

## Financial services tax alert

# 2011 Japan tax reform

## Taxation related to financial businesses

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Discussion of the proposed 2011 Japan tax reforms was delayed due to the Great Eastern Japan Earthquake that occurred in March 2011, however the proposal was eventually approved and passed by the Diet on 22 June 2011 and will apply from 30 June 2011. The revision regarding trust certificates with predetermined dividends for Muslim investors, which the Financial Services Agency (FSA) proposed to encourage investment by foreign investors in Japan, was approved on 17 May 2011 with other non-tax proposals separately from the main tax reform proposal. Other financial services-related items have been approved almost as originally proposed, such as the exemption of interest on cash collateral for securities lending transactions as described below. This tax alert will highlight some revisions anticipated to affect financial service businesses.

## **Tax exemption on interest and lending fees related to securities lending transactions for foreign financial institutions**

When financial institutions conduct securities lending transactions using cash collateral, many collateral providers require interest on the collateral. Such interest would be categorized as Japan domestic income (interest income) and would be subject to withholding tax in Japan. Furthermore, lending fees for borrowed securities would be considered income derived from possession of and investment in assets located in Japan. As such, foreign securities lenders would have tax filing obligations for Japanese corporate tax purposes although the fees would not be subject to withholding tax in Japan. In the case of foreign financial institutions which are eligible for tax treaty benefits that exempt such interest and lending fees, these items of income should not be taxed in Japan. However, for other financial institutions not eligible for such exemption, this taxation rule may have hindered them in the securities lending market in Japan.

To improve this situation, a tax exemption on certain interest income arising on cash collateral related to securities lending transactions and certain securities lending fees will be introduced where such interest or lending fees are paid to foreign financial institutions. In addition to Japan government bond (JGB) repo transactions, the tax exemption would be expanded to include registered municipal bonds, registered corporate bonds (excluding certain profit-linked bonds) and listed stocks used in securities lending transactions (Special Taxation Measures Law (STML) Articles 42-2 and 67-17). Interest on cash collateral may be exempted from tax if, on the trade date, the total cash collateral and the market value of securities used as collateral is in the range of 50% to 150% of the market value of the borrowed securities (STML Cabinet Order Article 27-2 (2)).

This reform will apply to interest income and lending fees for securities lending transactions or repo transactions entered into on or after 30 June 2011.

## **Clarification regarding tax exemption of interest on JGBs or other registered bonds for foreign investors**

### **Tax exemption for interest income on registered bonds for foreign pension funds**

If certain foreign pension funds fulfill the requirements in the name of trustees, then interest income on JGBs, registered municipal bonds or registered corporate bonds should qualify for a tax exemption. Foreign pension funds which are similar to Japan domestic pension funds as prescribed by Japanese corporate tax law could be required to establish a pass-through type trust under the relevant foreign law (STML Paragraph 3, Article 5-2, Paragraph 5, Article 5-3).

This reform will apply to interest income on JGBs, registered municipal bonds or registered corporate bonds with a calculation period starting on or after 30 June 2011.

### **Tax exemption application procedure for partnerships and pass-through type trusts**

Where foreign parties invest in JGBs, registered municipal bonds or registered corporate bonds through an NK (nin-i kumiai, Japanese partnership) or equivalent (such as foreign partnership), or pass-through type trusts, excluding foreign pension funds

above, the tax exemption rule for interest income on such bonds could apply if a general partner of the partnership or a trustee submits the required information (the name of investor, distributable ratio, partnership or trust agreement, etc.) to the tax authorities via the Japan Securities Depository Center or a certified foreign intermediary (STML Paragraph 4,

Article 5-2, Paragraph 5, Article 5-3 and Enforcement Order Paragraph 9, Article 3-18).

This reform will apply to interest income on JGBs, registered municipal bonds or registered corporate bonds with a calculation period starting on or after 30 June 2011.

## Tax exemption on dividends from trust certificates with predetermined dividends

The 2010 tax reform introduced tax exemption measures for interest accruing on registered corporate bonds paid to foreign investors. However, because Muslim investors are not permitted to receive fixed income derived from interest-bearing bonds, Japanese corporations are not able to issue bonds to Muslim investors when seeking financing. In the Islamic market, the equivalent of bonds, called sukuk, are generally used. In a structure similar to Islamic sukuk, the FSA proposed using trust certificates with predetermined dividends (shasai teki jueki ken) issued by a Special Purpose Trust (tokutei mokuteki shintaku, TMS) and proposed revising the tax treatment on dividends paid from trust certificates with predetermined dividends.

Previously under Japanese tax law, a TMS would be treated as corporate-type trust and income arising from the trust generally would be subject to corporate tax at the TMS level (Corporate Tax Law Article 2, 29-2) although dividends may be tax deductible if certain requirements are satisfied, such as the TMS distributing more than 90% of profit available for distribution (STML Article 68-3-2). As such, tax consequences for a TMS were similar to that of a TMK. Furthermore, dividends on such trust certificates paid to foreign investors are treated as dividend income and subject to withholding tax at the rate of 15% (STML Paragraph 3, Article 8-2).

Under the 2011 tax reform, such trust certificates will be included in the scope of special registered corporate bonds eligible for tax exemption, and accordingly, dividend income and redemption gains on such trust certificates will be exempt from tax. Please note that the details of these measures will be expected to be prescribed in the cabinet order to be issued shortly.

In the current financing market, few Japanese companies have used TMS structures because a TMS would be treated and taxed as a corporate-type trust. It is expected that opportunities for using a TMS as an Islamic financing structure may increase.

According to the FSA's comments regarding the 2011 tax reform, the structure of Islamic-type bonds would be as follows:

- i. A corporation entrusts assets to establish a TMS.
- ii. The corporation receives trust certificates issued by the TMS.
- iii. The corporation sells the trust certificates to a Muslim investor.
- iv. The TMS leases back the entrusted assets to the corporation.
- v. The corporation pays leasing fees to the TMS.
- vi. The TMS pays dividends on the trust certificates to the Muslim investor, funded from the leasing fees.

# Extension of 7% reduced tax rate on dividends and capital gains on listed stocks

The existing reduced tax rate for investments in listed stocks will be extended for an additional two years. The 7% withholding tax rate on dividends from listed stocks for foreign or domestic investors will apply until 31 December 2013. For individual investors too, the reduced 7% income tax rate for dividends and capital gains on listed stocks will also be extended (Income Tax Law 2008 Supplementary Provisions, Articles 32, 33, 43).

Corresponding to this extension, the tax exemption for dividends and capital gains in nontaxable accounts for individuals (Japanese Individual Saving Accounts, ISA) will apply from 1 January 2014 (Income Tax Law 2010 Supplementary Provisions, Articles 52, 64).

## Expansion of investment income from futures transactions for individual investors

The scope of investment income from futures transactions that will be subject to income tax separate from other taxable income will expand for individual investors (STML Paragraph 1, Article 41-14). The following income derived from net settlement of futures transactions will now be included in the scope of such separate taxation.

- ▶ OTC derivative transactions under Paragraph 14-1 to 5, Article 2 of the Commodity Derivatives Act
- ▶ OTC derivative transactions under Paragraph 22-1 to 4, Article 2 of the Financial Instruments and Exchange Act
- ▶ Exercising rights or transfer of securities under Paragraph 1-19, Article 2 of the Financial Instruments and Exchange Act

This reform will apply to investment income on futures transactions conducted on or after 1 January 2012.

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