International Journal™

December 03, 2021

New Tax Incentives for Companies With Certain Business Plans in Japan

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This article may be cited as 50 Tax Mgmt. Int'l J. No. 12 (Dec. 3, 2021).

Japan has been suffering from slow economic growth and has been trying to enhance the competitiveness of its companies under the Industrial Competitiveness Enhancement (ICE) Act. An amendment to the ICE Act was introduced on August 2, 2021 to mitigate the negative impact of the COVID-19 pandemic and facilitate the transition to the so-called "new normal." Importantly, this amendment includes digital transformation and carbon neutrality support.

As part of the amendment, incentives were introduced to encourage corporations to adopt certain business plans to enhance their competiveness by investing in the future and adapting to changes in the business environment ("Business Plans"). Corporations with approved Business Plans that fulfill certain conditions will be granted tax incentives and/or financial support.

A Business Plan must fall into one of three categories: (1) a Business Plan to enhance the growth and development of companies that incurred losses due to the pandemic ("Growth Plan"); (2) a Business Plan related to adopting digital transformation ("DX Plan"); or (3) a Business Plan to minimize the burden of the company's energy use on the environment ("Carbon Neutrality Plan").

NOL UTILIZATION UNDER A GROWTH PLAN

Under Article 57(1) of the Japanese Corporate Tax Law, a company with JPY 100 million or less in stated capital[1] can offset its net operating losses (NOLs) against 100% of its taxable income without limitation. On the other hand, a company with more than JPY 100 million in stated capital[2] could offset its NOLs against only up to 50% of its taxable income — but now, with an approved Business Plan (Growth Plan), a company may be able to double the NOLs it utilizes to 100% where such losses were incurred due to the pandemic.

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[1] Excluding a company which is in a 100% direct/indirect shareholding relationship with another company whose stated capital is JPY 500 million or more.

[2] Or a company with JPY 100 million or less in stated capital that is in a 100% direct/indirect shareholding relationship with another company with JPY 500 million or more in stated capital.

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The 2021 tax legislation adds this special NOL utilization rule for companies that otherwise would be subject to the 50% limitation. Companies with certain Business Plans approved under the ICE Act are allowed to deduct losses incurred due to the pandemic, if any, for up to five fiscal years up to the amount of their taxable income before deduction of loss carryforwards.[3]

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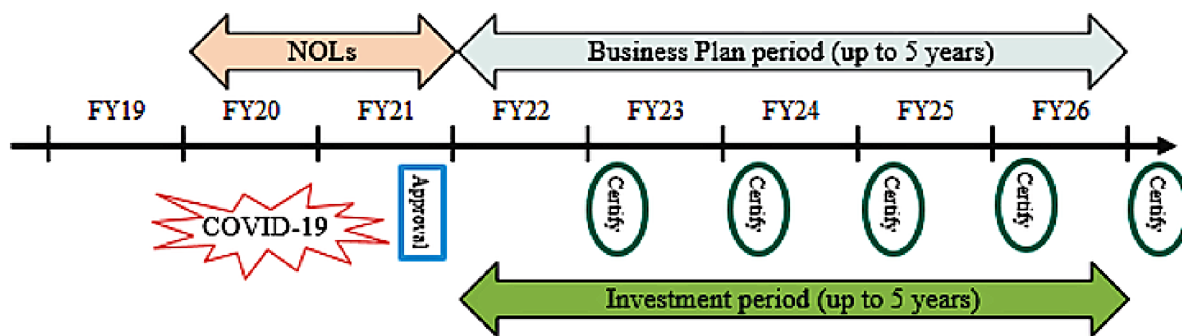
[3] For the portion exceeding 50% of that amount of income, up to the amount of cumulative investment made in accordance with the Business Plan.

For example, where a company has incurred losses in FY 2020 and 2021 due to the pandemic and has obtained approval for its Growth Plan for the five years from FY 2022 to FY 2026, it would be able to expand the maximum NOL utilization amount after obtaining certification from the relevant minister each year.

This can be visualized as follows.



(Source: Guidelines on the Special NOL Utilization Rule published by the Ministry of Economy, Trade and Industry ("Guidelines"))

Requirements

Requirements for a company	• File a blue form corporate tax return or make a consolidated tax filing.
To qualify for the NOL incentive, a company must:	• Have more than JPY 100 million in stated capital, or, if it has JPY 100 million or less, be in a 100% direct/indirect shareholding relationship with another company with JPY 500 million or more in stated capital.
	• Not be affiliated with an organized crime group.
	• Have its Business Plan approved under Article 21-15(1) of the ICE Act within one year from the enforcement date of the amended ICE Act (i.e., Aug. 2, 2021).
	• Carry out its business in accordance with the approved Business Plan.
	• Have a loss or a consolidated loss in a Special Business Year (in principle, one or two fiscal years, including the period from Apr. 1, 2020 to Apr. 1, 2021) due to the impact of the pandemic.

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	• Make certain investments in the growth and development of its business in accordance with the approved Business Plan under Article 21-16(2) of the ICE Act within five years from the commencement date of the approved Business Plan.
	• Include a breakdown of its utilization of NOLs under this rule with its tax return and a certificate with respect to certain investments issued by the responsible minister. The application for issuance of the certificate must be filed within one month after the fiscal year-end.
	• Aim in its Business Plan to improve its ROA or EBITDA margin by 5% by the end of the Business Plan period, based on the fiscal year preceding the year that includes the date on which the application for approval of the Business Plan was submitted.
The rule applies to fiscal years:	• That include a date implemented in accordance with the Business Plan.
	• Up to five years from the year in which the company returned to profitability after the first year of the Special Business Year.
	• That begin on or before Apr. 1, 2026.
Despite the pre-pandemic 50% limitation:	• NOLs exceeding 50% of taxable income can be utilized up to the amount of cumulative investment made in accordance with the Business Plan.

Procedure

The chart below is included in the Guidelines to illustrate the process.

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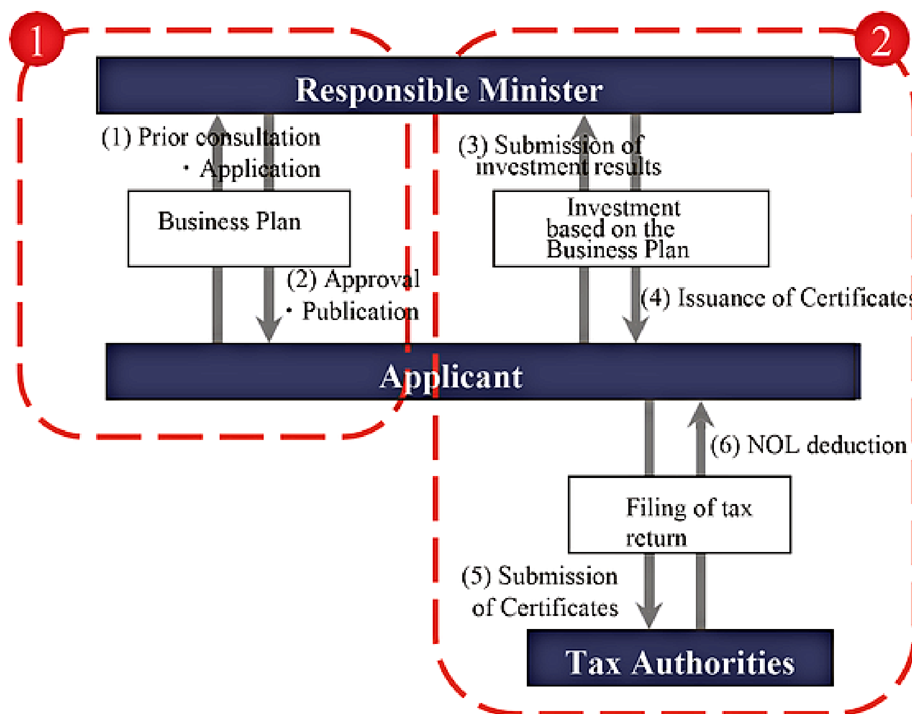

(Source: Guidelines)

(Source: Guidelines)

Companies considering applying for the above should make strategic preparations for the prior consultation with the responsible Minister and for the drafting of the application. It is important that the application specifically address and meet each of the tax incentive's requirements. A prior consultation with the relevant department at the responsible Ministry is also important in ensuring that an application is smoothly processed. It is generally recommended that companies work closely with the department of the responsible Ministry that oversees the company's business and the department that processes the application.

NOLs Incurred Due to the Negative Impact of the Pandemic

As mentioned above, the special NOL utilization rule is applicable only to NOLs incurred due to the pandemic. In this regard, while the tax law does not define NOLs incurred due to the pandemic, the Guidelines provide that losses incurred due to changes in the market/business environment that occurred during the pandemic and negatively impacted the company's business qualify for the rule. The Guidelines also provide examples of NOLs incurred due to the pandemic.

Example of a qualifying case	
A sharp drop in the market prices of major products due to the impact of the pandemic caused a large-scale loss due to inventory write-downs and, together with a decline in demand, resulted in a huge loss.	The NOLs are considered to have been incurred due to the pandemic because there were (1) changes in the external environment (ie, a drop in both market prices and product demand), (2) impacts on business activities (inventory valuation

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	loss and sales declines), and (3) as a result, losses were incurred.
Examples of non-qualifying cases	
A company's core businesses performed well and earned an operating profit. However, the value of securities held by the company declined significantly due to the impact of the pandemic. As a result, extraordinary losses were incurred.	NOLs are not considered to have been incurred due to the pandemic because the impact of the pandemic on the company's business activities cannot be confirmed.
The negative impact of the pandemic on a company's business activities and corporate earnings is unclear, and losses were incurred due to a large amount of impairment loss on fixed assets aimed at optimizing the scale of the company's operations. The company's relationships with its business partners have also deteriorated as a result of scandals.	NOLs are not considered to have been incurred due to the pandemic because changes in the external environment due to the pandemic cannot be confirmed, meaning that the impact of such changes on the company's business activities likewise cannot be confirmed.

(Source: Guidelines)

Investment in Growth and Development

Companies must make certain investments to promote the growth and development of their businesses in accordance with the approved Business Plan in order to enjoy the special NOL utilization rule. According to the Guidelines, the investments should be (1) necessary to implement the Business Plan; (2) aimed at the development of new products or services, the introduction of new production or sales systems for products or a new provision system for services; and (3) directed to research and development, fixed assets (tangible or intangible), mergers and acquisitions and other strategic initiatives, human resources and structural reorganization. The Guidelines also provide the following examples of qualifying investments.

Example of a qualifying case	
A corporation that runs a restaurant chain was negatively affected by the pandemic. In order to abandon face-to-face sales, it invested in a corporation that possesses an unmanned store technology that automatically identifies products held by customers using cameras and AI. The Business Plan aims to develop stores that are completely noncontact within three years and expand the chain's delivery/takeout services to make them a pillar of future profits.	The plan can be confirmed to meet all of the relevant requirements as (1) it is expected to improve future productivity (as measured by ROA) by adapting to changes in the business environment resulting from the pandemic, (2) it contributes to the development of new services and (3) it constitutes investment in R&D and strategic initiatives. Therefore, the investments listed on the left would be regarded as qualifying investments.

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Examples of non-qualifying cases	
An infrastructure-related corporation (eg, energy, railways, aviation) conducts maintenance and regular replacement of aging facilities (pipelines, rails, etc.).	Although it is an important investment, it is not applicable as it is related to mere maintenance and regular replacement. Specifically, the investment listed on the left does not fulfill requirement (2) above.
A corporation invests a large amount of cash on hand in a fund. The fund may become a future business partner, and it is also highly likely that the corporation will recover its invested funds through dividends and other sources.	A net investment like this does not qualify as the relationship between the business subject to the Business Plan and the investment stated in requirement (1) above cannot be confirmed.

(Source: Guidelines)

In order to enjoy the special NOL utilization rule, the company must obtain approval for the Business Plan from the relevant minister. If the company's NOLs are not regarded to have been incurred due to the pandemic or its investments do not satisfy the above requirements, its Business Plan will not be approved.

INCENTIVES TO ADOPT DX PLANS

Incentives to adopt DX Plans were also newly established under the 2021 tax reforms. These include special depreciation or tax deductions for digital-related investments (software and hardware) in connection with the cloud technology which is necessary for companies to achieve digital transformation.

During the period from August 2, 2021 — when the ICE Act amendment came into effect — to March 31, 2023, a company filing a blue tax return is eligible for special depreciation or a tax credit for the cost or the use of software necessary to implement the approved Business Plan. In this case, the company would be allowed to choose either a special 30% depreciation or a tax credit for 3% or 5% of the cost.

Eligible assets include new or specified software; initial costs for transitioning to a system that utilizes cloud technology (deferred assets); and machinery, equipment and fixtures used in conjunction with such software or deferred assets. The maximum investment amount eligible for the incentives to adopt DX Plans is JPY 30 billion per corporation. Moreover, if the tax credit is applied, the maximum total credit allowed is 20% for this incentive together with the carbon-neutral investment tax incentive, discussed below.

This tax incentive requires approval of the Business Plan under the ICE Act. Applicants are also required to obtain DX Certification via a system based on the Law on the Promotion of Information Processing. The table below summarizes the certification requirements.

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Overview of DX (Digital Transformation) Investment Promotion Tax System

[Applicable until March 31, 2023]

Certification Requirements

Digital Requirements (D)

①. Data linkage
Internal data must be used with data held by other corporations, etc. or data newly acquired by businesses using sensors, etc.
②. Utilization of cloud technology
③. Obtaining "DX Certification" from the Information-technology Promotion Agency (IPA) (legacy avoidance, ensuring cyber security)

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Corporate Transformation Requirements (X)

①. Expected to improve productivity or increase sales
- ROA improvement by 1.5% over the 2014-2018 average
- Growth rate of net sales ≧ Industry sales growth rate for the past five years +5 percentage points

②. Reduction of product manufacturing costs by 8.8% or more within the plan period, etc.
③. Transformation based on decisions made by the corporation (attach documents of resolutions of the Board of Directors, etc.)

Details of Tax Incentive

Eligible assets	Tax Deduction	Special depreciation
• Software • Deferred assets [1]	3%	30%
• Equipment and fixtures[2] • Machinery[2]	5%[3]	

1 Initial cost of migrating to a cloud system
2 Limited to those used in conjunction with software and deferred assets
3 When linked to data held by corporations outside the group

* **Minimum investment amount:** 0.1% or more of domestic sales
** **Maximum investment amount:** JPY30 billion (up to JPY30 billion for investments exceeding JPY30 billion)
*** **Maximum tax credit:** up to 20% of current income tax together with the tax incentive for Carbon Neutral Investment

(Prepared by Baker McKenzie based on data published by the Ministry of Economy, Trade and Industry)

CARBON NEUTRALITY INCENTIVE

Under this incentive, a tax credit of up to 10% or special depreciation of 50% can be applied to the introduction of (1) production equipment for products with significant decarbonization effects, or (2) equipment that both decarbonizes production processes, etc., and increases added value, based on the approved Business Plan. The amount of eligible investment is up to JPY 50 billion. The amount of the tax credit is up to 20% for this incentive together with the above incentives for a DX Plan.

Production equipment with significant decarbonization potential includes the following:

- Compound power semiconductors
- Lithium-ion batteries for electric vehicles (EVs) and plug-in hybrid EVs (PHEVs)
- Lithium-ion storage batteries for stationary use
- Fuel cells
- Major specialized components of offshore wind power generation equipment

Equipment that both decarbonizes production processes, etc. and increases added value is required to improve carbon productivity per facility by at least 1%.

This tax incentive will be available until March 31, 2024.

PREPARE EFFICIENTLY

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For all these incentives, it may take more than three to six months to get the Business Plan approved. Moreover, to successfully obtain that approval, a company will need coordination between multiple departments within a company and the relevant ministries to meet the requirements. Preparing efficiently in advance and getting an early start will be key.

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