unlike the other two categories of BAP described below, however, the Information Technology BAP has a precondition: the applicant must be DX-certified under the Act on Facilitation of Information Processing by METI's Information-technology Promotion Agency (IPA). Accordingly, taxpayers wanting to take advantage of incentives under an Information Technology BAP that are not already DX-certified will need to allow extra time to accommodate this additional requirement. The DX certification system ensures that businesses investing in DX and wishing to take advantage of the tax incentives are following guidelines prepared by METI, to promote good corporate management and strategy in relation to DX.

The three steps from DX-certification, BAP application and eligibility for tax incentives are as follows.

(1) Obtain DX certification

The taxpayer applies for and receives a DX certification from the IPA.

(2) BAP filed with the regional bureau of METI

The taxpayer must prepare the BAP, and attach documents that demonstrate that the BAP is a company-wide plan (not for individual departments), such as minutes of the Board of Directors approving the BAP, and that the BAP will achieve both aspects of DX - i.e., “digital” and “transformation”:

- Digital (data linkage / sharing, legacy avoidance, cyber security):
    - Linking of data of other corporations or data newly acquired digitally with existing internal data
    - Utilization of cloud technology

- Transformation (business model transformation, improvement in output):
    - Reduction in manufacturing costs by 8.8% or more
    - Increase in return on assets by 1.5% or more over the taxpayer's average return on assets over the 2014-2018 period
    - Sales growth rate equal to or greater than industry sales growth rate for the past five years plus 5%

(3) Taxpayer makes investments eligible for tax incentives

Investments eligible for the tax incentive include the following:

- Software
- Deferred assets (i.e., initial costs incurred for migrating to the cloud)
- Machinery and equipment (limited to those used in conjunction with software and/or deferred assets)

The tax incentives available to taxpayers with a certified Information Technology BAP are either additional special depreciation of 30% in the year of investment, or a tax credit of 3% of the investment amount in the year of investment. The available tax credit increases to 5% where the software or deferred asset costs were incurred in order to link data of corporations outside the taxpayer's corporate group. The following restrictions apply, however:

- The maximum total capital investment eligible for the tax incentives is JPY30 billion
- The minimum investment eligible for the tax incentives must be 0.1% or more of sales for the year
- The maximum tax credit is 20% of the taxpayer's tax liability for the current period (with no carry over), including any tax credit available under the carbon neutrality investment incentive described below

Incentives for taxpayers with a certified Information Technology BAP will be available for investments made from the effective date of the revised ICEA until 31 March 2023.

2. Energy Utilisation and Environment Protection BAP - to promote energy reform

In order to help achieve its carbon neutrality goals, the Japanese government, in the 2021 Tax Reform, introduced a carbon neutrality investment incentive. This incentive is available to taxpayers making investments in equipment to be used in Japan to reduce energy consumption, to reduce reliance on fossil fuels, or to achieve any other reductions in environmental impact associated with energy use. Taxpayers making such investments must apply for a certified Energy Utilisation and Environment Protection BAP under the ICEA in order to be eligible for the tax incentive.

The carbon neutrality investment incentive provides for special depreciation of 50% in the year of investment, or a tax credit of 5% of the investment amount in the year of investment. The available tax credit increases to 10% for manufacturing machinery, equipment or structures with a higher decarbonization effect for manufacturing processes. The maximum eligible investment is JPY50 billion. If the taxpayer elects the tax credit, the maximum amount of credit is 20% of the taxpayer's tax liability, including any credits available under the DX investment incentive described above.

The carbon neutrality investment incentive will be available for investments made from the effective date of the revised ICEA until 31 March 2024.

3. Growth and Investment BAP - to promote business restructuring to respond to social and economic changes via special tax loss deduction

The Growth and Investment BAP is focused on taxpayers whose business performance has been significantly impacted by unforeseen changes in social and economic conditions, in order for the taxpayer to continue to grow and develop its business despite such changes. For this category of BAP, investments must be in areas such as DX investment, carbon neutrality investment as well as investments for business restructuring or reorganization, and the investments must be in capital assets rather than simply in the maintenance or renewal of existing assets. Where DX investment and/or carbon neutrality investments are included in the Growth and Investment BAP, a certified Information Technology BAP and/or a certified Energy Utilisation and Environment Protection BAP, respectively, are also required.

Once a taxpayer has obtained a certified Growth and Investment BAP under the ICEA, the special tax measures for this category of investment provide more flexible rules for loss carry forwards. That is, the certified taxpayer may offset up to 100% of current year income with carry forward losses, rather than the usual 50%, for a maximum of 5 years (limited to the amount of investment). Given that the 50% loss carry forward deduction limitation does not apply to SME taxpayers under the existing Corporate Tax Law, this incentive will be most attractive to large enterprises.

This special loss carry forward incentive will be effective for BAP certified during the period from the effective date of the revised ICEA until one year from that date. As this is the shortest applicable period of all three categories of incentives, taxpayers wishing to take advantage of these special loss carry forward rules will need to act quickly once the ICEA is revised.

The takeaway

Through revision of the ICEA and the tax law, the Japanese government has provided tax incentives to promote corporate transformation and encourage growth in the post COVID-19 environment. Of course, taxpayers already planning on investing in any of the three focus areas of the ICEA would be wise to understand and take advantage of these tax incentives. However, other taxpayers may also benefit from understanding the incentives, to determine whether, and to what extent, they impact the cost/benefit analysis of making any future investments. They may, as the Japanese government hopes, make such investments more economically attractive.

Let's talk

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

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