

Japan tax alert

Ernst & Young Tax Co.

R&D tax credits under the COVID-19 pandemic: Promises and pitfalls

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The profound impact of the coronavirus disease 2019 (COVID-19) pandemic extends beyond the Japanese economy and is affecting the global economy itself. Concerns are rising that this impact may impede the research and development (R&D) activities that impacts the future of corporations. Since large investments are required to develop new products, technologies and services, securing research funding becomes an issue in the face of declining revenue. In times like these, an effective way of minimizing the corresponding financial burden is to make the most of the R&D tax credits.

In this article, we introduce the tax credit for special open innovation R&D expenses (hereinafter, the “open innovation incentive”), an R&D tax credit whose use is increasing in recent years. Even corporations that are only making use of the tax credit for general R&D expenses (hereinafter, the “general R&D incentive”) and not using any of the other available R&D tax credits are highly likely to have the option to utilize the open innovation incentive. It is advisable for corporations to proactively utilize the open innovation incentive to ensure that their R&D activities do not stagnate after the post-COVID-19 era.

Overview of the open innovation incentive

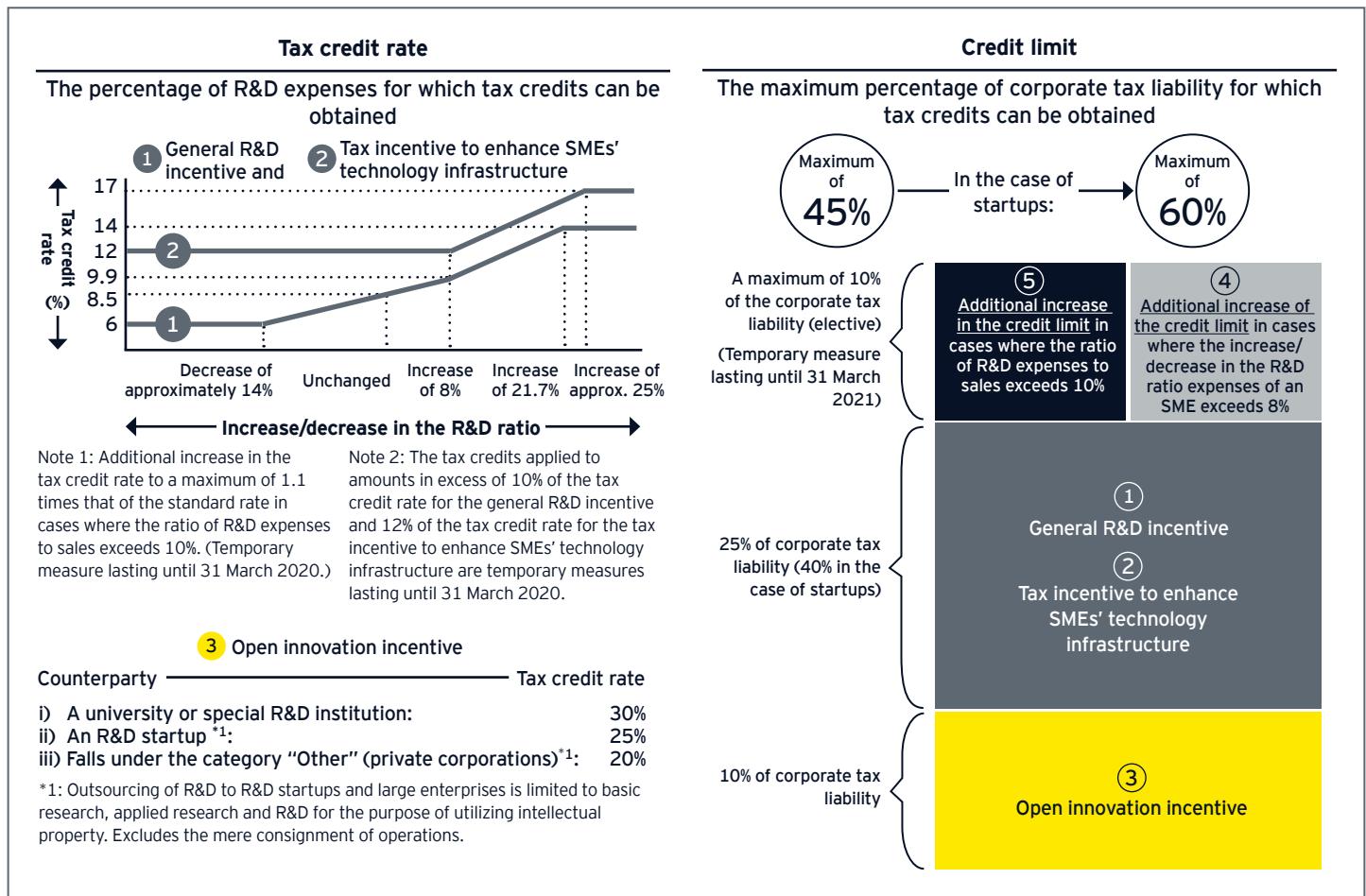
1. Role of the open innovation incentive in the R&D tax system

The R&D tax system includes the general R&D incentive, the tax incentive to enhance small and medium-sized enterprises' (SMEs) technology infrastructure and the open innovation incentive. The tax credit rates and credit limits of each of the incentives are shown in Figure 1 below. The tax credit rate of the open innovation incentive is quite high (two to five times larger than that of the general R&D incentive), and its credit limit is calculated separately from those of the general R&D incentive and the tax incentive to enhance SMEs' technology infrastructure.

2. Reasons for corporations to carefully examine the open innovation incentive

Given the state of the Japanese economy in 2020, corporate revenue and taxable income are forecast to decline due to the effects of COVID-19. In relation to this phenomenon, the number of corporations whose corporate income tax liability will decrease is expected to increase. Corporations that find themselves in these circumstances will have credit limits lower than the amount depicted in Figure 1 and will receive less tax credits for their R&D investments. However if a corporation in question is conducting joint research with or outsourcing R&D to a university or another corporation, and its R&D expenses are entirely eligible for the general R&D incentive, the corporation can still increase their total tax credit by applying the open innovation incentive.

Figure 1



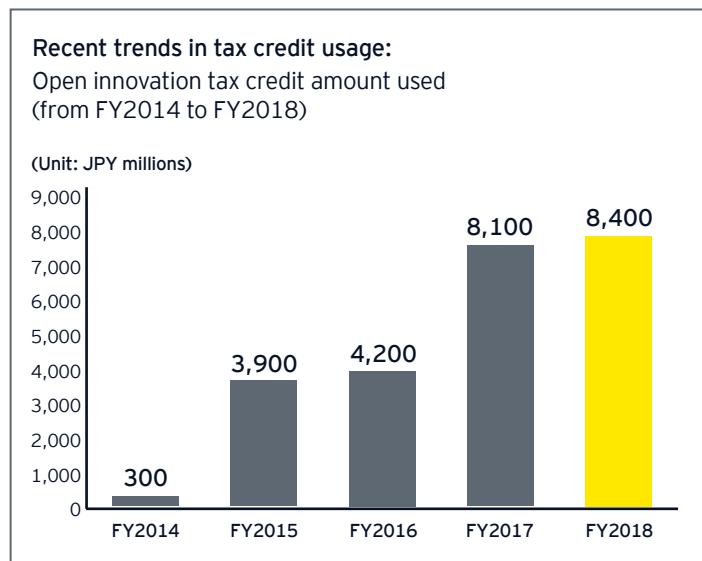
Prepared based on materials from the Ministry of Economy, Trade and Industry titled "Overview of the R&D tax system" dated April 2019.

As described in 1. above, the open innovation incentive has a high tax credit rate and a credit limit that is established separately from that of the general R&D incentive. Applying both incentives will result in an increase in the credit amount compared to the sole application of the general R&D incentive.

3. Recent trends in the amount of open innovation tax credits used

Recognition of the open innovation incentive among corporations and universities increased after the FY2015 tax reforms, whereby the open innovation incentive was established as a separate framework from the general R&D incentive, and as a result, the amount of tax credits used is increasing as indicated in Figure 2. Since the FY2019 tax reforms revised the credit limit from 5% to 10%, expectations are rising that the amount of tax credits used will further increase in the future.

Figure 2



Administrative precautions concerning the open innovation incentive

1. Precautions to take upon their application

When applying the open innovation incentive, there are three major precautions to take when carrying out administrative procedures as described below:

Preparation

Certain statements stipulated by tax law must be included into any joint research agreements or contract R&D agreements. The "Guidelines for the special R&D expense tax credit incentive"¹ published by the Ministry of Economy, Trade and Industry should serve as a reference.

If the requirements for such statements are fulfilled through a revision of a joint research agreement or contract R&D agreement, certain R&D expenditures incurred prior to the revision date may be included in the expenses eligible for the open innovation incentive, including those that were incurred during the fiscal year in which the revision occurs.

When drafting tax returns

A corporation is required to prepare a chart aggregating the amount of R&D expenditures incurred during a given fiscal year for conducting joint research or outsourcing research for each qualified expense account (hereinafter, the "breakdown of individual expense accounts"). Furthermore, with regard to the breakdown of individual expense accounts, the corporation must tally the amount of R&D expenses to be included in deductible expenses for the calculation of its taxable income in that given fiscal year. Particular attention must be given to the aggregation of labor costs and indirect costs.

In addition, expenses incurred for conducting joint research or outsourcing research, that were borne by the corporate tax filer pursuant to the relevant agreement must be audited by a professional in the area, such as a certified tax accountant.

¹ https://www.meti.go.jp/policy/tech_promotion/31fyguidline_r1.pdf

When filing tax returns

A report proving that the expenses were audited by a professional must be attached to the tax return alongside any written confirmations issued by the relevant universities.

2. Audits by professionals

In order to receive permission to apply the open innovation incentive, joint research agreements or contract R&D agreements must be prepared, and the expenses that are subject to aggregation in the preparation of the breakdown of individual expense accounts must be sorted out and organized. Please prepare the above well before the tax return deadline to have sufficient time to correctly include them into the tax return preparation process

EY provides services to prepare and make the necessary arrangements for the application of the open innovation incentive (advice concerning agreements and the breakdown of individual expense accounts, confirmation of corporate policies for treating R&D expenses as deductible expenses, provision of explanations to R&D Departments or universities, etc.) and for the preparation of audit reports concerning the open innovation incentive.

Please contact us with any questions or requests regarding this service.

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Japan Tax SCORE 20201008

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