# Japan Tax Bulletin

## Focusing on SME Growth Through Enhanced Investment Loss Reserve System

**October 2024**

Japan's commitment to invigorating its small and medium-sized enterprises (SMEs) took a significant step forward with the announcement of the 2024 fiscal year tax reforms. These reforms, part of the Reiwa 6 year plan, focus on expanding the SME Business Reorganization Investment Loss Reserve System. This policy is tailored to empower SMEs to grow through strategic acquisitions and integrations.

### 1. *Objectives and Scope of the Reforms*

These reforms are strategically crafted to reduce financial barriers and encourage SMEs to expand their market presence through effective subsidiary integration, with a purpose to foster a dynamic and competitive business ecosystem, making Japan a nurturing ground for ambitious SMEs. The expansion of the SME's investment loss reserve system is also projected to significantly boost the SME sector by making it more attractive for investments and strategic business activities. By facilitating easier access to M&A strategies and providing significant tax incentives, the expansion of the SME's investment loss reserve system is also poised to enhance the operational scale and market reach of SMEs across Japan.

### 2. *Detailed System Overview*

#### *(1) Extension of the mandatory holding period*

The revised system allows for reserved funds to be deducted from taxable income, provided they meet predefined criteria regarding acquisition costs. A notable change is the extension of the mandatory holding period for these funds from five to ten years, allowing a gradual release and taxation of the funds as profit, thus easing financial strains over a more extended period.

#### *(2) Comprehensive Extensions and Provisions*

The reform extends the existing system until March 31, 2027, and introduces new provisions for mid-sized businesses alongside SMEs. Under the enhanced system, businesses with approved management plans that include due diligence provisions can now deduct up to 70% of acquisition costs (including fees) directly from their taxable income. This allowance is intended to mitigate the upfront financial impact of mergers and acquisitions.

#### *(3) Enhanced Deductions for Experienced Enterprises*

For SMEs with prior M&A experience, the reforms offer even more substantial benefits. Upon obtaining certification under the new Special Business Reorganization Plan, these enterprises can deduct 90% of acquisition costs for their first post-certification M&A and 100% for subsequent acquisitions. This aggressive incentivization underscores Japan's commitment to enhancing its industrial competitiveness and encouraging continuous M&A activity among SMEs.

#### *(4) Exclusions and Specific Requirements*

The system sets clear boundaries by excluding transactions either below 100 million yen or exceeding 10 billion yen. Furthermore, it necessitates the formulation of a certified "Special Business Reorganization Plan" under the updated Act on Enhancing Industrial Competitiveness, ensuring that only well-planned and potentially successful M&As benefit from the system.

#### *(5) Documentation and Compliance*

Businesses must navigate both the extended and new provisions of the system carefully. Strategic planning is essential for aligning multiple M&A transactions with the stipulated requirements of the reserve system. Businesses must develop a management enhancement plan at the outset of any M&A deal, including a pre-M&A due diligence check (available in spreadsheet format) to be submitted for certification. Post-acquisition, businesses are required to report their activities and the contents of their initial due diligence to receive confirmation documents. Tax declarations must be accompanied by both the certification and confirmation documents to qualify for deductions.

### 3. *Conclusion*

The Reiwa 6 tax reforms represent a strategic enhancement to support Japan's SMEs, crucial for sustained economic growth and innovation. The expanded Business Reorganization Investment Loss Reserve System offers substantial benefits, encouraging SMEs to pursue growth through mergers and acquisitions actively. While the system provides substantial financial incentives, it requires careful strategic planning and management, emphasizing that it is a deferral of tax liability rather than its elimination. As such, businesses are encouraged to engage with these opportunities strategically, aligning them with long-term growth objectives.

For businesses considering taking advantage of this system, understanding the detailed operational requirements and ensuring alignment with long-term business strategies will be crucial to effectively utilizing the available incentives. As M&A

opportunities arise, seeking expert tax advice to navigate the evolving tax landscape effectively is highly recommended. This approach will ensure that strategic benefits are maximized while adhering to compliance requirements and optimizing financial outcomes.