

**Financial services
tax alert**

Ernst & Young Tax Co.

2015 Tax Reform - Taxation related to financial businesses

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Executive summary

The 2015 tax reform outline (Outline) was released on 30 December 2014 from the LDP/Komeito ruling coalition. The Outline includes revisions that will significantly affect the taxable income of corporations, such as the gradual lowering of the effective corporate tax rates to below 30%, the accompanying revisions of the dividends received deduction (DRD) system and the net operating loss (NOL) carry-forward system to expand the taxable base, and the expansion of the scope of size-based taxation (corporate enterprise tax).

Moreover, there are revisions that will have a direct impact on the business of financial institutions, such as the introduction of Junior NISA (Nippon Individual Saving Account) and expansion of the current NISA program (scheduled in 2016), and the introduction of a system for the automatic exchange of financial account information on non-residents (scheduled in 2017). Therefore, it is advised that financial institutions pay close attention to the details of these revisions that will be clarified shortly.

Among the revisions proposed in the 2015 tax reform outline, this alert focuses on the major revisions in taxation related to financial businesses and those that are particularly applicable to financial institutions.

Detailed discussions

1. Taxation of financial transactions

a. Introduction of tax-exempt accounts for minors (Junior NISA)

i. Purpose of the system

Under the current tax exemption system for dividends and capital gains arising from small investments in listed shares (Nippon Individual Saving Account "NISA"), which was introduced in 2014, only resident individuals aged 20 years or over can open a NISA tax-exempt account. Therefore, in order to promote the investment by supporting stable wealth accumulation of households and facilitating the transfer of financial assets from elder generations to younger



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generations, a new tax exemption system for dividends and capital gains arising from small investments in listed shares within accounts for minors' (Junior NISA) will be introduced. The scope of eligible listed shares, the period during which tax-exempt investments can be made, and the period during which the dividend and capital gain are exempted from tax under Junior NISA will be the same as the existing NISA. However, as this system is designed to support investments by minors for their future, there are certain differences from the existing NISA. For example, withdrawal is restricted until the holder of the tax-exempt account becomes 18 years old.

ii. Outline of Junior NISA

Under the Junior NISA program, if a resident individual under 20 years of age as of 1 January has opened a junior account and has accepted, in a tax-exempt investment account of the junior account, listed shares that have been newly purchased or transferred from another tax-exempt account of the same individual (up to an annual investment amount of 800,000 yen), any dividends and capital gains arising from the listed shares recorded in the account will be exempt from income tax.

However, withdrawal of listed shares from that account is restricted until 31 December of the year preceding the year in which the individual becomes 18 years old on or before 31 March, with certain exceptions such as in the case of a natural disaster. It should be noted that if this restriction is violated, dividends and capital gains that have arisen during the entire period that otherwise has been a tax exempt period, as well as any unrealized gains as of the withdrawal date will be subject to withholding tax at a rate of 20% (15% national tax and 5% local tax).

Junior NISA vs. Existing NISA

	Junior NISA	Existing NISA
Eligible person	Resident individuals aged below 20 years	Resident individuals aged 20 years or over
Period during which a tax-exempt investment account can be opened	From 2016 to 2023	From 2014 to 2023
Maximum annual tax-exempt investment	800,000 yen	1,200,000 yen (see below)
Tax exemption period	5 years from 1 January of the year during which the tax exempt investment account is opened	Same as on the left
Tax-exempt income	Dividends and capital gains	Same as on the left
Withdrawal	Restricted until 18 years old with certain exceptions such as in the case of disaster	Not restricted

After the initial period during which a new tax-exempt investment account can be opened, during the period from 2024 to 2028, such an individual can keep a renewal tax-exempt investment account to which listed shares can be transferred from another tax-exempt investment account opened by the individual up to 800,000 yen per year. This tax exemption treatment applies until 31 December of the year preceding the year in which the individual becomes 20 years old as of 1 January.

iii. Submission of annual transaction reports by financial institutions

Where a tax-exempt account has been opened by an eligible minor, the financial institution will be required to prepare a report containing, among others, the amount of dividends and the amount of capital gains arising from listed shares in each account during the year and submit it to the tax office by 31 January of the following year.

iv. Effective date

In principle, this rule is applicable to listed shares accepted on or after 1 April 2016 in a tax exempted account for which an application to open the account is accepted on or after 1 January 2016.

b. Expansion of the tax exemption system for dividends and capital gains arising from small investments in listed shares (NISA)

In addition to the introduction of Junior NISA described in *a.* above, the maximum tax-exempt amount of listed shares that can be accepted in a tax-exempt investment account opened each year for a tax-exempt account under the NISA program will also be raised to 1,200,000 yen (from the current 1,000,000 yen), as part of measures to support the stable wealth accumulation of households.

This revision will apply to the amount of listed shares accepted in a tax-exempt investment account for 2016 and subsequent years.

Although there have been various discussions as to by how much the maximum amount should be raised, the proposed amount appears to reflect the expectation that contributions will be made monthly, consistent with the purpose of the introduction of NISA, which is to facilitate the flow from savings to investments. In combination with Junior NISA, this revision is expected to further facilitate the wealth accumulation of households.

c. Revision of the special provisions on income calculation for listed shares held in a specified account

A person intending to transfer listed shares between specified accounts will now be able to do so by entrusting the custody of shares held in the old specified account with the director of the business office of the financial institution with which the new specified account is opened.

This revision is intended to enable the transfer of foreign shares between specified accounts. Following the implementation of administrative procedures for such transfers, including the transfer of required information such as the acquisition cost, this related tax rule is also revised.

This revision will apply to listed shares to be accepted in a specified account on or after 1 January 2016.

d. Expansion of the scope of listed shares subject to the special provisions on the taxation of capital gains on listed shares

The scope of listed shares will be expanded to include publicly offered beneficial interests issued by a specified trust. There has been no publicly offered beneficial interest issued by a specified trust in the past, but this revision is expected to broaden the use of specified trusts issuing beneficiary certificates.

This revision will apply to the transfer of listed shares on or after 1 January 2016.

2. Revision of the dividends received deduction (DRD) system

In general, financial institutions hold shares for investment purposes as well as for management purposes, such as shares in subsidiaries engaging in related businesses, and receive a significant amount of dividends from these investments. Although these dividends are still excluded from taxable income under the dividends received deduction (DRD) system, debt interest that has been deducted from the amount of the exempt dividends will no longer be deducted in certain cases. On the other hand, the amount of dividends that can be excluded from taxable income will be reduced as shown in the table below.

It should also be noted that dividends from securities investment trusts other than bond investment trusts, for which 50% or 25% has been excluded from taxable income, will no longer be excluded from taxable income and dividends from specified equity investment trusts will be treated as dividends on shares held for non-controlling purposes, as shown in the table below.

Current		Proposed	
Category (ownership ratio)	Amount excluded from gross revenue	Category (ownership ratio)	Amount excluded from gross revenue
Shares of wholly-owned subsidiaries (100%)	Full amount of dividends received	Shares of wholly-owned subsidiaries (100%)	Full amount of dividends received
Shares of affiliates (Less than 100%, but not less than 25%)	Full amount of dividends received (with debt interest exemptions)	Shares of affiliates (More than 1/3, less than 100%)	Full amount of dividends received (with debt interest exemptions)
		Other shares (More than 5%, up to 1/3)	50% of dividends received (no debt interest exemptions)
Other than the above (Less than 25%)	50% of dividends received (with debt interest exemptions)	Shares held for non-controlling purposes (5% or less)	20% of dividends received (no debt interest exemptions)

Under a new special provision, insurance companies will be allowed to exclude 40% of dividends on shares held for non-controlling purposes from taxable income.

While the revision will not affect dividends from corporations with a high ownership ratio such as 100% group-owned corporations, the amount not to be excluded from taxable income will increase with respect to dividends from corporations with an ownership ratio of 5% or less or securities investment trusts. Financial institutions need to review the securities they hold and quantify the impact of the revision on their taxable income including the effect of debt interest deductions that will no longer be applicable.

Although the Outline does not specify the effective date, the abovementioned revisions are expected to apply to fiscal years beginning on or after 1 April 2015. The final effective date should be confirmed going forward.

3. Measures to ensure a smooth transition to the attributable income approach of international taxation principle

The following measures will be taken to facilitate a smooth transition to the attributable income approach of the international taxation principle, which is scheduled for introduction in fiscal years beginning on or after 1 April 2016:

a. Clarification of income category of interest on trade receivables

Although the current law stipulates that interest that a foreign corporation receives on trade receivables due over 6 months shall be included in "interest income," which is Japan-sourced income, the treatment of interest on trade receivables due

within 6 months has not been stipulated by the law and it has not been clear whether it falls under “domestic asset investment/holding income” even if it does not fall under “interest income.” Therefore, it should be clarified that such interest does not fall under “domestic asset investment/holding income.”

b. Calculation of Japan-sourced income in the case of a transfer of domestic real estate between a permanent establishment (PE) of a foreign corporation and its headquarters

Income arising from any transfer of real estate located in Japan by a foreign corporation will be subject to taxation as Japan-sourced income regardless of whether the real estate is attributable to a PE of the foreign corporation. If there is any intra-company transaction between a permanent establishment (PE) of a foreign corporation and its headquarters that falls under such asset transfers, the intra-company transaction will be deemed to have been carried out at the amount equivalent to the tax carrying value immediately preceding the transaction in the calculation of taxable income attributable to the PE of the foreign corporation.

In this case, the acquisition cost of the asset transferred under an intra-company transaction at the PE of the foreign corporation shall be deemed to be an amount equivalent to the tax carrying value immediately preceding the intra-company transaction.

This revision is designed to address transactions in which domestic real estate with an unrealized gain is transferred from the headquarters of a foreign corporation to a PE in Japan and then from the PE in Japan to a third party in Japan. Under the current law, such an intra-company transaction is recognized in the taxable income calculation of the PE in Japan, but not in the taxable income calculation of the headquarters, which is subject to taxation in Japan. Accordingly, any unrealized gains arising before the transfer to the PE in Japan is not taxable, under the current law. The proposed revision is designed to address such a situation.

c. Treatment of the deductible amount of the debt interest corresponding to Tier-2 capital of a foreign bank

The deductible amount of the debt interest corresponding to Tier-2 capital of a foreign bank will be limited to the amount reported in the tax return, thereby clarifying that the tax authorities are not obligated to reassess and calculate the deductible amount in excess of the amount calculated by the taxpayer.

4. Reporting requirements for the automatic exchange of financial account information on non-residents

a. Purpose of the system

The Foreign Account Tax Compliance Act (FATCA) was recently enacted in the U.S. and global financial institutions took steps to respond to the new requirements. In the same vein, the OECD Taxation Committee has approved the Common Reporting Standard (CRS) for the purpose of facilitating the multilateral exchange of information rather than bilateral exchange between particular countries. In response to these developments, reporting requirements for the automatic exchange of financial account information on non-residents will be introduced in Japan and a mechanism will be established for the provision of information on financial accounts held by non-residents to the tax authority of the country of residence of each non-resident.

The new reporting system will also encompass the authority's right to ask questions and conduct investigation on the provision of information to be reported and penal provisions on the failure to submit reports or provide information to be reported, which will require careful responses on the part of financial institutions.

b. Notification obligation of a person who carries out specified transactions

A person who intends to carry out a certain transaction such as the acceptance of deposits or savings (specified transaction) with a bank or certain other financial institution (reporting financial institution) through its domestic sales office on or after 1 January 2017 will be required to submit a written notice containing, among others, the following information to the head of the sales office of the reporting financial institution each time the person carries out such a specified transaction: the name, address, date of birth, country of residence (i.e., the country in which the person is subject to taxation as a resident) of the person (including, if the person is a certain type of a corporation (specified corporation), an individual who controls the specified corporation) and the person's taxpayer identification number in the country of residence if it is a foreign state.

c. Obligations of reporting financial institutions

i. Identification of the country of residence

The reporting financial institution is required to identify the country of residence of each person who carries out specified transactions based on the information contained in the written notice submitted under (1) above (in the case of a person who carried out specified transactions on 31 December 2016 or before, based on the records held by the reporting financial institution).

ii. Reporting to the tax office

With respect to the contracts for specified transactions existing as of 31 December of each year, if the contract is held by (i) a person whose country of residence is one of the specified countries or regions including the counterparties to tax treaties (countries to be reported) (such a person is referred to as a "person to be reported") or (ii) a specified corporation whose country of residence is a country or region other than the countries to be reported and which is controlled by an individual who is a person to be reported, the reporting financial institution is required to submit certain information on such contracts including the name, address, and date of birth of the person who has a contract to be reported, and the value of the property to which the contract is subject, to the district director of the local tax office by 30 April of the following year.

iii. Preparation and preservation of records

The reporting financial institution is required to prepare and preserve records concerning the measures taken to identify the country of residence of persons who carried out specified transactions and other necessary information.

d. Effective date

This system will take effect on 1 January 2017.

5. Other revisions

a. Hedge effectiveness test on option transactions

With regard to hedge effectiveness testing for option transactions accounted for under the deferral or fair value hedge accounting, a corporation may change the effectiveness testing method to a method based on the comparison between the valuation difference on assets that are hedged items and changes in fair value of the underlying instrument of the option transactions by submitting a written notice to the tax office.

The commentary above is the method described in "Method of hedge effectiveness test on option transactions" in "Other information on the interpretation of law" which has been published in the website of the National Tax Agency but has not yet been legislated. The actual procedure under the new law should be confirmed.

(Reference)

<http://www.nta.go.jp/shiraberu/zeiho-kaishaku/joho-zeikaishaku/hojin/09/01.htm>

b. Revision of the pass-through requirements for Tokutei Mokuteki Kaisha (TMK, a type of specific purpose companies)

For fiscal years beginning on or after 1 April 2015, with regard to the special provisions for taxation on TMK, TMK established on or before 1 April 2010 that have not submitted the notice

of the commencement of business by 31 March 2015 will be, in the pass-through eligibility judgment, subject to the requirement that the ratio of specified shares offered within Japan should exceed 50%.

c. Revision of the special provisions on the taxation of JREIT (Japan Real Estate Investment Trust)

Given the revision of the JREIT related laws, the following measures will be taken in order to eliminate restrictions on the activities of JREIT arising from the mismatch between financial accounting and tax treatments.

i. Treatment of cases in which a non-deductible amount (temporary difference) is distributed in excess of profit

In the case where an expense associated with no cash outflow (e.g., impairment loss) is recognized, there may be cash distribution in excess of accounting profit (a distribution in excess of profit). Under the current rule, distribution in excess of profit arising from the tax-accounting mismatch is treated as a repayment of capital. However, given the revision of the related laws, the revised rule will treat such distribution as dividends that are deductible in the calculation of taxable income. More specifically, such a mismatch amount will be recognized as a reserve for temporary difference adjustment and treated as dividends also for tax purposes. As a result, it will be deductible in the calculation of taxable income of the JREIT. For investors, it will be treated as dividend income.

ii. Treatment of cases in which there is an expense that is treated as a deductible expense for tax purposes only

In the case where a deductible expense is recognized for tax purposes before it is recognized for accounting purposes, taxable income would be lower than accounting profit, in which case the JREIT should be exempt from tax if it distributes an amount equivalent to the amount of taxable income. However, under the current rule, it has been considered as a problem that the JREIT is forced to distribute an amount in excess of taxable income in order to satisfy the 90% requirement for dividends to be deductible. Under the revised rule, in the case where a reserve for temporary difference adjustment is recognized, it will be deducted from the amount of distributable profit for the purpose of the 90% requirement and the abovementioned problem will be solved.

d. Introduction of a tax exemption system for interest on margins for OTC (Over The Counter) derivative transactions

In response to the margin regulations to be introduced in December 2015, a tax exemption system will be introduced for interest on margins to be paid to foreign financial institutions for the purpose of facilitating the securing of margins from foreign financial institutions.

More specifically, in the case where a foreign financial institution carries out an OTC derivative transaction with a domestic financial institution and deposits margins with the domestic financial institution in cash, interest on such margins are treated as interest on loans, which is Japan-sourced income. However, such interest will be exempted from income tax until 31 March 2018 subject to certain requirements, including the submission of a tax exemption application. Therefore, no withholding tax will be required for interest on cash collateral paid by a domestic financial institution to a foreign financial institution.

The same treatment will also apply to interest on margins paid by a financial instruments clearing organization to a foreign financial institution and interest on margins paid by a domestic financial institution to a foreign financial instruments clearing organization.

While it has been an international trend that interest on margins for derivative transactions is exempt from tax in the source country, taxation has been unavoidable in Japan unless exempted under the application of a tax treaty. This revision will eliminate a tax barrier and avoid an increase in administrative workload expected after the introduction of the margin regulations.

e. Special provision on capital gains in the case of departure from Japan and foreign expatriates

When a resident satisfying the following requirements no longer has an address and residence in Japan (departure from Japan), if the resident has securities or unsettled derivative transactions, unrealized capital gains will be taxed at the time of departure from Japan (so-called exit tax) as if the securities had been transferred or the unsettled derivative transactions had been settled under the newly introduced special provisions.

- ▶ The total value of the securities and gains or losses on the settlement of unsettled derivative transactions held by the person is at least 100 million yen.
- ▶ The period during which the person has had an address or residence in Japan is over 5 years in total during the period of 10 years immediately preceding the date of departure from Japan.

This special provision applies to any resident who will depart from Japan regardless of his/her nationality. Therefore, foreigners without Japanese nationality may be subject to this taxation. However, "the period during which the person has had an address or residence in Japan" in the requirement above does not include the period during which a foreigner has stayed in Japan with a working visa. Therefore, it appears that a foreigner who has been temporarily transferred to Japan from overseas would not in general be subject to this special provision.

6. Concluding remarks

The 2015 tax reforms include a number of items that require responses on the part of financial institutions including the introduction of Junior NISA that will directly affect their business, the revision of the dividends received deduction (DRD) system to expand the taxable base that accompanies the lowering of effective corporate tax rates, and the introduction of reporting requirements for the automatic exchange of financial account information on non-residents. For the details of the revisions, financial institutions need to take appropriate responses by referring to the provisions of the applicable laws and regulations to be finalized going forward.

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