

Family Office Service: Global Economics, Markets and Tax Newsletter

Japan enters largest economic decline in recorded history

Q3 2020

Japan Big Picture

Politics

On 28 August 2020 Prime Minister Shinzo Abe announced his intention to resign from his post as prime minister due to ulcerative colitis, the same illness that forced him to resign as Prime Minister in 2007 after his first time as leader. In response to Abe's resignation, equity prices fell sharply in Japan while the value of the yen increased. Abe's Liberal Democratic Party, which retains a large majority in the Parliament, chose Chief Cabinet Secretary Yoshihide Suga as the new leader of the Liberal Democratic Party, succeeding Shinzo Abe as Prime Minister on 16 September 2020.

Economy

Q2 2020 GDP data, released in August, showed the economy contracted 7.9% quarter-on-quarter (q/q) from Q1. At an annualized rate this is equivalent to 28.1% - the biggest decline since records began in 1955. The contraction is due to a contraction in activity in April and May due to the government's encouragement that people put themselves in self-imposed lockdown to combat the spread of COVID-19. This is the third quarter of contraction the economy has experienced since Q4 2019 following the effects of the global slowdown, especially the impact of the trade tensions between the US and China. Japan's manufacturers play an important role in Chinese supply chains that feed into the production of exportable final goods. In addition, Japanese consumer spending had been hit by the late-2019 increase in the national sales tax.

Real private consumption is the single largest component of GDP and so the 7.6% q/q decline had a large impact on the economy. Exports of goods and services declined 18.5% which represents a collapse in economic activity in foreign countries while imports declined only 0.5%. The decline in exports included the near collapse of the increasingly important Japanese tourist sector. However, monthly export data from July (the first month of Q3) were down 19.2% year-on-year (y/y) – the 20th consecutive decline in exports. Exports declined to most trading partners except China, where exports were up 8.2%.

Business investment fell only 4.7% but government investment increased 1.2% in Q2. There is however some evidence that the economy was starting to turn by June 2020. Industrial production increased modestly in June, rising 1.9% month-on-month (m/m) from May but still down 18.2% y/y. The modest monthly increase was largely driven by a massive increase in automotive output, rising 28.6% m/m. Contributing to the rebound in economic activity is the fact that the state of emergency was lifted in May. Industrial production increased in July 2020 at a record pace, rising 8.7% m/m – although down 15.5% y/y. The most important contributor to the increase was production of motor vehicles which was up 38.4% m/m. The fact that output remains so far below pre-crisis levels is a reflection of weak domestic demand and disrupted global trade but with China's economy bouncing back quickly (see details on China in the next section) should ultimately have a positive spillover on Japan as suggested by the export data discussed above. In addition, Japan's government has implemented stimulus measures which should have positive short and long-term effects. Meanwhile, the virus situation is worsening. However, the government is not reverting to new lockdowns. However, in June, core machinery orders, a good leading indicator of capital expenditure over the short-term, were down 7.6% y/y. As such, the news bodes poorly for business investment.

Source: <https://www.reuters.com/article/us-japan-economy-gdp-poll/japans-second-quarter-gdp-likely-shrank-most-on-record-due-to-coronavirus-crisis-reuters-poll-idUSKCN2530MN>

Although private consumption was weak in the GDP data, retail sales in June rebounded at the fastest rate on record, 13.1% m/m and only down 1.2% y/y. Although general merchandise store sales were down 17.2% y/y as people continued to stay away from stores, food and beverage sales were up 3% y/y and machinery and equipment stores notched a 15.9% increase. This is

encouraging that consumer activity is starting to rebound a little which will contribute to at least a slowdown in the economic contracting in Q3 2020. Overall, the economic picture is relatively benign.

Source: <https://www.reuters.com/article/japan-economy-retail/japan-june-retail-sales-fall-1-2-year-year-govt-idUST9N2D902H>

Key Themes

1. Increasing productivity

When Shinzo Abe became Japan's Prime Minister for the second time in 2012, he launched an economic program that came to be known as "Abenomics" which included three "arrows." The first two arrows were monetary stimulus, fiscal stimulus, and the third was structural reforms. The first and second arrows were quickly implemented, although the net impact on growth could be described as modest at best. That might be because the third arrow never really got off the ground which was the most important to improve Japan's long-term potential. However, according to a new study by the Peterson Institute, the COVID-19 crisis might wind up creating the structural reforms that have so far been missing.

The term structural reform was meant to encompass changes to rules and regulations that could liberalize domestic and external markets as well as encourage productivity-enhancing investment. Despite having some of the world's most productive and iconic companies, Japan has long suffered from inefficiency in domestic markets and weak adaptation of new technologies. The coronavirus crisis has begun to change some of that. There are two reasons for this:

- 1) The threat of the virus has led many individuals and businesses to change behavior in ways that will likely boost productivity. This includes greater use of information technology for human interaction, including working from home, shopping from home, and using digital technology to undertake transactions.
- 2) The Japanese government responded to the crisis with a massive increase in spending meant to assist troubled households and businesses. However, within that extra expenditure are programs that will likely boost productivity. These include spending to increase digital healthcare services, boost digitization of government services, and invest in the implementation of fiber optic networks. The digitization of government services has included a requirement that, in order to obtain cash transfer payments, individuals must use new digital personal identification cards. In so doing, it is likely that the government will spur greater use of digital spending as opposed to the use of cash.

In addition, there have been changes in government regulations meant to smooth the transition toward a more digital world. These include the lifting of restrictions on online medical services. Also, the government increased the subsidy available to individuals who work from home. The government is also providing small- and medium-sized companies with financial incentives to invest in equipment for teleworking. The shift toward teleworking could be especially helpful in boosting female participation in the labor force, especially when it concerns women who have small children. Overall, these shifts will likely boost the growth of productivity, thereby enabling faster and sustained economic growth over the long-term. They will also help Japan to address the growing labor shortage that stems from a low birth rate and the resulting decline in the working age population. It appears that the COVID-19 crisis might accelerate the transition to a digital world that will enable businesses in multiple industries to become more efficient.

Source: <https://www.piie.com/blogs/realtime-economic-issues-watch/coronavirus-crisis-may-accelerate-japans-structural-reform>

Source: <https://www2.deloitte.com/us/en/insights/economy/global-economic-outlook/weekly-update/weekly-update-2020-07.html>

2. Trade

The UK and Japan reached a free trade agreement that will enable Britain to enjoy the benefits that the European Union (EU) has in trading with Japan upon exiting the EU. There is already a free trade agreement between the EU and Japan. With Brexit, Britain was in danger of losing preferential access to the Japanese market. With today's announcement, the UK retains preferential access. Moreover, in addition to agreeing to the same preferential tariffs as in the EU-Japan deal, the two sides agreed to eliminate tariffs on some traded goods such as automotive parts. The UK-Japan agreement will likely be beneficial to both sides. Britain retains access to the Japanese market, and Japanese auto companies that manufacture in Britain will be able to send automotive parts without tariff barriers. This deal could be a precursor to the UK joining the Trans-Pacific Partnership (TPP), the regional free trade agreement that includes countries on both sides of the Pacific, but not the United States.

Source: <https://www.reuters.com/article/uk-britain-japan-trade/uk-secures-agreement-with-japan-on-first-post-brexit-trade-deal-idUSKBN2620C0>

The Japanese government recently announced subsidies for Japanese manufacturers that shift parts of their supply chains from China to Southeast Asia. Now the government says that those subsidies will also be available to companies that move supply chains from China to India and/or Bangladesh. The government program is meant to reduce Japan's reliance on China and the resulting risk of disruption. Such disruption was evident earlier this year when China's economy shut down in the face of the coronavirus outbreak.

Economics and Markets Country/Regional Updates

1. China and the Asia Pacific

In China, economic activity nearly collapsed in Q1 2020 with a decline of -6.8% y/y before rebounding in Q2 growing at 3.2% y/y but so far in Q3, the economic data is mixed. Retail sales were down 1.1% y/y in July 2020 but turned positive in August growing 0.5% y/y, the first increase in retail sales since December 2019. Fixed asset investment in the first 8 months of 2020 was down 0.3% y/y, largely due to a sharp drop in private sector investment but industrial production was up 5.6% in August 2020, 4.8% y/y in July and June driven largely by a boost to manufacturing output, in particular there were strong increases in machinery, communication equipment and general equipment which should have a positive impact for Japanese industry as Japanese companies provide intermediate inputs into the Chinese production process. Also, if demand picks up sufficiently in China, when the rest of the world comes out of recession, there are likely to be demand pressures and capacity constraints may see an increase in demand for manufacturing machinery produced in Japan.

Source: <https://jp.reuters.com/article/us-china-economy-activity/chinas-august-industrial-output-accelerates-retail-sales-turn-up-in-boost-to-recovery-idUSKBN26609Q>

2. United States

The US real economy contracted 32.9% at an annualized rate in Q2 2020, the sharpest decline in recorded history. Consumer spending declined at an annual rate of 34.6% despite the fact that real disposable personal income increased at a rate of 44.9% due to massive transfers from the Federal government. The divergence of spending and income meant that consumers saved a great deal on aggregate. As for consumer spending, the lion's share of the decline was due to a reduction in spending on services which fell 43.5%. Spending on durable goods only fell 1.4% and spending on non-durables fell 15.9%. The sharp declines in spending on healthcare, recreation services, and at restaurants and on hotels accounted for 60% of the decline in GDP. So long as the virus remains a threat, spending on recreation, restaurants, and hotels is likely to remain suppressed. Also, the sharp decline in spending on healthcare might seem surprising, but it reflects people not visiting their doctors and dentists during the crisis.

There was also a sharp decline in investment spending. Non-residential business fixed investment fell at a rate of 27%. Investment in structures fell 34.9% and investment in equipment fell 37.7%. However, investment in intellectual property only fell 7.2%. Suggesting, for example, businesses were keen to pay software engineers to write code while working from home. Residential investment was also down, falling at a rate of 38.7%. Real exports of goods fell at a rate of 67.6% real imports of goods fell 48.8% in Q2. The only major category of GDP to increase significantly was Federal government spending.

Source: <https://www.reuters.com/article/us-usa-economy-instant/us-second-quarter-gdp-falls-at-steepest-rate-since-great-depression-idUSKCN24V2GJ>

3. European Union

In the 27 member EU, real GDP declined at an annualized rate of 39.8% from Q1 to Q2, a record decline. In the 19 member Eurozone, real GDP declined 40.3% annualized. The Q2 decline in Europe followed a steep decline in Q1. Specifically, Eurozone real GDP declined at a rate of 13.6% in Q1 while EU real GDP declined 12.2%. Thus, in H1 2020, Europe's economy collapsed as governments imposed severe economic restrictions in order to contain the virus. Restrictions only began to be lifted in May, and then only gradually.

Source: <https://markets.businessinsider.com/news/stocks/eurozone-gdp-contracts-12-in-q2-worst-rate-since-1995-2020-7-1029454734>

Tax Country/Regional Updates

1. Australia

Is Bitcoin a Foreign Currency and Lessons from the Rum Rebellion?

On 16 June 2020, the Administrative Appeals Tribunal of Australia issued its decision in *Seribu Pty Ltd and Commissioner of Taxation (Taxation)* [2020] AATA 1840 on whether Bitcoin is a foreign currency for the purpose of the rules governing the tax treatment of foreign currency gains and losses.

The Tribunal started with a short history lesson on the Rum Rebellion of 1808 in the penal colony of New South Wales. At the time of the Rum Rebellion, as the Tribunal went on to explain, rum was being used as a form of currency and the rum trade was controlled by a group of officers in the New South Wales Corps. As the Tribunal noted, "the experience of the Rum Rebellion and its aftermath demonstrates the importance of a stable money supply under the supervision of government."

The Tribunal ruled that "Australian currency" should refer to the official currency established under the Currency Act 1965 and agreed with the Commissioner that the word "currency" should similarly be read as an "official" currency issued by a government or some supra-national body, like the European Union. The Tribunal also ruled that the goods and service tax (GST) treatment of

digital currencies is not relevant for the purposes of the Income Tax Act, nor does the ordinary meaning of the word "currency" now extend to cryptocurrencies.

Source: Australia - Is Bitcoin a Foreign Currency and Lessons from the Rum Rebellion (23 June 2020), News IBFD (accessed 14 Sep. 2020).

Australian Taxation Office Consults on Outbound Interest-Free Loans

On 12 August 2020, the Australian Taxation Office (ATO) published draft Schedule 3 to Practical Compliance Guideline, which deals with interest-free loans between related parties. The Draft Schedule outlines the factors affecting the risk score assigned to outbound interest-free loans made between related parties. The factors outlined in the Draft Schedule seek to provide practical guidance as to when the ATO will dedicate resources to review arrangements involving such loans.

In general, the ATO is of the opinion that a high transfer pricing risk exists in the case of an outbound interest-free loan between related parties. This is because, generally, loans are not granted by independent parties on an interest-free basis. Subject to the consideration of the factors outlined in the Draft Schedule, an outbound interest-free loan would have an amber or red rating under the Guideline (i.e. attracting a medium or high risk rating).

The risk rating can be reduced if it can be evidenced that:

- the zero interest rate is an arm's length condition of the loan; or
- the loan is in substance an equity contribution; or
- Independent entities would not have entered into the actual loan and would have entered into an equity funding arrangement.

In transfer pricing there is usually the ownership threshold of 25%, which is the percentage that determines if entities can be considered related parties. Family members who own entities that meet those threshold will need to consider the 25% threshold. Additionally, some transactions (i.e. loans or selling a house) between family members are considered non-arm's length transactions, and will face more scrutiny from tax authorities, therefore, it is important to make sure these transactions are based on market conditions (arm's length).

Source: Australia - Australian Taxation Office Consults on Outbound Interest-Free Loans (17 Aug. 2020), News IBFD (accessed 14 Sep. 2020).

2. Netherlands

Bill on Ultimate Beneficial Ownership Register Enters into Force

From 8 July 2020, legal entities will have to maintain certain records relating to who their ultimate beneficial owners (UBOs) are, as well as to certain payments they make. The bill has different effective dates. These are:

8 July 2020 for:

- The obligation for legal entities to keep records as to who their ultimate beneficial owners are;
- The obligation for foundations (*stichtingen*) to keep records of persons to whom payments (*uitkeringen*) are made that do not exceed 25% of the maximum amount of payments that may be made during a year, as well as the exact amount and date of that payment; and
- The punishments associated with a breach of the abovementioned obligations.

27 September 2020 for:

- The obligation for legal entities to actually *register* their ultimate beneficial owners in the UBO register.

Source: Netherlands - Bill on Ultimate Beneficial Ownership Register Enters into Force (08 July 2020), News IBFD (accessed 14 Sep. 2020).

3. United Kingdom (UK)

United Kingdom Amends Corporate Interest Restriction Rules for Corporation Tax

On 21 July 2020, HM Revenues and Customs (HMRC) announced its intention to introduce two technical amendments to the Corporate Interest Restriction (CIR) rules in order to more effectively restrict the ability of large businesses to reduce their taxable profits through excessive UK interest expenses.

Those amendments consist of the following:

- The first amendment is intended to clarify the way the CIR rules apply in the context of Real Estate Investment Trusts (REITs), to consider the fact that UK property businesses of non-resident companies are now within the charge to Corporation Tax instead of Income Tax; and

- The second amendment concerns making sure that no penalties arise for late filing of an Interest Restriction Return if there is a reasonable excuse for the failure.

The measure is not expected to have an Exchequer impact or affect individuals, households or families.

Source: United Kingdom - United Kingdom Amends Corporate Interest Restriction Rules for Corporation Tax (28 July 2020), News IBFD (accessed 14 Sep. 2020).

Finance Act 2020: United Kingdom Introduces a New Digital Services Tax and Maintains the Corporation Tax Rate at 19% for 2020-2021

The corporation tax in the UK rate has been set at 19% for the financial year 2020/2021. Moreover, a new 2% tax on the revenues arising from digital services which derive value from UK users is applicable as from 1 April 2020. The purpose of the measure is to ensure that large multinational businesses in the scope of the measure make a "fair" contribution to supporting vital public services (as user participation is not the test for allocating profits between different countries).

The below table includes corporate and digital services tax rates of countries of interest:

Country	Corporate Tax Rate	Digital Services Tax Rate
France	31%	3%
Japan	30.62%	10%
Australia	26%	10%
Malaysia ¹	24%	6%
United States	20%	N.A.
United Kingdom	19%	2%
Singapore	17%	7%
Hong Kong	16.5%	N.A.

Source: United Kingdom - Finance Act 2020: United Kingdom Introduces a New Digital Services Tax and Maintains the Corporation Tax Rate at 19% for 2020-2021 (21 Aug. 2020), News IBFD (accessed 14 Sep. 2020).

Finance Act (FA) 2020: United Kingdom Introduces Changes to Entrepreneurs' relief and Principal Private Residence Relief Limits

The FA 2020 introduced changes to the entrepreneurs' relief. In brief, the entrepreneurs' relief allows for a 10% rate of capital gains tax when a business, or part of a business, is disposed of, provided that certain criteria are met. The amount of relief used to be limited to a GBP 10 million lifetime limit.

Source: United Kingdom - Finance Act 2020: United Kingdom Introduces Changes to Entrepreneurs' relief and Principal Private Residence Relief Limits (26 Aug. 2020), News IBFD (accessed 14 Sep. 2020).

¹ Malaysia is one of the few countries in the Asia-Pacific to introduce a digital services tax.

Useful Resources

Investing	Economic Data	Economic Analysis
<ul style="list-style-type: none"> investing.com MarketWatch 	<ul style="list-style-type: none"> United States: Bureau of Economic Analysis United States: Bureau of Labor Statistics 	<ul style="list-style-type: none"> Deloitte Insights: Economics Deloitte Weekly Global Economic Update
<ul style="list-style-type: none"> Yahoo! Finance 	<ul style="list-style-type: none"> Cabinet Office of Japan 	<ul style="list-style-type: none"> International Monetary Fund
Central Banks	<ul style="list-style-type: none"> European Commission: Eurostat 	<ul style="list-style-type: none"> Project Syndicate
<ul style="list-style-type: none"> Federal Reserve Board 	<ul style="list-style-type: none"> United Kingdom: Office for National Statistics 	<ul style="list-style-type: none"> Organization of Economic Cooperation and Development
<ul style="list-style-type: none"> Bank of Japan 	<ul style="list-style-type: none"> National Bureau of Statistics of China 	<ul style="list-style-type: none"> Central Intelligence Agency: The World Factbook
<ul style="list-style-type: none"> European Central Bank 	<ul style="list-style-type: none"> Federal Reserve Economic Database 	<ul style="list-style-type: none"> Aon: Political Risk Heatmap
<ul style="list-style-type: none"> Bank of England 	News	
<ul style="list-style-type: none"> People's Bank of China 	<ul style="list-style-type: none"> Reuters 	

Deloitte Information	Governmental Organizations	Independent Research Organizations
<ul style="list-style-type: none"> Deloitte Tohmatsu Japan Inbound Tax & Legal Newsletter 	<ul style="list-style-type: none"> The Organization for Economic Co-operation and Development (OECD) 	<ul style="list-style-type: none"> International Bureau of Fiscal Documentation (IBFD)
<ul style="list-style-type: none"> Deloitte tax@hand 	<ul style="list-style-type: none"> Internal Revenue Service (IRS) Inland Revenue Department (Hong Kong) 	<ul style="list-style-type: none"> Australian taxation Office (ATO) National Tax Agency (NTA)

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- Family enterprise consulting;
- Succession Advisory Services
- Cross-border Succession and Reorganization Support
- Family Governance and Council Support for Owner Family

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