Japan Inbound Tax & Legal Newsletter

Wage increase tax incentives revised (2018 Tax Reform)

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Overview

Revisions to Japan’s income tax law, which include amendments to the tax incentives for wage increases implemented in the 2013 tax reform, were approved by the National Diet on 28 March 2018 and enacted on 31 March 2018. The 2018 tax reform renames the incentives program “tax incentives for wage and investment increases,” and aims to further promote increases in wages, employee training and capital investment.

1. Summary of program changes

The revised law expands the tax incentives for wage increases that were applicable to fiscal years beginning on or before 31 March 2018 (and which were set to expire), and extends the applicable period by three years. Under the revised rules for large companies, a maximum tax credit of 20% (increased from 10%) is available to companies that increase both wages and capital investment in Japan (instead of only wages under prior law), which includes a new additional tax credit for companies that incur higher training costs. The program’s rules for small and medium-sized entities (SMEs) also are revised. Corporations paying wages to employees in Japan are eligible for the benefits under the revised program for fiscal years beginning from 1 April 2018 to 31 March 2021 (excluding the year in which the company is established, dissolved or liquidated).

The following tables summarize the key changes for large corporations and SMEs.

(1) Large corporations (non-SMEs)

		Prior law	Revised law	
Eligibility tests	Wage tests	Current fiscal year (FY) total wages ≧ base FY total wages x 105%; and Current FY total wages ≧ previous FY total wages; and Average current FY wage for continuous employees ≧ average previous FY wage for continuous employees x 102%	Current FY total wages for continuous employees ≧ previous FY total wages for continuous employees x 103%; and Current FY total wages > previous FY total wages	
	Capital investment test	N/A	Current FY capital investment ≧ current FY depreciation expenses x 90%	
Training expense test for additional tax credit		N/A	Current FY training expenses ≧ average training expenses in prior two FYs x 120%	
Tax credit calculation		(Current FY total wages – base FY total wages) x 10% + (Current FY total wages – previous FY total wages) x 2%	If only wage and capital investment tests are met	(Current FY total wages – previous FY total wages) x 15%
			If training expense test also met	(Current FY total wages – previous FY total wages) x 20%
Tax credit limit		10% of current FY corporate tax	20% of current FY corporate tax	

(2) SMEs

<table>
<tr><th></th><th colspan="2">Prior law</th><th colspan="2">Revised law</th></tr>
<tr><td>Eligibility tests - wage tests</td><td colspan="2">Current FY total wages ≧ base FY total wages x 103%; and
Current FY total wages ≧ previous FY total wages; and
Average current FY wage for continuous employees > average previous FY wage for continuous employees</td><td colspan="2">Current FY total wages for continuous employees ≧ previous FY total wages for continuous employees x 101.5%; and
Current FY total wages > previous FY total wages</td></tr>
<tr><td>Conditions for additional credit</td><td colspan="2">Average current FY wage for continuous employees > average previous FY wage for continuous employees x 102%</td><td colspan="2">See below</td></tr>
<tr><td rowspan="2">Tax credit calculation</td><td>If conditions for additional credit are not fulfilled:</td><td>(Current FY total wages – Base FY total wages) x 10%</td><td>If conditions for additional credit are not fulfilled</td><td>(Current FY total wages – previous FY total wages) x 15%</td></tr>
<tr><td>If conditions for additional credit are fulfilled:</td><td>(Current FY total wages – Base FY total wages) x 10% + (Current FY total wages – Previous FY total wages) x 12%</td><td>If conditions for additional credit are fulfilled</td><td>(Current FY total wages – previous FY total wages) x 25%</td></tr>
<tr><td>Tax credit limit</td><td colspan="2">20% of current FY corporate tax</td><td colspan="2">20% of current FY corporate tax (i.e. unchanged from prior law)</td></tr>
</table>

2. Revised eligibility requirements

The changes in the eligibility requirements are discussed below.

(1) Fiscal year for comparing wage payments

Under prior law, the determination of whether wages increased was made by comparing total wage payments for the current fiscal year with those for the “base” year, i.e. the fiscal year just before the first fiscal year beginning on or after 1 April 2013 (e.g. the year ending 31 March 2013 for corporations with a 31 March year-end and the year ending 31 December 2013 for corporations with a 31 December year-end). To promote further wage increases, the 2018 tax reform changes the fiscal year to be used for comparing wage payments to the previous fiscal year.

(2) New capital investment test for large corporations

Under the 2018 reform, large corporations are required to make “domestic capital investments” of at least 90% of their total depreciation expenses for the current fiscal year (in addition to meeting the tests for increased wages) to be eligible for program incentives.

Domestic capital investment for purposes of the program is the total cost of “eligible assets” acquired, manufactured or constructed (not via merger, etc.) in Japan during and owned as of the end of the relevant fiscal year.

Eligible assets are the following assets used for the company’s business in Japan, including assets that have not yet been but are expected to be used for the business as of the end of the relevant fiscal year, but excluding assets that were not acquired during such year:

- Buildings and attached equipment;
- Structures;
- Machinery;
- Vessels;
- Aircraft;
- Tools, equipment and fixtures;
- Intangible assets; and
- Biological assets, etc.

Inventory, securities, deferred assets and certain other assets are not considered eligible assets.

Total depreciation expense is the sum of book depreciation on the company's business assets within and outside of Japan for the current fiscal year and a provision for a special depreciation reserve from retained earnings prior to the date the accounts are closed.

(3) New training expense test for additional tax credit

If a large corporation increases its training expenses by 20% or more over the average training expenses for the prior two fiscal years, it can obtain an additional 5% tax credit on the wage increase from the previous year. It should be noted that this test is not met if training expenses for the relevant fiscal year and for the two immediately prior fiscal years are zero.

SMEs that satisfy the following additional conditions can receive an extra 10% tax credit on the wage increase from the previous fiscal year:

- Total wages paid to "continuous employees" increased by at least 2.5% from the previous fiscal year; and
- Either of the following is met:
    1. Training expenses increased by at least 10% from the previous fiscal year (this test is not met if training expenses for the relevant and previous years are zero, or if training expenses for the previous year cannot be calculated); or
    2. A plan for business enhancement is certified under the SME business enhancement law by the competent minister by the end of the relevant fiscal year, and the fact that the business has been improved based on the plan is certified by the Ministry of Economy, Trade and Industry. The latter certification needs to be attached to the taxpayer's tax return.

Training expenses are costs incurred by a company to help its employees in Japan acquire or improve the necessary skills or knowledge for their performance of business activities, including:

- Where the company holds the training, fees paid to trainers (including their travel costs incurred by the company) and costs for renting facilities, equipment and other assets for such training;
- Where the company commissions an outside service provider to arrange a training session for its employees, fees paid to the service provider; and
- Where the company's employees attend a training session held by another party (i.e. which is not solely for the company's employees), participation and other fees paid to the other party.

Training expenses must be for employees in Japan and be deductible for the relevant fiscal year. Training expenses do not include textbook costs, except where the training session is held by an outside training organization (which may be an affiliated company) and the related participation fees include such costs. Training expenses do not include payments made by other parties for the company's training.

(4) Definition of “continuous employee”

Whether or not wages increased is determined based on a year-over-year comparison of total wages paid to employees in Japan and wages paid to “continuous employees.” The definition of “continuous employee” is revised to mean an employee in Japan to whom wages were paid for every month of the relevant and previous fiscal years (instead of for any month under prior law).

Deloitte’s View

The wage increase tax incentive has been revised several times since its introduction in 2013 and previous versions have not resulted in the level of wage growth the government had expected. With the possibility of increased credits under the new law, the government hopes that companies will increase wages, which hopefully will stimulate domestic demand and consumption.

Also, while the requirements for eligibility for the incentive have largely been relaxed making it easier for companies to apply, for large companies, an additional requirement to increase investment in capital has been added. Therefore, even if a large company increases wages, it will not be eligible for the credit if it does not also increase its capital investment.

Finally, the introduction of an additional credit for increased training costs shows that the government would like to encourage investments in human capital.

Given the possibility of obtaining a substantial tax credit, companies’ tax departments should make management aware of the new rules so they can factor in the potential tax savings when making decisions regarding additional increases in wages or in human or physical capital.

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