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Japan tax newsletter

Ernst & Young Tax Co.

The Impact of the 2022 Japan Tax Reforms for Inbound Businesses

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Contents

- Corporate taxation 2
- International taxation 7
- Tax administration 8

On 10 December 2021, the ruling parties (a coalition comprised of the Liberal Democratic Party and Komeito) released an outline of the 2022 tax reforms. This years' tax law changes are relatively 'modest' and should not require companies to make significant structural changes. This newsletter focuses on the areas of the 2022 tax reform most relevant to Japan's inbound businesses and investors. Therefore it does not comprehensively cover all aspects of this year's tax law changes. For a more comprehensive overview of the 2022 tax reform, please see the newsletter titled "2022 Japan tax reform outline" issued by EY on 27 December 2021.

The Kishida Cabinet, which was formed in October, strives for a version of capitalism where there is "a virtuous cycle of growth and distribution" … "developing a new post-COVID-19 society." The Cabinet sees it as vital that companies achieve sustainable growth by increasing investments in R&D and personnel as well as returning profits to a diverse range of stakeholders. As such, through the 2022 Japan tax reform, tax reduction measures have been further enhanced for companies that proactively increase employee wages and those undertaking open innovation, encouraging businesses to transform and increase the value they add.

Out of consideration for the challenges business operators face introducing electronic data retention, a grace period of 2 years will be granted, deferring the mandatory introduction deadline from 1 January 2022 to 1 January 2024. In addition, measures will be implemented in preparation for the upcoming consumption tax invoice system, which is scheduled to be enforced from October 2023.

In October 2021, under the OECD/G20 Inclusive Framework on Base Erosion and Profit Shifting (BEPS), an international agreement was reached concerning new international taxation rules. Within the outline of the 2022 tax reforms, it is declared that Japan will also establish tax rules in accordance with the international agreement. The government states that it will deliberate on revising domestic law to fulfill this objective while keeping in mind its effects on existing rules to avoid placing excessive burdens on Japanese companies.

Please note that the contents of this newsletter may be partially revised, deleted or supplemented in response to future Diet deliberations on the reform bill.

EY

Building a better working world

Corporate taxation

1. Enhancement of the tax incentives to encourage wage increases

Wage increases are at the center of Prime Minister Kishida's economic policy and the starting point of his "virtuous cycle of growth and [re]distribution [of companies' profits]." The basic concept to reward taxpayers that increase their employees' salaries is not new. In fact, it had already been introduced some years ago as part of 'Abenomics.' Still, the 2022 tax reform provides further incentives to encourage pay rises as well as higher spending on employees' learning and development.

(1) Increased employee compensation credit

The tax incentive shall be increased as detailed in the two tables below. There is a difference in the available amount of credit between large enterprises[1] and small and medium sized enterprises (SMEs), with large enterprises being able to enjoy a tax credit of up to 30 percent, whereas for SMEs, it is up to 40 percent. This is a noticeable increase from the current rules where the maximum credit rates are only 20 and 25 percent, respectively.

The tax credit amount is a percentage of the total year-on-year increase in the sum of wages, potentially including bonuses, paid to all employees except directors and certain other exceptions. For large enterprises, the current tax credit, which is limited to wages paid to newly employed persons, shall be expanded to wages paid to now cover continuously employed personnel. Continuously employed means that the employee has worked for the company in Japan for the relevant fiscal year as well as the entire previous fiscal year. For SMEs, the rule does not differentiate between newly hired or continuously employed employees.

To obtain such a tax credit within their annual corporate income tax return, both large companies and SMEs must raise wages and, ideally, spend more on employee trainings than the previous fiscal year. Higher training spending alone will not result in receiving an additional credit.

The requirements for large enterprises are stricter compared to those for SMEs. Large companies need to increase the total amount of salary payments by at least 3 percent compared to the previous fiscal year. In contrast, SMEs must only increase wages by 1.5 percent to receive a credit. By making only the minimum level of wage increase, a company would receive a corporate income tax credit equal to 15 percent of the total year-on-year increase in the total of wages paid.

In addition, large companies must submit a report to the Ministry of Economy, Trade and Industry (METI) that they have published their policies on returning profits to employees and establishing 'good relationships' with their business partners on the company's website (Multistakeholder Benefit Declaration).

To benefit from the maximum credit rates of 30/40 percent of the total year-on-year increase in the total of wages paid, large companies must increase salary payments by 4 percent, plus spend 20 percent more on employees' education and training. For SMEs, salaries must be increased by 2.5 percent and education costs by 10 percent compared to the previous fiscal year.

Finally, the available tax credit will be capped at 20 percent of the corporate income tax amount for a given fiscal year.

[1] For purposes of this tax credit, generally, a large enterprise company is a corporation with a stated capital amount exceeding JPY100m. Under certain circumstances, also corporations with a stated capital of JPY100m or less could be regarded as large enterprise, for example if they have more than 1000 regular employees.

Changes relevant to large businesses

		Current rule:	Reform proposal:
Application requirements			
Minimum year-on-year increase in the amount of total wages paid		2% (only newly hired employees).	3% (continuously hired employees).
Multistakeholder Benefit Declaration		–	Required(*1)
Maximum tax credit rate		**20%** **(Total credit amount capped at 20% of corporate income tax liability for the current fiscal year).**	**30%** **(Total credit amount capped at 20% of corporate income tax liability for the current fiscal year).**
Tax credit rate	Standard (in case of minimum increase)	15%	15%
	Addition (wage increase)	–	+10% (4% or more year-on-year increase in the amount of total wages paid).
	Additional (education and training expenses)(*2)	+5% (20% or more year-on-year increase of education and training expenses).	+5%(*3) (20% or more year-on-year increase of education and training expenses).

Source: Created using material from the Liberal Democratic Party Research Commission on the Tax System.

*1: Required for companies with a stated capital of JPY1 billion or more and full-time employees of 1,000 or more; such companies must submit a notification to the METI stating that is has posted details of its policy on its company website. The reform proposal does not clarify the requirements of such Multistakeholder Benefit Declaration or of the policy, particularly how to realize a 'good relationship' with business partners.

*2: Currently, a detailed statement of education and training expenses must be attached with the final tax return. The reform proposal states that the attachment of such statement will become obsolete, but retention will be required.

*3: Resulting in a total maximum tax credit rate of 20% if the company does not meet the additional wage increase of 4% or more.

Changes relevant to SMEs

		Current rule:	Reform proposal:
Application requirements			
Minimum year-on-year increase in the amount of total wages paid		1.5%	1.5%
Maximum tax credit rate		**25%** **(Total credit amount capped at 20% of corporate income tax liability for the current fiscal year)**	**40%** **(Total credit amount capped at 20% of corporate income tax liability for the current fiscal year)**
Tax credit rate	Standard (in case of minimum increase)	15%	15%
	Additional (wage increase)(*1)	+10% (2.5% or more year-on-year increase in the amount of total wages paid).	+15% (2.5% or more year-on-year increase in the amount of total wages paid).
	Additional (education and training expenses) (*1) and (*2)	+10% (10% or more year-on-year increase of education and training expenses (*2)), or Certification of management capability enhancements conducted in accordance with a management capability enhancement plan under the SMEs Business Enhancement Act.	+10%(*3) (10% or more year-on-year increase of education and training expenses). The certification requirement under the SMEs Business Enhancement Act will be abolished.

Source: Created using material from the Liberal Democratic Party Research Commission on the Tax System.

*1: Under the current rules, it is necessary to meet both the wage and education and training expenses requirements in order to qualify for the maximum tax credit.

*2: In addition to the required increase of education and training expenses, a detailed statement concerning the education and training expenses must be attached to the final tax return under the current rules; the reform proposal states that such a statement must be retained.

*3: Resulting in a total maximum tax credit rate of 25% if the company does not meet the additional wage increase of 2.5% or more.

These increases to the employee compensation credit are a temporary measure applicable for any fiscal year beginning between 1 April 2022 and 31 March 2024. However, whilst only a temporary measure, this year's tax reform provides the highest tax credit rates ever for a tax incentive tied to wage increases.

Given the interconnectivity of multiple business functions with this credit, this is an area where the accounting and tax departments need to partner closely with Human Resources (HR) given the impact of compensation, rewards, and education and training of employees for these incentives. Furthermore, when preparing the tax returns, it will be necessary to interface with HR as they have detailed information required for applying for the credit in the tax returns.

Finally, large companies should monitor how the requirements towards the Multistakeholder Benefit Declaration will be specified by the Government, METI and/or the tax authorities going forward.

(2) Stricter conditions for R&D and other tax incentives for large companies

Under the 2022 tax reform, key changes to the accessibility of R&D tax credits as well as other tax incentives such as those to promote investments into 5G infrastructure, digital transformation and carbon neutrality are to be introduced. The key aim of these measures is to target large companies that exhibit a notable unwillingness to increase both wages and investments despite growing profits.

The current rules do not contain any conditions regarding the minimum percentage of wage increase to access the tax incentives. However, under the tax reform proposal, for fiscal years beginning from 1 April 2022 to 31 March 2023, large companies are required to increase the total amount of salary payments from the previous fiscal year by 0.5%. Furthermore, the minimum required percentage increase will increase to 1% for fiscal years beginning on or after 1 April 2023. Large companies which fulfill the salary increase requirements outlined above should generally meet these minimum requirements.

For these purposes, a large company means a Japanese corporation with a stated capital of at least JPY1 billion and 1,000 or more regular employees. In addition, such large company must have been profitable in the previous fiscal year.

In addition to the newly introduced wage increase condition, another unchanged condition of Japan's tax incentive rules for large companies is that it must make domestic capital investments exceeding 30% of its depreciation expenses incurred in the same fiscal year. An exemption from this investment requirement is available for companies whose income in the current fiscal year is less than the previous fiscal year.

As mentioned above, this is an area where accounting and tax departments need to work closely with HR and the business sections to monitor the impact, particularly on R&D as well as investment related to digital transformation and carbon neutrality.

(3) Additional enterprise tax incentives for large enterprises that increase salary payment

For any fiscal years beginning between 1 April 2024 and 31 March 2026, companies with a stated capital of more than JPY 100 million are defined as large enterprises. They are subject to business scale taxation instead of income-based enterprise tax. When computing the company's tax liability, business scale, or factor-based enterprise, taxation comprises an income levy, a capital levy, and a value-add levy. The latter levy comprises various factors, including net rent/lease expenses and the total of the company's annual salary payments.

If a large enterprise increases the wages paid to all continuously employed persons by 3% or more, then said company will be permitted to deduct this increase in year-on-year total wages from the tax base of the value-add levy.

While similar to incentives that had been introduced for large enterprises through prior tax reforms, this measure complements the enhanced employee compensation credit outlined above, creating further benefits for larger companies that increase wages.

2. Extension and enhancement of the tax incentives to promote open innovation

For a number of years, Japanese tax law has been providing R&D tax credits to taxpayers for certain activities. To further expand the scope of such incentives, the Japanese Government introduced new tax incentives to encourage collaboration between special companies involved in innovation and taxpayers. These open, innovation-related incentives with a two-year limit were introduced in 2020. They are due to expire on 31 March 2022.

Where certain conditions are met, a taxpayer can deduct up to 25% of the investment in specific shares (as defined by tax law) of companies involved in innovation from their taxable income. The amount which should be invested is at least JPY100 million for domestic companies and JPY500 million for foreign companies.

As of October 2021, there were 118 certified investments made (i.e., those certified by the Ministry of Economy, Trade and Industry under the Act of Strengthening Industrial Competitiveness) under the open innovation regime, with the total amount invested being JPY34.9 billion.

Given the popularity of the open innovation incentive, the Japanese Government has extended it for two years to now include investments made between 1 April 2022 and 31 March 2024. The benefit (i.e., a deduction of 25% of the investment made from taxable income) will remain the same. Additionally, the main conditions for the open innovation-related tax incentives remain the same; however, the 2022 tax reform relaxes some of the conditions which must be met (including a reduction in the required holding period for such specified shares from 5 years to 3 years).

Companies with plans to engage with third parties for innovation have an extended opportunity to consider open innovation-related tax incentives until 31 March 2024.

3. Revision to the calculation method for deemed dividends

When a company conducts a capital reduction, it can use both its accounting retained earnings and capital surplus to distribute to its shareholders (mixed source dividends). However, these mixed-source dividends' tax treatment differs from the accounting treatment. For tax purposes, the company is required to divide the total distribution into a capital repayment portion and a deemed dividend portion based on a specific formula under Japanese tax law. For tax purposes, the company's shareholder realizes a taxable capital gain/loss (the difference between the capital repayment portion received and the tax book value in the company's shares) and a deemed dividend, regardless of the accounting treatment.

Before the 2022 tax reform, the tax calculation of the capital repayment portion and deemed dividend portion were a stand-alone exercise and did not consider the amount by which the retained earnings and capital surplus were reduced for accounting purposes. As a result, there were cases where the capital repayment portion for tax purposes exceeded the reduction in capital surplus.

The 2022 tax reform (based on a Supreme Court case dated 11 March 2021) changes these rules. In cases of mixed source dividends, the amount of capital repayment for tax purposes cannot exceed the amount of the reduction in capital surplus. This new rule will impact the calculation of capital repayment for tax purposes which will in turn impact the calculation of capital gains/losses and the amount of deemed dividends to be recognized by shareholders in cases of mixed source dividends.

4. Amendments to withholding tax requirements related to domestic dividends received from subsidiaries

Currently, dividends paid by a Japanese domestic company to its Japanese shareholder(s) are subject to Japanese withholding tax at a rate of 20.42%. This also applies to dividends between companies in a consolidated tax group, and in its replacement, the group relief system.

Note that the domestic dividend withholding tax rule does not apply to dividends received by a Japanese company from a foreign subsidiary, i.e., does not apply to cross-border situations, because such dividends are subject to foreign withholding tax and not to Japanese withholding tax.

Depending on the relevant percentage shareholding of the recipient company, the domestic dividend is wholly or partially exempt from Japanese corporate income tax. The withholding tax can be netted against the dividend recipient's total corporate income tax liability, or if the withholding tax exceeds the corporate income tax inability, then this excess is refundable.

As the withholding tax is netted against the corporate income tax liability due 2 months after the company's fiscal year-end, or refunded, this delay in having the cash available could result in the Japanese shareholding company having to reduce the dividend it pays to its shareholders, postpone that dividend payment, or obtain additional finance to cover the waiting period.

The tax rules will be revised to ensure withholding tax is not levied on dividends received from certain domestic companies. The withholding tax will not be withheld at source in relation to those dividends. The relevant domestic companies are:

a. Dividends related to the shares of wholly-owned subsidiaries (i.e., 100% shareholding ratio)

b. Dividends related to the shares of another domestic company whose shares are directly owned by a domestic company, as of the record date related to the payment of dividends, provided that the ratio of outstanding shares against the total shares of that other domestic company exceeds one-third.

Therefore, this change should improve the cashflow in a group of companies, mitigating the possible problems mentioned above. Furthermore, this should reduce the administrative burden for taxpayers (as well as the tax authority).

Though the tax reform proposals are not clear, the abolition of the dividend withholding requirement could help companies in real estate investment structure. For example, often Japan real property is held through a Japan property company, a TMK (tokutei mokuteki kaisha, basically a special purpose company). The TMK is subject to Japanese corporate income taxes. However, if a TMK satisfies certain requirements, the dividends distributed to its equity holders are deducted from the taxable income, significantly reducing the amount of income subject to CIT. However, the dividends paid by a TMK are currently subject to 20.42% withholding tax. As a TMK is unlikely to have significant reserve cash balances, the removal of the withholding tax requirement at the TMK level would be much appreciated by real estate investors. It would allow them to pay up 100% of the dividend without reducing the amount by approximately 20% WHT, with no time delays, allowing more cash to quickly be available at the higher tiers for funding/onward distribution.

The above revision is expected to apply to dividend payments received on or after 1 October 2023.

International taxation

Revision to the earnings stripping rules

Loans from overseas related parties are often an important source of financing for Japanese entities, and interest on these loans is generally tax-deductible subject to several potential restrictions.

One possible limitation on interest deductibility is the earnings stripping rule. Under this rule, net interest payments (to a related or unrelated party) in excess of 20% of adjusted taxable income are non-deductible unless the interest is paid to a Japanese taxpayer. The 20% threshold applies for fiscal years that started on or after 1 April 2020, a reduction from the previous limit of 50% – which was a reduction, or increase in limitation, for the amount of interest potentially deductible. While this Proposal would see the scope of the rule expanded for foreign corporations in certain situations.

As a reminder, a foreign corporation can have a Japanese permanent establishment ("PE"), i.e., a corporate taxable presence arising due to its employees' activities in Japan or an agency relationship it has in Japan. A PE often takes the legal form of a Japanese branch.

The table below shows that currently, income attributable to a Japanese PE is subject to the earnings stripping rule. Under the proposals, income attributable to a PE and Japan source income subject to Japanese corporate income tax (other than PE attributable income) is subject to the rule. Similarly, where a foreign corporation has no PE in Japan but does have Japan source income that is subject to corporate income tax, this will now be subject to the rule.

	Current rules	Proposal
Foreign corporations with permanent establishment ("PE") in Japan	Income attributable to PE	Income attributable to PE, and Japan sourced income subject to CIT (other than PE attributable income)
Foreign corporations without Japanese PE	N/A	Japan sourced income subject to CIT

One significant example of Japan-source income subject to corporate income tax, which is not PE attributable income, is rental income from Japanese real estate leased by a foreign company.

Net interest that is non-deductible in a period can be carried forward for seven years and can be offset in a subsequent period subject to the 20% test.

When making a loan to a Japanese subsidiary, an overseas parent company (or affiliate) should also consider the following factors:

- Thin capitalization rule - while the earnings stripping rule is a P&L-focused test, the thin capitalization rule is balance sheet-focused. Under this rule, where a debt-to-equity ratio of 3:1 is exceeded, interest on the "excess" portion of the loan is permanently non-deductible. A corporate taxpayer must apply both tests to its interest expense on foreign-related debt. If both tests are relevant, the test that gives rise to greater disallowance will apply.
- Transfer pricing - the interest rate and terms of the loan should be consistent with the arm's length principle, with any "excess" interest potentially being non-deductible.
- It should also be noted that interest rates in Japan on Yen denominated loans are typically low.

Given the various potential restrictions, we recommend that taxpayers model the impact of these on any proposed loans and consider the tax efficiency of the arrangements.

Tax administration

1. Revisions to the consumption tax invoice system

(1) Revision of the procedures required to register as a qualified invoice issuer

A consumption taxpayer must register itself as a qualified invoice issuer. The registration itself is possible for all taxpayers. The tax authorities can only reject the application for registration if the taxpayer has had serious JCT non-compliance case in the past.

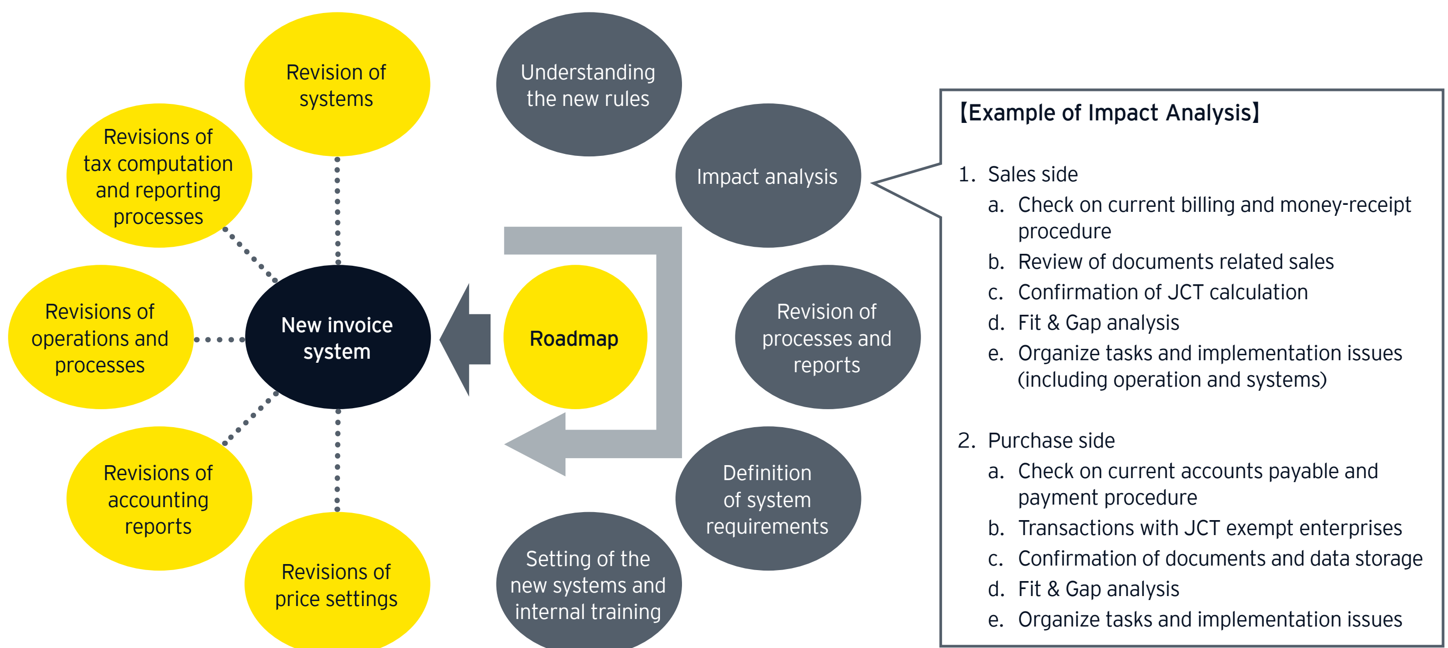
The registration process started on 1 October 2021. The qualified invoice system will begin from 1 October 2023. If the enterprise would like to become a qualified invoice issuer from 1 October 2023, it must register itself by 31 March 2023. The tax authorities will issue the registration number (14 digits, i.e., T+13 digits current corporate number) to the registered consumption taxpayers.

Please find below a summary of the impact of the qualified invoice system:

- There is an obligation for issuance of invoices (penalties for issuing false invoices)
- Only registered consumption taxpayers can issue the tax invoices
- Input tax credit on the basis of invoices or transaction amounts
- No input tax credits available from consumption tax-exempt enterprises (in principle). For six years, certain input credits will be available for taxable purchases from tax-exempt enterprises

Under the proposed revision, for the purpose of enabling tax-exempt businesses to become qualified invoice issuers under a flexible schedule designed to provide enough time to consider the necessity of registering, such businesses will be permitted to register during a taxable period that contains any date between 1 October 2023 and 30 September 2029.

Though the qualified invoice system will begin from 1 October 2023, the changes required will potentially require significant internal discussion/actions across various company functions, e.g., finance, sales, IT systems, and many others. The diagram below illustrates some of the issues that our specialists assisted companies with.



2. Electronic data retention for electronic transaction data – Safe harbor rules

Japanese tax law defines electronic transaction data as data where only electronic data exists, and a paper document is not created. For example, if a company receives an invoice in a pdf, the pdf invoice would be treated as electronic transaction data since a paper invoice does not exist. In Japan, paper retention is the default retention method. Most companies have historically printed electronic transaction data and stored the data in paper format (e.g., printing paper invoices) for tax and accounting purposes. Companies could only use electronic retention (e-retention) for electronic transaction data if they met certain technical and procedural conditions (i.e., the use of e-retention for electronic transaction data was not mandatory).

The 2021 tax reform changed the rules and required taxpayers to meet all necessary technical and procedural conditions to start e-retention from 1 January 2022, i.e., keeping all electronic transaction data in an electronic format. If the taxpayer continued to print out electronic transaction data and keep the paper document, they would be non-compliant from 1 January 2022 under the new rules, potentially facing serious penalties for not keeping proper tax and accounting records.

Japanese taxpayers found it difficult to meet the requirements by the 1 January 2022 deadline. To ease these problems, the Japanese Government will introduce transitional measures allowing taxpayers to continue to use paper retention for electronic transaction data until 31 December 2023. However, it is necessary that the tax office in charge of the taxpayer acknowledges that the taxpayer could not start e-retention for electronic transaction data due to a reason deemed unavoidable (e.g., selecting an appropriate system for e-retention taking longer than anticipated). Therefore, it is important to stress that the transitional measure has not granted taxpayers an additional automatic two-year extension to introduce e-retention for electronic transaction data. Taxpayers should continue to make their best efforts to commence with e-retention of electronic transaction data as soon as it is possible from a technical and procedural perspective. If the Japanese subsidiary of a foreign company uses a global IT system, it could become a challenge to adjust the IT system only for the benefit of the Japanese subsidiary to enable it to meet the e-retention related specific technical requirements for Japanese tax purposes. Foreign companies should be aware of this issue since they would have to find an alternative solution or approach in such cases within the two-year time limit.

For inquiries in relation to tax matters for Japan inbound investments, please contact any of the following members of our Inbound Tax Advisory Services Team:

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