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Luke Tanner is of counsel at Baker McKenzie in Tokyo.

In this article, Tanner provides an overview of recent tax developments in Japan, including the tax reform package and other legislation, the OECD's two-pillar proposal, changes to consumption tax, and the transfer pricing regime.



Japan's 2023 tax reform package announced in December 2022 and submitted to the Diet in February 2023 includes various measures aimed at strengthening the Japanese start-up ecosystem and reorganizing the research and development taxation system.

Importantly, the draft legislation also includes provisions related to the OECD's global minimum tax proposal (pillar 2). The draft pillar 2 rules are broadly in line with the OECD's pillar 2 inclusive framework and include a global anti-base erosion (GLOBE) rule. It comprises two parts: the income inclusion rule and the UTPR (now known as the undertaxed profits rule). Both rules are designed to impose additional tax in the jurisdiction where a corporate group's ultimate parent entity (UPE) is located.

This reform would also modify Japan's controlled foreign corporation rules. The CFC rules would remain in existence after the introduction of pillar 2, but there will be further review of the CFC rules in the future to align them with the IIR and to ease the administrative burden for companies subject to both the pillar 2 and CFC rules. If passed, Japan's pillar 2 rules would become effective from the fiscal year beginning on or after April 2024.

The reform also includes changes to the tax spinoff rules that would relax certain continuity of control tests required for "tax qualified" status, potentially expanding their application. Further, to improve incentives for companies that increase investment in R&D and promote open innovation, the proposal revises the existing R&D tax credit rules to increase the range and maximum deduction amounts, expand the scope of R&D for start-up companies, and improve the quality of R&D investment.

## Recent Legislative Amendments

Japan's 2021 and 2022 tax reform packages included measures aimed at post-COVID-19 economic revitalization and promoting business growth and innovation. The key changes implemented by the tax reform are discussed below.

### Digital Transformation

Japan's 2021 tax reform package contained an incentive for investment in digital transformation, such as cloud-based IT systems. The incentive includes a tax credit of 3 percent or special depreciation of 30 percent of the acquisition cost, subject to certain caps. Assets covered by the tax incentive include new or expanded software and hardware that improve productivity or lead to the development of new products, production, and sales methods. Investments must be made under a business plan for the introduction of IT/digital solutions that must be approved by the government. The initial period for the tax incentive is until March 31, 2023, but this is expected to be extended for two years under the draft 2023 tax reform.

### Carbon Neutrality

The 2021 tax reform package contained an incentive for companies to invest in assets to reduce their carbon footprint in the context of Japan achieving carbon neutrality by 2050. It includes a tax credit of up to 10 percent of the asset acquisition cost or special depreciation of 50 percent of the acquisition cost, subject to certain caps. Investments covered by the tax incentives include facilities for manufacturing products that will accelerate carbon neutrality and manufacturing processes that will either accelerate carbon neutrality or conserve energy. Investments need to be made according to an environmental adaptation plan that must be approved by the government. The period for acquisition of the new assets runs until March 31.

### Research and Development

The 2021 tax reform included a modest expansion of Japan's R&D tax credits. Tax credit rates and limits were increased, and the scope of R&D costs eligible for tax credits was expanded to include certain internal-use software costs (previously not creditable). The draft 2023 tax reform would further expand the scope of eligible R&D costs to include certain other costs, such as those relating to joint research and outsourced R&D. While the calculation of the tax credit is complex, the reforms amended the creditable ratio to be between 2 and 14 percent of R&D costs, generally capped at 25 percent of corporate income tax payable (although the draft 2023 tax reform will further modify these rates, if passed). An additional creditable amount of 5 percent will be allowed if gross sales in a year beginning between April 1, 2021, and March 31, 2023, decrease by 2 percent or more when compared to the last year ending before February 1, 2020, and qualified R&D expenditures for the year are greater than the amount spent in that year.

### Temporary Increased Limit for NOLs

Under Japan's loss carryforward rules, prior-year net operating losses can only shelter up to 50 percent of the current year's taxable income, except for certain small and medium-size enterprises, and can be carried forward for up to 10 years. Under the 2021 reform, the limitation on the use of NOLs was temporarily increased to up to 100 percent (the actual limit depends on the investment amount under an approved business plan). This increase was a temporary measure in response to COVID-19.

NOLs generated between April 1, 2020, and March 31, 2021, are eligible. The NOLs so carried forward can be used to offset income in future years (broadly for income years starting within five years of the loss year, beginning before April 1, 2026).

Taxpayers must satisfy applicable procedural requirements, including implementing a business plan that is certified by the government. Also, taxpayers must have blue form taxpayer status (a preferential status that grants certain benefits to taxpayers such as carryforward of tax losses).

### Wage Increase

Both the 2021 and 2022 tax reform packages increased tax incentives for promoting wage and investment increases. Under the prior rules, a credit of 15 to 20 percent of the wage increase was available for wage increases of 3 percent or more for current employees, subject to certain limitations. Under the 2021 tax reform (applicable for fiscal years from April 1, 2021, to March 31, 2022), a credit of 15 to 20 percent was also available for increases in salary and remuneration expenses for new employees (not previously covered).

Under the 2022 tax reform (applicable for fiscal years from April 1, 2022, to March 31, 2024) a credit of 15 to 30 percent of expenses related to increased wages were available for large companies. This credit varied based on the percentage increase (between 3 and 4 percent or 4 percent and above) and whether the company also increased education and training expenses for employees (a 20 percent or greater year-on-year increase). For SMEs, the credit was higher (between 15 and 40 percent of expenses relating to the increase), and the wage increase thresholds were lower (between 1.5 and 2.5 percent or 2.5 percent and above), as was the education expense criteria (a 10 percent or above increase).

The total amount of the tax credit is capped at 20 percent of the corporate tax liability for the current fiscal year, and large companies with stated capital of ¥1 billion or more and 1,000 or more regular employees are subject to additional requirements to publicly announce the wage increase and to notify the government.

### Profit-Linked Director Compensation

The 2021 tax reform package replaced requirements for the deductibility of profit-linked director compensation for certain investment managers, removing one perceived barrier for Japan being chosen as a financial services hub. Under prior law, calculation methods for profit-linked director compensation needed to be disclosed in annual securities reports (among other requirements), and investment firms that did not prepare annual securities filings could not satisfy this requirement. The changes to the law remove this requirement, potentially allowing these investment firms to qualify. However, additional requirements remain, including how profit-linked compensation is calculated, the disclosure of the calculation method, and preapproval by investors.

### Wholly Owned Subsidiaries

Under prior law, dividends paid by a Japanese resident wholly owned subsidiary (or from an "affiliated subsidiary" — that is, a subsidiary in which the recipient owns more than one-third of the total number of outstanding shares) to a Japanese resident parent would be subject to withholding tax at 20.42 percent. The parent corporation would generally receive a refund or credit for the withholding tax at the time it files its corporate tax return. When calculating its corporate tax amount, the parent corporation can exclude the entire amount of the dividend from income, resulting in no corporate tax being imposed. However, the credit or refund would be obtained through the corporate income tax return, and cash flow would be affected between the date of payment of the withholding tax and the credit or refund.

The 2022 tax reform exempted from withholding tax dividends paid by wholly owned domestic subsidiaries and other domestic affiliated companies in which the dividend recipient owns more than one-third of the outstanding shares as of the dividend record date. This revision was intended to eliminate the inconsistency of imposing withholding tax on dividends that are not subject to corporate tax. The revision applies to dividends received on or after October 1.

### Earnings-Stripping Rules

Japan's earnings-stripping rules restrict deductions for net interest expenses (for payments to related or unrelated parties) that exceed 20 percent of a Japanese company's "adjusted taxable income" unless paid to a Japanese taxpayer. The 20 percent limitation has applied since April 1, 2020; before then, the threshold was 50 percent.

The 2022 tax reform further strengthened the rules by expanding the scope for foreign companies. Under the previous rules, foreign companies were only subject to the earnings-stripping provisions on Japanese-source income that was attributable to a Japanese permanent establishment. The 2022 tax reform expanded the scope of the earnings-stripping rules to include the Japanese-source income of a foreign company that does not have a PE in Japan or that is not attributable to a Japanese PE. An example of this income is real estate rental income.

### Restrictions on Tax Incentives

The 2022 tax reform revised certain restrictions on the availability of tax incentives, including the R&D incentives, digital transformation, and carbon neutrality tax incentives. The restrictions apply to large companies with stated capital of ¥1 billion or more, or with 1,000 or more employees that do not increase employee wages or investments despite being profitable. In order to access the tax incentives, large companies must increase the total amount of salary payments by 0.5 percent compared to the prior fiscal year (for years beginning between April 1, 2022, and March 31, 2023), or by 1 percent for fiscal years beginning on or after April 1, 2023. The restriction does not apply to companies in a loss position.

## Consumption Tax Qualified Invoices

Japan's consumption tax (JCT) system will introduce a qualified invoice requirement from October 1. Under the new system, qualified invoices are required in order to claim JCT input credits and receive JCT refunds. In order to issue qualified invoices, taxpayers are required to register and become "qualified invoice issuers." This differs from the current system, in which JCT taxpayers can recognize JCT input credits for transactions with suppliers that are JCT exempt.

After October 1, a JCT taxpayer cannot recognize the input tax credit for transactions with nonregistered invoice issuers. As a transitional measure, a partial JCT credit may be available over a six-year transition period (from October 1, 2023, to September 30, 2026, 80 percent of the input credit amount is available, and from October 1, 2026, to September 30, 2029, 50 percent of the input credit amount is available). Further transitional measures are included in the draft 2023 tax reform, including a simplified calculation method for new JCT taxpayers and a reduction in documentation requirements where JCT taxable sales are below a certain threshold.

The application process for registration as a qualified invoice issuer began on October 1, 2021, and applications must be submitted by March 31 to be a qualified invoice issuer on the day that the new rules become effective. After registration, the name of the qualified invoice issuer and its registration numbers can be confirmed through the website of Japan's National Tax Agency (NTA).

If a non-JCT taxpayer registers as a qualified invoice issuer, non-JCT taxpayer status is forfeited, and they become a JCT taxpayer. While Japanese law contains a strictly enforced due date to become a voluntary JCT taxpayer, there is an exception for non-JCT taxpayers that register as qualified invoice issuers during their fiscal year in which the October 1 effective date falls. This exception allows the taxpayer to become a voluntary JCT taxpayer from the date of registration as a qualified invoice issuer.

The new rules also specify the information that must be stated in a qualified invoice: the supplier name, the qualified invoice registration number, a description of the goods or services, the invoice amount, and the customer name. For businesses that provide JCT-taxable transactions to numerous counterparties (for example, retail businesses, restaurants, and so forth), simplified qualified invoices that do not include the customer name are allowed.

For intermediary transactions, such as consignment sales, if both the consignor and the consignee are registered invoice issuers, the consignee can issue qualified invoices to the counterparty of the transaction (such as the customer), subject to certain conditions — for example, retention requirements regarding copies of qualified invoices for both the consignor and the consignee.

In addition to the invoice itself, the introduction of the qualified invoice system has implications for accounting, tax, and IT/enterprise resource planning systems, and broader businesses. These include management and price negotiations between registered and nonregistered suppliers, document retention policies for tax audit preparation, accounting entries and JCT classification codes, calculation of input and output JCT during the transition period, and compliance with the JCT law in contracts.

## Transfer Pricing Updates

### Updates to the Administrative Guidelines

#### Cost Contribution Arrangements

On June 10, 2022, the NTA finalized amendments to the commissioner's directive on the operation of transfer pricing (administrative guidelines) regarding cost contribution arrangements (CCAs) and financial transactions. It is relevant to note that the administrative guidelines do not have the force of law in Japan. However, Japanese tax authorities at all levels can be expected to act in accordance with the administrative guidelines for transfer pricing matters. The revisions are effective (and will be referred to by tax administrations in audits and advance pricing agreements) for years beginning on or after July 1, 2022.

As Japanese transfer pricing law does not contain specific rules relating to CCAs, the administrative guidelines, together with the OECD transfer pricing guidelines, represent authoritative guidance on how the arm's-length principle applies to CCAs in Japan.

The amendments revise the definition of a CCA. They expand the scope of a CCA and clarify that an "assumption of risk" is to be included in the contribution to the joint activity consistently with the OECD transfer pricing guidelines. The clarification that the development of tangible assets as well as the provision of services can be subject to a CCA increases the potential applicability of CCAs. For example, under the revised definition, a CCA could cover capital expenditure for industries that require large capital investments or for services related to certain centralized group functions.

The amendments further clarify that a CCA is considered to be consistent with the arm's-length principle when the following requirements are met:

- the proportion of the total amount of expected benefit ("expected proportion of benefit") is properly estimated;
- the amount of each participant's value contribution is consistent with the amount of consideration that would be paid if the transaction were conducted at arm's length and in accordance with the terms and conditions of a transaction between independent parties; and
- the proportion of the value of each participant's contribution is consistent with the expected proportion of benefit.

The revised guidelines also clarify that "if an adjustment payment is made to align the contribution value ratio with the expected proportion of benefit, the amount after the payment shall be considered to be the value of the contribution of each participant." They also state that "if the amount of the expenses borne by a participant under the CCA does not differ significantly from the value of the participant's contribution, the expense amount may be treated as the value of the participant's contribution." These amendments should improve the predictability of the application of the arm's-length principle to CCAs in Japan.

Section 3-17 of the administrative guidelines sets out criteria to be considered by an examiner when analyzing a CCA during a transfer pricing audit. The amendments significantly revise and add to the criteria, which now instruct an examiner to analyze whether:

- the details set out in the contract are consistent with the work actually performed by the CCA participant and other facts relating to the CCA;
- all participants obtain the expected benefits;
- the expected benefit ratio has been properly calculated;
- the contribution value ratio has been properly calculated;
- each participant's respective value contribution percentage is consistent with its respective expected benefit percentage and, if not, whether an adjusted amount of payment was given or received; and
- appropriate compensation has been paid or received when a participant joins or withdraws from a CCA or when the CCA is terminated.

The revised guidelines further include a list of documents examiners should request and review when conducting an audit of a CCA. Although there is no stand-alone requirement for contemporaneous documentation and ordinary documentation thresholds apply to CCA-related transactions, taxpayers are expected to prepare these documents and deliver them to an examiner upon request.

### Financial Transactions

In addition to the revisions described above relating to CCAs, the administrative guidelines were also amended to update guidance on financial transactions. Based on the explanatory material provided by the NTA, the changes are intended to align Japanese transfer pricing practice with the updated OECD guidelines on financial transactions in Chapter X.

The revisions were primarily made to Chapter 3 of the administrative guidelines, which provides instructions to auditors for use during tax examinations.

Chapter 3-8 was revised to remove the priority of methods for intercompany loans. Previously, the administrative guidelines broadly provided that where no direct internal comparable uncontrolled price exists, taxpayers not principally engaged in moneylending should test the appropriateness of the interest rate used in lending or borrowing based on the following approaches (in order of priority from 1 to 3):

1) the interest rate that would apply if the borrower borrowed from an unrelated bank on similar terms;

2) the interest rate that would apply if the lender borrowed from an unrelated bank under similar terms; and

3) the interest rate that would be expected if the funds were invested in government securities.

Further guidance from the NTA clarified that these approaches would be based on market interest rate data. In practice, based on the previous guidance, taxpayers could use the lender's borrowing rate and add a spread to support loans to Japanese subsidiaries. The updated administrative guidelines remove the priority of methods, including the reference to the lender's borrowing rate, and instead state that the loan should be priced using the most appropriate method. Further, while in the past it was common for companies to set the arm's-length interest rate for financial transactions based only on interest rates informally provided by a commercial bank, Chapter 3-8(5) of the updated administrative guidelines now clearly denies the arm's-length principle in those cases.

Also, Chapter 3-7 was updated to emphasize the need to accurately delineate financial transactions, focusing on comparability. In this connection, Chapter 3-8(2) now specifies that when analyzing comparability, the creditworthiness of the borrower must be considered. This may be, for example, based on a synthetic credit rating tool or using a group credit rating methodology. The administrative guidelines also specify the need to consider implicit support when analyzing creditworthiness (consistent with OECD concepts).

As a practical matter, these changes taken together require the borrower's characteristics (including credit rating) to be considered in all cases, that a proper comparability analysis of the financial transaction is undertaken, and that robust economic analysis (for example, benchmarking) is performed to support the interest rate. Before the changes, it was common for Japanese taxpayers to exclude intercompany loans from analysis or inclusion in their transfer pricing documentation. Interest payments were also often considered immaterial because of a prolonged low interest rate environment. The changes to the administrative guidelines signal a potential focus by the tax authorities on intercompany loans involving Japanese companies, which is particularly relevant in the context of increasing interest rates.

## The NGK Case

In the NGK case, NGK Insulators, Ltd. received an assessment for a tax deficiency of about ¥6.2 billion from the Nagoya Regional Taxation Bureau (NRTB). The assessment related to royalty income that NGK received from its manufacturing subsidiary in Poland and covered four consecutive tax years through March 31, 2010. On November 26, 2020, the Tokyo District Court partially accepted NGK's arguments and reduced the assessment by approximately ¥5.8 billion.[1] This decision was upheld by the Tokyo High Court in its judgment on March 10, 2022.[2] The NTA, a higher authority than the NRTB, did not appeal, and the judgment became final.

NGK is a Japanese resident entity engaged primarily in the manufacture of ceramic products, licensing patent and manufacturing know-how to its Polish subsidiary. The Polish subsidiary was engaged in the manufacture of particulate removal devices for cars that were sold to car manufacturers through another affiliated entity. European regulations and improved manufacturing techniques increased demand for the parts, resulting in a significant increase in the Polish subsidiary's profitability.

A Japanese tax audit concluded that the Japanese entity's royalty income was below the arm's-length price established based on the residual profit-split method (RPSM). The tax authority's position was that the contributions of each party to the development of important intangible assets should be factored into the profit split. The taxpayer argued that the depreciation expenses of the Polish subsidiary should also be included (which would increase the Polish subsidiary's allocation), as its large capital investment significantly contributed to its high profit.

[1] Tokyo Chiho Saibansho, Hei 28 (gyou) no. 586 (Nov. 26, 2020).

[2] Tokyo Koto Saibansho, Rei 3 (gyoko) no. 25 (Mar. 10, 2022).

The courts ultimately ruled in favor of the taxpayer, finding that the contribution factor is not necessarily limited to intangible assets and that other interrelated factors contributed to the high profit. It was therefore appropriate to include the residual depreciation expense (the excess over the normal level of depreciation expense obtained from the comparable companies for routine return) in the split factor for the Polish subsidiary.

Other factors considered by the courts include the scale profit and the taxpayer's decision to make a large-scale investment in Poland ahead of competitors. The scale profit was attained by reduced manufacturing costs per unit as a result of substantial sales increases. The courts recognized the Polish subsidiary's contribution to the scale profit when finding that the excess depreciation expense should be included in the split factor. On the other hand, the courts rejected the tax authority's argument that NGK's decision regarding the upfront investment should be included in the split factor for NGK on the grounds that these decisions by a parent company on a large investment in its subsidiary should generally be rewarded through dividends, and it is inappropriate to consider when it comes to determining a residual profit-split factor.

This was the third time the application of the RPSM was disputed in court in Japan. Unlike previous cases, this case was unique because the court first acknowledged that there is a factor other than those relating to nonroutine intangible assets that can be included in the split factor under the RPSM and that the factor can be split among associated companies relevant to the transaction in the same manner as those related to intangible assets. This decision could require the Japanese tax authority to change its way of applying the RPSM in a transfer pricing audit going forward.

## Expected Increase in Controversies

The number of transfer pricing audits and assessments by the Japanese tax authorities declined following the outbreak of COVID-19 in 2020. Similarly, during the pandemic, there have been delays in the resolution of transfer pricing controversies through mutual agreement procedure and advance pricing agreements. However, audit activity is expected to increase with tax auditors coming back to the office. As a result of reduced audit activity, many taxpayers may have many unaudited years that may still be open under the longer statute of limitations period for transfer pricing assessments, which is seven years from the prescribed due date of their Japanese income tax return.

In recent transfer pricing audits, tax examiners have focused on analyzing losses caused by the COVID-19 pandemic and the impact of supply chain disruptions. In this connection, tax examiners often challenge the characterization of the Japanese subsidiary and assert that it should receive an operating margin return as a reseller instead of a cost-plus return as a service provider, which would generally result in a higher profit for the Japanese entity. Also, Japanese tax examiners typically focus on transfer pricing adjustments (including end-of-year adjustments), multiple-year operating losses, and intangible property transactions (especially the legality and reasonableness of applying the RPSM of calculation, as described in *NGK*).

Historically, few transfer pricing cases have been brought before the courts in Japan. The main reason for this is Japan's extensive network of tax treaties, and most transfer pricing disputes have been resolved through MAP under the relevant treaty. However, taxpayers have recently been successful in an increasing number of cases, which appears to be driving a rise in transfer pricing litigation. Also, in cases involving multiple foreign related parties and controversies with countries in which mutual agreement with Japan may be challenging (for example, Poland in *NGK* and Southeast Asian countries in other litigation cases), litigation may be an attractive option for taxpayers. ■