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Client Alert

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Japan Corporate and Tax Quarterly Update: December Issue

In brief

In this issue, we focus on the 2023 Japan tax reform proposal and corporate legal considerations for spin-offs in Japan.

On December 16, 2022, Japan announced its 2023 tax reform proposal, which contains a number of changes that may impact multinational companies doing business in Japan, including the introduction of Pillar Two legislation in Japanese domestic tax law. This update provides a brief overview of the relevant items that would likely have the largest impact on such companies. In addition, this update also provides a brief overview of the recent developments of spin-off rules and corporate legal considerations and benefits of using spin-offs in Japan.

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Outline of the 2023 Japan Tax Reform Proposal

On December 16, 2022, the Japanese ruling party announced its 2023 tax reform proposal (the "Proposal"), which is scheduled to be approved by the Cabinet in late December, 2022. The Proposal reflects Prime Minister Kishida's goal of strengthening investment in the "market," "industry," and "human capital" and creating a "positive cycle of growth and distribution" by combining certain distribution policies, not limited to distribution policies with respect to tax. Specifically, the Proposal includes various measures aimed at strengthening the start-up ecosystem and reorganizing the R&D taxation system.

Further, the Proposal incorporates legislation related to Pillar Two as a result of the progress of the OECD BEPS discussions. The Proposal's Pillar Two rules include an income inclusion rule ("IIR") and modifications to the Japanese controlled foreign corporation ("CFC") rules. The CFC rules will remain in existence after the introduction of the Pillar Two rules, 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 of companies subject to both the Pillar Two and CFC rules.

The items outlined below are those that would likely 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 provisions of the Proposal may be subject to change.

A. International Tax Matters

1. Inclusion of Pillar Two Rules in Japanese Domestic Tax Law

The Pillar Two rules introduced by the OECD establish a global minimum effective tax rate ("ETR"), and 140 countries have agreed to the OECD Inclusive Framework, which would enact a two-pillar solution to address the challenges arising from the digitalization of the economy. While the "Implementation Framework," which stipulates detailed rules for implementing Pillar Two, is currently still being discussed by the OECD with public consultation documents released on 20 December 2022, the Pillar Two rules are expected to include a global anti-base erosion ("GloBE") rule that is comprised of two parts, an income inclusion rule (the IIR) and an under-taxed payments rule ("UTPR"), which are both designed to impose additional tax in the jurisdiction where a corporate group's ultimate parent entity ("UPE") is located. The IIR also allows for the introduction of a national minimum tax (i.e., a qualified domestic minimum top-up

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tax ("QDMTT")), as additional tax will be imposed in another jurisdiction if the aggregate ETR of group entities located in that jurisdiction is less than 15% (i.e., the tax that would otherwise be payable in the low-tax jurisdiction will be paid in another jurisdiction).

As domestic legislation in other countries regarding the IIR, UTPR, QMDTT is advancing rapidly, delays by Japan in adopting similar legislation may result in tax that should have been paid in Japan begin paid in other countries. Thus, the Japanese government felt it imperative to enact Pillar Two legislation in Japan as soon as possible and included such rules in the Proposal.

The Pillar Two provisions of the Proposal are broadly in line with the OECD's Pillar Two Inclusive Framework. Under the Proposal's IIR, if a country's adjusted ETR is less than the base tax rate (15%), additional tax (i.e., international minimum tax) will be imposed in the UPE's jurisdiction equal to the group's aggregate income in the low-tax country less (i) 5% of total labor costs and (ii) 5% of property, plant, and equipment in the country (note that there are transitional measures that will increase both of these deduction percentages for a certain period), multiplied by the difference between the base tax rate and the low-tax country's ETR.

The group's aggregate income in the country, i.e., the total amount of separately calculated income for each group company, is generally based on the amount of income of the respective group companies for accounting purposes, which is the basis for preparing the consolidated financial statements of the UPE, subject to certain adjustments. In the Proposal, such adjustments include dividends from companies that held a certain fixed percentage of the equity interests for one year or more. In addition, other adjustment items listed in the Inclusive Framework are also considered to be included, such as gain or loss on the transfer of shares/business transfer of companies for which a certain fixed percentage of ownership is held.

As the Pillar Two framework includes matters to be stipulated by laws and regulations, there is a possibility that the rules may change depending on the progress of international discussions and the OECD's public consultation process. That said, assuming there are no delays with the Implementation Framework, the IIR will apply to fiscal years commencing on or after April 1, 2024.

Additionally, although the Proposal does not include provisions with respect to the QMDTT or UTPR, considering the responses of other countries, it is believed that such provisions will be announced as part of the 2024 tax reform proposal and take effect for fiscal years commencing on or after April 1, 2025.

2. Information Returns for Corporate Tax on the International Minimum Tax Amount

The filing and payment of corporate tax for each target fiscal year under the new IIR (i.e., the corporate tax on the international minimum tax amount) for a domestic company belonging to certain specified multinational groups is significantly different from ordinary corporate tax. Domestic companies belonging to such specified multinational groups must file an information return which includes certain information (e.g., the ETR by country for each country in which companies of the specified multinational group are located, the international minimum tax amount of the specified multinational group, etc.) via Japan's electronic tax filing system (i.e., e-Tax) and pay taxes related to the international minimum tax amount within one year and three months (in certain cases, one year and six months) from the day following the last day of the target fiscal year. However, if there is no international minimum tax amount (i.e., tax base) for the relevant target fiscal year, no filing/payment obligation will apply.

These rules will apply for relevant fiscal years commencing on or after April 1, 2024.

3. Revision of Japanese CFC Rules

Certain revisions are made to the current Japanese CFC rules, including reducing the ETR for exemption from the rules (for specified foreign related companies (*tokutei gaikoku kankei gaisya*) (i.e., paper companies without business substance)) from the CFC rules from 30% to 27%, and modifying the rules regarding the foreign affiliate-related documents that must be attached to the tax return.

The revisions to the Japanese CFC rules will apply for fiscal years of the domestic corporation commencing on or after April 1, 2024.

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4. Practical Impact

Foreign subsidiaries of Japanese multinational companies are subject to CFC taxation on a company-by-company basis under the current Japanese CFC rules if the foreign subsidiary has an ETR of less than 30% and no business substance. For multinational companies with such foreign subsidiaries, it is generally believed that the impact of the international minimum tax system will be minimal, as their foreign subsidiaries located in tax haven countries/territories are already subject to domestic taxation under the CFC rules. However, some multinational companies are likely to be affected if they receive tax incentives in foreign countries in which they have substantive business presence. For example, if a multinational company has a foreign subsidiary with an ETR of less than 15% (e.g., due to the ETR being reduced by applicable tax incentives) that is not subject to CFC taxation on a company-by-company basis due to the fact that the foreign subsidiary meets the active business exemption test, the impact of the international minimum tax system may be significant, and there may be a risk that the after-tax profits of the Japanese multinational company will be reduced, as the profits of the foreign subsidiary would now be subject to tax in Japan. Thus, going forward, we recommend that taxpayers consider measures to mitigate potential negative impacts of the IIR, including reexamining applicable investment incentives to be received in foreign jurisdictions in the future, reviewing and renegotiating existing tax incentives, as well as implementing group reorganizations.

B. Corporate Tax Matters

The Proposal includes several revisions to the Corporate Tax Act, including, among other things, changes to the tax spin-off rules and R&D tax credit provisions. The following items are those that are likely to have the largest impact on multinational corporations doing business in Japan.

1. Revisions to the Tax Spin-off Rules

A spin-off is a method used to carve out a corporation's business, which can be accomplished using a "qualified demerger" and "qualified share distribution", both of which require meeting certain continuity of control tests (for more detail regarding spin-offs and related corporate law considerations, see Section II below). As a result, since the tax qualification rules state that no control relationship with another party can exist, there may be tax qualification issues that arise if the business/subsidiary is separated in stages.

That said, the Ministry of Economy, Trade and Industry requested relaxation of the continuity of control requirements, and in response the Proposal included a limited revision to the spin-off rules. Under the revision, if a corporation that has obtained approval for a business restructuring plan under the Act on Strengthening Industrial Competitiveness ("SICA") makes a distribution in-kind to transfer shares of a wholly-owned subsidiary as a specified surplus dividend under the SICA, such transfer would be considered a qualified share distribution if it meets all of the following requirements:

- Only shares of the wholly-owned subsidiary are delivered in accordance with the number of shares held by the shareholders of the corporation;
- Immediately after the distribution in-kind, the number of shares of the wholly-owned subsidiary held by the corporation is less than 20% of the total number of issued shares;
- Approximately 90% or more of the employees of the wholly-owned subsidiary are expected to continue to engage in the business;
- The same control requirements, major business continuity requirements, and specified officer continuity requirements applicable to qualified stock distributions are satisfied; and
- The requirement that stock acquisition rights are granted, or are expected to be granted, to the related business operator or the specified officer of the foreign related corporation pertaining to the SICA approval is satisfied.

The above rules would apply to distributions in-kind made by corporations with a business restructuring plan approved under the SICA between April 1, 2023 and March 31, 2024.

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2. Revisions to the R&D Tax Credit

In an effort to further improve incentives for companies that increase investment in R&D and promote open innovation, the Proposal makes certain revisions to 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.

In particular, the range for the amount of R&D tax credit that can be taken will be expanded from 2% - 10% (of qualified R&D expenditures) under the current rules to 1% - 14% for a period of three years. Also, the cap on R&D tax credits which is determined based on a certain percentage of corporate tax due will now vary depending on the increase/decrease of qualified R&D expenditures compared to the previous year (among other factors).

The Proposal did not specify the effective date from which the revisions to the R&D tax credit will apply.

3. Restrictions on the Use of the Share Delivery System

In response to revisions of the Companies Act, the 2021 tax reform revised the share delivery system to permit deferral of any capital gain tax arising on the delivery of shares if certain requirements are satisfied. However, due to instances of excessive tax reductions in which shares of family corporations were transferred to asset holding companies in a tax-free manner, the Proposal revises the share delivery system rules to state that if the parent company to which the shares are transferred is a family corporation after delivery of the shares, tax deferral will no longer apply.

These revised rules will apply to share deliveries made on or after October 1, 2023.

C. Other Revisions and Future Issues

1. Revision to Stock Option Tax Rules

Under the current stock option tax rules, there are a number of requirements that stock options granted to employees must meet in order to be treated as "qualified stock options" (in which case taxation of the qualified stock options is deferred until the shares obtained from exercising the option are sold). Among these is the requirement that the exercise period is between two and ten years from the time of grant. However, the Proposal revised this requirement to allow an exercise period of 15 years from the grant date for new share acquisition rights granted by certain unlisted corporations that have been established for less than five years

The Proposal did not specify the effective date from which the revisions to the stock option tax rules will apply.

2. Revisions to the Japanese Consumption Tax ("JCT") Qualified Invoice System

Effective October 1, 2023, the current JCT system will transition to a qualified invoice system. Under the new system, qualified invoices are required in order to claim JCT input credits and receive JCT refunds. Under the current rules, JCT taxpayers can recognize JCT input credits for transactions with suppliers that are JCT exempt, but under the new system, in order to issue qualified invoices, taxpayers are required to register and become “qualified invoice issuers”. Non-registered taxpayers cannot issue qualified invoices, and there are penalties for issuing false invoices.

The Proposal revises the qualified invoice system rules, adding a transitional measures for certain small and medium-sized businesses to not require preservation of invoices for taxable purchase of less than JPY 10,000 for the first six years after the qualified invoice system goes into effect. An additional transitional measure is proposed to be added for tax-exempt businesses that are no longer eligible for exemption due to becoming qualified invoice issuers, or due to electing to be treated as JCT taxpayers. The transitional measure would reduce the JCT amount to be paid by such taxpayers to 20% of the total JCT amount for three years after the effective date of the qualified invoice system.

3. Increase in Failure to File Penalties for Large Unreported Tax Amounts and Non-Reporting for Consecutive Years

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Under the current rules, non-filing penalties are 15% of the unpaid tax amount of JPY 500,000 or less and 20% of the unpaid tax amount exceeding JPY 500,000. However, to deter non-reporting for consecutive years and large unreported tax amounts, the Proposal increases failure to file penalties to 30% for the unpaid tax amount exceeding JPY 3 million. In addition, the Proposal adds an additional 10% penalty for taxpayers who have had non-filing penalties for national tax imposed on them for the previous year two fiscal years consecutively, and who fail to file the same national tax returns in the current fiscal year.

These revised failure to file penalties will apply to national taxes due on or after January 1, 2024.

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Corporate Legal Considerations for Spin-offs in Japan

A. What is a Spin-off?

A spin-off is a transaction in which a company (the "original company") carves out a particular business unit or subsidiary and delivers shares of the spun-off company (the company succeeding the business unit or subsidiary subject to the spin-off) to the shareholders of the original company on a pro rata basis, such that, from the original company's shareholders' perspective, shares of the spun-off company are acquired and previously held shares of the original company are still retained.

It is generally recognized that a spin-off has the following benefits:

- The management of both companies are able to concentrate on their respective core businesses, which will enable quick and flexible decision making.
- The spun-off company is able to raise its own capital and conduct business with competitors of the original company, thereby increasing its degree of freedom in management.
- The elimination of the conglomerate discount makes it possible to achieve an optimal capital structure in accordance with the characteristics of the business.

B. Recent Developments of Spin-off Rules in Japan

In Japan, it has been pointed out that taxation issues have hindered the implementation of a spin-off. However, revisions to the spin-off tax rules have been periodically implemented since 2017, including as part of the 2023 tax reform proposal (as discussed in Section I.B.1 "Revisions to the Tax Spin-off Rules" above).

In addition to revisions to the spin-off tax rules, the SICA was amended in 2018 to promote the use of a spin-off. A special measure was introduced to mitigate the procedural requirements for a spin-off by allowing a dividend in-kind for a spin-off to be approved by a board resolution or a shareholders' ordinary resolution, instead of a shareholders' special resolution, if the dividend in-kind is certified by the competent minister. In addition, under the 2021 amendment to the SICA, the liability of directors was limited, and in the case of a spin-off being implemented upon approval of a business restructuring plan under the SICA, even if a loss arises as a result of the spin-off, directors are liable for such loss only in the case of willful action or gross negligence.

As a result of these recent developments of spin-off rules in Japan, some actual spin-off cases have been recently carried out.

C. Spin-off Methods in Japan

Under the Companies Act of Japan, there are two main spin-off methods: (1) a demerger-type in which a specific business unit within the original company is carved out to the spun-off company by way of a demerger, and the shares of the spun-off company are then distributed to shareholders of the original company as a dividend in-kind; and (2) a stock distribution-type in which all shares of the subsidiary subject to the spin-off are distributed to the shareholders of the original company as a dividend in-kind.

In the case of method (1), it is necessary for the original company (and the spun-off company) to carry out certain procedures for a demerger and dividend distribution, such as board/shareholders' resolutions and creditor protection procedures for the demerger. As noted above, a shareholders' special resolution is required for a demerger and dividend distribution under the Companies Act of Japan. In this case, the original company is not required to have a sufficient distributable amount for the dividend distribution.

In the case of method (2), it is necessary for the original company to carry out certain procedures for the dividend distribution, such as board/shareholders' resolutions. In this case, unlike method (1), the original company is required to have a sufficient distributable amount for the dividend distribution.

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As stated above, if a business restructuring plan is approved under the Act, the procedural requirements of the dividend distribution can be mitigated.

In addition to the above procedures under the Companies Act, if shares of the original company are listed on a stock exchange in Japan, it may also need to examine the requirements/procedures under the Financial Instruments and Exchange Act and the listing rules.

D. Japanese Foreign Investment Law Considerations

If a spun-off company is engaged in a business regulated under the Foreign Exchange and Foreign Trade Control Law, a foreign investor who is a shareholder of the original company is generally required to file a prior notification in acquiring shares of the spun-off company by way of a spin off. As such, foreign investors of the original company will need to be careful about the type of business that will be carved-out to the spun-off company in the spin-off.

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