

January 2005

Gets Vol. 27

Unification of Taxation on Income from Financial Assets for Individuals

On June 15, 2004, the sub-committee of the Tax Commission of the Ministry of Finance issued their report "*The Basic View on the Unification of Taxation on Income from Financial Assets*" (the "Report"). In the report for the Tax Reform FY2005 issued by the Tax Commission recently, the direction proposed in the Report was basically supported though the report suggested that it is not expected to give shape to the direction in the Tax Reform 2005.

Background and basic rationale for unification

The Report identifies the significant decline in the savings rate - which is not expected to recover due to the declining birthrate and the rapid aging of the population - as a motivation to encourage utilization of existing financial assets more efficiently in order to stimulate economic growth. One proposed stimulant is a strategy to develop the individual tax framework to shift financial assets from deposit savings to investments in listed stocks and stock investment trusts.

The Report considers whether unification of the taxation on income from financial assets will assist in creating a tax system that is: simple; neutral amongst financial assets; and contributes to the reduction of risk on stock investments for individual investors. To achieve such a tax system, there are essentially two strategies discussed in the Report, as detailed further below:

- Equalization of tax system amongst financial assets; and
- Aggregation of profits and losses from financial assets.

Equalization of tax system amongst financial assets

The Report describes the direction of the revisions of the taxation on dividend income, capital gains/losses on bonds, foreign currency deposits and insurance assets as examples of the trend towards equalization of the tax system amongst various financial assets. The table below summarizes this direction.

Income	Current taxation (as of September 2004)	Direction of revision
Dividend Income	In principal, dividend income is subject to withholding tax at a rate of 20% and included the comprehensive tax system. There is a special rule that allows separate withholding tax system at source at the rate of 10% for listed stock, although this rule does not apply to individual investors who have large shares. Dividend deduction and adjustment of interest deduction may apply under a comprehensive tax system.	Dividends should be subject to separate assessment tax system and taxed at the rate of 20%. However, a comprehensive assessment tax system should be applied for investors who have large shares. Dividend deduction and adjustment of interest deduction under the comprehensive assessment tax system may be reviewed.
Capital gains/losses on bonds	Capital gains are exempt from taxation. Capital losses are deemed tax nothings.	Capital losses should be realized as transfer losses and capital gains and losses on bonds should be treated the same as those of stocks.
Foreign currency deposit	Exchange gains/losses are categorized as miscellaneous income/loss and are subject to the comprehensive assessment tax system.	Exchange gains should be subject to separate assessment tax system and taxed at the rate of 20%.
Insurance products	If income from insurance products is similar to that from financial assets, such income is subject to separate withholding tax at the rate of 20%. Other incomes from insurance products are categorized as miscellaneous income or occasional income and subject to the comprehensive assessment tax system.	Income from insurance products should be subject to the separate assessment tax system to the extent such income is similar in nature to that from financial assets.

Aggregation of profits and losses from financial assets

Currently, income from financial assets is categorized as various type of incomes for tax purposes and the aggregation of profits and losses amongst the different types of income is strictly restricted. The Report states that since profits and losses in each category of income are considered to have economically the same nature, the risk on stock investments would be reduced by allowing taxpayers to deduct investment losses from profits on other financial assets.

The Report considers it inappropriate to aggregate incomes that are subject to different tax systems nor incomes within the same tax system but subject to different tax rates. In addition, the Report states that an impact of the decrease of tax revenue due to the aggregation of profits and losses from various financial assets needs to be considered.

The Report made the following recommendations:

Aggregation of profits and losses from transfer of stocks and transfer of bonds should be allowed.

Aggregation of losses from transfer of listed stocks or public stock investment trust and dividend income or distribution from them should be allowed within certain limits. Losses from the transfer of stocks should be carried forward within subsequent years and included in the aggregation of incomes.

Aggregation of interest income and losses from transfer of stocks should be allowed on condition that the assessment tax system and payment record system for interest income are incorporated into a unified tax system.

Capital losses on stocks due to bankruptcy of the issuer corporation, which are not treated as tax losses under the current tax law, should be treated the same as capital losses on the transfers of the stocks. Pay-off losses arising from bank insolvencies for depositors, however, should not be treated as tax losses.

The Financial Services Agency recently proposed the following three requests for tax reform for year 2005 with regard to the aggregation of profits and losses from financial assets:

Set up special measures for the aggregation of profits and losses from financial assets such as stocks (listed and non-listed), stock investment trust, bonds, bond investment trust, futures, option forwards and bank deposits.

Utilize specific accounts (*Tokutei Kouza*) for the aggregation of profits and losses from financial assets.

Expand the scope of losses from the transfer of stocks which can be carried forward, which is limited to aggregate the losses from certain listed stock under current tax law, and to extend the period of loss carried forward from three years to five years.

Development of tax payment environment

The Report concluded that, in order to operate a unified tax system, it is necessary to develop a good tax compliance environment to enforce tax administration appropriately and provide more convenience for taxpayers.

Under the current tax system, most office workers are not required to file their individual tax return. The Report points out that if the aggregation of profits and losses arising from financial assets is permitted, the opportunity to file individual tax returns will be increased so as to enjoy the benefit on aggregation. This is considered a desirable change in the light of increasing taxpayers' involvement in the tax administration. The Report mentions that it is also important to maintain the withholding tax system considering convenience for taxpayers and individual investors and as an appropriate enforcement of tax administration, although the aggregation of profits and losses will be made through the filing of individual tax return.

The Report also considers that introducing a taxpayer's identification number system would be necessary for tax authorities in order to confirm consistency amongst individual tax returns and payment records submitted by withholding agents with limited resources and time constraints. There is a debate that the residents' identification number could be used as a taxpayer's identification number although there is not a national consensus to introduce a nationwide tax identification number. There is another argument that the tax identification number should be selectively introduced where those who want to enjoy the benefit of the unified tax system are allocated their tax identification numbers.

The taxpayer's identification number may be leaked out from a withholding agent since taxpayers have to provide their identification numbers to the withholding agent so that the agent can prepare payment records to be submitted to the tax authorities. The Report mentions that special laws or measures aimed of protecting privacy should be incorporated in addition to protection afforded under the Act for Protection of Computer Processed Personal Data.

© 2004 PricewaterhouseCoopers. All rights reserved. "PricewaterhouseCoopers" refers to the network of member firms of PricewaterhouseCoopers International Limited, each of which is a separate and independent legal entity.

For further information, please contact Yasuko Takahashi or Mayumi Nakamura at:

E-mail: pwcjapan.taxpr@jp.pwc.com Tel:03-5251-2400