January 2012

Financial services tax alert

2012 tax reform proposal
Focus on financial reforms

Contents

Japan's 2012 tax reform proposal was announced by the Tax Commission on 10 December 2011. This 2012 proposal includes certain measures from the Financial Services Agency (FSA) such as: (1) a tax exemption on interest income from Japanese revenue bonds aimed at financing reconstruction after the March 2011 earthquake, (2) the facilitation of tax exemption application procedures for interest earned on registered government or corporate bonds by foreign investors, and (3) the simplification of administrative procedures for Japanese individual savings accounts (ISAs) starting from 2014. This alert will highlight some revisions relevant to financial institutions' business in Japan.

The proposed tax reforms will be discussed by the Diet and are expected to be passed before the end of March 2012. Please note, however, that the Diet may modify, delete or add certain items.

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Revision of the tax exemption on interest from registered government or corporate bonds and *minkan kokugai sai* [1]

Tax exemption on interest from Japanese revenue bonds

The FSA assumes that a Japanese revenue bond is a bond issued by a government corporation and its interest is calculated based on the issuer's profit. The purpose of such revenue bonds is to finance infrastructure construction, such as residential developments, water and sewer equipment, or expressways. Under current Japanese income tax law, a tax exemption is available to foreign investors for interest from certain registered corporate bonds. However, this exemption does not apply to interest earned on a corporate bond if the interest amount is linked to the profit of the issuer or its affiliates, since such profit-linked bonds could be used for tax evasion. Therefore, if foreign investors invest in Japanese revenue bonds, the interest would be taxed in Japan under current rules even if the bond is issued by a government corporation to finance infrastructure (i.e., not tax evasion).

Considering Japan's economy and the need to promote effective use of private capital, the proposal introduces a tax exemption measure on interest arising from Japanese revenue bonds issued by 100% subsidiaries of certain local government institutions as defined in the Earthquake Reconstruction Zones Law (*Higashi Nihon Dai Shinsai Fukko Tokubetsu Kuiki Hou*), limited to non-secured bonds by local governments. This measure is intended to encourage foreign investors to provide reconstruction funds.

This reform will apply to interest on Japanese revenue bonds described above with an interest calculation period starting on or after 1 April 2012.

Facilitation of application procedures for pass-through trusts

The 2011 tax reform revised the procedures to apply for a tax exemption for interest from registered government or corporate bonds received by foreign pension funds (under this rule the trustee is deemed as the bondholder). The 2012 proposal further introduces a procedure to allow trustees of pass-through trusts, other than foreign pension funds, to apply for the exemption.

Under the current application procedures, foreign investors need to submit application forms through sub-custodians. To facilitate this procedure, if pass-through trusts, other than foreign pension funds, have registered government or corporate bonds managed by sub-custodians, the trustee should submit the application forms instead of the sub-custodians.

This reform will apply to interest on registered government or corporate bonds with an interest calculation period starting on or after 1 April 2012.

Tax exemption for related foreign financial institutions as underwriters of *minkan kokugai sai*

Under rules introduced with the 2010 tax reform, interest paid to related parties of the issuer of *minkan kokugai sai* is not eligible for a tax exemption. Accordingly, with respect to a requirement for *tokutei minkan kokugai sai*, foreign residents and corporations who have a special relationship with the bond issuer were recognized as related parties subject to a sales limitation. The 2012 proposal, however, introduces a provision allowing related parties who have an underwriting agreement with the issuer to apply for the exemption of *tokutei minkan kokugai sai*. This is limited to parties who acquire unsubscribed bonds pursuant to an underwriting agreement.

This reform will apply to *minkan kokugai sai* issued on or after 1 April 2012.

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1 Bonds issued outside Japan by Japanese corporations whose interest is also paid outside Japan

Revision of adjustment for double taxation under Japanese CFC rules

When large Japanese banks issue preferred shares to procure funds from foreign or Japanese investors (mainly insurance companies or local banks), they previously established two offshore SPCs, one as an issuer of the preferred shares, and the other as a vehicle to circulate the funds to the Japanese banks. Since the Japanese controlled foreign corporation (CFC) rules were changed so that CFC subsidiary profits before dividends are included in Japanese parent companies' income, the 2010 tax reform introduced adjustment measures to avoid double taxation when a second-tier subsidiary was a CFC subsidiary (i.e., CFC profit would be added to the Japanese parent company's taxable income, but certain dividends paid through a first-tier subsidiary (indirect dividends) would be exempt at the parent company's level). However, this adjustment measure is applied only if the parent company (i.e., investor) indirectly holds shares in the second-tier subsidiary at the end of its tax year. As such, this adjustment may not be sufficient in tax years when preferred shares are redeemed.

The 2012 proposal changes the determination date for these indirect dividends. That is, the amount of indirect dividends to be exempted will be calculated based on the shareholding ratio at a certain date for the dividend, rather than the end of the investor's tax year.

Submission of information on compensation related to foreign parent company's stock

The Japanese tax authorities have been finding cases where directors or employees did not properly declare taxable income earned on stock vested from foreign companies. To remedy this, the proposed rule requires that Japanese subsidiaries held 50% or more by a foreign company and Japan branches of foreign companies submit information on stock compensation for directors and employees who are tax residents in Japan. Stock compensation includes income arising from stock option plans and compensation linked to the parent company's stock price. Under the proposal, information should be submitted by 31 March of the year after the stock option is exercised or the compensation is paid.

This reform will be applied to information to be submitted on or after 1 January 2013.

Simplification of administrative procedures for Japanese ISAs

Japanese ISAs (tax-free individual savings accounts) will be available from 2014. The 2012 reform proposal introduces simplified administrative procedures to encourage use of the new account type for individual investors.

(i) Items required on the ISA annual report have been changed.

(ii) Administrative procedures to open an ISA will be simplified.

2011 tax reform (law enacted on 2 December 2011)

The 2011 tax reforms relating to corporate income tax, the tax environment and administrative matters were enacted on 2 December 2011 as the "Reform act for partial revision of income tax law, etc. in response to the changing economic environment".

	Main items	Reform
Corporate income tax	Tax rate reduction	Tax rate reduced by 4.5% for tax years starting on or after 1 April 2012. The effective tax rate combined with the additional tax rate for earthquake reconstruction is 38.01% (until tax years starting on or after 1 April 2014).
	Tax loss carry-forward rules	Carry-forward period extended to 9 years and creditable amount limited to 80% of taxable income in the tax year.
	Depreciation provisions	Depreciation rate of declining balance method reduced from 250% to 200% of the straight line method.
	Bad debt reserves	Bad debt reserves abolished for corporations other than banks and certain business; historical deductible reserves to be added back for next 4 years.
Administrative matters	Request for corrections/ claims	Claimable period for correction extended to 5 years.

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