



Financial Services Tax News

Financial Services Tax Group

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Japan 2005 Tax Reforms Update for the Financial Services Industry

In prior editions of Tax News, we provided general guidance on the 2005 Tax Reforms relating to the taxation of kumiai or partnerships and new rules affecting the taxation of real estate holding companies.

A summary of three specific developments arising from the 2005 Tax Reforms and of particular interest to the financial services industry are included within this issue:

1. **Expansion of scope of special tax treatment to support corporate revitalization**
2. **Expansion of scope of anti-tax haven rule to specified foreign trust**
3. **Simplification of requirements for attaching a residency certificate to tax treaty application forms**

1. Expansion of scope of special tax treatment to support corporate revitalization

Where a civil rehabilitation plan is approved under the *Civil Rehabilitation Law* or a certain private rehabilitation plan similar to that under the *Civil Rehabilitation Law* is agreed, the following measures will apply to the company:

- (i) The company can recognize revaluation gains/losses on its assets.
- (ii) Gains recognized from the debt forgiveness (after deduction of net revaluation losses on its assets) can be offset against special net operating losses (expired tax losses) before offset against net operating losses (valid tax losses).

According to public comment issued by the National Tax Agency under the advance confirmation system, this new measure will apply to private rehabilitation plans led by the Resolution and Collection Corporation (Seiri Kaishu Kiko) and the Association for Revitalization Support for Small and Medium Sized Enterprise (Chusho Kigyo Saisei Shien Kyogikai) and to private rehabilitation plans made in accordance with the Creditor-led Rehabilitation Guidelines (Shiteki Seiri Guidelines).

Prior to the 2005 Tax Reforms, a company undergoing a company revitalization plan under the Corporate Reorganization Law or the Civil Rehabilitation Law, was permitted to recognize revaluation losses on its assets for corporate income tax purposes, whereas a company under non-legal proceedings was denied equivalent treatment. Furthermore, a company undergoing a rehabilitation plan under the Civil Rehabilitation Law or certain non-legal proceedings, such as Creditor-led Rehabilitation Guidelines, had to offset gains from the debt forgiveness against ordinary net operating losses before special net operating losses. As a result of the 2005 Tax Reforms, the tax treatment of revaluation gains/losses and utilization of tax losses for companies under revitalization plans under the Corporate Reorganization Law, the Civil Rehabilitation Law and certain non-legal proceedings have become basically uniform.

2. Expansion of scope of anti-tax haven rule to specified foreign trust

From fiscal years commencing on or after April 1, 2005, where Japanese corporations and resident individuals establish foreign trusts that are similar in nature to specified trusts (Tokutei Shintaku), the income retained in such trusts will be subject to the income aggregation rules for Japanese tax purposes.

Foreign trusts which are subject to the income aggregation rules are foreign investment trusts that are similar in nature to specified trusts, as defined in Article 2 (29-3) of the Corporation Tax Law, and are treated as taxable entities for Japanese corporate tax purposes. A private placement investment trust other than securities investment trust is categorized as a specified trust for this purpose.

If more than 50% of the beneficiary interests of such foreign trusts are owned directly or indirectly by Japanese corporations and/or Japanese resident individuals ("foreign related trust"), and if a foreign related trust is established in a country or a jurisdiction which levies no income tax or the effective income tax rate of a foreign related trust is 25% or less, the foreign trust will be treated as a special foreign trust and subject to Japan's anti-tax haven rules.

Before the 2005 Tax Reforms, income pooled in foreign trusts by Japanese corporations and resident individuals was not within the scope of the anti-tax-haven rules. However, Japan's anti-tax haven rules are now applicable to foreign specified trusts. Therefore, when Japanese corporations and resident individuals invest in trusts established in a zero or low tax jurisdiction, due consideration should be made regarding the application of the anti-tax haven rules to the particular foreign trust.

3. Simplification of requirements for attaching a residency certificate to tax treaty application forms

In order for resident in a jurisdiction that has a double tax treaty with Japan to receive treaty entitled benefits on the taxation of its Japan source income, the taxpayer had to submit prescribed treaty application documentation to the appropriate tax office through the payer of the income.

To claim entitlement under a tax treaty which includes a limitation on benefits article (for example, Article 22 of the Japan-US tax treaty), the taxpayer is required to attach a certificate of residency issued by the competent authority of the jurisdiction of its residency with the application form.

However, since original copies of the residency certificate had to be attached to the treaty form, a taxpayer who has a variety of Japanese source income had to obtain an equivalent number of residency certificates from its home jurisdiction.

This was considered an administrative burden; not only for the person claiming treaty benefits but also the competent authority concerned. This procedural requirement was amended as part of the 2005 Tax Reforms and if the residency certificate is presented to and confirmed by the withholding tax agent, the requirement of attaching a residency certificate to the treaty application form is deemed satisfied. Where applicable, the withholding tax agent is required to retain a copy of the residency certificate for at least five (5) years from the date of verification of the residency certificate.

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