Japan Tax Bulletin

Focusing on SME Growth Through Enhanced Investment Loss Reserve System

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Japan's commitment to invigorating its small and medium-sized enterprises (SMEs) took a significant step forward with the announcement of the 2024 fiscal year tax reforms. These reforms, part of the Reiwa 6 year plan, focus on expanding the SME Business Reorganization Investment Loss Reserve System. This policy is tailored to empower SMEs to grow through strategic acquisitions and integrations.

1. *Objectives and Scope of the Reforms*

These reforms are strategically crafted to reduce financial barriers and encourage SMEs to expand their market presence through effective subsidiary integration, with a purpose to foster a dynamic and competitive business ecosystem, making Japan a nurturing ground for ambitious SMEs. The expansion of the SME's investment loss reserve system is also projected to significantly boost the SME sector by making it more attractive for investments and strategic business activities. By facilitating easier access to M&A strategies and providing significant tax incentives, the expansion of the SME's investment loss reserve system is also poised to enhance the operational scale and market reach of SMEs across Japan.

2. *Detailed System Overview*

(1) Existing loss reserve in accordance with Management Enhancement Plan

The current system allows for SME to set up tax deductible reserve for losses from acquiring another company, provided they meet predefined criteria regarding acquisition costs. The tax-deductible reserve amount is 70% of the acquisition cost. The determent period for the reserve is 5 years and reversed to profits over 5 years after the determent period. This measure is extended for another 3 years in 2024 tax reorm.

(2) Enhanced Deductions for Experienced Enterprises

2024 tax reform added measures pertaining to special business restructuring plans. Upon obtaining certification under the new Special Business Reorganization Plan, these enterprises can deduct 90% of acquisition costs for their first post-certification M&A and 100% for subsequent acquisitions as loss reserves. This aggressive incentivization underscores Japan's commitment to enhancing its industrial competitiveness and encouraging continuous M&A activity among SMEs.

(3) Exclusions and Specific Requirements

The new system sets clear boundaries by excluding transactions either below 100 million yen or exceeding 10 billion yen. Furthermore, it necessitates the formulation of a certified "Special Business Reorganization Plan" under the updated Act on Enhancing Industrial Competitiveness, ensuring that only well-planned and potentially successful M&As benefit from the system.

(4) Documentation and Compliance

Businesses must navigate both the extended and new provisions of the system carefully. Strategic planning is essential for aligning multiple M&A transactions with the stipulated requirements of the reserve system. Businesses must develop a management enhancement plan at the outset of any M&A deal, including a pre-M&A due diligence check (available in spreadsheet format) to be submitted for certification. Post-acquisition, businesses are required to report their activities and the contents of their initial due diligence to receive confirmation documents. Tax declarations must be accompanied by both the certification and confirmation documents to qualify for deductions.

3. *Conclusion*

The Reiwa 6 tax reforms represent a strategic enhancement to support Japan's SMEs, crucial for sustained economic growth and innovation. The expanded Business Reorganization Investment Loss Reserve System offers substantial benefits, encouraging SMEs to pursue growth through mergers and acquisitions actively. While the system provides substantial financial incentives, it requires careful strategic planning and management, emphasizing that it is a deferral of tax liability rather than its elimination. As such, businesses are encouraged to engage with these opportunities strategically, aligning them with long-term growth objectives.

For businesses considering taking advantage of this system, understanding the detailed operational requirements and ensuring alignment with long-term business strategies will be crucial to effectively utilizing the available incentives. As M&A opportunities arise, seeking expert tax advice to navigate the evolving tax landscape effectively is highly recommended. This approach will ensure that strategic benefits are maximized while adhering to compliance requirements and optimizing financial outcomes.