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## Japan to introduce "Innovation Box"

Takato Masuda (Nishimura & Asahi (Tokyo)) · Tuesday, August 20th, 2024

One strategic response of countries to the Global Minimum Tax (the GloBE rules) would be restructuring their tax incentives. The top-up tax effectively nullifies any tax incentive that brings the effective tax rate below 15%. This would push countries to redesign tax incentives that would otherwise produce an effective tax rate below 15%. In a July 2021 press release,[1] at a very early stage of the global minimum tax project, OECD Secretary-General Mathias Cormann had already emphasized that "[t]his package does not eliminate tax competition, as it should not, but it does set multilaterally agreed limitations on it." As this statement suggests, countries apparently did not want the GloBE rules to bring a definitive end to tax competition, but rather to start a new round of tax competition by developing more attractive tax incentives within the boundaries established by the GloBE rules.

Japan has implemented the main parts of the GloBE rules (the so-called Income Inclusion Rule) from April 1, 2024, while Japan will introduce a new tax incentive for intellectual property, named the "Innovation Box" regime, for seven years beginning April 1, 2025. Is the Innovation Box regime Japan's strategic response to this new round of tax competition? – Or maybe not. Although "enhancing Japan's competitiveness" was a key phrase featured in its legislative history, the Japanese Innovation Box might be too modest a tax incentive to make Japan competitive.

Japan has decided to introduce the "Innovation Box" with the following background. It is said that Japan has had tax incentives based on inputs (e.g., R&D expenditures) but not on outputs (income derived from intellectual property) like the IP Box regime in major European and Asian countries. In particular, in July 2023, the Japanese Ministry of Economy, Trade and Industry (METI) posted a report on its website recommending that Japan also introduce the "Innovation Box" regime as an output-based tax incentive to keep pace with global trends.[2] Later, the Cabinet proposed introducing the Innovation Box regime when submitting the Tax Reform Package Bill 2024, and the National Diet passed the bill this March. Japan fills the missing output-based tax incentives gap with the newly introduced Innovation Box. In this regard, the Japanese government has noted that the Innovation Box is intended to improve Japan's competitiveness. For example, the Japanese Ministry of Finance (MOF) published its technical explanation on the tax reform 2024, saying that Japan introduced the Innovation Box to enhance its competitiveness as an R&D center location.[3]

However, it may remain questionable whether the Japanese Innovation Box can achieve such an ambitious goal since it appears to be a modest tax incentive for the following reasons. First, the Japanese Innovation Box provides a 30% deduction for qualified IP income.[4] Since Japan's effective corporate tax rate is usually about 30% (including local taxes), the Innovation Box would,

at best, reduce the effective tax rate on qualified IP income to about 21%.[5] The effective tax rate of 21% may not sound like a significant tax cut, especially considering that some countries offer more drastic tax incentives for intellectual property.[6] Second, Japan caps the Innovation Box deduction at 30% of current income (before applying the Innovation Box) minus any unused loss carryforwards. Any amount exceeding this ceiling cannot be deducted and will not be carried over. (For example, if qualified IP income is 300, but current income after offsetting unused loss carryforwards is only 100, the deduction under the Innovation Box would be 30 instead of 90). This sealing would prevent the Japanese Innovation Box from producing significant tax cuts even when combined with other income deduction-type incentives and the current or carryforward losses. Finally, not all income derived from intellectual property is eligible for the Innovation Box. For example, the Innovation Box covers only patents and AI-related software programs; it will not apply to other intellectual property. Furthermore, to qualify for the Innovation Box, the intellectual property must meet the somewhat tricky requirement of "contributing to improving Japan's international competitiveness.[7] Income from licensing or domestic sale of those intellectual property is covered, but so-called embedded royalties are not. Furthermore, income from related party transactions (e.g., licensing to a foreign subsidiary) is excluded, even if they are done at the arm's length price. For these reasons, the Japanese Innovation Box seems to be a moderate tax incentive.

One might argue that in the age of the GloBE rules, Japan can ensure its competitiveness even with modest tax incentives. However, it may sound a bit optimistic or even naive to think so. It is true that the GloBE rules ensure a minimum effective tax rate of 15%, regardless of the location of the enterprise. Accordingly, the GloBE rule can help Japan maintain its competitiveness by making tax incentives adopted by other countries virtually meaningless as long as the effective tax rate goes below 15%. However, 15% is a fairly low tax rate from the perspective of a high-tax country like Japan. As noted above, even under the Innovation Box, the effective tax rate in Japan is expected to remain well above 15%. Thus, even after implementing the 15% global minimum tax and the Japanese Innovation Box regime, MNEs would still be motivated to establish R&D centers outside of Japan in search of a lower tax rate than in Japan.

In summary, it is fair to say that the Japanese Innovation Box is a moderate tax incentive. Several countries have responded strategically, developing mechanisms to maintain the strong tax incentives of their IP Box regimes even under the GloBE rules.[8] In contrast, Japan appears to have a policy of staying away from such movements and seeking to remain a high-tax country. It will be interesting to see if the Japanese Innovation Box can be a game changer even under such a policy.

[1] https://web-archive.oecd.org/2021-07-08/593841-130-countries-and-jurisdictions-join-bold-new-framework-for-international-tax-reform.htm

[2] Study Group on Promoting Innovation Investment by the Japanese Private Sector, Interim report, 15 (2023). The study group comprises 12 members, including three academics and ten companies, such as Honda and SONY. Its secretariat is the METI which may negotiate tax policy with the Ministry of Finance of Japan from the economic and industrial policy perspectives.

[3] Nobuhisa Abe et al., Reiwa 6 Nendo Zeiseikaisei no Kaisetsu 554 (2024). The authors of this technical explanation are ministry officials. Although these officials wrote in their personal capacity, the technical explanation is generally considered authoritative literature in practice.

[4] In a nutshell, the "qualified IP income" is essentially the "domestic self-development" portion of income arising from the licensing or domestic sale of the qualified IP. The "domestic self-development" portion is determined by the ratio of R&D costs directly related to the qualified intellectual property to the remaining R&D costs after excluding those without the domestic or self-development nature. According to the MOF, limiting tax benefits to the self-development portion will ensure that the Japanese Innovation Box is in line with the "nexus approach" recommended by the final report of BEPS Action 5 (Addressing Harmful Tax Practices) (*Id.* at 555).

[5] 21% = 30% * (1 – 30%). *See, e.g.*, METI, Reiwa 6 Nendo (2024 Nendo) Keizaisangyo Kankei Zeiseikaisei Nitsuite, 6 (2023).

[6] For the tax rate under the IP Box regime in each country, *see, e.g.*, Alex Mengden, Patent Box Regimes in Europe, 2023 (2023) (the tax rate under the IP Box regime would be lower than 21% in all of the featured countries).

[7] The details of this requirement have yet to be determined and will be laid down by the MOF later. In addition, taxpayers must obtain a certificate confirming the qualification of their intellectual property by the METI and attach it to their tax return.

[8] For example, Belgium has reformed its Innovation Income Deduction regime (85% deduction of the qualified IP income, effectively reducing the effective tax rate to 3.75%) to allow taxpayers to convert a certain excessive portion of their deductible amount into a non-refundable tax credit to be carried forward indefinitely, and, in effect, to manage their effective tax rate from year to year.

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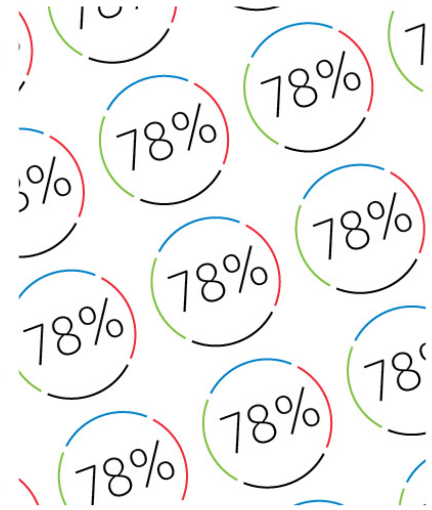

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