

Japan Tax & Legal Inbound Newsletter

Japan adopts OECD Pillar Two Side-by-Side package into Domestic Tax Law

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Overview

On 31 March 2026, the National Diet of Japan has passed tax reform legislation partially implementing the OECD's Pillar Two Side-by-Side Package, including a safe harbor for U.S.-parented multinational enterprise (MNE) groups. Notably, Japan adopted only select provisions from the OECD Side-by-Side Package—several elements were deliberately excluded.

Background

On 5 January 2026, the OECD/G20 Inclusive Framework on BEPS released the Side-by-Side Package (the “**OECD Side-by-Side Package**”) as a political compromise designed to preserve the Pillar Two global minimum tax framework while updating the GloBE Model Rules. The package introduces a dedicated safe harbor for U.S. Ultimate Parent Entities (UPEs) and other jurisdictions that maintains qualified tax regimes (the “**Qualified Sbs Regimes**”). More broadly, it provides administrative guidance aimed at reducing cross-border tax friction between the OECD framework and the United States.

Japan's 31 March implementing legislation adopts four of the five safe harbors contemplated under the OECD Side-by-Side Package. Specifically, it adopts three of the four new permanent safe harbors, namely (i) the Side-by-Side Safe Harbor, (ii) the UPE Safe Harbor, and (iii) the Substance-Based Tax Incentive (SBTI) Safe Harbor, while also extending (iv) the Transitional CbCR (Country-by-Country Reporting) Safe Harbor.

These measures operate within the broader Pillar Two framework, which subjects large MNE groups to a minimum effective tax rate (ETR) of 15% in each jurisdiction, calculated as adjusted covered taxes over GloBE income. Japan has been building out this framework incrementally—enacting the Income Inclusion Rule (IIR)¹ in March 2023, followed by the Undertaxed Profits Rule (UTPR)² and a Domestic Minimum Top-up Tax (DMTT)³ in March 2025.

Within the OECD Side-by-Side Package, the Side-by-Side Safe Harbor and UPE Safe Harbor determine whether a group qualifies for relief based on the jurisdiction of its UPE. The SBTI Safe Harbor, meanwhile, falls under the permanent simplifications category and requires groups to demonstrate their substantive activities through numerical thresholds. The foundational rules for the global minimum tax impose the tax on the global minimum top-up tax amount. The specific mechanisms for the safe harbors, including the conditions under which the top-up tax is deemed to be zero (for Sbs Safe Harbor, UPE Safe Harbor, and the CbCR Safe Harbor) and the

¹ The Income Inclusion Rule (IIR) is the primary charging rule under the Pillar Two global minimum tax framework. It operates on a top-down basis: where the effective tax rate of a foreign Constituent Entity (CE) within an MNE group falls below 15%, the tax authority in the UPE's jurisdiction imposes a Top-up Tax on the parent entity to make up the shortfall.

² The Undertaxed Profits Rule (UTPR) serves as a backstop to the IIR under the Pillar Two framework. Where the UPE's jurisdiction has not implemented a Qualified IIR (QIIR) leaving a CE's effective tax rate below 15% and the resulting Top-up Tax uncollected at the parent level, the UTPR enable other jurisdictions in which the MNE group operates to collect the shortfall. Collection is allocated among those jurisdictions according to a prescribed formula, typically through mechanisms such as the disallowance of expense deductions.

³ The Domestic Minimum Top-up Tax (DMTT) is a mechanism under the Pillar Two framework that allows a jurisdiction to retain primary taxing rights over low-taxed profits generated within its borders. It operates by imposing a Top-up Tax directly on domestic CEs to bring their effective tax rate up to the 15% minimum, thereby preventing other jurisdictions from collecting the shortfall through the IIR or UTPR (Note: When assessed as meeting OECD standards, it is referred to as a Qualified Domestic Minimum Top-up Tax (QDMTT)).

adjustments for Qualified Tax Incentives (for the SBTI Safe Harbor), are detailed accordingly in Japanese provisions.

Side-by-Side Safe Harbor

Where the jurisdiction of UPE is recognized as having a Qualified SbS Regime, the MNE group may elect to have its Top-up Tax deemed to be zero Tax under both the IIR and UTPR.

A jurisdiction qualified as having a Qualified SbS Regime if it meets all of the following requirements:

1. It has an Eligible Domestic Tax System satisfying both of the following:
 - a. A statutory nominal corporate income tax (CIT) rate of 20% or higher;
 - b. Either a QDMTT or a domestic alternative minimum tax mechanism; and
 - c. No material risk that in-scope MNEs will have a Global Anti-Base Erosion (GloBE) effective tax rate below 15%.
2. It has an Eligible Worldwide Tax System satisfying all of the following:
 - a. A comprehensive tax regime applied to the foreign-sourced income of all domestic corporations;
 - b. Substantial mechanisms for addressing BEPS risks; and
 - c. No material risk of foreign profits being subject to an effective tax rate below 15%.
3. Taxes related to QDMTT are creditable under the Foreign Tax Credit (FTC) rules.
4. The eligible domestic or worldwide tax system must be assessed before 1 January 2026, or by having sanctions established on or after that date.

Jurisdictions with a Qualified SbS Regime are listed in the Central Record published on the OECD website⁴. As of 16 April 2026, the United States is the only jurisdiction listed.

An MNE group whose UPE is located in a Qualified SbS Regime jurisdiction may elect the SbS Safe Harbor for fiscal years beginning on or after 1 January 2026, or for fiscal years beginning after the date of the jurisdiction's publication in the Central Records, whichever is later. An MNE group making this election in a jurisdiction subject to IIR or UTPR must file Section 1 of the GloBE Information Return (GIR) for that jurisdiction. The GIR is expected to be revised in due course to reflect the SbS Safe Harbor framework.

UPE Safe Harbor

The permanent UPE Safe Harbor replaces the UTPR Safe Harbor, which expired at the end of 2025, and applies to fiscal years beginning on or after 1 January 2026. Where the jurisdiction of a UPE is recognized as having a Qualified UPE Regime, the MNE group may elect to have the UTPR Top-up Tax amount attributable to that UPE jurisdiction deemed to be zero. This election does not affect the application of a QDMTT, nor does it affect Constituent Entities (CEs) located in jurisdictions other than the UPE's home jurisdiction.

A jurisdiction qualifies as having a Qualified UPE Regime if, as of 1 January 2026, it has an Eligible Domestic Tax System that is both enacted and in effect. The requirements for this Eligible Domestic Tax System are the same as those applicable to the Eligible Domestic Tax System under the SbS Safe Harbor. Jurisdictions meeting this standard will be listed in the Central Records in due course.

⁴ OECD Central Records for purposes of the Global Minimum Tax (<https://www.oecd.org/en/topics/sub-issues/global-minimum-tax/central-record-of-legislation-with-transitional-qualified-status.html>) provides three reference tables relevant to the global minimum tax framework:

- Qualified Income Inclusion Rules: Jurisdictions that have enacted a Qualified IIR
- Qualified Domestic Minimum Top-up Tax Rules and QDMTT Safe Harbors: Jurisdictions that have enacted a QDMTT
- Qualified SbS Regime: Jurisdictions recognized as having a Qualified SbS Regime. As noted above, the United States is currently the only jurisdiction listed.

These tables are updated periodically to reflect developments in domestic legislation and the status of the OECD's review process.

Substance-based Tax Incentive (SBTI) Safe Harbor

The Side-by-Side Package introduces a new Substance-based Tax Incentive Safe Harbor (the “**SBTI Safe Harbor**”). Upon election, Qualified Tax Incentives (QTIs) may be added to the jurisdiction’s Adjusted Covered Taxes. This addition is subject to a ceiling, the Substance Cap, calculated by reference to payroll costs and tangible assets in the relevant jurisdiction.

(1) Qualified Tax Incentives (QTIs)

QTIs must be generally available preferential measures open to all qualifying taxpayers. Measures targeting only MNE groups subject to global minimum taxation, or those granted under agreements with a government, do not qualify. QTIs fall into two categories:

- **Expenditure-based Tax Incentives**: Preferential measures where the reduction or exemption is calculated by reference to qualifying expenditures. Where the value of the tax benefit exceeds the amount of the underlying expenditure, the measure does not qualify as a QTI.
- **Production-based Tax Incentives**: Preferential measures where the reduction or exemption is calculated by reference to the production of tangible property in the jurisdiction, including activities such as manufacturing, power generation, mining, and smelting.

Where a Qualified Refundable Tax Credit (QRTC) or a Marketable Transferable Tax Credit (MTTC) falls within either category above, an annual election may be made to treat it as a QTI.

A QTI is limited to measures calculated by reference to expenditures incurred or output produced within the period in which the reduction or exemption is determined. Measures based on expenditures or production predating the preferential measure’s effective date, or on future expenditure or production, are excluded.

(2) Substance Cap

The amount of QTIs added to the Adjusted Covered Taxes is capped at 5.5% of the greater of:

- Total Eligible Payroll Costs, including those of employees working in the target jurisdiction; and
- Total Depreciation Expenses relating to Eligible Tangible Assets located in the target jurisdiction.

Alternatively, a five-year election is available to apply a cap of 1% of the carrying value of Eligible Tangible Assets located in the target jurisdiction, excluding land and other non-depreciable assets.

The SBTI Safe Harbor is available for fiscal years beginning on or after 1 January 2026.

Extension of Transitional CbCR Safe Harbor

The transitional CbCR Safe Harbor is a temporary relief measure introduced to reduce the administrative burden on MNE groups arising from the implementation of the global minimum tax. Where a Constituent Entity of a qualifying MNE group satisfies any one of three tests (the De Minimis Test, the Simplified Effective Tax Rate Test, or the Routine Profits Test) based on information reported in its Country-by-Country Report (CbCR), the Top-up Tax for that entity’s jurisdiction is treated as zero.

The OECD Side-by-Side Package extends this Transitional CbCR Safe Harbor by one year. Previously applicable to fiscal years beginning on or before 31 December 2026, the safe harbor now covers fiscal years beginning on or before 31 December 2027. Fiscal years ending after 30 June 2029, remain excluded.

Implications & Takeaways

Omission of the Simplified ETR Safe Harbor

Japan’s implementation of the OECD Side-by-Side Package is largely aligned with the OECD’s released framework; however, it does not incorporate the Simplified ETR Safe Harbor. This omission reflects both the technical complexity of the provision and the constraints imposed by Japan’s legislative calendar. Following the

OECD's release of the package on 15 January 2026, policymakers at the Ministry of Finance faced a highly compressed window to draft and enact the legislation ahead of 31 March deadline. The Simplified ETR Safe Harbor introduces entirely new and intricate mechanical rules for calculating simplified income and taxes and transposing such a permanent measure into domestic law requires careful calibration to avoid unintended conflicts with the existing Corporate Tax Act. In the interim, however, MNE groups are not left without recourse, as Japan's concurrent extension of the Transitional CbCR Safe Harbor ensures that temporary relief remains available.

Japan's swift adoption removes a significant risk for U.S.-parented groups.

Because the United States has not incorporated Pillar Two directly into its domestic tax law, U.S.-parented MNE groups with Japanese subsidiaries faced considerable uncertainty around double taxation and compliance costs. By enacting the SbS Safe Harbor and UPE Safe Harbor as of 31 March 2026, Japan has effectively removed the risk of IIR and UTPR exposure for U.S. companies operating in Japan.

It should be noted, however, that the SbS Safe Harbor does not apply retroactively to fiscal year 2025. Accordingly, U.S.-parented MNE groups may still need to contend with IIR exposure for that year in certain circumstances, particularly where a Japanese subsidiary of a U.S. parent holds interests in non-Japanese subsidiaries. MNE groups in this position should carefully assess their 2025 filing positions considering these limitations.

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