Statement of the American Chamber of Commerce in Japan Regarding Japan's Net Operating Loss System

December 8, 2014

Prime Minister Shinzo Abe's announcement to call snap elections on December 14, while also announcing his decision to delay the planned increase in the consumption tax from 8 percent to 10 percent until April 2017, has put a spotlight on tax policy and Japan's fiscal circumstances. In particular, the Government of Japan (GOJ) is focusing on how revenue can be secured to address the growing fiscal imbalances, while at the same time sustaining, and indeed expanding, the real economic growth focus that is at the center of Abenomics' Third Arrow. The American Chamber of Commerce in Japan (ACCJ) strongly supports all efforts to enhance the attractiveness of the Japanese economy for investment, particularly for growth companies and for foreign direct investment (FDI). As noted in the ACCJ's Growth Strategy White Paper, "Charting a New Course for Growth: Recommendations for Japan's Leaders," most new jobs in Japan are now driven by a combination of foreign invested firms and new start-up companies. Clearly, increasing the investment environment to expand exactly these kinds of job-creating enterprises must be a key part of the GOJ's Growth Strategy.

The ACCJ applauds the GOJ's stated intention to reduce corporate tax rates from their current high levels to rates more consistent with other Organisation for Economic Cooperation and Development (OECD) countries. Yet as important as bringing corporate tax rates in line with other countries is, the corporate rate is not the only tax condition that potential new market entrants will consider. Given that growth companies, be they a result of FDI or domestic start-ups, will likely incur several initial years of losses while they invest to build up production capabilities, distribution infrastructure, and market share, these companies will look less at the corporate rate in those initial years – when they will have little or even no income to report – and more at the long term return on their investment. And one of the significant factors in determining the return on investment during a start-up period is the ability to tax effect those up-front losses over a long enough period to make the investment economically viable.

In this context, the ACCJ notes that the incentive for and capacity of companies to make long-term investments in growth and innovation is greatly enhanced by a net operating loss (NOL) carry-forward period that is sufficiently long to apply to new business lines and innovative projects that often take many years to become profitable. It has thus been the long-standing position of the ACCJ that extension of the NOL carry-forward period by Japan would stimulate both domestic innovation, and foreign direct investment into growth industries, benefiting the overall Japanese economy. We have thus recommended that the GOJ lengthen the NOL carry-forward period from the nine years under current Japanese law to at least twenty years, in line with the U.S. and Canadian practice, and ideally to an indefinite period, as prevails in Europe.

As shown, Japan is already an outlier among its trading partners in the OECD with its short carry-forward period. Lengthening the period would not only bring Japan in line with its major trading partners, but would strengthen incentives for investment in new industries and innovative and start-up companies, support companies that have invested in Japan in the recent challenging years since the global financial crisis and through the triple disasters of 2011, accelerate the growth and jobs connected with such investment, and facilitate FDI.

Country	UK	Germany	France	Swiss proposal	Italy	Singapore	Hong Kong	Canada	US	Korea	Taiwan	Japan
C/F period	Unlimited	Unlimited	Unlimited	Unlimited	Unlimited	Unlimited	Unlimited	20 yrs	20 yrs	10 yrs	10 yrs	9 yrs
Annual usage cap	No limit	60%	50%	80%	80%	No limit	No limit	No limit	No limit	No limit	No limit	80%
Tax rate	24%	30%	34%	24%	27%	17%	16%	26%	39%	24.2%	17%	35%

Significantly, in this period of fiscal consolidation, lengthening the NOL carry-forward period would have largely back-ended fiscal costs compared to other forms of tax stimulus, whereas the investment incentives would be front-ended, contributing more quickly to growth and the tax revenues generated thereby.

In this context, the ACCJ acknowledges that there are concerns that the NOL system can be part of a strategy by permanently loss incurring companies to avoid paying their fair share of tax. To increase the incentives for companies to become profitable, we understand, including from very recent press reports, that the GOJ is looking to reduce the current NOL annual usage cap of 80 percent down to the range of 65 percent in 2015, and further to 50 percent in 2017, when it would also look to increase the carry forward period to 10 years. The ACCJ does not have a formal position on the annual usage cap, but ***even assuming*** that such a reduction may be useful both to incentivize profitability, as well as to accelerate tax revenue, an understandable goal in light of Japan's need for fiscal consolidation, this incentive will be ***most effective*** if the usage cap reduction *is combined at the same time with* a significant extension of the loss carry-forward period, for without that, Japan's short carry-forward period increases the risk that losses, even those incurred for valuable investment in growth and innovative technologies, will expire before they can be absorbed. If the annual usage cap is significantly reduced, say to a level below 60%, it would be necessary to extend the NOL carry forward period significantly towards the OECD standard of 20 years or so in tandem, to avoid actually reducing the incentives for many kinds of valuable investments. These include not only new start-up growth companies, but also FDI by way of merger and acquisition activity, which create jobs and innovation, fueling exactly the kind of growth that is a core goal of the Third Arrow.

For these reasons, the ACCJ applauds the recommendations of the Government Tax Committee, chaired by Hiroko Ota, issued in June, which include a call to extend the carry-forward period while tightening the usage caps.

The ACCJ would also note that Switzerland, perhaps the only developed economy in Europe with a short NOL period (7 years), is now in the midst of its Third Corporate Tax Reform initiative. The Reform has an explicit goal of strengthening Switzerland's competitiveness and attractiveness as a business location, and thus offers a parallel for consideration by Japan. The Swiss Federal Council plans to extend the tax loss carry-forward period from 7 years to *an unlimited period of time*, while limiting the annual usage cap to 80% of the taxable profit. Moreover, to support companies that have already started long-term investments, it would apply the longer carry forward period to existing losses. We think this "packaging" of the tighter usage cap, with a simultaneous lengthening of the carry-forward period that compensates for reduction of the usage cap, is important to communicate to the market that while continual use of losses to offset income, and avoid taxes, is to be discouraged, long term investment that produces future profitability is to be encouraged. We would thus respectfully suggest that Japan, like Switzerland, couple any restriction of the usage cap with a significant lengthening of the carry-forward period, applicable to all existing losses.

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