Corporate income tax reform in Japan

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Background: Globalization and International tax competition

Japanese Economy and Policy Measures
MOF 2014

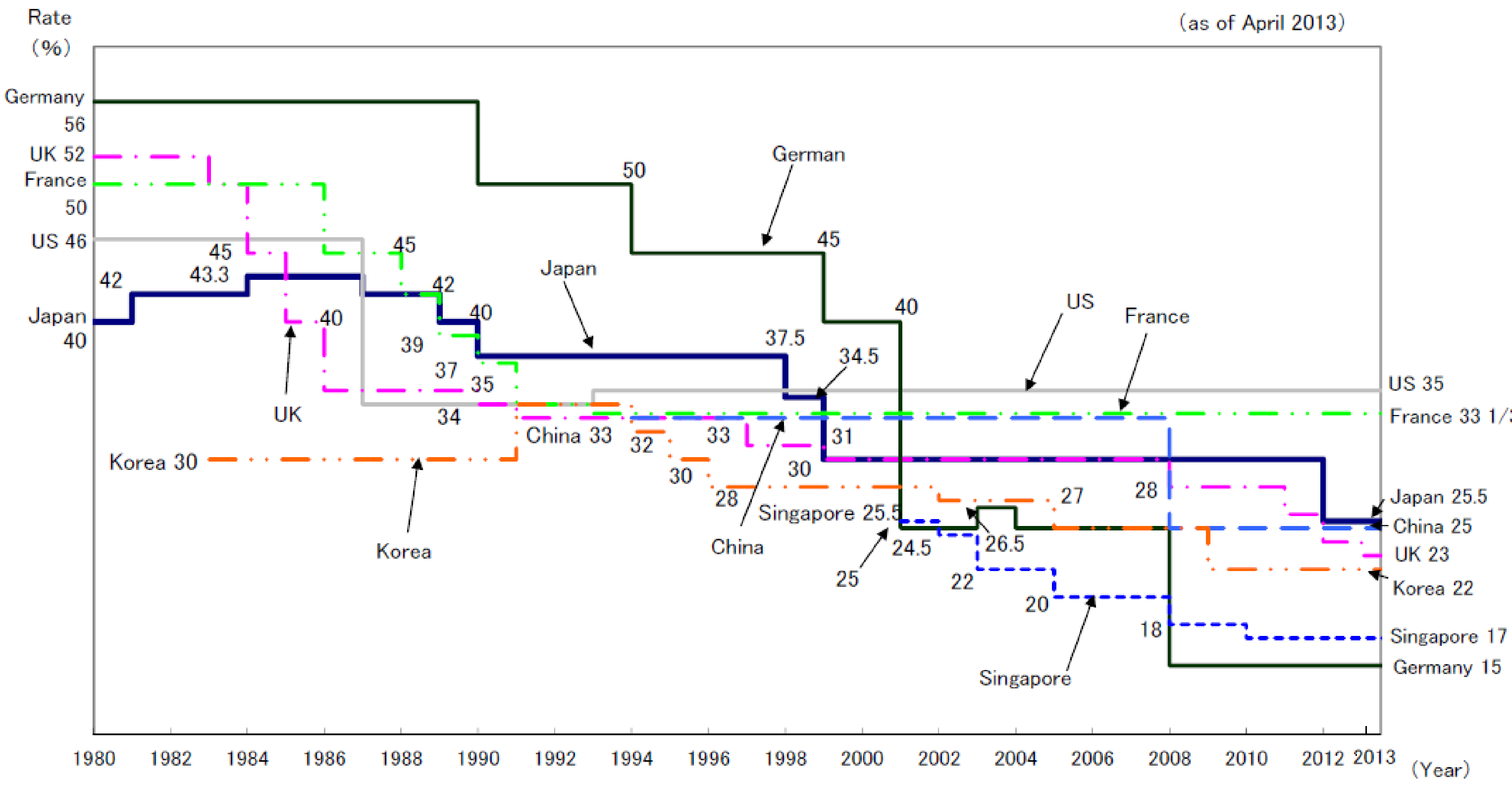
- With economic globalization, high CIT turn to be impediment to international competitiveness of domestically locating business.

☐ High CIT is translated into high production cost

- Countries now compete one another reducing own CIT to ①defend domestic business and to ②attract foreign investments/profits

⇒Globalization intensifies international tax competition

Trends in Corporation Tax Rates (Basic Rates) in Major Countries



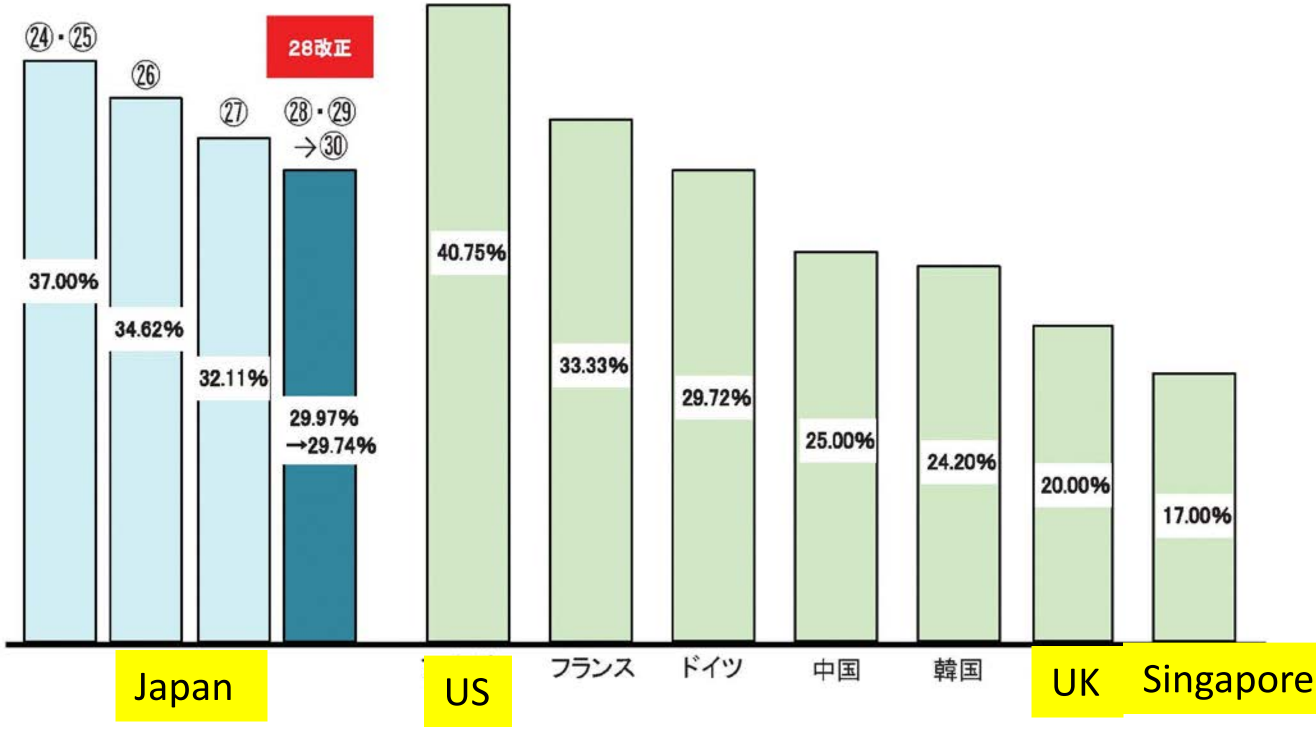
Cut of corporate income tax (CIT)

- Japan government has decided to lower CIT rate combining both the central and local rates below 30% .
- ➢ It remains high compared with other Asian countries.
- ✓ President Trump proposes federal CIT rate down to 15%!

⇒Does Japan need to conduct further CIT cut?

- Why is Japan CIT high?
- ➢ On the top of central CIT, there are local CITs charged, undermining international competitiveness of domestic business.
- ➢ Local CITs (enterprise tax and corporate inhabitant tax) leads to inter-regional fiscal gap and unstable local tax revenue.

⇒We need to conduct reform of local CIT(business tax).



Impact of CIT rate cut?

- Corporate sector in Japan has accumulated cash-holdings

⇒Lower CIT may simply increase their cash… without being invested or raising wage/ employment

✓ CIT cut is just windfall gain to companies

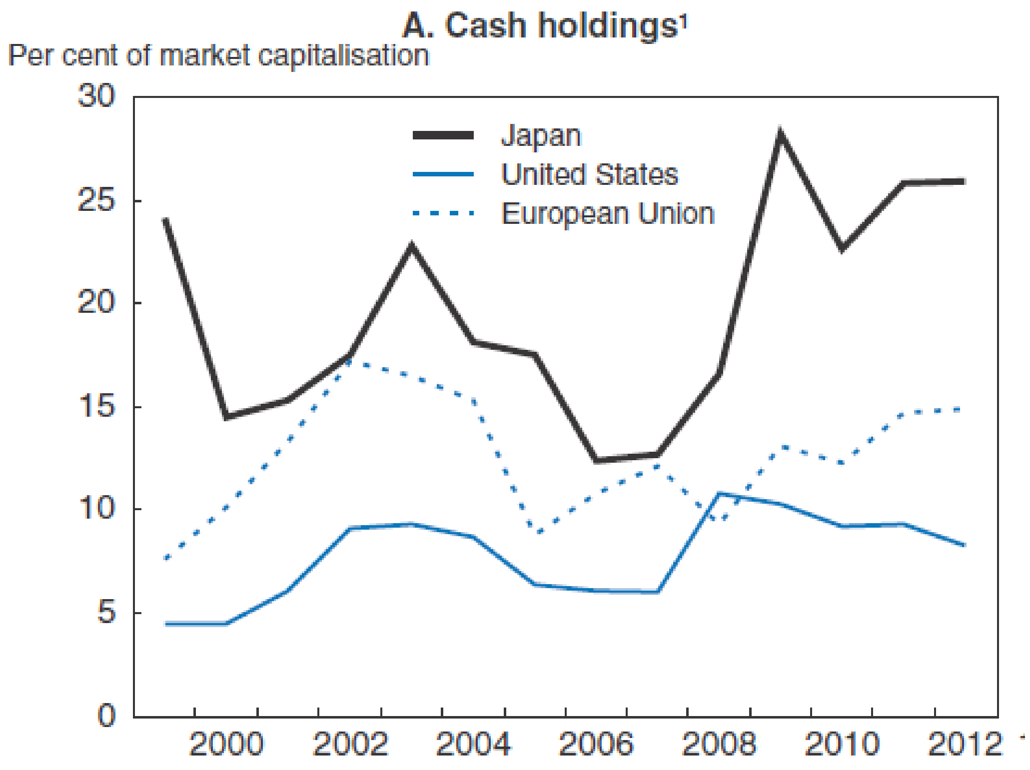
- Accumulated cash-holdings cause or consequence…

✓ It may be a consequence of lower net of tax return on investment in Japan..

- Lower CIT rate can enhance net of tax return

✓ If firms are forward looking, high net of tax return can encourage them to invest

✓ But there can be other things that undermine their incentives of investment



OECD Economic Surveys
JAPAN
APRIL 2015

Tax base broadening

- Corporate tax reform follows the principle of lower tax rate with broadening tax base

✓ The principle is not only for revenue neutrality.

- Marginal versus average effective tax rate

➢ Effective tax rate accounts for not only statutory but also depreciation allowance, inflation, interest deduction and tax credits influencing real response of business including investment and location whereas statutory tax rate affects profit shifting/ tax planning

➢ Marginal effective tax rate applies to marginal or zero net of tax return investment and is lowered with investment tax credits.

✓ Investment tax credits in general enhances low return (less productive) investments/projects that would not have been otherwise undertaken

➢ Average tax rate on investment is weighted average of statutory and effective marginal tax rates where weight relies on invest return

✓ Average effective tax rate converges to statutory tax rate as return increases and to marginal effective tax rate as it decreases.

⇒Tax reform Involving statutory tax cut and tax base broadening diminishing tax credit favors higher return investments/ projects promoting their location as well as containing incentive of profit shifting.

Too broad tax base?

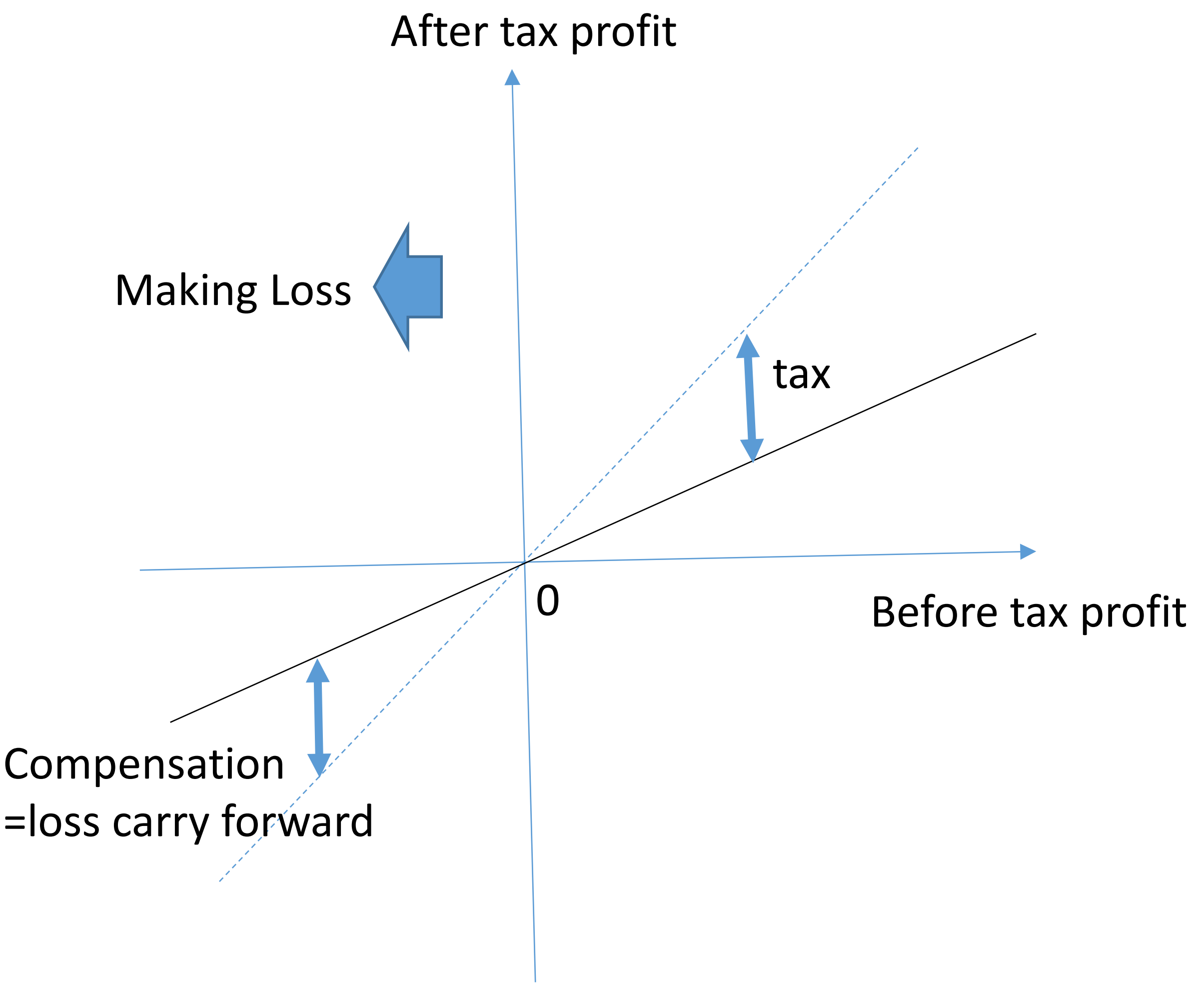
- Loss carry forward is limited to 50% for large business after April 2018 (currently it is 55%) whereas its period is extended to 1o years.

- For on-going business, loss carry forward serves as risk sharing device with the government.

✓ Income taxation has insurance function when gain and loss are treated symmetrically.

- Limit loss carry forward implies profit is taxable but loss is not compensated = asymmetric treatment

⇒ It could undermine the insurance function which could discourage business to take risky investment.

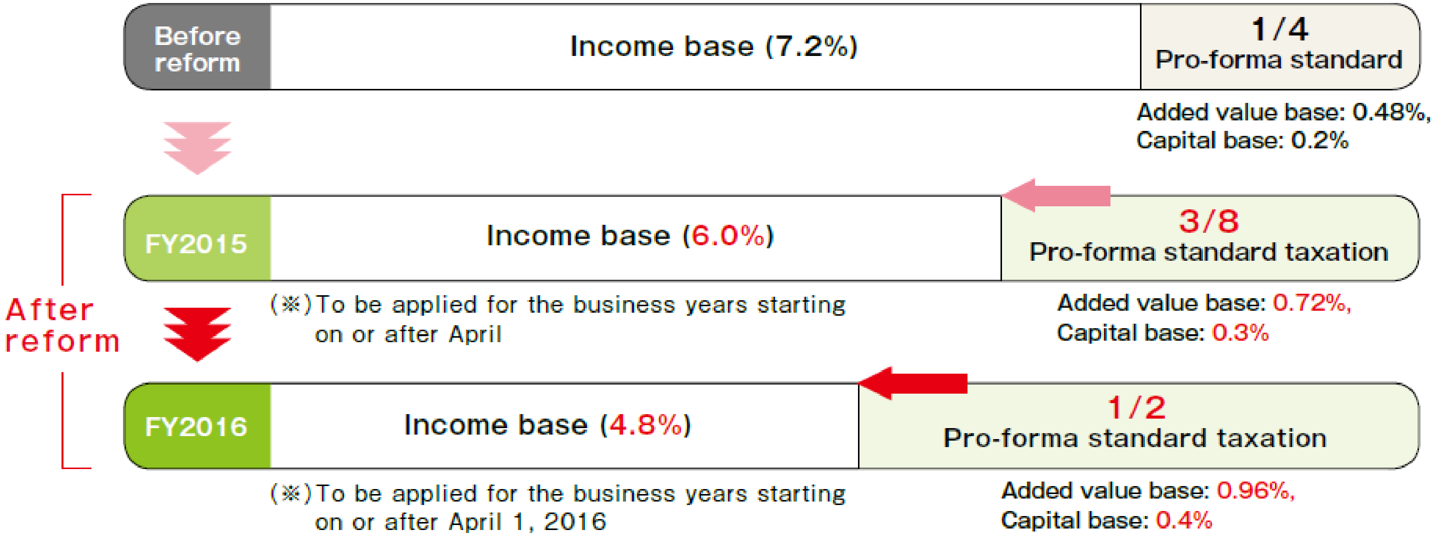


Local Business VAT in Japan

- To compensate revenue loss to local government, pro-forma standard taxation is enhanced.

✓ It includes added value base = Business VAT

- The tax is more or less equivalent to VAT (consumption tax) ⇒Hidden VAT increase?
- It applies only to large business and origin based and thus distortive compared to VAT that is levied on all business and follows destination principle.



・VAT is better than the pro-formula standard tax

Profit + wage + interest payment
= sales – purchase of inputs

Source: MOF

IP/Patent Outflow?

- CIT reform preserves or even enhances R&D tax incentives.

- Both R&D site and IP can be internationally mobile
  - There can arise not only international tax competition over R&D activities but also over IP/patent
  - Given that many firms/subsidiaries across countries are being involved in R&D activities, it is increasingly difficult to identify right place of IP/patent to locate
  - ✓ Multi-national firms may be able to undertake cherry-picking behavior, undertaking R&D in a country with generous R&D tax incentives and moving IP to another country with lower patent box tax rate.
  - ✓ National government cannot recover tax revenue from successful R&Ds

Tax Factors	*Belgium*	*Netherlands*	*United Kingdom*
Headline tax rate	6.8%	5%	10%
Year Enacted	2007	2007, 2010	2013
Qualified IP	Patents and extended patent certificates	Patents and IP derived from technological R&D activities	Patents, supplementary protection certificates, regulatory data protection, and plant variety rights
Applicable to existing IP?	IP granted or first used on or after 01/01/2007	IP after 31/12/2006	Yes
Applicable to acquired IP?	Yes, if further developed	Yes, if further self-developed	Yes, if further developed and actively managed
Includes embedded royalties?	Yes	Yes	Yes
Can R&D be performed abroad?	Yes, if qualifying R&D centre	Yes, for patented IP; strict conditions for R&D IP	Yes

Patent Box Policies
Gaétan de Rassenfosse, University of Melbourne
2015

IP/Patent can move to lower tax country

Financial constraint and SCC

- CIT gives favorable treatment to SMEs including lower tax rate and generous tax incentives.
- It is SSC (social security contribution) that SME bears a lot.

➢ Cutting CIT may not be helpful much for innovative SMEs

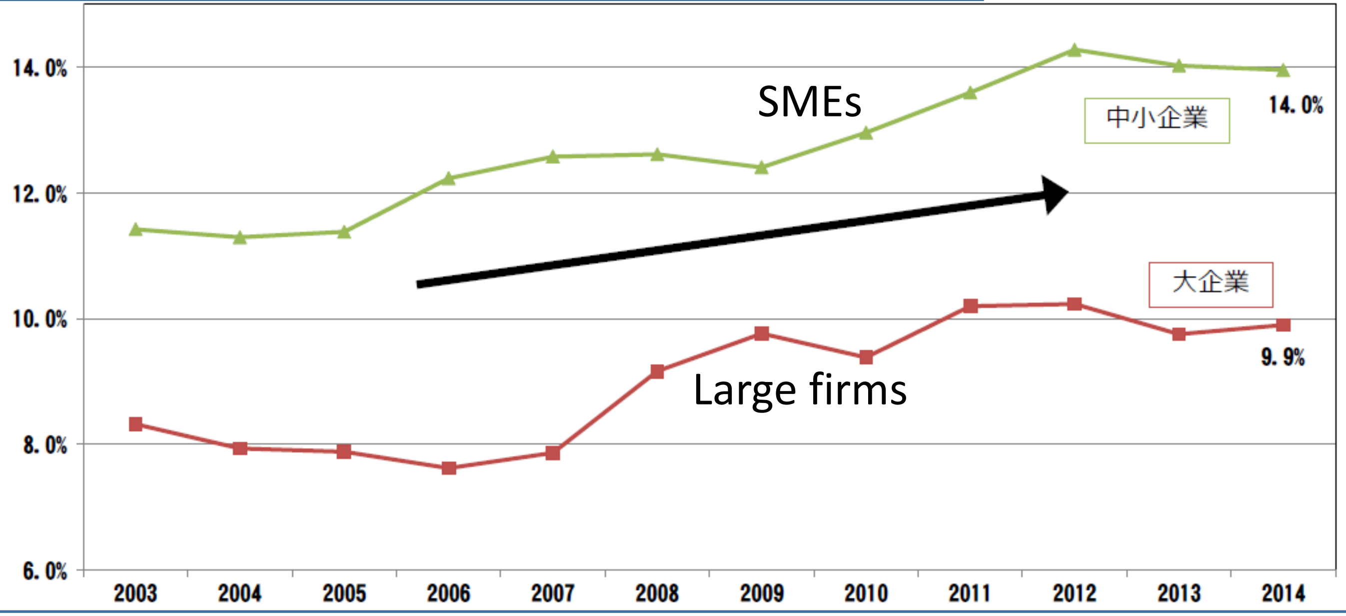
✓ In the Netherland, R&D spending can be deductible from SSC (WBSO).

- Unused R&D tax credit in CIT may be used to lower SSC
- Or overall SSC on firms should be reduced

✓ Sifting from CIT/SSC to VAT may support SMEs

Burden of Social security contribution on firms in Japan

SSC/Proceeds of Sales (%)



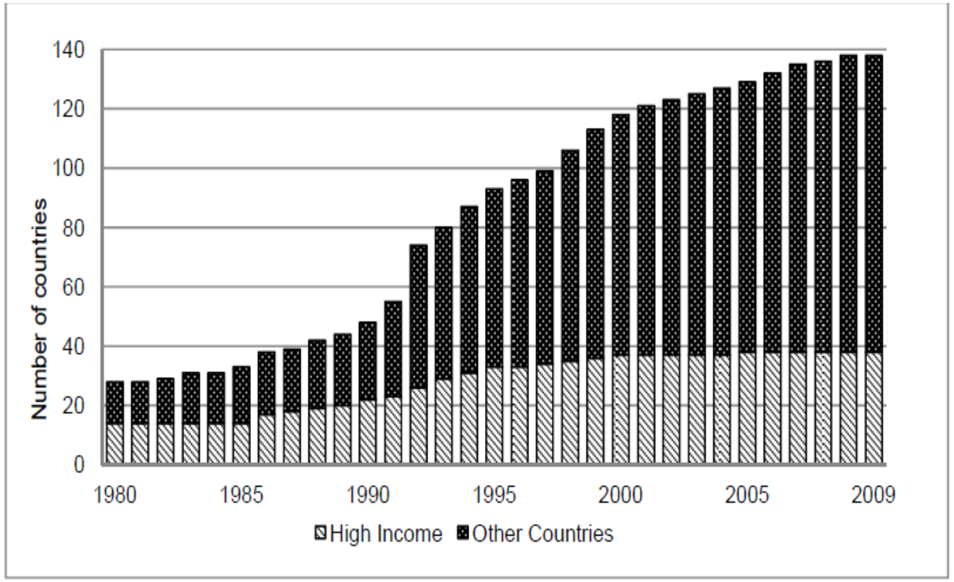
METI(2016).

Increasing dominance of VAT

- In the last decades, (i) VAT has been widely spreading in both developed and developing countries, (ii) its share in GDP increasing relative to CIT and SSC
- There has been shift in tax mix toward consumption tax away from income taxation including SSC(Social security contribution)

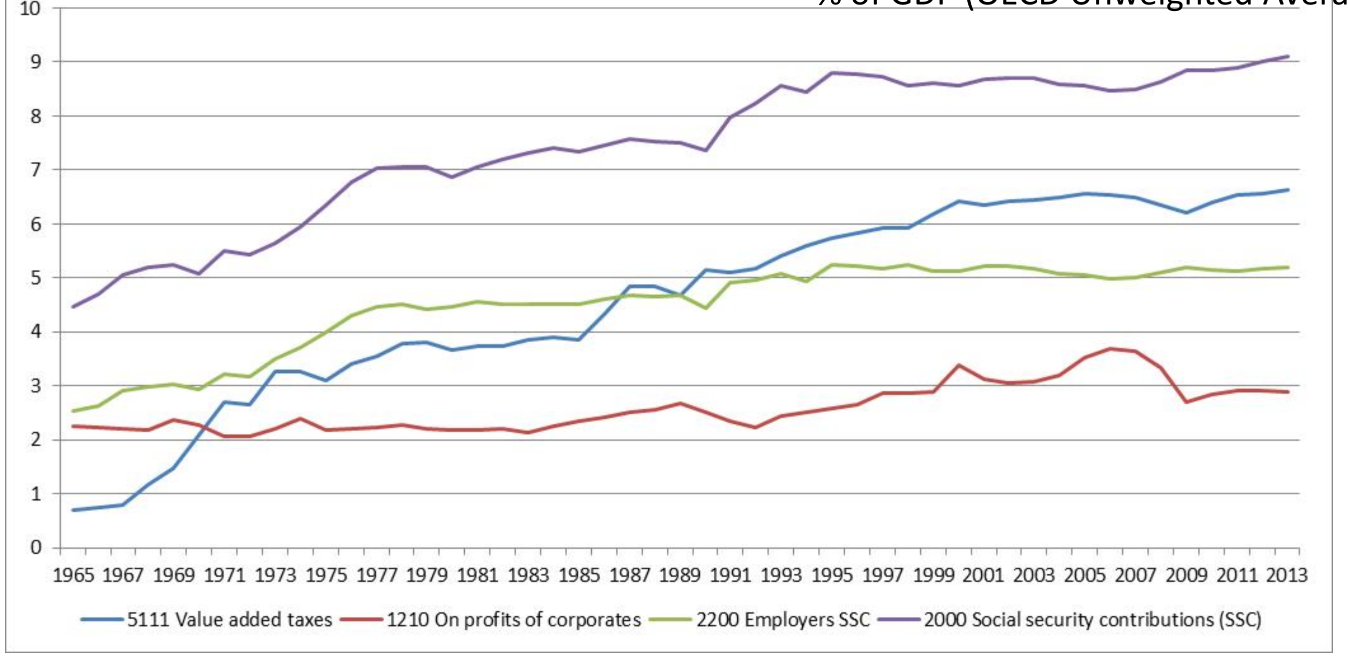
⇒VAT fits better to newly emerging economic environment namely economic globalization

The Spread of the VAT, 1980–2009



Source: IMF data.
Note: Figure shows the number of countries with a VAT at each date.

% of GDP (OECD Unweighted Average)



Source: OECD Revenue Statistics

What is good about VAT?

- VAT burden accrues to the final consumption domestically and internationally.

➢ It does not accumulated at the production stages that assures the production efficiency.

➢ It does not undermine “international competitiveness”.

❑ In contrast, CIT as well as SSC (Social Security Contribution) distorts both (i) production efficiency and (ii) international competitiveness.

✓ VAT levied on every stage of transaction works to secure tax revenue as well

❑ Fiscal devaluation = moving away from source based taxation such as CIT and social security contribution toward destination based taxation

Key feature	Economic consequence
Tax refund/credit mechanism	Production efficiency ⇒Growth friendly
Destination principle	International competitiveness ⇒ Fiscal devaluation

Cash flow tax in Japan?

- Fundamental CIT reform may be to transform corporate income taxation to cash flow taxation or its equivalence.

➢ Cash flow tax = tax on economic rent

✓ Destination based cash flow tax = VAT minus SSC

✓ ACE allows deduction of opportunity cost of equity finance = Equivalent of R+F origin based cash flow tax

- Japan—2014 Article IV Consultation Concluding Statement of the IMF Mission

✓ As an alternative to a CIT rate cut, consideration could be given to opt for an Allowance for Corporate Equity (ACE) system, which would be a more cost effective way of encouraging investment.

✓ An ACE treats debt and equity financing in the same manner and has recently been adopted in some advanced and emerging economies.

Capital income taxation

▪At the individual level, economic rent or above normal return can be taxed differently from normal return.

⇒Combination of capital income tax and cash flow tax may work to reconcile income redistribution with growth

	Economic rent	Normal return
Business/ Corporation	taxable ACE＝R+F base or R based cash flow tax	Non taxable
Individual	Taxable at a flat rate with full loss offsetting	
	Surcharge / progressive taxation	