International Taxation in the Digital Economy

(Interim Report of the "Study Group on International Taxation in the Digital Economy")

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Study Group on International Taxation in the Digital Economy

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I. Development of Tax System Supporting Digital Economy and "Investment Nation"

Amid changes in the global economic environment, including economic development in Asian countries since the end of the 20th century, Japan is rapidly changing from a "trade nation" based on activities of domestic production and exports to an "investment nation" based on investment activities and investment income from overseas affiliates. Revenue earned by ultimate parent entities domiciled in Japan from overseas growth markets is now critical to the overall economy of Japan. It is necessary to construct a tax system suitable for our "investment nation" in response to the change of the global economy in which digitalisation is accelerating.

Meanwhile, as a result of digitalisation, the system of international taxation, which supports a fair competitive environment, has been shaken in countries, including Japan. There is a large tax burden disparity globally and domestically between (i) traditional companies that pay taxes with permanent establishments such as branches (permanent establishment: PE[1]) in the market jurisdiction, and (ii) companies that conduct digital business, do not have PEs in the market jurisdiction, and transfer intangible assets, etc., to no or low-tax jurisdictions for tax avoidance, creating doubts about the fairness of competition between traditional companies and companies that conduct digital business. Reform of the international taxation system is an urgent task. In light of ongoing international discussions, Japan needs to develop a fair competitive environment that enables companies to make risk investments for growth, such as M&As and innovative R&D.

(Transformation of Japan into an "investment nation" and the role of the international taxation system)

With the shrinking population and domestic market, Japan's economic structure is changing rapidly from a "trade nation" where it conducts R&D and manufacturing, mainly in Japan, to an "investment nation" based on profits from overseas investments (establishment of overseas subsidiaries and acquisition of overseas companies) in order to acquire rapidly growing overseas markets, including those of other Asian countries[2].

To support the current momentum of investment-based nation, it is important to reform the international taxation system, which is the cornerstone of both the international competitive conditions for Japanese companies, and the allocation of funds at home and abroad. In other words, in line with changes in the economic environment such as digitalisation, it is necessary to develop a fair competition environment in overseas markets between Japanese companies and foreign companies[3]and encourage earned profits to return to Japan. It is expected that the profits returned to

[1] PE, in the case of Japan, means a permanent establishment (Article 2, item (12)-19 of the Corporation Tax Act) under the provisions of the Corporation Tax Act.

[2] In recent years, the primary income balance (dividends, securities investment income, etc.) has greatly contributed to Japan's current account surplus. In 2019, the current account surplus was about 20 trillion yen, while the income balance accounted for about 20.1 trillion yen. (Ministry of Economy, Trade and Industry, White Paper on International Economy and Trade, July 7, 2020, p. 282 (p.278 in English edition), part II -2 -3 -16, breakdown of current account balance)

[3] In this report, "Japanese companies" refer to MNE groups based in Japan. "Foreign companies" refer to a group of MNEs based in a foreign country.

Japan will be utilized not only for distribution to employees and shareholders but also for growth investment in Japan, including basic R&D investment, leading to a virtuous economic cycle.

Only when a fair competitive environment is developed on a global basis can Japanese companies promote overseas risk investments. This importance cannot be overemphasized.

(Weakening competitiveness of Japanese companies in overseas markets)

At present, in overseas markets, the international competitiveness of Japanese companies has declined in many product fields[4], and it has been pointed out that there are problems with the enhancement of added value such as the development of new products and services. One reason for this is the relative few of risk investments for growth (basic R&D, startup investment, etc.) by Japanese companies compared with foreign companies[5]. At present, overseas M&As, etc. by Japanese companies are more active than before[6], but it is necessary to establish an institutional environment to enable further risk investment.

(Foreign monopolies and oligopolies in the domestic digital market)

Risk investment issues exist not only in overseas markets but also in domestic digital markets. As the digitalisation of the economy is accelerating globally, the set-up and growth of Japanese companies, especially in the digital market, will lead to the next generation of profitable overseas investments, but in reality, such birth and growth of Japanese companies is few. Rather, it has been pointed out that monopolization and oligopolization by foreign companies are progressing year by year[7]. Structural factors are also pointed out, such as the accumulation of disparities in R&D investment.

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[4] Compared with not only European and American companies but also Chinese and South Korean companies, international competitiveness is an issue, especially in many product fields, from infrastructure to electric vehicles. For example, looking at changes in the ROE (return on equity) of listed companies in Japan, the United States, and Europe based on data from Bloomberg, we can see that the ROE of listed companies in Japan is on an upward trend, but there is still a gap with those of listed companies in the United States and Europe.

[5] The level of investment in venture companies by business corporations and CVCs (corporate venture capital) is low in Japan compared to that of other major countries. It is only about one-third of that of the United States (in 2018: Japan 0.04%, US 0.13%) as a percentage of GDP. (CB Insights, "The 2018 Global CVC Report")

[6] In this environment, Japanese companies are struggling to survive by transferring their R&D bases overseas (although there are various factors involved in the relocation of R&D bases, it is also difficult to acquire human resources in Japan), conducting M&As with overseas companies, and investing in small amounts in overseas companies, including startups. For example, according to the Recof M&A Database, the number of overseas M&As by Japanese companies is on an increasing trend: 299 in 2009, 557 in 2014, and 826 in 2019.

[7] The share of foreign companies in many fields of domestic digital services is increasing. According to the presentation materials by Mr. Motohiko Sato of the Japan Association of New Economy at this workshop, the share of foreign companies in each digital service is 50-70% in the Internet advertising field, 25% in the e-commerce field (approximately doubled from 2010 to 2016), 75% in the music subscription service field, 20% in the video subscription service field (approximately doubled from 2010 to 2018), 100% in the application store field, and 20% in the game field.

(Concerns over further expansion of gap in tax burden in the digital economy)

Disparity of tax burden may affect corporate competitiveness through differences in cash flows, which are the source of growth investment such as M&As and R&D investment. As the digitalisation of the economy progresses, there is concern pointed out that the unfairness of tax burden will further increase.

Digital companies, especially businesses such as online advertising, online games, and cloud services, can expand their overseas business without having to set up physical equipment (PE) such as factories or offices in their host countries (market jurisdiction). In addition, it is easier to reduce the tax burden in one's home country (residence jurisdiction) by placing intangible assets such as income source data in a no or low-tax jurisdiction and recording the income there. In addition, it has been pointed out that loopholes concerning tax burdens have been exploited by utilizing domestic systems such as tax credit of each country and tax treaties. As a result, the global trend in cash flow is considered to be shifted from the country of income (market jurisdiction) to a no or low-tax jurisdiction, and from the home country (residence jurisdiction) to a no or low-tax jurisdiction. As a result, on the one hand, there is competition to lower tax rates, including corporate taxes, in each country, and on the other hand, there is a large gap[8] in tax burdens between digital and non-digital companies, creating an environment in which fairness cannot be institutionally ensured. Against this backdrop, international discussions are rapidly advancing, taking into consideration not only the tax systems of market jurisdictions and residence jurisdictions, but also those of no or low-tax jurisdictions.

(Viewpoints of the study group: Improving the international competitiveness of Japanese companies and strengthening the resilience of domestic supply chains)

The viewpoints of this study group are as follows. Based on international discussions led by the OECD, and in particular on the trend toward a global minimum tax (Pillar 2) and the allocation of new taxing rights to market jurisdictions (Pillar 1) in response to taxation issues arising from the digitalisation of the economy (Tax Challenges Arising from Digitalisation of the Economy), a fair tax burden will be realized between Japanese and foreign companies, as well as between traditional and digital companies in domestic and foreign markets, through changes in our country's international tax system. This will support a virtuous cycle in the tax system in which Japanese companies secure

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[8] As an example of the disparities pointed out in tax burdens, according to the European Commission's March 2018 report, digital companies in the EU have a difference of about 14% in annual average rate of increase in profits compared to companies engaged in traditional business, and the effective tax rate is about half (9.5% for digital companies and 23.2% for traditional businesses). (European commission, "Questions and Answers on a Fair and Efficient Tax System in the EU for the Digital Single Market," 21 March 2018)

According to a report in the Nihon Keizai Shimbun, the tax burden of the big 4 U.S. IT (information technology) companies, known as GAFA, was about 15.4% on average, about half the level of the major manufacturing industries. The report points out that "the current corporate tax system fails to effectively impose taxes on data and other intangible assets. Reviewing global taxation rules to eliminate tax burden distortions is a global challenge for the growth of the digital economy." In the same article, regarding the tax burden rate (average) based on financial data, it was analyzed that the rate was 25.1% for global companies, 20.7% for U.S. companies, 29.0% for European companies, 28.3% for Japanese companies, and 27.3% for Asian companies. ("Visual explanation: Why is the tax burden of GAFA light?" Nihon Keizai Shimbun, May 13, 2021)

sufficient cash flow to fund their investment, promote further risk investment, and improve their international competitiveness.

In considering the specifics, we highlight that while the degree of dependence on tangible assets (factories, offices, etc.) and employment in all types of businesses, including traditional companies, has generally decreased in line with the digitalisation of the economy, the degree of dependence on intangible assets, such as various data on individual preferences and activities, and intellectual property, has increased and this trend is expected to continue in the future.

At the same time, consideration will be given to the importance of locating industries in Japan. In other words, while continuing to respect the economically rational decision by companies to expand their businesses overseas and relocate bases overseas, it is also necessary to make the supply chains more resilient in our country as a whole in the medium- to long-term by enabling companies to locate bases in Japan with good economic rationale, with regard to intangible assets that serve as a source of added value and high-added-value bases such as R&D functions for the formation of above value (including R&D using data and DX activities).

From this perspective, this study group examined three specific points. With a view to ensuring the fairness of tax burdens between Japanese companies and foreign companies that do not have a PE, etc., in Japan, the following were examined: (1) matters to be noted in the formulation of domestic laws such as global minimum tax on Japanese companies, from the viewpoint of ensuring a fair tax burden in overseas markets ; (2) appropriate taxation measures to ensure fairness with Japanese companies, from the viewpoint of ensuring a fair tax burden in domestic markets, in particular, for foreign companies that do not have a PE, etc., in the digital market; and (3) ideal medium- to long-term tax bases, etc.

II. Recent Major Trends in International Taxation

1. Recent development of major international taxation systems

Major revisions in Japan's international taxation system in recent years include the introduction of a foreign subsidiary dividend exemption system in 2009, and the strengthening of the taxation system for controlled foreign company (hereinafter, "CFC rules"), in 2017. The former is an amendment that takes into account the neutrality of the tax system with respect to dividend policy and the simplification of the practical complexity of the former indirect foreign tax credit system. Specifically, 95% of dividends from certain subsidiaries to their parent companies will be exempted from taxation, which has, to a certain extent, the same effect as the territorial taxation method, or the foreign income exemption method. As a result of this amendment, when one of Japanese companies establish a subsidiary in a host country, 95% of dividends from the subsidiary to its parent company are exempted in Japan, and the income earned by the subsidiary is taxed only by the tax system of the host country, thus ensuring a neutral condition of competition with foreign companies in the host country. Neutrality is the basis of the international taxation that this study group aims at, and it can be evaluated as an important revision that also took into account the needs from the industry. The latter is considered to have a certain significance in the sense of preventing unjust transfer of business and assets from Japan under partial territorial taxation as described above.

In addition to these revisions, the following tax system revisions have been made in response to the BEPS Final Report in 2015. These revisions are evaluated to respond with global trends.

- Establishment of a system to require transfer pricing documentation and provision of Country-by-Country Reports (BEPS Action 13: Implemented through FY 2016 revision)
- Review for the prevention of artificial avoidance of permanent establishment (PE) status (BEPS Action 7: Implemented through FY 2018 revision)
- Revision of Japan's rule on interest deductibility(BEPS Action 4: Implemented through FY 2019 revision)
- Introduction of price adjustment measures for transactions of hard-to-value (specified intangibles transactions) under transfer pricing taxation (BEPS Action 8-10: Implemented through FY2019 revision), etc.

2. Addressing the Tax Challenges of The Digitalisation of the Economy (Framework agreement reached in July 2021)

Since the release of the BEPS Final Report in 2015, ongoing discussions have focused on addressing the tax challenges of the digitalisation of the economy (Tax Challenges Arising from Digitalisation of the Economy). Specifically, in order to secure tax payments to market jurisdictions by multinational enterprises (MNEs) including digital companies, discussions were focused on the allocation of new taxing rights to market jurisdictions (Pillar 1), as well as on the prevention of the transfer of assets and businesses from residence jurisdictions to no or low-tax jurisdictions, and on the prevention of competition to lower corporate taxes among countries that induce such transfers (Pillar 2). Pillar 1 and 2 were discussed as one.

The OECD/G20 Inclusive Framework on BEPS (IF) announced Statement on a Two-Pillar Solution to Address the Tax Challenges Arising from the Digitalisation of the Economy on July 1 this year. It contains the following outline agreement, which was approved at the G20 Finance Ministers and Central Bank Governors Meeting on July 9 and 10 this year.

[Pillar 1 (In this report, we refer to Amount A used in international discussions.)]

- In-scope companies are the multinational enterprises (MNEs) with certain global turnover (initially above 20 billion euros*) and pre-tax profit margins (above 10%) (exclude Extractives and Regulated Financial Services).

* The threshold for "certain global revenue" is above 20 billion euros (approx. JPY 2.6 trillion) at the initial period. A review will be conducted 7 years after the agreement comes into force, and discussions will be held on the reduction of the threshold to 10 billion euros (approx. JPY 1.3 trillion), subject to the smooth implementation of the system.

- The profits of these MNEs will be allocated to market jurisdictions within a range of 20% to 30% (to be agreed internationally in the future within this scope) of the residual profit[9] exceeding 10% of revenue.

[9] In the Statement on a Two-Pillar Solution to Address the Tax Challenges Arising From the digitalisation of the Economy (OECD, 1 July 2021), the term "residual profit" is defined as "profit in excess of 10% of revenue".

- As a general rule, Amount A is allocated to a market jurisdiction if the MNE concerned derives at least 1 million euros (approx. JPY 130 million) in revenue from that jurisdiction.
- Implementation target is to develop a Multilateral Convention in 2022, with implementation by 2023.

[Pillar 2 (In this report, we refer to the GloBE rule[10] used in international discussions.)]

- Each government imposes an additional tax at least to the agreed minimum tax rate (at least 15%: to be finally agreed internationally in the future) on its MNEs.
- As a common approach, implementation of Pillar 2 by each member jurisdiction is voluntary, but if it chooses to do so, it will be design and implement in a manner consistent with agreed model rules and guidance.
- With regard to an exclusion that allows a certain amount of deduction from the tax base (carve-out), an amount of income at least 5% (in the transition period of 5 years, at least 7.5%) of the carrying value of tangible assets and payroll will be excluded. (A specific percentage will be agreed upon internationally in the future.)
- Implementation target is to revise domestic laws in 2022, to be effective in 2023.

A final agreement on the details of the system will be reached in October this year. After the final agreement is reached, a Multilateral Convention and domestic institutional arrangements will be considered.

3. Trump tax reform (2017) of the United States

In the United States, no major corporate tax reform had been implemented for a long time since the Reagan administration revised the tax system in 1986. Whereas, as the OECD member countries have been revising their corporate taxes since the 1990s, EU countries have adopted tax policies (foreign income exemption method) that basically do not levy taxes on income earned overseas. As a result, there had been growing concern about the global tax burden gap between OECD countries and the United States, which had adopted a worldwide income taxation system for corporations. On the other hand, there has also been criticism of the transfer of assets and businesses by digital companies to no or low-tax jurisdictions, etc., and tax avoidance by making use of tax systems in various countries and tax treaties. In this situation, after several years of debate, the Trump administration passed a major tax reform bill (Tax Cuts and Jobs Act: TCJA) in 2017. This tax reform is wide-ranging. In addition to lowering the corporate tax rate to 21%, the international tax reform is notable in that it imposes minimum tax on the income of subsidiaries outside the United States (GILTI) in order to prevent the outflow of high value-added businesses to countries outside the United States

[10] The GloBE (Global Anti-Base Erosion) rule refers to an IIR (Income Inclusion Rule: IIR) in which income attributable to a subsidiary, etc., located in a no or low-tax jurisdiction is taxed up to a minimum tax rate in a jurisdiction where its parent company is headquartered, and a UTPR (Undertaxed Payment Rule: UTPR) in which a subsidiary, etc., that makes a payment to a no or low-tax jurisdiction is taxed in the payer's jurisdiction.

and to promote the establishment of operations in the United States, as well as introducing income deductions (FDII) on the income from overseas business conducted in the United States as a counterpart of GILTI.[11] In addition, from the perspective of ensuring a balance of competitive levels between US and foreign companies, the introduction of a tax on deductible expenses paid to foreign related parties (BEAT)[12] was of particular interest. See Figure 1 below for an overview.

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[11] GILTI (Global Intangible Low-Taxed Income) is a system under which income related to intangible assets (specifically, a certain amount of excess income is assumed to be the intangible income) earned by a foreign subsidiary is included in the gross income of U.S. shareholders of the foreign subsidiary. This is in addition to the existing U.S. CFC rules, which include subpart F income and U.S. investment in assets earned by the foreign subsidiary as the gross income of U.S. shareholders.

FDII (Foreign-Derived Intangible Income) is a system under which a certain special deduction is allowed for income derived from intangible assets (specifically, in the same manner as the GILTI described above, a certain amount of excess income is assumed to be the income) of U.S. corporations.

Regarding the purpose of these legislations, the existing system resulted in "significant profits being attributable to a single entity, which may result in significant tax savings if that entity is subject to a low effective tax rate. The Committee believes that the ability to obtain this result provides significant financial incentive for companies to structure in this manner in order to concentrate profits in low-tax jurisdictions, ultimately leading to the migration of valuable jobs and property from the United States." Therefore, GILTI was institutionalized to ensure "a balance between protecting the U.S. tax base and promoting the global competitiveness of U.S. workers and companies." (Source: 115 TH CONGRESS 1st Session, HOUSE OF REPRESENTATIVES REPORT, 2017 115 – 409, TAX CUTS AND JOBS ACT, REPORT OF THE COMMITTEE ON WAYS AND MEANS HOUSE OF REPRESENTATIVES ON H.R. 1 together with DISSENTING AND ADDITIONAL VIEWS, NOVEMBER 13, 2017, p. 389 et seq.)

In relation to the FDII, "One of the Committee's goals in tax reform is to remove the tax incentive to locate intangible income abroad and encourage U.S. taxpayers to locate intangible income, and potentially valuable economic activity, in the United States. The Committee believes that offering similar, preferential rates for intangible income derived from serving foreign markets, whether through U.S.-based operations or through CFCs, reduces or eliminates the tax incentive to locate or move intangible income abroad, thereby limiting one margin where the Code distorts business investment decisions." (Source: 115TH CONGRESS 1st Session, COMMITTEE ON THE BUDGET, UNITED STATES SENATE, Committee Report, *S. PRT.* 2017 115–20, RECONCILIATION RECOMMENDATIONS PURSUANT TO H. CON. RES. 71, COMMITTEE RECOMMENDATIONS AS SUBMITTED TO THE COMMITTEE ON THE BUDGET PURSUANT TO H. CON. RES. 71, P.375).

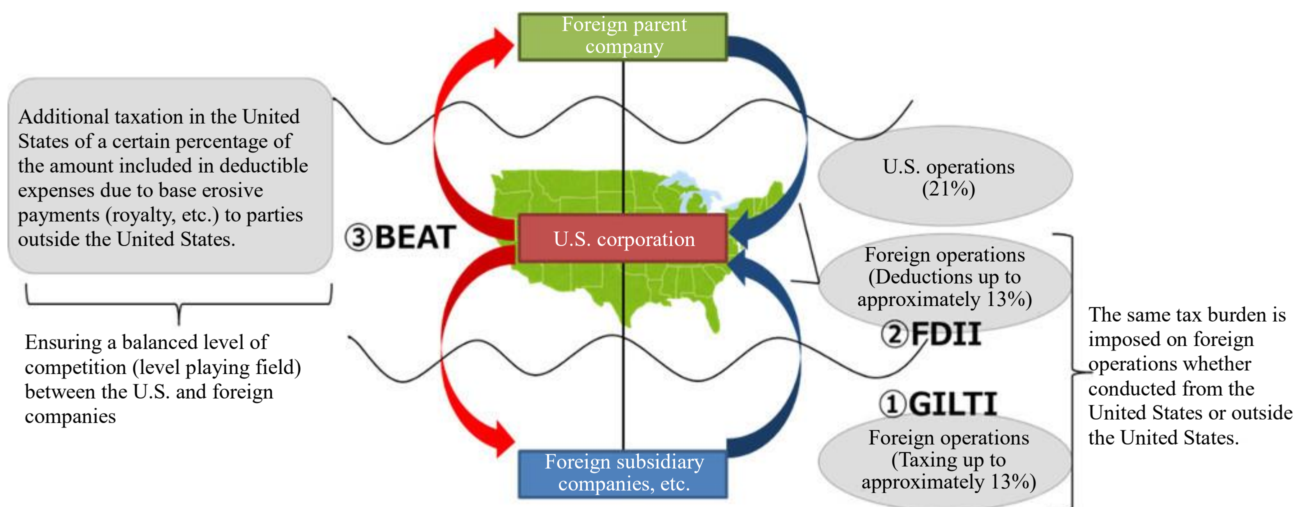
Therefore, it can be said that GILTI and FDII are systems intended to "prevent companies from transferring jobs and capital outside the United States".

(The Japanese translation of this Note is taken from Research Report commissioned by the Ministry of Economy, Trade and Industry "FY 2018 Survey on the Development of Investment Promotion Systems in Japan and Overseas (Survey and research on tax systems in foreign countries and taxation issues of local subsidiaries in foreign countries)".)

[12] The BEAT (Base Erosion Anti-abuse Tax) provides for the imposition of the BEAT tax in addition to any other taxes levied under income tax provisions of the Internal Revenue Code. The BEAT tax amount is calculated by multiplying the adjusted income amount (the amount obtained by adding the amount of the Base Erosion Benefits and the loss carried forward for the current period multiplied by the Base Erosion Percentage to taxable income) by the BEAT tax rate (a typical BEAT tax rate was expected to vary from 5%, 10%, to 12.5% depending on the taxable year) and then, comparing the regular corporate tax amount before tax credit with certain adjustments, and if the former exceeds the latter, imposing a minimum tax for the excess. BEAT is a system that ensures a level playing field between the U.S. and foreign companies. (Research Report commissioned by the Ministry of Economy, Trade and Industry, "FY 2018 Survey on the Development of Investment Promotion Systems in Japan and Overseas (Survey and research on tax systems in foreign countries and taxation of local subsidiaries in foreign countries)")

It is also said that the GloBE (Global Anti-Base Erosion) rule (Income Inclusion Rule (IIR) and UTPR) in international discussions is a system based on the GILTI and BEAT in the U.S. Trump tax system.

< Figure 1 > Outline of Trump Tax Reform in the United States



4. Unilateral measures in European countries (Full-scale introduction after 2019)

While a certain amount of time is required for convergence and materialization of international discussions led by the OECD, some countries such as the United Kingdom and France are introducing DST (Digital Service Tax: DST) as a interim measure until an international agreement (for Pillar 1) is realized, limited to online advertising and other services provided by digital platform providers, or to a wide range of digital transactions[13]. Similar developments have been observed in developing countries. For example, India introduced an Equalization Levy, as discussed in BEPS Action 1, and expanded its scope in 2020. In parallel with these developments, the EU is proposing a new framework for Digital Levy in 2020[14]. See Figure 2 below for the taxation targets, tax bases, and tax rates in the unilateral measures in the United Kingdom, France, and other countries.

[13] The United Kingdom introduced DST in 2020, and France did so in 2019. Outside Europe, Canada, for example, is considering introduction of DST in 2022.

[14] It is necessary to pay close attention to future trends of digital levy and its relation with DST.

< Figure 2 > Outline of unilateral measures taken by the UK, France, and Others (Subject of taxation, tax base, tax rate, etc.)

	France	The United Kingdom	Italy	Spain
Target business	• Digital interface service • Online targeting advertising	• Social media service • Search Engine Service • Online marketplace	• Online targeting advertising • Online platform • Selling user data	• Online targeting advertising • Online platform • Selling user data
Tax base and tax rate	Target business provided in France Tax rate: 3% levy on revenue	Target business provided to UK users Tax rate: 2% levy on revenue (*) *Less £25 million (approx. JPY 3.8 billion) from revenue	Target business provided in Italy Tax rate: 3% levy on revenue	Target business provided in Spain Tax rate: 3% levy on revenue
Taxpayer *A person who satisfies both (i) and (ii)	(i) Annual global revenue in the target business exceeds 750 million euros (approx. JPY 96.8 billion) (ii) Annual domestic revenue in the target business exceeds 25 million euros (approx. JPY 3.2 billion)	(i) Annual global revenue in the target business exceeds £500 million (approx. JPY 74.5 billion) (ii) Annual revenue for UK users in the target business exceeds £25 million (approx. JPY 3.7 billion)	(i) Annual global revenue in the target business exceeds 750 million euros (approx. JPY 96.8 billion) (ii) Annual domestic revenue in the target business exceeds 5 million euros (approx. JPY 650 million)	(i) Annual global revenue in the target business exceeds 750 million euros (approx. JPY 96.8 billion) (ii) Annual domestic revenue in the target business exceeds 3 million euros (approx. JPY 390 million)
Tax estimate	Approximately 500 million euros in 1 year (approx. JPY 64.5 billion)	£19 billion over 7 years (approx. JPY 2.83 trillion)	Approximately 708 million euros in 1 year (approx. JPY 91.3 billion)	Approximately 968 million euros in 1 year (approx. JPY 124.9 billion)
Introduction time	Effective from January 2019 (In consideration of the United States, the collection was postponed until the end of 2020 and resumed in December 2020.)	Effective from April 2020 (The collection is from December 2021.)	Effective from January 2020 (The collection is from February 2021)	Effective from January 2021 (The collection is from April 2021)

(Reference) Prepared by METI based on the following:
USTR (2019), Section 301 Investigation Report on France's Digital Services Tax
TAX FOUNDATION (2019), Revenue Estimates for Digital Services
USTR (2021), Section 301 Investigation Report on United Kingdom's Digital Services Tax
USTR (2021), Section 301 Investigation Report on Italy's Digital Services Tax
PwC (2019), Italy's draft 2020 budget calls for unilateral digital services tax
USTR (2021), Section 301 Investigation Report on Spain's Digital Services Tax
KPMG (2020), Guide to the new Tax on Certain Digital Services

Calculated at the following exchange rates:
- 1 euro = approx. JPY 129
- 1 pound = approx. JPY 149

In response to these unilateral measures taken by each country, the United States conducted investigations based on Article 301 of the Trade Act and announced countermeasures with retaliatory tariffs (implementation postponed to secure time to complete international negotiations[15]).

In a related move, the United Nations has proposed an amendment to the United Nations Model Double Taxation Convention, which provides for withholding of digital services[16].

Apart from international discussions on digital taxation, as a movement related to corporate tax reform that goes beyond that, the EU is proposing taxation on business operations in Europe (Business in Europe: Framework for Income Taxation: BEFIT), which would standardize the tax base and allocate profits across EU countries, in order to reduce the compliance costs of EU companies and promote investment in the future.

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[15] The Office of the United States Trade Representative (USTR) announced on June 2, 2021, that it would postpone for 180 days the imposition of retaliatory tariffs on 6 countries, including the United Kingdom. (USTR Announces, and Immediately Suspends, Tariffs in Section 301 Digital Services Taxes Investigations, 06/02/2021)

[16] Specifically, the government is studying a plan to secure the right in a market jurisdiction to levy taxes on "automated digital services (ADS)" in the simple form of a withholding tax.

III. Tax System that Enables Fair Competition in Overseas Markets

1. Regarding a global minimum tax[17]

(1) Basic approach

As mentioned above, there is a global tax burden gap between digital and non-digital companies due to the nature of their businesses, for example, whether or not intangible assets such as data, which is a source of income, can be transferred to no or low-tax jurisdictions. This situation may expand to various business areas in the future. From the viewpoint of rectifying these situations and building a fair competitive environment on a global basis, Pillar 2 approach, in which each jurisdiction, including Japan, imposes a minimum tax burden on the ultimate parent companies of group companies on a global basis, is a valuable initiative. Japan must consider introducing the system as soon as possible, based on a final agreement scheduled for autumn.

(2) Issues related to international discussions on a global minimum tax and domestic legislation of the rules.[18]

The following items should be considered when considering implementation of the rules under the domestic legislation in Japan.

(i) When to introduce

(Consideration of trends in Japan's competitors countries)

In order to balance maintaining and improving the international competitiveness of Japanese companies in overseas markets, such as Asian markets, and initiating a global minimum tax at the same time, it is necessary to legislate a global minimum tax as soon as possible, appropriately taking into account the introduction timing of residence jurisdictions (Europe, North America, China, South Korea, etc.) of foreign companies that are competitors of Japanese companies.

If Japan introduces a global minimum tax ahead of other countries, depending on the level of exemption (carve-out) described below[19], it may adversely affect the competitiveness (especially price competitiveness) of Japanese companies in competition with foreign companies in overseas markets by the portion of the tax burden imposed by a global minimum tax. Therefore, it is necessary to consider the magnitude of such influence.

In addition, in developing a global minimum tax under domestic legislation, attention should be paid not to impose an additional tax burden on Japanese companies heavier than

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[17] In this report, "a global minimum tax" refers to the income inclusion rule (IIR) among the GloBE rules (Income Inclusion Rule (IIR) and Undertaxed Payment Rule (UTPR)).

[18] Under the framework agreement, a global minimum tax is agreed as a common approach. While the introduction of a global minimum tax is voluntary in each jurisdiction, it will be designed and implemented in a manner consistent with model rules and guidance in case of introduction. Therefore, it is necessary to examine the details of the international agreement and to sort out the issues to be examined in the domestic legislation.

[19] For example, if a sufficient carve-out does not impose additional taxes on Japanese companies that already have factories or branches in Southeast Asian countries and conduct business, the impact on Japanese companies would be mitigated.

on foreign companies by adopting means such as carve-out, while taking into account international agreements (see (ii) below).

(Attention to the introduction of SHIELD under the U.S. tax reform)

It should be noted that under the U.S. tax system reform, there are discussions on a taxation system (SHIELD[20]) that imposes taxes on U.S. subsidiaries of foreign companies that do not bear the minimum tax burden. If the United States actually introduces SHIELD, while Japan does not introduce a global minimum tax, the burden of paying royalties and interest to the Japanese parent company from a U.S. subsidiary of a Japanese company may increase due to restrictions on the inclusion in deductible expenses in the calculation of the amount of U.S. corporate tax. Therefore, regarding the timing of a global minimum tax to be enacted in Japan, it is necessary to consider developments in the U.S. SHIELD tax system in addition to those in other jurisdictions, including major competitors.

(ii) Consideration for businesses with substantial local economic activities (manufacturing, etc.)

Considering that the purpose of a global minimum tax mainly is to prevent the transfer of profits to no or low-tax jurisdictions assuming highly mobile intangible asset businesses[21], it should be prudent to impose additional tax burdens based on a global minimum tax on manufacturers, etc., whose foreign subsidiaries hold PEs with less mobility, such as factories, etc. In this regard, international discussions have indicated that a certain percentage of the carrying value of tangible assets and payroll held by foreign subsidiaries in each jurisdiction should be deducted from taxable income subject to a global minimum tax calculated for each jurisdiction (carve-out). It is desirable that sufficient carve-out be ensured in future international discussions and domestic legislation[22].

When introducing a global minimum tax, it is desirable to consider transitional measures under domestic law, taking into account the purpose of a global minimum tax, which is to prevent competition in lowering the corporate tax rate. For subsidiaries that already have PEs, such as factories, these PEs are generally not easily transferable to other countries, even if they fall below the minimum tax rate and become subject to consolidated taxation.

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[20] SHIELD (Stopping Harmful Inversions and Ending Low-Tax Developments) is being considered under the Biden administration to replace the BEAT tax system introduced under the Trump tax reform (a system of imposing taxes on all or part of base-erosion payments on certain foreign affiliates, regardless of the jurisdiction in which they are located) as a mechanism to deny deductible expenses to parent companies located in no or low-tax jurisdictions that do not bear minimum tax burdens. The so-called Green Book states that SHIELD covers corporate groups whose consolidated revenue exceed approximately JPY 55 billion (500 million USD).

[21] It should be noted that a highly mobile intangible asset business may be a business activity similar to that of a manufacturing industry, which requires a certain level of capital investment and employment; however, the text assumes a business in which intangible assets are transferred to a no or low-tax jurisdiction and income derived from intangible assets is concentrated in the no or low-tax jurisdiction.

[22] In addition to such a carve-out, regarding exemptions and covered income which are factors that determine the tax base for a global minimum tax, it is also desirable to establish a system that is consistent with other countries through international and appropriate monitoring, from the perspective of the international competitiveness of Japanese companies.

Therefore, it is desirable to give consideration, for example, to exempting companies that moved overseas before a certain period from the application of a global minimum tax, or to limit the scope of application by setting carve-out, etc.

(iii) Reduction of compliance costs by companies, etc.

It is necessary to minimize the increase in compliance costs associated with a global minimum tax in international taxation, which has become increasingly complex year by year and the compliance costs of companies continue to increase. It is desirable that all four simplification options[23] proposed in the Blueprint[24] be adopted in Japanese domestic legislation in order to reduce the compliance costs on companies.

In addition, because the Blueprint requires calculation of the tax base to be based on fair and appropriate accounting standards used by the parent company, it is considered that Japanese GAAP (JGAAP), in addition to IFRS[25], is likely to be accepted. However, considering that there are significant differences between IFRS and JGAAP in terms of treatment of goodwill recognized in business acquisitions, asset impairment, pension accounting, etc., it is desirable that under domestic law, we should adopt a design that does not give rise to superiority or inferiority in terms of intertemporal tax burden, depending on the accounting standards currently selected by the company.

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[23] The four simplification options are: (i) Country-by-country reporting effective tax rate (ETR) safe-harbour; (ii) De minimis profit exclusion; (iii) Single jurisdictional ETR calculation to cover several years; and (iv) Tax administration guidance (so-called whitelist).

(i) Country-by-country (CbC) reporting ETR safe-harbour is a proposal to calculate the ETR after making certain adjustments for the Profit (loss) before Income Tax and Income Tax Accrued in jurisdictions, which are items included in a CbC report, and if the jurisdictional ETR based on the CbC report was above a certain threshold, then no further work to calculate the actual ETR would be required for that jurisdiction.

(ii) De minimis profit exclusion is a proposal to eliminate the need to calculate the ETR for each jurisdiction, if the pre-tax profit in that jurisdiction meets conditions such as less than a certain percentage of the pre-tax profit of the entire MNE group.

(iii) Single jurisdictional ETR calculation to cover several years is a proposal to require an MNE to perform the jurisdictional ETR calculation for every jurisdiction in the base year, but, in the case that the ETR of a particular jurisdiction exceeded a certain threshold rate then the MNE would not be required to compute the ETR for that jurisdiction for several years.

(iv) The Tax Administration Guidance (so-called whitelist) is a proposal that, based on the guidance developed in international discussions, tax administrations would publish guidance (whitelist jurisdictions) that set out jurisdictions deemed to be low-risk and then MNEs would not be required to perform the ETR calculation for those jurisdictions.

Some pointed out that (ii) and (iv) are particularly important, not only from the perspective of reducing the compliance costs, but also because they are considered to contribute to preventing the occurrence of a situation where the ETR is unintentionally lowered and additional tax payments are required.

[24] Tax Challenges Arising from Digitalisation – Report on Pillar Two Blueprint (OECD, Published on October 14, 2020)

[25] IFRS refers to International Financial Reporting Standards, which are accounting standards developed by the International Accounting Standards Board (IASB).

2. Relationship between a global minimum tax and the existing CFC rules

(1) Necessity of reconsidering the relationship between a global minimum tax and CFC taxation system (way of thinking)

While the institutional purposes[26] of a global minimum tax and CFC rules are different, there are some common measures and effects of imposing additional taxes on the parent company regarding the profits of foreign subsidiaries after being taxed at a low foreign tax rate. Therefore, it is desirable to avoid overlap between the two systems and reduce the compliance cost[27][28] <Figures 3 and 4>. In doing so, the introduction of a global minimum tax would ensure a minimum level of tax burden, no matter where and in what form the business is operated in the world, and would substantially reduce incentives for the transfer of business and assets to no or low-tax jurisdictions. As a result, the purpose of the CFC rules to prevent tax avoidance would be achieved to a certain extent. In this respect, there seems to be room to simplify the CFC rules. It should be noted that the level of the minimum tax rate is "at least 15%" (to be agreed internationally in the future) in the framework agreement, and that the higher the level, the closer to 20%, which is the exemption standard for the CFC rules, the greater the overlap between the two systems.

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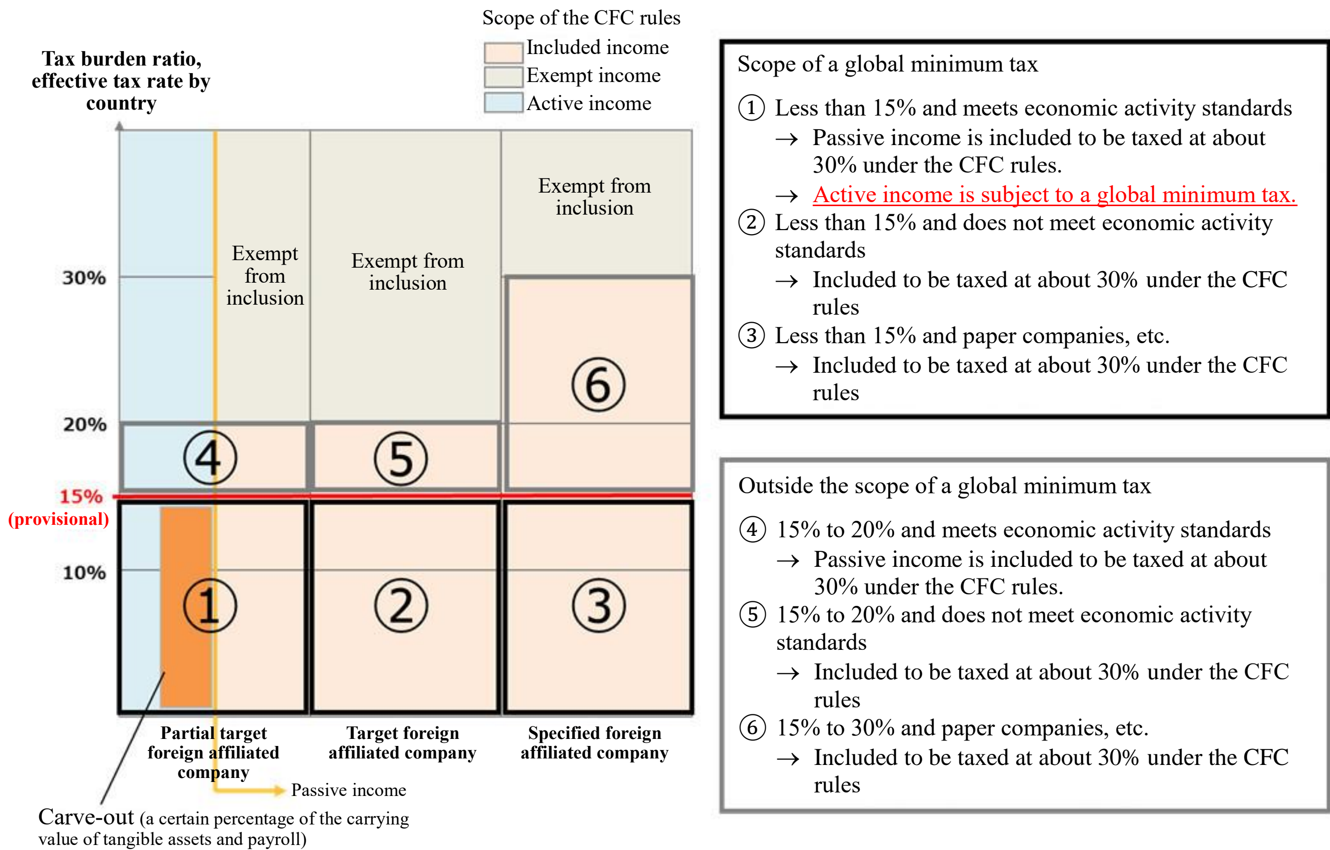
[26] The purpose of a global minimum tax is to prevent the transfer of profits to no or low-tax jurisdictions and to prevent race to the bottom of the corporate tax. On the other hand, the purpose of CFC rules was changed from "system for including income retained in foreign subsidiaries (suppression of tax deferral)" to "system for including income generated by foreign subsidiaries (suppress tax avoidance when it occurs)" in 2009, when the foreign subsidiary dividend exemption system was introduced (October 14, 2016 4th Government Tax System Research Council, [Sou 4 -1] Ministry of Finance explanatory material (International Taxation 2) 1/2, page 5).

[27] For example, the effective tax rate and the calculation method of the tax burden ratio may differ significantly.

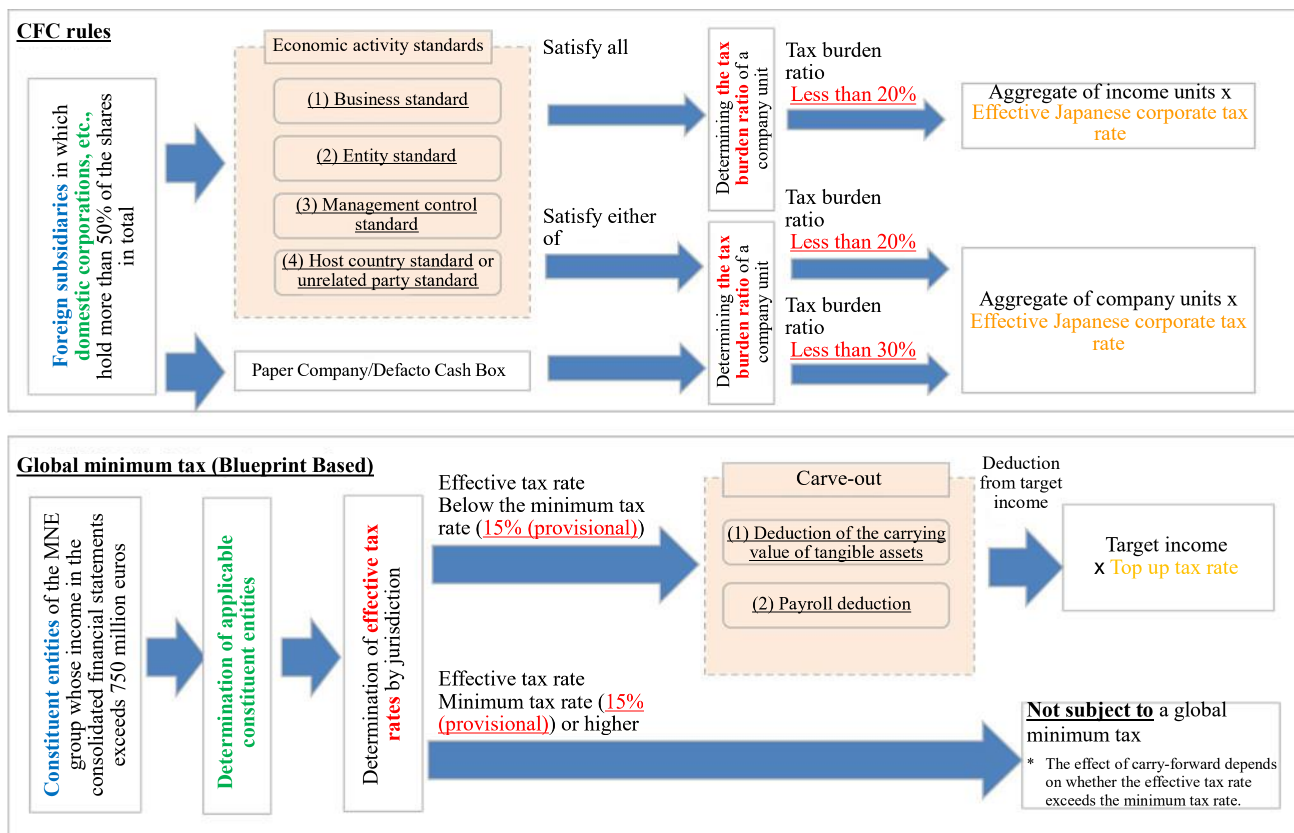
[28] There was an opinion that it is also important to avoid the practical complications associated with the two different standards (double standard) in the two systems and lead to reduction in the compliance costs.

< Figure 3 > Scope of CFC rules and a global minimum tax (Image *)

*It should be noted that CFC rules and a global minimum tax differ in the method of calculating the effective tax rate, the scope of parent companies, and foreign subsidiaries subject to such taxation.



< Figure 4 > Flow of application of CFC rules and a global minimum tax (Image)



(2) Direction of simplification of CFC rules in view of introduction of a global minimum tax

In principle, a certain tax burden should be secured on the earnings of foreign subsidiaries through a global minimum tax, and consideration could be given to an idea to that CFC rules are exceptionally applied only to business activities with little economic rationality other than tax avoidance. This would clarify the roles of a global minimum tax and the CFC rules. Based on this approach, it is necessary to further deepen the discussion on specific systems, including the arrangement of the relationship between the two systems, based on the contents of the final agreement.

With regard to the CFC rules after the introduction of a global minimum tax, there was an opinion that the following points should be taken into consideration, based on the understanding that it is particularly important to avoid excessive aggregation and to alleviate the compliance costs [29] that has been pointed out to be excessive at present.

- The entity approach to determine the necessity of aggregation at the subsidiary level should continue to be utilized to the maximum extent possible, since it would impose an excessive compliance costs on Japanese companies to determine whether each transaction conducted by a foreign subsidiary falls under tax avoidance[30].

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[29] As an example of the actual compliance costs under the current CFC rules, there was an opinion that the number of foreign subsidiaries subject to the system increased by a factor of 3 times and the number of man-hours increased 4-5 times compared with those before the 2017 revision.

[30] There was also an opinion that in jurisdiction where tax payments are made on a consolidated basis, consideration should be given to enable verification on that tax payment unit.

- In this case, as a criterion for narrowing down the target subsidiaries, consideration should be given to not only the monetary importance but also the possibility that the subsidiaries are actually used for tax avoidance[31].
- The included income should be limited to income for the purpose of tax avoidance without business rationality[32]. Specifically, capital gains associated with reorganization after M&A and gains on debt forgiveness at the time of liquidation, etc., should be excluded[33].

- Furthermore, because it is not always easy to determine whether a case falls under tax avoidance, some argued that it is important to provide Japanese companies with an opportunity, including judicial proceedings, for tax avoidance to be determined based on the substance of the act rather than just the formality of preparing documents when imposing tax on them for tax avoidance.

(3) Treatment of companies not subject to a global minimum tax under international agreements

The target of a global minimum tax that is being considered is corporate groups with consolidated revenue of approximately 100 billion yen or more. Since there is no such threshold in CFC rules, there will be a case where CFC rules are applied to companies that do not meet this 100-billion-yen threshold of a global minimum tax.

The premise for the simplification of CFC rules seems to be that the application of a global minimum tax will also change the incentives for tax avoidance, and therefore it will be necessary to determine whether it is appropriate to apply the simplified CFC rules to companies that are not subject to a global minimum tax. In this regard, for example, based on the actual probability that SMEs in our country actually use subsidiaries in no or low-tax jurisdictions to avoid taxes, if such practices are scarce, it may be conceivable to simplify CFC rules, including for companies that are not subject to a global minimum tax. There is an opinion that it is possible to simplify CFC rules by applying a global minimum tax to all companies even if there is a certain degree of tax avoidance among SMEs.

In addition, if the whitelist approach is introduced, which is considered as a simplification measure under a global minimum tax, there will be a difference that a global minimum tax is not applied to whitelist countries while CFC rules are applied. When considering simplification of CFC rules in light of the impact of the introduction of a global minimum tax, it is possible, for example, to take into account such differences in scope. From the perspective of simplification, however, there was also an opinion that in CFC rules, various verification work could be exempted in advance using a whitelist.

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[31] For example, there was an opinion that regarding the current exemption standards, the current 30% or more will be reviewed and unified to 20% or more, and that regarding economic activity standards, the current business standard and the host country standard or the unrelated party standard that limit the scope of business activities should be abolished, because they are no longer in line with the actual state of economic activities, and only the entity standard and the management control standard should be remained. There was also an opinion that it would be possible to use, as a criterion for narrowing down the scope, whether or not subsidiaries with a certain level of revenue are continuously acquiring excess profits.

[32] There was an opinion that it would be desirable to determine whether transactions should be captured as tax avoidance from the following two perspectives: (i) whether procedures not assumed in ordinary business are being followed, and (ii) whether there is a reasonable business purpose other than tax.

[33] Some argued that even when passive income is included, consideration should be given to limiting it to the total amount of income per tax unit.

3. Rules on limitation of payment as deductible expenses to parent companies, etc., in no or low-tax jurisdictions (UTPR)

The undertaxed payment rule (UTPR) is a system in which tax is imposed on a subsidiary by denying the inclusion in deductible expenses of a payment from a foreign subsidiary to a parent company of MNE when the parent company is located in a no or low-tax jurisdiction, etc., that has not introduced GloBE. By fulfilling its role as a backstop for the introduction of a global minimum tax, UTPR is expected to ensure the fairness of competitive conditions in overseas markets between companies in jurisdictions that have introduced a global minimum tax and companies in jurisdictions that have not introduced a global minimum tax. Japan should also consider UTPR along with introduction of a global minimum tax.

In considering UTPR, it is necessary to take appropriate measures, taking into account the existence and extent of the impact on foreign direct investment in Japan. In other words, if Japan introduces UTPR, there is a possibility that the Japanese subsidiary will have to bear additional taxes on payments to the parent company, etc., in no or low-tax jurisdictions where GloBE has not been introduced. Therefore, in order to avoid the UTPR introduced in Japan, other jurisdictions that have not introduced the UTPR may be chosen as the investment destination, rather than Japan. Consideration should be given to avoid negative effects on such foreign direct investment (new investments and existing investments) in Japan (especially those from financial industries of Singapore, etc.).

4. Development of tax systems to promote the formation and use of intangible assets in Japan

(Dealing with the digital economy through the formation and use of intangible assets in Japan)

Japan has a large number of bases in Japan for corporate technology development and R&D in the manufacturing industry. As a result, Japan has a large number of engineers and researchers, and it has been pointed out that they have played a major role in the development of Japan's technological capabilities and supported its development as a "manufacturing superpower" through synergy with basic research at universities and other research institutions across the country. In recent years, however, many companies have tended to localize their R&D functions other than basic ones in order to grasp local needs more quickly and accurately. In the areas of software and ICT, the number of cases of conducting basic research overseas is increasing.

(Impact of the digital economy)

The importance of intangible assets such as data and software will increase in R&D and product development in the digital economy. Combined with its mobility, there is an incentive to implement such operations overseas, where tax rates are lower than in Japan, resulting in higher returns. In fact, in the hearings conducted by the secretariat of this study group, it was pointed out that when Japanese companies acquire foreign companies, they intentionally do not bring data to Japan, where tax rates are higher than overseas, or that there is a problem that research institutes for pharmaceuticals, semiconductors, etc., set up by global companies in Japan are outflowed overseas, mainly for tax reasons.

The ease with which these businesses acquire ICT human resources is also considered to have an important impact, but considering that there are issues with variety of human resources in these fields in Japan, holding intangible assets in Japan may be relatively disadvantageous for some businesses in terms of taxation (it would be advantageous to move abroad). As a result, the R&D and product development functions in Japan may hollow out over the medium to long term as the digitalisation of the economy progresses (to be in an economically rational position to relocate abroad).

(Response of other countries)

While intangible assets such as data (not necessarily limited to those developed in-house; many of them are acquired or formed through M&A or joint R&D) play an increasingly important role as a source of innovation, there are many cases in which special tax measures, such as the so-called IP regime (a system of taxation on income from a certain Intellectual Property (IP) at a lower rate than the statutory tax rate), are adopted in other countries because they are mobile and easy to transfer abroad[34]. For an overview of the patent box tax system in the United Kingdom and France, see Figure 6.

In particular, in the 2017 Trump tax reform in the United States, in order to prevent the outflow of high-value-added functions from the United States, minimum tax on the income of subsidiaries outside the United States (GILTI) and the income deduction on the income earned from overseas business conducted in the United States (FDII[35]) were introduced in relation to intangible assets-related business, thereby achieving neutralization of the domestic and international tax system concerning the location of intangible assets-related business, and it has been pointed out[36] that there were cases where IP was in fact brought back to the United States (see Note 11 for their backgrounds.). At present, the review of the FDII is being considered, but it is necessary to pay close attention to future developments.

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[34] For trends in IP regimes in other countries, see OECD, "Corporate Tax Statistics: Third Edition" 29 July 2021, pp. 46 – 49.

[35] Under the FDII rule, U.S. corporations are allowed to deduct up to 37.5% of their income related to intangible assets derived from abroad (Foreign Derived Intangible Income: FDII) (at a tax rate of 21%, effective tax rate of 13.125%). The calculation formula is as follows.

FDII = (Deduction Eligible Income - Deemed Tangible Income Return) x Foreign Derived Deduction Eligible Income /Deduction Eligible Income

[36] According to reports, after the U.S. tax reform, companies such as Microsoft, Qualcomm, McKesson, and Google are bringing IP back to the U.S. (THOMAS HORST, Tax Notes, 「The TCJA‘s Incentives for and Impediments to Repatriating Intangible Property」, FEB. 27, 2020)

< Figure 6 > Outline of patent box taxation in the UK and France

The United Kingdom	France
Summary	
• A corporate tax rate of 10% is applied to the amount obtained by deducting a certain amount from the income obtained from a certain license, etc. • The income from certain licenses is calculated by deducting expenses from license fees, etc. • Deduction such as routine return, etc. is made for deduction of a certain amount	• A corporate tax rate of 10% is applied to the income obtained from certain licenses, etc. • When calculating the income from certain licenses, etc., R&D expenses are deducted from license fees, etc., and then multiplied by the Nexus rate. • The Nexus rate is the ratio of 130% of the expenses directly incurred by taxpayers to the total amount of R&D
Purpose	
• Cross-Business innovation, promotion of R&D, and support for the commercialization of patents and R&D in the United Kingdom	• Promotion of R&D activities in France
Target income	
• Income from certain licenses, etc. • Certain licenses, etc., mean licenses, etc., to be used by persons who positively hold patent rights, etc.	• Income from certain licenses, etc. • Certain licenses, etc., are license fees, etc., from assets used by corporations for commercial purposes.

(Reference) Compiled based on Research Report commissioned by the Ministry of Economy, Trade and Industry "Survey and research on trends in taxation in light of the digitalisation of the economy in foreign countries, etc. Summary report", page 71.

(Response in Japan)

It is true that there are some issues in the FDII and IP regimes adopted by some countries[37]. Also, discussions are necessary in narrowing the focus of tax measures, for development using intangible assets such as data it is also necessary to discuss, for example, whether to focus on the development stage or on the (successful) use of development results.

In light of these movements in other countries, also in terms of international taxation, the formation, maintenance, and accumulation of intangible assets, including data, in Japan, as well as the development of a tax system that can be used for various business activities, including R&D, are extremely important issues for maintaining and developing Japan's position as a "manufacturing superpower". At present, it is urgent to seriously consider the reality that it is not always economically rational to retain and accumulate intangible assets in Japan, and to deepen discussions on specific efforts in Japan[38][39]. In doing so, it is necessary to pay sufficient attention to

[37] For example, it has been pointed out that the FDII may fall under the category of export subsidies prohibited under the WTO Agreement, and that there are concerns that it may fall under the category of harmful taxation referred to in the Forum on Harmful Tax Practices established by the OECD. Some IP regimes may fall under the category of harmful taxation in the Harmful Tax Regime Forum, depending on the institutional design.

[38] From the viewpoint of securing the necessary funds for domestic R&D bases, there was also an opinion that it is important to consider measures to promote the profits obtained overseas to return to Japan.

[39] There was also an opinion that IP and R&D activities have positive externalities because they lead to the benefits of other economic activities, and that there is room for the government to intervene because a single company would expense less.

the status of noteworthy measures such as the U.S. tax system (GILTI and FDII) that aims for tax neutrality of the location (whether domestically or overseas) of intangible asset-related businesses.

5. Japanese companies' global tax administration system

As mentioned above, M&As and small investments in foreign companies have increased in Japan for the purpose of strengthening international competitiveness, etc. Apart from the business strategies of individual companies, as a global institutional environment, international taxation rules are rapidly being developed and strengthened based on the BEPS project, and the transfer of profits and tax payments among each group company are being utilized by tax authorities of each country in transfer pricing taxation, etc. New international taxation rules are expected to be established in the future, including a global minimum tax and the allocation of new taxing rights to market jurisdictions.

In order for Japanese companies to respond appropriately to such situation, it is becoming increasingly necessary not for each group company to optimize individually, but to grasp information relating to the finances and tax of each group company on a company group-wide basis more broadly and in a timely manner and to manage it appropriately. In the context of ESG investment, it has also become important to ensure tax transparency in relation to stakeholders outside the company.

Specifically, for example, with regard to business activities (for example, M&A) that can have a significant impact on the tax burden of the entire company, the corporate division of the head office (tax department, etc.) needs to be appropriately involved in advance in order to ensure a company-wide strategic and rational response. As a basis for this, it is an urgent task to integrate the information systems of group companies, including foreign subsidiaries and affiliated companies. In addition, as a parent company, it is necessary to develop a management system for the decision-making process, such as prior involvement and evaluation of the tax department prior to acquisition and reorganization. In particular, system integration is very important for integration activities (PMI) after M&As to foreign companies[40].

There was also an opinion that, among the limited resources, it is important to simplify the system in order to allocate sufficient resources to the high-value-added operations mentioned above.

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[40] A report by the "Study Group for Japanese Companies' M&A Overseas" published by the Ministry of Economy, Trade and Industry pointed out as follows: "System integration is essential to understand whether business synergies are being created". The introduction of a common management platform that enables timely access to key management information (e.g. revenue of products in major markets, comparison with previous year and plan, etc.) at headquarters has the effect of facilitating discussion of competitive and regulatory trends based on above information. In addition, there were cases in which an ERP package was introduced at an early stage at an acquiree and infrastructure development was promoted so that the same management could be carried out because there was an asymmetry of information between the headquarters and the acquiree, which made it impossible to have a good discussion when formulating a business plan because it raised suspicion that something was being hidden." (METI, Report by the "Study Group for Japanese Companies' M&A Overseas", p. 71, March 2018). ERP (Enterprise Resource Planning) refers to an integrated mission-critical business system.

IV. Tax System that Enables Fair Competition in the Domestic Digital Market

1. Problem consciousness

The global situation in which digital companies do not necessarily need PE, etc., in the market jurisdictions and do not pay sufficient corporate tax to the market jurisdictions according to the added value created under the current system seems to apply to Japan as well. Specifically, in Japan, there seems to be an environment for foreign companies to monopolize and oligopolize the online advertising, cloud services, online games, and other markets. Moreover, the degree of concentration of foreign companies seems to increase (see note 7.). However, Japanese companies, as competitors, point out that there is a difference in tax burdens between foreign companies and Japanese companies, and that difference is an unfair competitive environment in the sense that it accumulates every year as a difference in R&D capabilities and product development capabilities.

In order to ensure a fair competitive environment for domestic and foreign companies, it is considered necessary to require foreign companies to bear a fair tax burden[41] in the digital field in comparison with Japanese companies.

2. International agreement on the allocation of new taxing rights to market jurisdictions (Pillar 1)

(1) Basic approach

From the viewpoint of ensuring fairness in the tax burden of domestic and foreign companies in the domestic digital market, it is important to implement the international agreement on the allocation of new taxing rights to market jurisdictions (Pillar 1). While approximately 40 countries/regions have already introduced or are planning to introduce DSTs, etc., as their unilateral measures, it is expected that international discussions will bear fruit as soon as possible as a concrete agreement and be promptly implemented from the viewpoint of avoiding the burden on companies such as double taxation (with corporate tax, etc.) and administrative costs associated with the expansion of unilateral measures.

Pillar 1 idea[42] is, in theory, to allocate a portion of residual profits to market jurisdictions, and it is appreciated that it does not impose a tax on routine profits, and that it also ensures neutrality in economic activities. It can also be considered to have an aspect of commonality with the destination-based corporation tax as described below.

Whether or not to further expand the allocation to market jurisdictions in the medium- to long-term should be carefully considered from the viewpoint of whether or not to impede the cycle of promoting corporate innovation, taking into account that the jurisdictions in which corporations

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[41] In particular, in the digital industry, which requires continuous investment, differences in free cash flow, which is the source of investment, may affect the growth of digital companies.

[42] Some members argued that Pillar 1 is not appropriate, in that almost all industries are now included in the scope of the Pillar 1 framework, although the original issue of the Pillar 1 framework is to secure appropriate taxing rights for digital companies that do not have PEs in market jurisdictions. In response to this, it was pointed out in international discussions that if a company has a PE, etc., in a market jurisdiction, and if appropriate profits are granted to the market jurisdiction based on the conventional rules, measures such as no additional allocation or restriction of additional allocation are being considered, and that detailed institutional design in the future is important.

reside have contributed to the increase in corporate profits as a result of their economic and fiscal policies, including education, investment in various infrastructure, development of medical systems, and tax systems, and have collected them from corporate profits in some aspects, and that R&D activities and the formation and use of intangible assets, etc., involving risks in the countries/regions concerned have contributed to the increase in corporate profits in the market jurisdictions.

(2) Technical issues in institutional design

Pillar 1 can be applied to companies that have PE, etc., and pay tax in the market jurisdictions, so it is essential to take appropriate deductions, etc., to prevent double taxation including such companies when introducing Pillar 1. In addition, there are a wide range of issues to be discussed: from the standpoint of a company that is liable for tax payment, how to make tax payments to a market jurisdiction where the company does not have a PE, etc.; and from the standpoint of the tax authorities of the market jurisdiction, how to confirm whether the amount of such tax payments is appropriate. It is expected to be a difficult task, as more than 130 countries/regions, which have already agreed to a broad framework, are expected to formulate a Multilateral Convention. However, from the viewpoint of taxpayers' companies and tax authorities, it is very important to establish a simple system that enables practical responses and enforcement. The following points are considered to be particularly important, taking into account the above and other issues.

- Scope: The scope of excluded industries (for example, whether automobile finance companies will be in the scope of exclusion). In addition, the treatment of cases where excluded industries (Regulated Financial Services, etc.) are included as part of MNEs.
- Revenue sourcing rule[43]: Consideration should be given to the administrative burden on companies involved in information sharing system. With regard to information used in BtoBtoC third-party transactions, consideration should be given so that the collection of information is not requested at the expense of the company, such as by requiring a contract amendment (for example, the place of sales may be determined by the location of the business customer.).
- Segmentation[44]: Use of existing disclosure segments. Since reallocation of common expenses, etc., for Pillar 1 is difficult in practical work, the use of disclosure segments already used should be allowed.
- Development of measures to restrict additional allocation in cases where a company already has a PE, etc., in a market jurisdiction and the profit is appropriately recorded under the conventional rules.
- Elimination of double taxation: There was an opinion that the foreign income exemption method should be adopted instead of the foreign tax credit method.
- Tax certainty: Development of mandatory and binding dispute prevention and resolution mechanisms for tax certainty for all issues related to Pillar 1.

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[43] Revenue sourcing rule is a mechanism for determining from which market jurisdiction Pillar 1 revenue originate.

[44] Segmentation refers to a mechanism, in the application of Pillar 1, for differentiating the profit of a corporate group to be targeted by Pillar 1 between the targeted portion of Pillar 1 and the other portion.

3. Remaining issues regarding taxation of foreign companies

(1) Consumption tax related to cross-border transactions

With the increase in cross-border transactions by overseas operators in the domestic digital market[45][46], the following issues exist regarding the consumption tax system in Japan.

The tax-exempt company system of the consumption tax in Japan is also applied to overseas business operators, and there is a problem that even overseas business operators with large revenue can benefit from the tax-exempt company status for two years, if there is no taxable revenue in Japan during the base period (in principle, the base period is the business year two years prior). At a time when corporate revenue is rapidly expanding, overseas companies are allowed to sell their products as tax-exempt company in Japan for two years, causing unfair price competitiveness with domestic businesses in the same industry. For digital companies, it is not considered impossible to create a separate entity to do similar work, such as selling online games with different titles.

In addition, some pointed out that there is no problem in the case where assets are transferred by the cross-border EC, because import consumption tax is paid. However, the Japanese consumption tax system does not limit the right of import consumption tax credit to the person with the right to dispose of them, and the person in the name of the importer can make a credit. For example, in the case where an overseas business operator sells goods to Japan by the cross-border EC, if the overseas business operator is a tax-exempt business operator and the company has a service company in Japan, and the service company becomes the import holder, the service company can make a purchase tax credit for import consumption tax and sell the goods tax-free for two years.

As mentioned above, it is considered necessary to review the fact that some cross-border transactions are currently not taxed.

(2) Responding to tax burden reduction through deductible payments by Japanese subsidiaries of foreign companies

In the United States, BEAT was introduced in 2017 to ensure that foreign companies pay the minimum amount of tax in the United States and to prevent tax avoidance by arbitrarily increasing payments to parent companies and affiliates. Under the Biden administration, a shift to the SHIELD taxation system is under consideration.

At present in Japan, due to the thin capitalization rules and the Japan's rule on interest deductibility, certain measures are taken to prevent erosion of the tax base by Japanese subsidiaries of foreign companies through the deductible payment of interest to foreign parent companies. On the other hand, in the future digital economy, it is highly likely that the payment of royalties on

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[45] According to the presentation materials of Motohiko Sato of Japan Association of New Economy at this workshop, it is pointed out that among the top 100 downloaded games in the smartphone game market, Japanese smartphone games are 36 titles, and the remaining 64 titles are all imported.
The top 100 sellers include 18 Chinese games, with total revenue of about 42.9 billion yen (62.5% increase from the same period last year).

[46] According to the Customs and Tariff Bureau of the Ministry of Finance, the number of air cargo import permits has been on a significant upward trend in recent years due to the expansion of e-commerce. In 2020, the number of air cargo import permits was more than 1.5 times that of the previous year (42,121,000 cases (2019) to 65,597,000 cases (2020)), and about 2.6 times that of 4 years ago (25,288,000 cases (2016) to 65,597,000 cases (2020)). (Customs and Tariff Bureau, Ministry of Finance, "Recent Situation of Customs Policies and Administration" April 13, 2021.)

data and intangible assets to the parent company, etc., will increase significantly. Therefore, from the viewpoint of ensuring the fairness of tax burdens in Japan with Japanese companies, it would be desirable to consider measures to restrict foreign companies' deductible expenses other than interest payments to their Japanese subsidiaries, while referring to the U.S. BEAT tax system, in light of the payment status of foreign companies' Japanese subsidiaries to their parent companies.

(3) Preparing for delay in pillar 1 entry into force

(i) Basic approach

As mentioned above, it is desirable that an international agreement on Pillar 1 be implemented as a Multilateral Convention at an early date and take effect as soon as possible. At the early stage of entry into force, it is important to promptly repeal DST, etc.,[47] in foreign countries whose purposes are similar to those of Pillar 1 from the perspective of stimulating international investment through the elimination of double taxation.

On the other hand, there are various issues to be addressed in the future, such as agreement on the text of the Multilateral Convention and ratification procedures in each national assembly. Therefore, it is necessary to pay close attention to the extent to which these issues will be realized, including domestic coordination in each jurisdiction, on a scheduled basis. If it is difficult to agree on the details of Pillar 1 and put it into effect at an early date, the problem is that it will be difficult to secure appropriate taxation in accordance with the value added generated in Japan, and the competitive environment between companies will remain unfair. In addition, given that the development of a domestic digital environment is an important and urgent issue, there was an opinion that Japan should closely monitor future international trends[48] and, depending on the situation, deepen discussions on Japan's appropriate concrete measures as a transitional measure until an international agreement is reached.

In addition, there was an opinion that, if such a response had to be considered, it would be necessary to establish a system that ensures fairness among companies, instead of taking measures that some countries have already introduced to target companies in specific jurisdictions.

(ii) Tax items

Specific tax items for responding to these opinions include sales tax, income tax, and consumption tax. The characteristics and problems of each are as follows.

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[47] Note that each country's unilateral measures, called DST, vary. Note that here, for example, Equalization Levy in India is included in the "DST, etc.".

[48] For example, in the EU, Digital Levy is being considered from the viewpoint of securing financial resources for reconstruction.

[Sales tax[49]]

・ This can be seen in the example of DST introduced in other countries.
・ If the marginal cost of producing goods and services for a digital company is close to zero, it can be seen as essentially taxing income, even if it is formally taxing sales, so there is room to position it as a supplement to corporate tax.

(Merits)

・ The mechanism is relatively simple.
・ It is not restricted by existing tax treaties, because it is a tax on sales (not income).

(Demerit)

・ Because it is a tax on sales, double taxation occurs structurally when a tax credit from corporation tax is not allowed[50].

[Income taxation]

・ Withholding income tax (to the gross transaction value). To ensure such taxation, a draft revision of the UN Model Tax Convention is under consideration discussed in UN.

(Merits)

・ Since the taxation is on income, double taxation can be eliminated by allowing tax credits based on tax treaties.

(Demerit)

・ It is necessary to revise existing tax treaties.

[Consumption tax]

(Merits)

・ In terms of administrative costs and enforcement, it is advantageous to be able to utilize the existing consumption tax system.

(Demerit)

・ When advertising sales and data sales are subject to taxation, they are considered to be BtoB services under the Consumption Tax Act, and therefore tax revenues do not increase when the beneficiaries are businesses that are fully eligible for purchase tax credits. It will be necessary to limit the amount of tax credits for purchases after reviewing the rules governing the place for consumption tax payment.

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[49] As a basis for taxation, the sales tax on digital services, particularly on two-sided businesses, is characterized by (i) rents (excess profit) are generated to sales in that the marginal cost is close to zero due to enormous up-front investment, and (ii) sales are generated from information provided by service users, and while taking the form of a sales tax, substantially, it has aspects similar to taxation on corporate income. There is a view that even if a foreign company does not have a PE in a jurisdiction, it is justified that the market jurisdiction has taxing rights based on the location-specific rent (LSR).

[50] In addition to the double taxation of the sales tax and the corporate tax, it was pointed out that the double taxation of the sales tax of one jurisdiction and the sales tax of another jurisdiction could become a problem.

(iii) Common issues

(Pros and cons of imputation)

There was an opinion that, given the widespread presence of monopolies and oligopolies in the domestic digital industry, it is necessary to bear in mind the possibility that the tax burden will ultimately be passed on to users, and if all or most of the tax burden is passed on to users through the exercise of monopolies, etc., the objective of ensuring a fair competitive environment may fail to be sufficiently achieved in practice. Furthermore, there was an opinion that in a situation in which only companies in a dominant position in the market pass on the tax burden, market dominance might be maintained.

This issue raises the question of how much tax burden a foreign company will actually bear as the ultimate tax bearer, based on the possibility of passing on the tax burden to users when considering countermeasures, and it is necessary to pay close attention to cases in other countries.

(Adjustments with corporate taxes)

There was an opinion that, in the case of imposing sales tax on Japanese companies that are subject to corporate tax, measures such as deductions from corporate tax should be considered to the extent that double taxation occurs in order to ensure a fair competition environment with overseas digital companies. Although it is considered that new taxation should be cautiously examined because there are issues such as the above-mentioned problems related to pass-through and the possibility of substantial double taxation with corporate tax, some Japanese companies argued that if such measures have to be considered, there would be room for discussion to limit the use of tax revenues to the urgent task of developing a digital environment in Japan (introduction of digital networks for schools and medical care, development of 5G networks, cashless infrastructure, and invitation of data centers in Japan) in order to respond to social demands. On the other hand, there were also opinions that limiting the use of tax revenue might lead to fiscal rigidity and that there might be room to reduce the burden on companies by expanding other tax measures.

V. Medium- to Long-term International Taxation

1. Issues to be considered

(Difficulty in applying the arm's length principle, etc.)

Current international taxation rules are based on the principle of "No taxation without PE". In other words, based on the principle that taxes should be imposed where value is actually created (value creation principle), whether it is R&D activities, advertising activities to increase brand value, or sales activities, the allocation of value to headquarters and PE of each jurisdiction is based on the Authorized OECD Approach (AOA) or the arm's length principle (ALP).

These principles are more likely to be valid in a situation where traditional business models for manufacturing and selling tangible assets are globally dominant. But these principles may become increasingly difficult to apply in modern business environments, where the digitalisation of the

economy is progressed and services are often optimized for each customer on the basis of intangible assets, due to the lack of comparable transactions needed for validation.

(Destabilization of tax revenues)

Because intangible assets are highly mobile, it is possible to manipulate the place of value recognition to some extent, which may lead to international tax avoidance and destabilize tax revenues.

(Destination principle taxation proposal)

As a drastic solution to the difficult situation of international taxation, there is the idea of shifting from the current corporate tax, which can be called a "principle of origin" based on the principle of value creation, to a tax system based on the principle of destination; that is, the taxation of the value created by companies at the place of consumption through the introduction of border tax adjustment (export tax exemption, import tax). Pillar 1 can be regarded as a form of destination principle taxation in that it gives the taxing rights to the market jurisdiction; that is, the place of consumption. Similarly, the allocation of tax revenues between jurisdictions by revenue, etc., which has been discussed in the EU (Business in Europe: Framework for Income Taxation: BEFIT), is also similar to the destination-based approach.

This study group examined the significance of the shift to destination based corporate tax from a medium- to long-term perspective, using the destination based cash flow tax (DBCFT — Destination Based Cash Flow Tax), which was discussed in the United States, as a concrete theme of destination based corporate tax.

2. Key issues and directions

(1) Basic approach

The concept of a destination based cash flow tax, such as DBCFT, is intended to ensure the neutrality of taxation on investment activities by using the cash flow basis as the tax base, in addition to obtaining stable tax revenues by imposing taxes on less mobile consumption. It should be noted that there are no countries that implemented such tax at present, and theoretical considerations play a central role in many aspects. However, it can also be considered to be similar to the consumption tax in Japan, except for the deduction of wages from the tax base and whether or not the ultimate bearer is the final consumer.

(2) Concrete mechanism

- Destination-based principle is a system in which assets and services are taxed in the country of destination where they are sent out through border tax adjustments (export tax exemption, import tax). It is also used in the Japanese consumption tax.
- The cash-flow tax[51] is a system that imposes taxes based on cash flow and allows immediate depreciation rather than depreciation over a useful life on investments.

[51] There are various ways of thinking about the cash flow tax, depending on which type of cash flow you pay attention to. For example, there is a mechanism to focus only on spot transactions without considering financial transactions.

(3) Merits and demerits conceivable from theoretical consideration

Based on the above understanding, the following merits and demerits are conceivable.

(Merits)

(i) Viewpoints of destination-based principle

- It is neutral in determining the location of a company and does not result in an international income transfer.
- Countries with VAT should be able to establish a mechanism that has an economic effect similar to that of DBCFT by expanding VAT while reducing corporate tax, without making corporate tax a destination basis.

(ii) Viewpoints of cash-flow as tax base

- It is neutral [52]to investment, and investment promotion effect is expected.
- It is neutral to funding.

(Demerit)

(i) Viewpoints of destination-based principle

- Tax revenues may decrease for jurisdictions with excess exports
- Border tax adjustments on a destination basis may fall under export subsidies prohibited under the WTO Agreement
- Jurisdictions changing over from current corporate taxes to DBCFT may become tax havens (It is the same as abolishing the current corporate tax and introducing the corporate tax portion of VAT), exacerbating current tax avoidance problems.
- The outlook for convergence regarding the impact of exchange rates arising from the adoption of a destination basis is unclear.

(ii) Viewpoints of cash-flow as tax base

- Taxes on financial services, along with the extent to which cash flows are measured, will be a point of contention.
- Whether or not interest is included in deductible expenses. If interest is excluded from deductible expenses, the hurdle rate for investment will increase, and leverage will not be realized from the viewpoint of foreign investors.

(iii) Enforcement issues

- It is necessary to ensure the enforcement of border tax adjustments. In particular, border tax adjustments may be difficult to implement for intangible assets and services. (This is the same challenge as with the current VAT.)
- In order to introduce DBCFT globally, it is necessary to introduce a system similar to the one-stop shop system adopted in the EU's VAT.
- It is necessary to introduce strong dispute resolution measures such as arbitration.

(4) Considerations

DBCFT has the potential to fundamentally solve some of the current issues of international taxation in that it adopts a destination basis and does not require the identification of value creation sites or the allocation of value among countries. In addition to the issue of international taxation, as

[52] Specifically, when fixed assets, etc., are purchased, they can all be treated as expenses in the fiscal year of purchase.

the impact on the economy in general, it may also contribute to the promotion of corporate investment on the premise that cash flow is the tax base and capital investment is subject to immediate depreciation. In particular, it should be kept in mind that in Japan, where the consumption tax is already a fundamental tax, the effects contemplated by DBCFT may, virtually, be relatively easy to introduce by rearranging part of the corporate tax in an appropriate form.

On the other hand, at the present time, it is not common for each jurisdiction to adopt a destination basis or a cash-flow basis for corporate tax (except that the VAT is substantially similar). Furthermore, it is pointed out that if DBCFT is introduced as one of the corporate taxes, there is a possibility that export tax exemptions related to border tax adjustments could fall under export subsidies prohibited under the WTO Agreement.

Whether or not to actually adopt DBCFT is a matter that needs to be continuously examined over the medium to long term, and it is considered to provide a useful perspective when considering the future of international issues of taxation in market jurisdictions and domestic issues of tax mix.

List of committee members

(Japanese syllabary order, titles omitted)

<Members, etc.> * Chairman

・ Keiji AOYAMA (Visiting Professor, Graduate School of Chiba University of Commerce; Project Leader（International Taxation）of Keidanren the 21st Century Public Policy Institute)
・ Hideyoshi IWANE (Executive Officer, General Manager, Corporate Accounting, Marubeni Corporation)
・ Yo OTA (Partner, Nishimura & Asahi)
・ Tadao OKAMURA (Professor, Graduate School of Law, Kyoto University)
・ Masaaki KURIHARA (Director for Tax Affairs and Tax Department, Toray Industries, Inc.)
・ Kaname SHIMIZU (General Manager, Accounting Division, Toyota Motor Corporation) [Up to the 4th meeting].
・ Hiroyuki SUZUKI (General Manager, Accounting Division, Toyota Motor Corporation) [from the 5th meeting]
・ Masaaki SUZUKI (Professor, Faculty of Economics, Senshu University)
・ Hidemichi TAKENAKA (Senior Global Tax Expert, Sony Global Tax Office, Sony Group Corporation)
◉ Eiji TAJIKA (Professor Emeritus, Hitotsubashi University)
・ Junichi TANI (General Manager, Group Accounting Department, Tax Department, Rakuten Group, Inc.)
・ Keisuke HIOKI (Partner & Associate Director, Boston Consulting Group)
・ Fumiko MIZOGUCHI (Partner, Leader of Indirect Tax Services, Deloitte Tohmatsu Tax Co.)
・ Tetsuya YAMAGISHI (Certified Public Accountant & Licensed Tax Accountant, Partner, International and Deals Tax Group, PwC Tax Japan)
・ Masao YOSHIMURA (Professor, Graduate School of Law, Hitotsubashi University)

<Observers>

○ Economic organizations

・ Yoshiharu OBATA (Director, Business Infrastructure Bureau, Keidanren (Japan Business Federation))
・ Yuji SEIYA (Group Leader, First Policy Proposal Group, Japan Foreign Trade Council, Inc) [Up to the 2nd meeting]
・ Masayuki FUJII (Group Leader, First Policy Proposal Group, Japan Foreign Trade Council, Inc) [From the 3rd meeting]
・ Motohiko SATO (Department Manager, Global Public Policy Department, Secretariat, Japan Association of New Economy)

○ Relevant ministries and agencies

・ Daiho FUJII (Former Director, International Tax Policy, Tax Bureau, Ministry of Finance) [Up to the 5th meeting]

- Daisaku KIHARA (Director, International Tax Policy, Tax Bureau, Ministry of Finance) [the 6th meeting]
- Nobuaki IZAWA (Former Director (International), Large Enterprise Division, Large Enterprise and Criminal Investigation Department, National Tax Agency) [Up to the 5th meeting]
- Ryuta ISOMI (Director (International), Large Enterprise Division, Large Enterprise and Criminal Investigation Department, National Tax Agency) [the 6th meeting]
- Shigeki OHNUKI (Director, Corporate Affairs Division, Economic and Industrial Policy Bureau, Ministry of Economy, Trade and Industry)

(End)

Holding results

The 1st (March 1, 2021)

○ Theme: Opinions on international taxation in the digital economy and issues to be considered by the study group

○ Guest lecturer: Takeshi EBIHARA (Representative Director and Founding General Partner, Rebright Partners)

The 2nd (March 29, 2021)

○ Theme: Overseas business of Japanese companies and fair tax system in consideration of its diversification and competitive environment with European and American companies

○ Guest lecturers

・ Naoki OKA (Research Fellow, Certified Public Tax Accountant, The Tokyo Foundation for Policy Research)

・ Masahiko HATA (Ernst & Young LLP Partner Certified public accountant, Lawyer)

The 3rd (May 14, 2021)

○ Theme: Tax system that contributes to fair competition with overseas digital companies in Japan

○ Guest lecturers

・ Tetsuya WATANABE (Professor, School of Law, Waseda University)

・ Motohiko SATO (Department Manager, Global Public Policy Department, Secretariat, Japan Association of New Economy) *Observer

○ Guest companies

・ Rhett Charles, SHAVER (Director, International Tax Department, Amazon Japan G.K.)

・ Yuriko OGAWA (Senior Manager, International Tax Department, Amazon Japan G.K.)

・ Andrew URE (Director for Japan and Public Policy, Google Asia-Pacific)

・ Miho KISHITANI (Policy Advisor to EVP, GCTSO Division, Z Holdings Corporation)

The 4th (June 2, 2021)

○ Themes: Medium- and long-term international taxation, Pillar 2, and tax regimes for overseas businesses, including CFC rules

○ Lecturer: Masaaki SUZUKI (Professor, Senshu University) *Member of the Committee

The 5th (June 29, 2021)

○ Theme: Interim summary (outline proposal)

The 6th (July 21, 2021)

○ Theme: Interim summary (proposal)