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Japan Tax & Legal Inbound Newsletter

Tax incentives along with a growing technology sector encourage investments in Japanese technology start-ups

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Background

Japan is often thought of as an innovative economy, but much of the innovation has been in the manufacturing sector rather than in technology and software as standalone products and service offerings. That is not to say that Japan has not had success in the technology or software sectors. Some of its gaming brands are world famous. Additionally, Japanese software developed and used in manufactured goods, such as automobiles, and imaging and sensing solutions used in electronics are renowned around the world.

However, Japan has struggled to incubate technology and software as standalone products and service offerings, which is primarily due to companies having limited access to human capital and funding. According to the Ministry of Economy, Trade and Industry (METI), workers perceive manufacturing to be a more attractive career, especially within the larger manufacturing and trading companies. In addition, companies with both hardware and software products tend to have more leadership positions with individuals from hardware divisions, because software often acts as a custom component that is embedded into the manufactured hardware products. Furthermore, Japanese companies have been struggling to find skilled technology workers in part because of the limited technology skills and lack of technical qualifications among the working population. This has created a talent gap, which is further exacerbated by language (i.e., coding languages are developed in English or built on English keywords), culture (established companies are considered more secure for employment purposes), and access to skilled labor (skilled technology workers are incentivized to work overseas for higher salaries). In 2018, METI estimated a skilled labor shortfall in the information technology sector in Japan of approximately 600,000 jobs by 2030.

The business environment also has historically been less supportive of start-ups, especially technology and software ventures, with such companies having limited access to funding due to a lack of cash or willingness of banks to lend to start-ups. This may force companies to go public earlier than what is optimal, because management may be beholden to shareholders seeking short-term gains, which may blunt the creative and innovative impulse of the company.

Open innovation and other tax incentives

In December 2019, as part of the fiscal 2020 tax reform the government announced an open innovation tax incentive that allows companies to deduct from their taxable income 25% of share purchase amounts in start-ups (for partnerships and other similar business arrangements). Those eligible are large companies that purchase JPY 100 million or more (and small companies that purchase JPY 10 million or more) in start-up shares.

The open innovation tax incentive is aimed at supporting companies that are accelerating cross-industry cooperation as part of their efforts to manage societal changes (e.g., ageing population and migration to larger cities from rural areas). This tax relief is part of a wider government push for open innovation to strengthen Japan's competitiveness by utilizing companies' technologies, ideas, resources, and other assets to develop new products and business models and create innovative technological seeds across the entire country. These government measures were introduced before the COVID-19 pandemic, but the need for transformation has been hastened by the economic effects of the pandemic. Furthermore, the government's commitment to contribute to decarbonization (with its goal to be carbon neutral by the year 2050) has led to additional tax incentives (outlined in the fiscal 2021 tax reform) for investment in digital transformation and becoming carbon neutral.

According to METI, open innovation tax incentives have been given to 77 companies in 122 cases but not specifically to companies in the technology and software sectors. In order to increase the reach of this program to such companies, the minimum amount of the share purchase required for large companies to be eligible for the tax incentive possibly could be reduced from the current JPY 100 million. This may encourage larger companies to invest in more start-ups. In addition, it may make entrepreneurs more open to receiving capital injections from larger companies, as it may reduce the fear of management losing control of the start-up to external shareholders at critical early and growth stages (e.g., developing and perfecting technologies, understanding the market in which it is competing, developing strategies, and working out staffing needs).

The open innovation tax incentive was originally intended to be a two-year temporary measure and is due to expire on 31 March 2022 (i.e., the end of the current fiscal year), but, with the recent tax incentives outlined in the fiscal 2021 tax reform, METI has submitted a proposal to the government to extend the open innovation tax incentive to 31 March 2024.

A growing technology market with new investment opportunities

In Japan, the most common method of raising capital for start-ups is through an initial public offering (IPO) on the Market of the High-growth and Emerging Stocks (Mothers) at the Tokyo Stock Exchange. In 2020, the Mothers Index gained substantial international interest as it was one of the best performing indexes in all of Asia. The performance in 2020 was the result of a wider structural change within the Mothers, which indicates how the start-up environment in Japan is changing. In fact, from fiscal year 2016 to 2020, the market cap of the Mothers rose from approximately JPY 3.5 trillion to 9.5 trillion. Furthermore, in 2016, almost all of the ten largest companies on the Mothers Index were in the manufacturing industry (including pharmaceuticals), but, in 2020, the information technology industry dominated the top spots with several companies in the SaaS sector.

In addition, retail investors had predicted that technology companies would benefit from the remote work environment brought about by the COVID-19 pandemic, and professional investors have taken notice. This has created a space for venture capitalists that may be willing to provide the capital injections needed to promote innovation and give entrepreneurs room to innovate and create, while waiting for their Japanese unicorn company.

Japan still remains an attractive investment destination with a budding technology sector, which, although still in a nascent stage, is starting to garner interest from international investors. This would be welcomed by the Japanese government as it not only encourages innovation, but the technology sector may act as a catalyst to attract international financial firms on both the buy and sell-side, bolstering another flagship government project and the development of Tokyo as an international financial hub.

Deloitte Japan's View

The Japanese government has been actively promoting open innovation across Japan, but it is the technology sector that has gained substantial interest from investors as a result of the stock market performance in 2020 on the Mothers. Moreover, investors have been speculating on technology companies that provide back office capabilities due to a change in work culture as a result of the COVID-19 pandemic. International investors also have taken notice of Japan's fledgling technology sector.

Providing tax incentives to encourage investment in technology start-ups should foster innovation and technological development without hindering the innovation and creativity of start-up entrepreneurs and management. Companies seeking technology investment opportunities should review any tax incentives encouraging innovation that may be available.

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Family Consulting	Michael Tabart, Partner
email to japan_taxlegal_inbound@tohmatsu.co.jp	

Issued by

Deloitte Tohmatsu Tax Co.
Marunouchi-Nijubashi Building, 3-2-3 Marunouchi, Chiyoda-ku, Tokyo 100-8362, Japan
Tel: +81 3 6213 3800 email: tax.cs@tohmatsu.co.jp Corporate Info: www.deloitte.com/jp/en/tax