Japan Tax Bulletin

Digital Taxation

January 2024

On October 8, 2021, it was announced that 136 of the 140 member countries of the OECD/G20 Inclusive Framework on BEPS, representing more than 90% of global GDP, agreed on new international tax rules, which is the Two-Pillar Solution to Address the Tax Challenges Arising from the Digitalisation of the Economy ("digital taxation"). As of November 15, 2023, 140 countries/regions have agreed.

This digital taxation consists of "Pillar One" and "Pillar Two" and is a response to the situation where the current principles of international taxation are no longer fully functional as the economy becomes increasingly digitalized.

1. *Pillar One*

Pillar One is a review of the rules for appropriately allocating taxable income to market countries.

Under the digitalisation of the economy, the number of digital companies, etc., which do not necessarily need a physical location to conduct business, has increased, and under the principle of "no taxation without PE," the problem of insufficient taxation in the market country has become apparent. As of 2023, it has not been introduced in Japan.

(a) Enterprises subject to the Pillar One

Multinational enterprises ("MNEs") with worldwide revenues exceeding 20 billion euros and a profitability exceeding 10% are subject to the Pillar One.

* The revenues threshold will be reviewed seven years after the entry into force of The Multilateral Convention to Implement Amount A of Pillar One, and will be lowered to 10 billion euros, subject to smooth implementation of the system.

* If there is a segment that meets the above threshold, the tax will be imposed on a segment-by-segment basis on an exceptional basis.

(b) Amount A

25% (Amount A) out of the MNE's pre-tax profit margin in excess of 10% (excess profit) shall be allocated to the market country with the nexus (tax base) in proportion to revenues, etc.

(c) Nexus

The MNE shall allocate Amount A to the market countries in which the MNE earns more than 1 million euros* in the following proportions;

Revenue in the market country / Revenue in the consolidated financial statements of the MNE

* In the case of countries with a GDP of less than 40 billion euros, it is 250,000 euros.

2. *Pillar Two*

Pillar Two is a measure against profit shifting to tax havens. In Japan, it was introduced in the 2023 tax reform. It was enacted because the digitalisation of the economy has increased the value of intangible assets such as patents and brands, making it difficult to calculate appropriate "arm's length" prices and increasing the risk of international tax avoidance by transferring easily transferable intangible assets to subsidiaries in tax havens.

(a) Enterprises subject to the Pillar Two

Domestic enterprises belonging to a specific multinational group, etc. (at the same level as enterprises subject to country by country reporting items) with total revenues of at least 750 million euros for two or more of the four subject fiscal years immediately preceding each subject fiscal year.

(b) Minimum tax rate (effective tax rate)

15%

* The effective tax rate is calculated for each country where the subsidiary is located, and the difference between the tax amount calculated by 15% tax rate and by the effective tax rate is toped up to the ultimate parent company etc.

(c) The amount of income exclusion on a real basis

The amount of international minimum tax for the current year is calculated as follows;

((i) Amount of group net income by country - (ii) Real basis income exclusion amount) x (15% - (iii) Effective tax rate by country)

(ii) Real basis income exclusion amount is 5% of tangible assets (book value) and salaries and wages paid (special measures* are available for the first 10 years).

* For tangible assets (book value), it is 8% at the time of introduction, decreasing at a rate of 0.2% for the first five years and 0.4% for the following five years. For salaries and wages, it is 10% at the time of introduction, decreasing at a rate of 0.2% for the first five years and 0.8% for the following five years.

(d) Exemption

The exemption shall apply if the following conditions are met;

(i) The amount calculated in a certain way as the average amount of income of the specific multinational group, etc. for the subject fiscal year and the two subject fiscal years immediately preceding the subject fiscal year in the country where the constituent company, etc. is located is less than 10 million euros and (ii) the amount calculated in a certain way as the average amount of profit or loss of the specific multinational group, etc. for the subject fiscal year and the two subject fiscal years immediately preceding the subject fiscal year in the country where the constituent company, etc. is located is less than 1 million euros.

(e) GloBE information declaration

A domestic enterprise that is the ultimate parent company, etc. of a specific multinational group, etc. is required to declare certain information regardless of whether or not it has paid the top up tax amount.

3. Introduction status in Japan

With regard to Pillar One, the Outcome Statement released by the OECD on July 11, 2023 clearly states that a signing ceremony for a multilateral convention ("MLC") will be held by the end of 2023, with the aim of the convention entering into force by the end of 2025. Prior to ratification of MLC, it is expected that domestic rules are introduced to put Pillar One into force.

With regard to Pillar Two, Japan enacted the basic rule of income aggregation (establishment of corporate income tax on the international minimum tax for each subject fiscal year) in the tax reform of 2023. This system is effective for fiscal years beginning on or after April 1, 2024, and the Basic Corporation Tax Notice was revised in September of 2023. It is necessary to keep a close watch on the publicity and announcements of the system by the National Tax Agency. Currently, only IIR （Income Inclusion Rule） of 2 above was introduced in the domestic law. Introductions of UTPR (Undertaxed Payments Rule) and QDMTT (Qualified Domestic Minimum Top-up Tax) will be discussed in upcoming tax reforms.