

Japan: Corporate and Tax Quarterly Update | January Issue

Introduction

Japan recently announced its 2025 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.

Japan Tax Update

Outline of the 2025 Japan Tax Reform Proposal

On 20 December 2024, the Liberal Democratic Party announced its 2025 tax reform proposal ("**Proposal**"). The Proposal is expected to be approved by the Cabinet in late December 2024 and enacted after approval by the Diet (Japan's parliament) around the end of March.

The items outlined below are those likely to have the largest impact on multinational corporations doing business in Japan.

The Proposal is merely an outline of a number of proposed reforms which have not yet been enacted. Historically, the contents of tax reform proposals generally did not undergo material changes before being approved by the Diet. However, after the recent elections in Japan, the Liberal Democratic Party no longer holds a majority of the Diet. The Liberal Democratic Party therefore needs support from minority parties to pass legislation.

Additionally, although not discussed in detail below, the Proposal includes an increase of the standard deduction for individual income tax purposes as a result of a last-minute request from the Democratic Party for the People.¹ However, the Democratic Party for the People did not find the increase to be satisfactory, so some uncertainty exists as to whether the tax reform proposal will be approved as-is.

Thus, there is a higher likelihood in comparison to prior years that some of the contents of the Proposal may change during the Diet's deliberations.

I. International tax matters

A. Inclusion of UTPR and QDMTT in Japanese domestic tax law

Japan's 2023 tax reforms contained a number of items related to the OECD's Pillar Two model rules (also referred to as the "Global Anti-Base Erosion (GLOBE) Rules), including enacting an income inclusion rule (IIR) into domestic law

¹ The proposed increase would still result in a standard deduction amount that is much lower than similar deductions provided in the US and European countries.



applicable to fiscal years beginning on or after 1 April 2024. 2024 tax reform further revised these rules to be consistent with additional administrative guidance published by the OECD.²

The Proposal continues the domestic implementation of Pillar Two and includes the introduction of an under-taxed payments rule (UTPR) and a national minimum tax (i.e., a qualified domestic minimum top-up tax (QDMTT)). Further details regarding the UTPR and QDMTT are expected to be released at a later date, but both will apply for fiscal years beginning on or after 1 April 2026.

Consistent with the OECD's Pillar Two model rules, the UTPR will not apply if the country where the ultimate parent entity (UPE) is located has adopted a qualified IIR, so in many cases the new rule may not be directly relevant for companies whose UPEs are located in countries that have already adopted qualified IIRs. However, for companies with UPEs located in jurisdictions such as the US, which to-date has not adopted a qualified IIR, the new UTPR may have a significant impact on the Japanese subsidiaries of such companies (although other factors, such as political or practical factors may also be relevant).

If a US UPE has multiple subsidiaries located in countries that have adopted a UTPR, it will need to wait for further details regarding the UTPR allocation mechanism to determine how to coordinate the new Japanese rules with those in other countries.³

In addition, although unlikely to be relevant in many cases given Japan's relatively high effective tax rate (ETR), companies may need to consider the applicability of the QDMTT for Japanese corporations that receive certain tax credits (e.g., R&D credits) or that conduct certain tax-free reorganizations that generate accounting income.

B. Timing of introduction of Pillar One, Amount B

The OECD's Pillar One Amount B is intended to provide a uniform and simplified mechanism for calculating the return for "baseline marketing and distribution activities" for tangible goods, and it is expected to have a significant impact, as many multinational enterprises conducting routine sales activities may fall within the scope of the rules. The OECD issued additional guidance regarding the scope and calculation of Amount B on 19 February and 17 June 2024.

If a jurisdiction allows taxpayers to elect to apply Amount B, taxpayers can choose to continue applying their existing transfer pricing approach or use Amount B.⁴ However, taxpayers who do not apply Amount B and whose profit margins are below the Amount B return may face scrutiny from tax authorities, who may seek to apply the Amount B pricing matrix if it is more favorable for them (e.g., by arguing that the comparability analysis provided by a taxpayer is not reliable).

The Proposal states the following:

...simplification and rationalization of the application of transfer pricing taxation will be considered in the future, taking into account international discussions and trends in each country, but will not be implemented at the current time. If other countries implement such simplification and rationalization, Japan will respond in accordance with international agreements under existing laws and tax treaties.

Therefore, it is not expected that Amount B will be enacted into domestic law for the time being. However, the US Treasury Department recently published a notice regarding the introduction of Amount B for taxable years beginning on or after 1 January 2025, and given that the introduction of Amount B in the US may be expected to affect Japan, it will be necessary to keep an eye on Amount B-related developments going forward.

II. Corporate tax matters

A. Expansion of investment incentives for SMEs

² For greater detail regarding the Pillar Two changes enacted as part of the 2023 and 2024 tax reforms, please refer to our [December 2022 Japan Corporate and Tax Quarterly Update](#) and [December 2023 Japan Corporate and Tax Quarterly Update](#) newsletters.

³ According to the Proposal, allocation will be based on employees and tangible assets in accordance with the OECD model rules.

⁴ Under the Amount B guidance issued on 19 February 2024, if a jurisdiction adopts Amount B, the jurisdiction will either (1) allow taxpayers an option to apply Amount B or (2) make it mandatory to apply Amount B for applicable entities in that jurisdiction.



Small and medium-sized enterprises (SMEs)⁵ for Special Tax Measures Act purposes that acquire certain assets to improve their management capabilities are entitled to investment incentives (in the form of either a tax credit or special depreciation) with respect to such assets. The Proposal extends the duration of the investment incentives by two years and expands the scope of assets⁶ eligible for the incentive regime to include buildings and their auxiliary structures ("**Buildings, etc.**").

To qualify for the investment incentives, the eligible assets must be acquired in accordance with a plan approved by the Ministry of Economy, Trade, and Industry (METI) as being expected to achieve an average annual return on investment of 7% or more and that meets certain requirements for expanding the scale of the business.

In particular, the plan must meet the following requirements:

- Must provide a roadmap showing measures to increase sales and the timing of capital investments.
- Sales for the base fiscal year⁷ must be more than JPY 1 billion and less than JPY 9 billion.
- Business, financial and organizational foundations must be in place to aim for sales of more than JPY 10 billion.
- Must aim for sales of more than JPY 10 billion and an average annual sales growth rate of 10% or more.
- Must involve capital investments that meet certain requirements.
- Must increase the amount of salaries, etc., paid during the period of the plan.
- Requirements necessary for achieving sales of more than JPY 10 billion must be met.

Businesses with an approved plan may choose to take either (i) a tax credit of 7% (1% or 2% for Buildings, etc.) of the acquisition cost of the eligible asset or (ii) special depreciation of 100% of the acquisition cost of the eligible asset (15% or 25% for Buildings, etc.).

C. Plans to increase corporate tax

Amid a general global climate of reducing corporate tax rates in the 2010s, Japan enacted corporate tax legislation measures to lower its corporate tax rate to 23.2% in an effort to promote capital investment, employment and wage increases and strengthen location competitiveness. In return, businesses were asked to expand domestic investment and raise wages accordingly.

However, while overseas investment has increased since that time, domestic investment, particularly by large companies, has remained low, and wage increases in Japan have also been sluggish for many years compared to other countries. Rather, there has been an even stronger tendency for corporations to retain profits (e.g., in the form of cash and deposits). As such, the Proposal mentions that the previous corporate tax legislation has not produced the intended results and that the nature of corporate taxation must be changed.

The Proposal notes that previous overseas research has shown that corporate tax rates have a limited impact on capital investment and wages. Thus, in order to encourage companies, especially large corporations that have accumulated large amounts of cash and deposits, to increase domestic investment and raise wages, the government

⁵ An SME is a company with stated capital of JPY 100 million or less that is not 50% or more held by a large company (i.e., a company with stated capital over JPY 100 million) or two-thirds or more held by two or more large companies. Additionally, a company with annual average income (i.e., income in the three FYs prior to the current FY) of over JPY 1.5 billion will not be considered an SME.

⁶ Eligible assets generally include machinery, tools, fixtures, Buildings, etc. and software of a certain size or larger that are essential for achieving the investment objectives set out in a plan approved by METI. However, assets acquired by businesses engaged in medical and health care services and assets used for power generation that are acquired primarily for the sale of electricity are generally not included in the scope of eligible assets.

⁷ The "base fiscal year" above refers to the fiscal year immediately preceding the fiscal year in which the plan is certified.



intends to build a well-balanced corporate tax system, which is expected to include raising the corporate tax rate and implementing targeted policy measures (such as those developed using "evidence based policy-making").

As a result of the above, we expect that there may be frequent revisions to the corporate tax system and related incentives in the future,⁸ and it will be important for companies to continue to closely monitor the corporate tax landscape going forward to ensure that they are aware of changes and know how to appropriately respond.

D. Introduction of special corporate tax for defense

In addition to the plans to increase corporate taxes to meet the government's policy objectives discussed above, the Proposal also contains plans to increase the corporate tax rate to raise revenue for purposes of strengthening defense starting in April 2026. In this regard, a so-called "special corporate tax for defense" will be introduced. While additional details regarding the calculation of this new surtax are not yet available, the special corporate tax for defense will likely be calculated as (corporate tax⁹ for the year - JPY 5 million) x 4%.

The current ETR in Japan is approximately 30% for non-SMEs and 35% for SMEs, but such ETRs are expected to increase by approximately 1% after the special corporate tax for defense goes into effect in April 2026.

E. Factor-based enterprise tax

In an effort to reduce the number of companies making capital reductions to avoid factor-based enterprise taxation, 2024 tax reform modified the factor-based enterprise tax rules. The revisions included, among other things, changes to include in the scope of factor-based taxation companies that were factor-based enterprise taxpayers in the previous fiscal year and have stated capital plus capital reserves exceeding JPY 1 billion. Such companies will still be subject to factor-based taxation in the current fiscal year, even if a company's stated capital decreased to JPY 100 million or less before the current fiscal year end.¹⁰

While not included in the Proposal, the above changes are set to go into effect for fiscal years beginning on or after 1 April 2025. We note them here to draw attention to the changes and ensure that companies are aware that the new rules will soon take effect to plan accordingly.

⁸ One example of such frequent changes can be seen with the digital transformation incentives. Such incentives were somewhat recently introduced as part of 2021 tax reform, but they are already set to be abolished by the Proposal.

⁹ The current national corporate tax rate is approximately 25.59% (corporate tax of 23.2% plus a local corporate tax of 23.2% x 10.3%).

¹⁰ For greater detail regarding the factor-based enterprise tax changes enacted as part of 2024 tax reform, please refer to our [December 2023 Japan Corporate and Tax Quarterly Update](#) newsletter.



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