Baker McKenzie.

Client Alert

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Japan Corporate and Tax Quarterly Update: December Issue

Introduction

On December 14, 2023, Japan announced its 2024 tax reform proposal, which contains a number of changes that may impact multinational companies doing business in Japan. This update provides a brief overview of the relevant items likely to have the largest impact on such companies.

Outline of the 2024 Japan Tax Reform Proposal

On December 14, 2023, the Japanese ruling party announced its 2024 tax reform proposal (the "Proposal"), which was approved by the Cabinet on December 22, 2023. The Proposal is expected to be enacted after approval by the Diet, which is normally scheduled around the end of March.

The items outlined below are those likely to have the largest impact on multinational corporations doing business in Japan. Please note, however, that the Proposal is merely an outline and has not yet been enacted. As such, the details of the Proposal will be disclosed when legislation is enacted.

I. Japanese Consumption Tax ("JCT")

Digital platform taxation

Cross-border digital transactions between Japanese customers and overseas sellers conducted via digital platforms have become increasingly common, and such transactions can be challenging for the Japanese tax authorities to ensure that JCT is properly collected and paid.

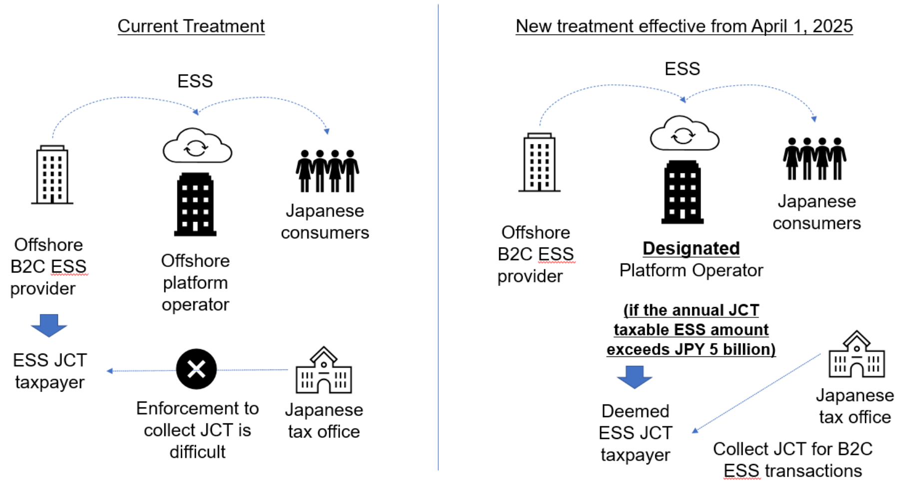
Under the current JCT rules, the JCT treatment of digital transactions (i.e., electronically supplied services or "**ESS**") conducted via digital platforms depends on whether the customer is a business or individual (i.e., whether it is a B2B or B2C transaction). For B2C transactions, the offshore B2C ESS provider is responsible for collecting JCT on services provided to customers in Japan as a rule. In the case of B2B transactions, Japanese service recipients (i.e., customers) are responsible for handling JCT matters by means of a so-called "reverse charge" mechanism. However, even an offshore B2C ESS provider may not be required to remit JCT collected to the Japanese tax authorities depending on the service provider's JCT taxpayer status (e.g., applicability of the small/medium-sized enterprise exemption). As a result, the Japanese tax authorities have had difficulty identifying offshore B2C ESS providers who are JCT taxpayers, and in some cases have been unable to collect JCT on B2C ESS of foreign businesses conducted through digital platforms. Collection is especially difficult if the platform operator is an "intermediary" between the ESS provider and Japanese customers as opposed to a purchaser of digital content.

To deal with these issues, the Proposal introduces a platform taxation regime similar to that adopted by EU countries under which platform operators become "deemed ESS providers" when they facilitate certain cross-border B2C transactions by third party ESS providers. Such platform operators would therefore be liable to collect (and possibly report/remit depending on whether certain conditions are met) JCT due from customers.

The new rules would only apply to platform operators that meet certain conditions in order to be considered "**Designated Platform Operators**" (i.e., platform operators with JCT taxable transactions comprising of B2C ESS (limited to services provided by offshore suppliers) and with JCT taxable B2C ESS transaction amounts exceeding JPY 5 billion during the taxable year). Designated Platform Operators are required to notify Japan's National Tax Agency ("**NTA**") that they meet the conditions to be treated as Designated Platform Operators by the deadline for submitting their final JCT return for the taxable period and must notify offshore B2C ESS providers conducting sales through their platforms accordingly. On the other hand, transactions by B2B ESS providers through the relevant platform are not subject to platform taxation.

The new digital platform taxation rules are expected to go into effect starting April 1, 2025 after a one-year grace period to allow Designated Platform Operators time to prepare for compliance with the new rules.

See the illustration below for a summary of the proposed rule changes:



Considering other recent actions by the Japanese tax authorities, it appears that the number of tax audits for offshore B2C ESS transactions have increased despite the practical difficulties mentioned above, and some such audits have been reported in the media. Thus, even if the proposed tax legislation is enacted, audit scrutiny is likely to continue for B2C ESS transactions, which are outside the scope of the digital platform taxation rules. In this regard, a potential issue is that the scope of B2B transactions for JCT purposes is generally narrower than that under the value added tax ("**VAT**") regimes of many other countries (e.g., the scope of B2B transactions under EU VAT rules). It is therefore possible that a transaction considered to be B2B for VAT purposes in another jurisdiction would be categorized as a B2C transaction for JCT purposes. It is therefore recommended that taxpayers consult with their Japanese tax advisors on this point.

II. Corporate tax

The Proposal includes several revisions related to corporate tax matters, including, among other things, changes to the factor-based enterprise tax (under the Local Tax Act) and the tax qualified contribution in-kind rules (under the national Corporate Tax Act), as well as introduction of an innovation box regime (also under the national Corporate Tax Act). Of the items contained in the Proposal, the following are likely to have the largest impact on multinational corporations doing business in Japan.

A. Factor-based enterprise tax

Under the current enterprise tax rules, companies with a stated capital exceeding JPY 100 million (as of the fiscal year end) are subject to factor-based enterprise taxation, which is levied based on both income and non-income-based factors (such as the amount of salaries, office rents and interest paid, as well as a capital levy).[1] However, in recent years the number of companies subject to factor-based taxation has decreased significantly, in part due to companies undertaking capital reductions (i.e., converting stated capital to capital surplus (*musho genshi*)[2] to reduce their stated capital amounts below the JPY 100 million threshold (with such reduction impacting factor-based enterprise tax for a fiscal year if implemented before the fiscal year end). In addition, the scope of factor-based taxation has been substantially reduced by companies setting the stated capital of a subsidiary at JPY 100 million or less during reorganizations.

In an effort to rectify these issues, the Proposal modifies the factor-based enterprise tax rules as follows:

- The stated capital threshold of more than JPY 100 million remains in place, but if a company was a factor-based enterprise taxpayer in the previous fiscal year and the company's stated capital plus capital reserves exceed JPY 1 billion, the company would still be subject to factor-based taxation in the current fiscal year, even if the company's stated capital decreased to JPY 100 million or less before the current fiscal year end.[3]

The above amendments are expected to apply for fiscal years beginning on or after April 1, 2025 after a one year grace period.[4]

- For wholly-owned subsidiaries[5] of a parent company whose total stated capital and capital reserves exceeds JPY 5 billion, if the subsidiary has a stated capital of JPY 100 million or less but a total amount of stated capital and capital reserves that exceeds JPY 200 million[6] as of the fiscal year end, the subsidiary would be subject to factor-based taxation. Certain measures to mitigate the rapid impact of this change are also expected to be promulgated.

The above amendments are expected to apply for fiscal years beginning on or after April 1, 2026 after a two year grace period.[7]

Note that the above amendments target not only foreign multinationals, but also domestic companies. Thus, the effective date is set as "fiscal years beginning on or after April 1, 2025 (for the first revision) or 2026 (for the second revision)," as the fiscal years of large domestic companies typically begin on April 1 (unlike those of many foreign companies that use a calendar fiscal year). As a result, for calendar-year taxpayers, the new legislation would actually operate from the fiscal year commencing on or after January 1, 2026 (for the first revision) or 2027 (for the second revision). That is, a two- or three-year period grace period is expected to apply, respectively.

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[1] Companies with stated capital of JPY 100 million or less are subject to regular enterprise tax, which is levied based solely on income.

[2] Which may be followed by (i) repaying the (converted) capital surplus to shareholders (*yusho genshi*), or (ii) compensating for the deficit created by the (converted) capital surplus (*kesson tenpo*).

[3] While the revision is expected to apply from April 1, 2025, a capital decrease conducted on or before the date the Diet approves the Proposal (which, as mentioned above, is normally scheduled for around the end of March) may be captured by the proposed revision.

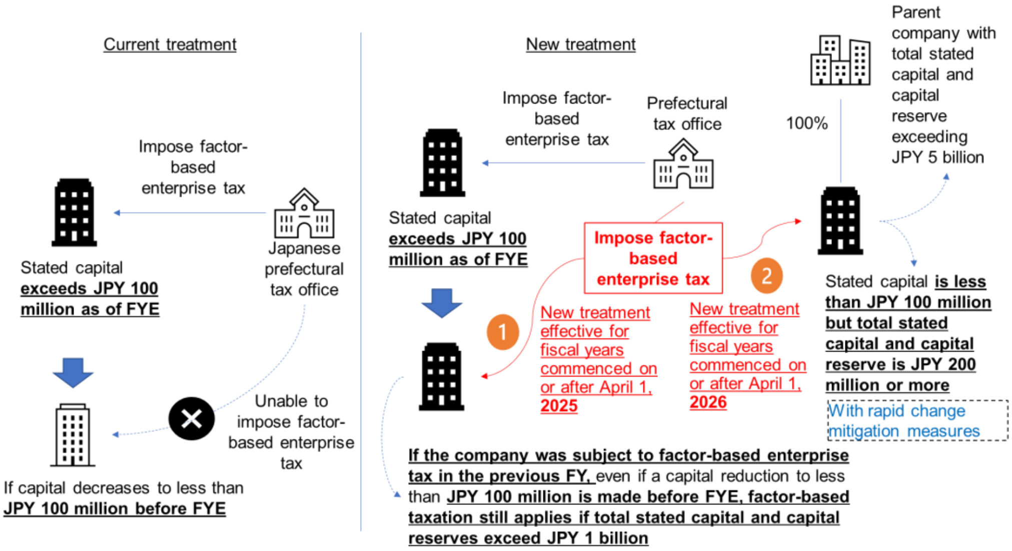
[4] If new legislation contains drastic changes to a current tax treatment, a grace period is often provided.

[5] This refers to a parent-subsidiary with a 100% controlling relationship as defined in the Corporate Tax Act and subsidiaries whose shares are wholly owned by multiple persons within a 100% group.

[6] Note that if the subsidiary pays a dividend to its 100% parent from capital reserves, the dividend equivalent amount will be added to the total stated capital and capital reserve amount for purposes of determining whether the JPY 200 million threshold is met.

[7] See footnote 5 above.

See the illustration below for a summary of the proposed rule changes:



B. Tax qualified contributions in-kind

The current tax qualified (i.e., tax deferral) rules with respect to contributions in-kind provide that contributions in-kind of "offshore" assets, both tangible and intangible, by a foreign branch of a Japanese company to a foreign company can be considered tax qualified contributions in-kind. However, a similar contribution in-kind of "domestic" assets by a Japanese company to a foreign company is not eligible for tax qualified treatment, with the exception of contributions in-kind to a foreign company where 25% or more of the shares in the foreign company are owned by the Japanese company.

The "situs rule" which determines where such contributed assets are located is accounting-based (i.e., the entity or branch which records the assets on its balance sheet).

To avoid the arbitrary expatriation of valuable assets owned by Japanese companies, the Proposal would modify these rules as follows:

- Contributions in-kind of "tangible" assets by a foreign branch to a foreign company are eligible for tax qualified treatment only if the assets relate to the business conducted by the branch (i.e., where they are business assets of the branch or permanent establishment ("**PE**") in the foreign country).

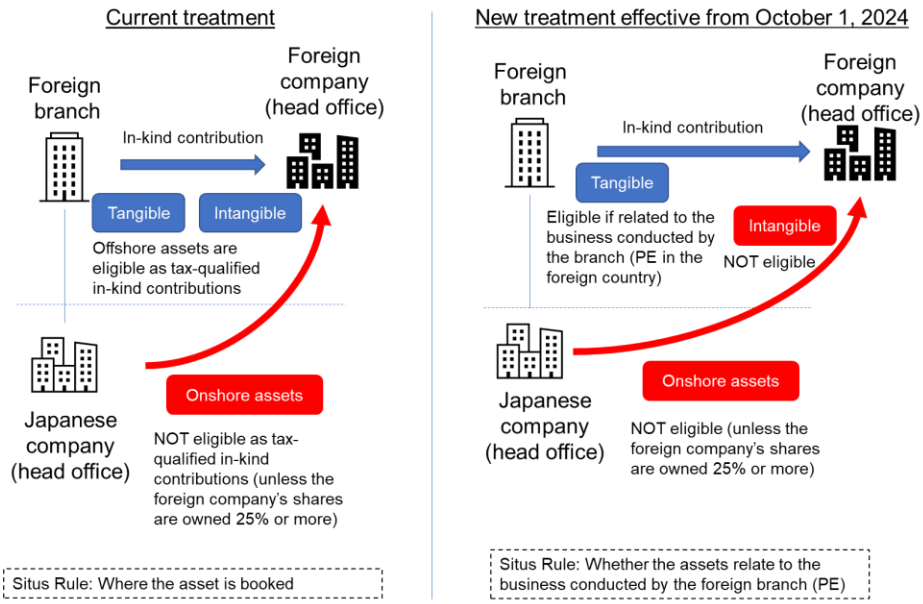
- Contributions in-kind by a foreign branch to a foreign company of "intangible" assets[8] would no longer be eligible for tax qualified treatment.

- Application of the "situs rule" for determining whether the assets are "offshore assets" would depend on whether the assets relate to the business conducted by the foreign branch (PE).

The above amendments are expected to apply to contributions in-kind made on or after October 1, 2024. As the proposed legislation relates to contribution in-kind transactions, a comparatively shorter grace period is provided.

[8] Intangible assets for this purpose are valuable industrial property rights and copyrights for which consideration would normally be paid if transferred/licensed.

See the illustration below for a summary of the proposed rule changes:



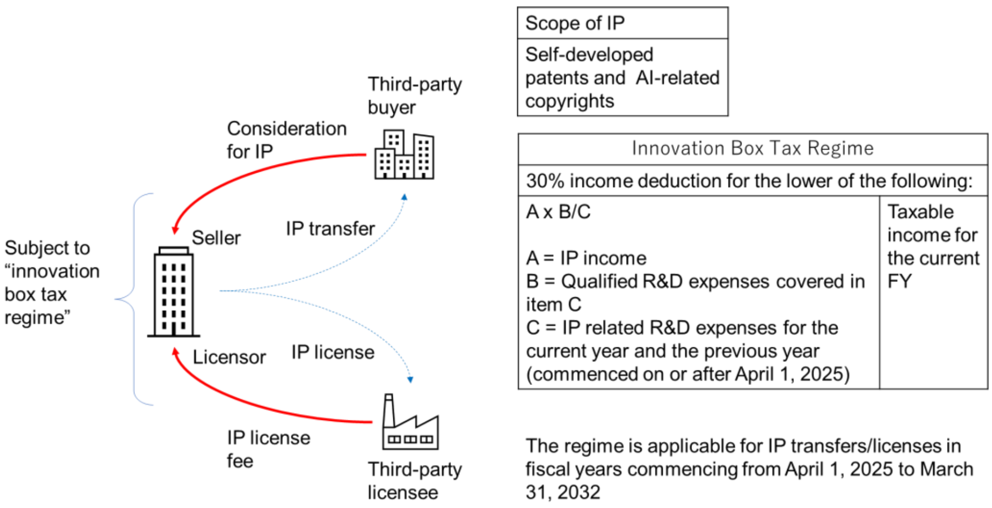
C. <u>Innovation box regime</u>

In an effort to combat increasing international competition and strengthen domestic research, development and innovation, the Proposal introduces an innovation box regime that grants certain tax incentives for income generated by intellectual property originating from domestic research and development activities. In particular, for self-developed patents and copyrights related to domestically-developed AI where the rights are assigned to a domestic person or company (excluding a related party) or licensed to a third party, up to 30% of certain IP-related income can be treated as a deductible expense for the period from April 1, 2025 to March 31, 2032. Thus, the effective corporate tax rate on qualifying income would be reduced to approximately 7%.

Eligible income is expected to include the smaller of (1) income generated from an eligible patent or copyright multiplied by a certain ratio (see the illustration below) or (2) taxable income for the current year.

Note that to avoid potential abuse, certain restrictions are expected to be placed on the ability of companies utilizing the innovation box regime to also utilize research and development credits.

See the illustration below for a summary of the proposed rule changes:



D. Tax incentives for areas of strategic growth

The Proposal introduces tax incentives to encourage production and sales in certain fields designated by the government as strategically important. In particular, the incentives are aimed at increasing the domestic production of digital, environmental and economic security-related products such as electric vehicle batteries, green steel, green chemicals, sustainable air fuel and semiconductors.

To qualify for the incentives, companies must have a business plan approved under the Industrial Competitiveness Enhancement ("**ICE**") Act prior to March 31, 2027 and purchase certain production assets in accordance with the plan. In addition, companies must meet certain wage increase or capital investment requirements.

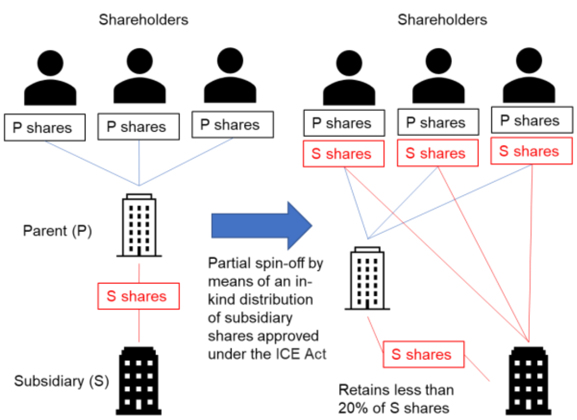
Eligible companies would generally be entitled to a tax credit of up to 40% (20% for semiconductor activity) of their corporate tax liability for the year, calculated based on the smaller of (1) the quantity of goods produced/sold within 10 years of the business plan certification date under the ICE Act or (2) the acquisition cost of the production assets. Unused credits can be carried forward for up to four years (three years for semiconductor activity).

E. Extension of applicable period for tax-free spin-offs

The tax-free spin-off regime introduced as part of the 2023 tax legislation is expected to be extended for an additional four years.

Under this regime, "partial" spin-offs in which an existing 100% parent company retains a portion of a subsidiary's shares can be treated as tax-qualified (i.e., tax deferred) if certain requirements are met and the in-kind distribution for the spin-off is approved under the ICE Act.

See the illustration below for a summary of the proposed rule changes:



- In the case of a "partial" spin-off under which the existing 100% parent company retains a portion of the subsidiary shares, such spin-off would generally be out of scope of the tax qualified reorganization rules under Japanese corporate tax law.
- However, if certain requirements under the Japanese Special Measures Tax Law are satisfied (and the in-kind distribution for the partial spin-off is approved under the ICE Act), tax qualified treatment is available (i.e., tax deferral at the shareholder level is allowed).
- These rules were originally a one-year temporary measure applicable only for the period of April 1, 2023 to March 31, 2024.

This special measure will be extended for four more years, with some deregulating requirements

III. International tax

A. Changes to Pillar Two legislation

Japan's 2023 tax legislation contained a number of items related to the OECD's Pillar Two rules, including enacting the income inclusion rule ("**IIR**") under domestic law.[9] However, since the 2023 tax legislation was passed in April 2023, the OECD has published additional administrative guidance regarding how the Pillar Two rules should operate. In this context, the Proposal revises Japan's IIR as follows to be consistent with recent OECD administrative guidance and international discussions:

[9] For more detail regarding the Pillar 2 changes enacted as part of the 2023 tax legislation, please refer to our December 2022 Japan Corporate and Tax Quarterly Update newsletter.

- An exemption is expected to be provided for constituent entities that are subject to a qualified domestic minimum top-up tax ("**QDMTT**") in their country of residence if the country meets certain requirements, whereby the jurisdictional top-up tax (i.e., the basis for calculating the international minimum tax amount under the IIR) in the country would be treated as zero (i.e., the so-called QDMTT safe harbor).

- If a stateless constituent entity is subject to a QDMTT, the amount of the tax would be deducted from the calculation of the jurisdictional top-up tax.

- Specified multinational corporate group ("**Specified Group**") companies can elect to include gain or loss on the mark-to-market valuation of certain ownership interests (which would otherwise be excluded) in calculating the group income amount.

- An election is available to add the amount of applicable tax credits (which meet certain requirements) related to ownership interests in certain conduit companies to the adjusted covered tax amount (i.e., the total amount of adjusted covered taxes of all constituent entities in the same country of residence for the applicable fiscal year) for each country related to the Specified Group.

- Reporting obligations for Specified Groups are to be revised depending on the classification of the Japanese companies subject to such obligation.

- Certain top-up taxes in other jurisdictions are to be excluded from the foreign tax credit, but a QDMTT arising in a foreign jurisdiction would be eligible for the foreign tax credit.

Note that although the introduction of an IIR in other countries has been delayed, the IIR is certain to be implemented in Japan. As such, companies would be well advised to promptly consider how best to adapt to the revised rules.

As described above, the 2023 tax legislation domestically implemented the IIR in Japan with an effective date of April 1, 2024. Until recently, it was widely expected that the 2024 tax legislation would introduce the QDMTT and the undertaxed profits rule (UTPR) into Japanese domestic law. However, these rules are not included the Proposal, and as such are expected to be further deferred until 2025.

B. Earnings stripping rules

The carry forward period for non-deductible excess interest generated in fiscal years beginning between April 1, 2022 and March 31, 2025 is to be extended from seven to ten years.

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