EUROPEAN BUSINESS COUNCIL IN JAPAN
THE EUROPEAN (EU) CHAMBER OF COMMERCE IN JAPAN

TAX

ISSUES AND RECOMMENDATIONS

RESEARCH & DEVELOPMENT (R&D) TAX INCENTIVES

Research & Development Tax Incentives

YEARLY STATUS REPORT: Little Progress

- Innovation-intensive industries are a key driver of growth and employment.
- R&D tax incentives are widely recognised as an effective instrument for encouraging R&D activities and related (foreign) investments.
- While Japanese rules give some tax consideration to R&D expenses incurred in Japan, the current tax credit is generally too restrictive in scope (both in terms of access and benefit) to be a deciding factor in a foreign company's choice between potential R&D locations.
- Having said that, the decision to award higher credit rates to increased R&D expenses or newly started activities is welcome and foreign companies reviewing their R&D policy in Japan could benefit from this.

Research & Development Tax Incentives

YEARLY STATUS REPORT: Little Progress

- In general, however, Japan still needs to revise its current R&D tax policy if it wishes to maintain and improve its international attractiveness as a location for R&D activities.

- In this respect, it should be noted that many other countries have in recent years introduced some form of "back-end" Intellectual Property (IP) regime that applies to income earned after the creation and exploitation of IP.

- Furthermore, the current R&D credit regime is not available to companies that are loss-making, and so is of little benefit to many start-up companies.

Research & Development Tax Incentives

RECOMMENDATION

- Revise the current R&D tax policy to maintain and improve Japan's international attractiveness as a location for R&D activities (paying particular attention to the specific position of start-up companies).

CORPORATE RESTRUCTURING

Corporate Restructuring

YEARLY STATUS REPORT: No Progress

- The current tax treatment of cross border and triangular mergers is, in practical terms, a barrier to those market entrants who have no established business in Japan but aim to use their own shares to acquire a Japanese company.

- Current rules do not permit tax deferral in respect of stock swaps between foreign and domestic companies, even if the transaction is carried out using a Japanese special purpose company, and this has a stifling effect on inward investment.

Corporate Restructuring

YEARLY STATUS REPORT: No Progress

- The current tax treatment of cross border and triangular mergers is, in practical terms, a barrier to those market entrants who have no established business in Japan but aim to use their own shares to acquire a Japanese company.
- For example, the current rules do not permit tax deferral in respect of stock swaps between foreign and domestic companies, even if the transaction is carried out using a Japanese special purpose company, and this has a stifling effect on inward investment.
- In addition, triangular merger taxation rules make reference to so-called "paper companies", although a definition of a paper company has not yet been released.
- The same lack of a definition is also a concern for multinational groups with overseas affiliates and therefore subject to anti-tax haven rules, as those rules also mention but do not define a paper company.

Corporate Restructuring

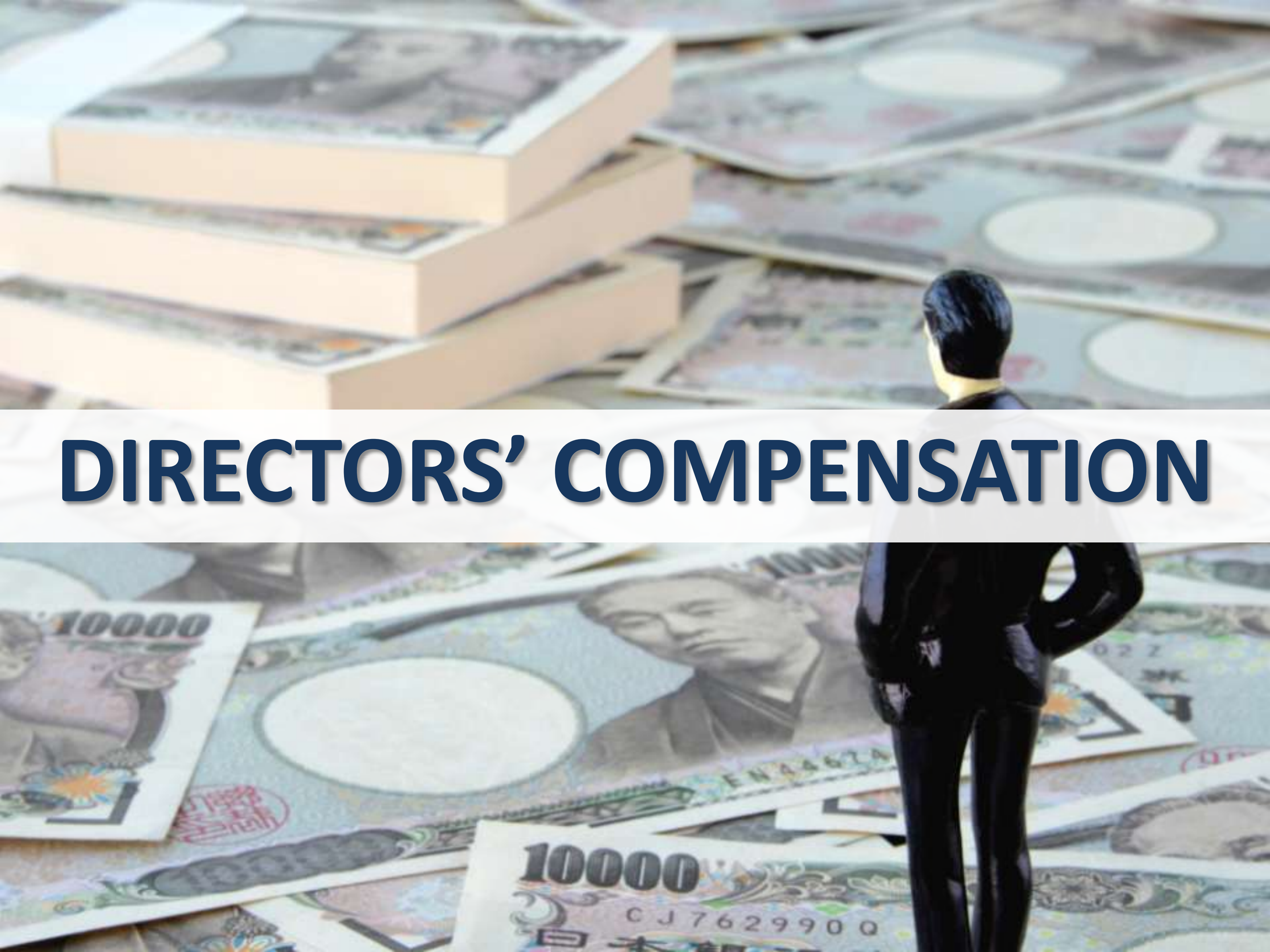
RECOMMENDATIONS

- ❑ Tax deferral should be permitted in respect of share-for-share exchanges, including those involving foreign companies with no previous operations in Japan.

- ❑ Rules and regulations underpinning corporate restructuring laws should be further simplified and clarified to reduce costs and limit the tax authorities’ discretion to interpret undefined key concepts.

- ❑ A definition of a paper company should be provided.

DIRECTORS’ COMPENSATION



Directors’ Compensation

YEARLY STATUS REPORT: New Issue

- Recent tax reform has provided some degree of relief from unfavourable directors’ compensation tax rules that limit the deductibility of performance-based directors’ compensation.
- However, in practice the relief only applies to listed companies issuing securities reports.
- In particular, small and medium-sized enterprises and foreign affiliated companies are unable to take advantage of the reforms, with the result that these companies have to pay performance-based directors’ compensation from their after-tax income.

Directors' Compensation

RECOMMENDATION

- Remove barriers to relief for small and medium-sized companies, as well as foreign affiliated companies, to enable the deduction of reasonable performance-based directors' compensation.

EXTENDED TAX RETURN FILING PERIODS

Extended Tax Return Filing Periods

YEARLY STATUS REPORT: Some Progress

- Japanese rules require companies to file tax returns no later than two to three months after the end of the calendar or fiscal year.

- This deadline causes very high compliance and overtime costs and puts unreasonable pressure on companies, staff and associated service providers.

- In Europe and elsewhere, an average period of nine months is allowed, and sometimes up to one year.

Extended Tax Return Filing Periods

YEARLY STATUS REPORT: Some Progress

- The extremely short deadlines in Japan compromise the quality of tax filings and the working and family lives of those preparing the returns, while driving up expenditure on overtime.
- Not surprisingly, international comparison of the cost incurred for tax compliance shows that Japan has the highest level among developed countries.
- The 2017 tax reform introduced measures intended to provide relief but these have proven impractical and have yet to be adopted by many Japanese taxpayers.

Extended Tax Return Filing Periods

RECOMMENDATION

- Tax filing periods should be extended to one year without a formal application process, to reduce the current unduly high cost of tax compliance. Any negative impact on public finances could be avoided as long as the tax rules continue to allow prepayments and impose interest if insufficient prepayments are made.

INCOME AND INHERITANCE TAXES

Income and Inheritance Taxes

YEARLY STATUS REPORT:

Progress with drawbacks for long-term residents.

- With top rates of more than 55%, Japan's income, inheritance and gift taxes are the highest in Asia and, indeed, in the world.
- Foreign nationals are exempt from Gift and Inheritance Tax for the first ten years of their stay in Japan.
- However, anyone who becomes a long-term resident is subject to Gift and Inheritance Tax, and continues to be so for up to a five-year period after their departure from Japan.

Income and Inheritance Taxes

YEARLY STATUS REPORT:

Progress with drawbacks for long-term residents.

- Only one other nation imposes such extraterritorial taxation upon foreigners and it has a wider inheritance tax treaty network than Japan, which provides relief for many expatriates.
- Moreover, Japan's top inheritance tax rate applies to inheritance between close family members, and starts at much lower thresholds and allowances than in other countries.
- Japan's Gift and Inheritance Tax is negatively impacting the ability to retain long-term residents, potentially triggering a loss in foreign intellectual capital and foreign investment.

Income and Inheritance Taxes

RECOMMENDATIONS

- Align the categories of foreign nationals who are subject to Gift and Inheritance Tax with the categories of foreign nationals who are subject to exit tax, so that only foreign nationals who can reside permanently in Japan are subject to taxation on global assets.
- Repeal the extraterritorial taxation of former long-term residents.

ACCOUNTABILITY

Accountability

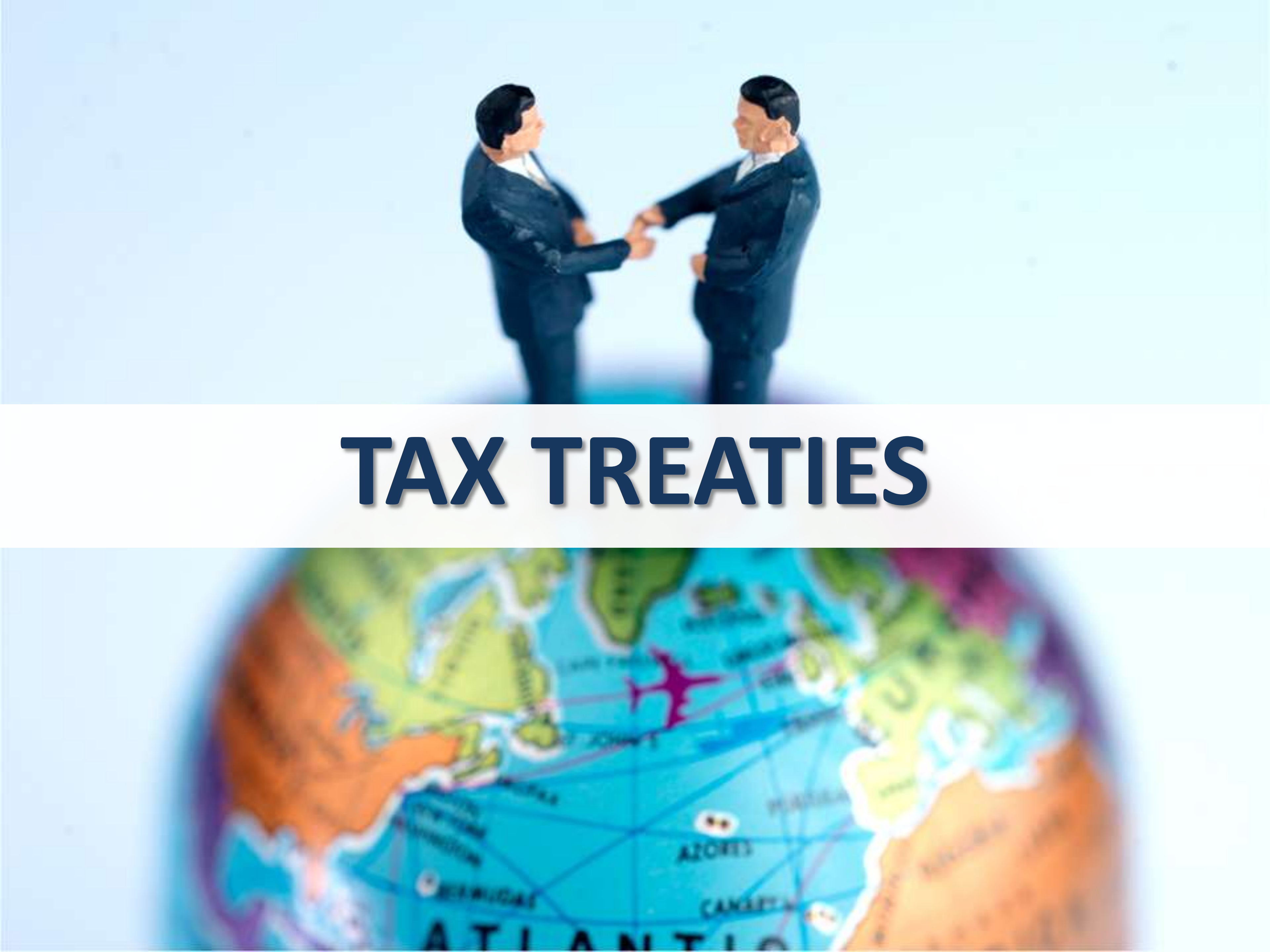
YEARLY STATUS REPORT: No Progress

- The overall lack of transparency and systematic accountability in the domestic tax regime continues to impede the development of business in Japan.

RECOMMENDATIONS

- The tax authorities in Japan should be obliged to accept and process applications for tax rulings, and tax law should enshrine the right to request and obtain tax rulings. The system should be more user-friendly.

- Consider the merits of introducing a system offering Horizontal Monitoring, Risk Rating and Senior Accounting Officers, which have each helped to improve efficiency in the UK and The Netherlands.


TAX TREATIES

Tax Treaties

YEARLY STATUS REPORT: Progress

- Japan recently concluded and ratified a new tax treaty with Germany, as well as reaching an agreement with Austria and an agreement in principle with Denmark.
- However, its treaties with 19 other EU Member States still need to be renegotiated.
- The EBC welcomes treaties that include the exemption of withholding tax on royalties and qualified dividends and interest.

Tax Treaties

RECOMMENDATIONS

- The Government should review all current tax treaties with EU Member States.
- Any new or revised treaty should address the issue of withholding tax on royalties and qualified dividends and interest, and contain arbitration provisions if not already covered by the multilateral instrument.
- The EU-Japan EPA should include an arbitration clause to ensure that double taxation is effectively eliminated where the multilateral instrument does not apply and the applicable tax treaty does not resolve double taxation.