



*Financial Services Tax Group*

# *News Letter*

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## **FY 2004 Japanese Tax Reform**

### **(Finance and securities)**

Fiscal year 2004 Japanese tax reforms were legislated in April 2004. What follows is an outline of the major points of the FY 2004 Japanese tax reforms affecting the finance and securities taxation area, together with the international taxation and tax treatment for real estate investment companies.

#### **I. Taxation of Financial Assets and Stocks**

##### **1. Income tax treatment of publicly offered stock investment contractual funds**

(1) Capital gains, including sales through securities companies, realized on or after January 1, 2004 are subject to reduced income tax rates (7% national tax and 3% local tax).

(2) Publicly offered stock investment contractual funds are added to the list of assets in a “special account” (*Tokuteikouza*) for which the special taxation method for capital gains on transfer may be applied, i.e., tax is withheld from any resultant income incurred by the transfer of such assets, and no further tax liability arises. This treatment will apply to:

Foreign publicly offered stock investment contractual funds for capital gains incurred on transfers on or after April 1, 2004; and

Domestic publicly offered stock investment contractual funds for capital gains incurred on transfers on or after October 1, 2004.

(3) Capital losses incurred on the sale of publicly offered stock investment contractual fund securities on or after January 1, 2004 may be carried forward for 3 years.

Sales to registered financial institutions and investment trust management companies apply the tax treatments of (1) and (3) stated above.

(4) When certain financial institutions repurchase investments from investors, and then subsequently redeem these investments on or after April 1, 2004, profit distributions from those redemptions may be exempt from withholding tax.

## 2. Tax rate reduction on capital gains of unlisted stocks

The tax rate on capital gains on disposal of unlisted stocks realized on or after January 1, 2004 is reduced from the former rate of 26% (20% national tax, 6% local tax) to 20% (15% national tax, 5% local tax).

## 3. “Special account” (*Tokuteikouza*)

Other changes to the treatment of “special accounts” include:

(1) Banks, *Kyodososhiki-kinyukikan* and registered financial institutions are allowed to operate “special accounts” from April 1, 2004.

(2) When residents who hold “special accounts” leave Japan, such residents may be permitted to maintain their “special account” during their absence and on return under certain conditions. This treatment is applied for departures on or after April 1, 2004.

## 4. Exemption of withholding tax imposed on redemption gains

(1) Redemption gains on short-term bonds held in a paperless trading system (i.e., so called “*Denshi CP*”) issued by foreign corporations are exempt from withholding tax at the time of issuance. This change is applied to bonds issued on or after April 1, 2004.

(2) A system of payment slips for the transfer and redemption of short-term bonds is introduced for transfers of short-term domestic and foreign corporate bonds on or after April 1, 2006.

(3) A qualified foreign intermediary must maintain its books of record and notify financial institutions with regard to the paperless transfer of short-term government bonds. The financial institutions must maintain its books with regard to the paperless transfer of short-term government bonds as well. These rules apply to the paperless transfer of short-term governments bonds transferred on or after April 1, 2004.

(4) Financial institutions are required to submit payment slips concerning transfer of short-term government bonds in a paperless trading system. This applies to transfers on or after April 1, 2004.

#### **. International Taxation**

1. Measures undertaken in the context of new Japanese-US tax treaty

(1) Clarification of business entity treated differently in Japan and US

The new treaty incorporates provisions regarding application of the treaty for business entities that are subject to differing tax treatment in Japan and US. In context of these provisions, the taxation treatment of such entities is clarified.

(2) Limitation on benefits article

The new treaty incorporates a comprehensive limitation on benefits article, which prevents treaty benefits being applied unless the resident satisfies the detailed criteria in the treaty. In context of the article, procedural rules for applying treaty benefits are clarified, i.e., the residents who bear the Japan source income are required to submit application forms to the Director-General of National Tax Administration Agency.

The treatments stated in (1) and (2) above apply on or after April 1, 2004, however, in practice, on or after the effective date of the new treaty, which is July 1, 2004 for withholding tax purposes.

(Note) A record of discussions with respect to the new treaty was signed on May 2004 by U.S. and Japanese officials. This record clarifies the application of clause 3 (c)(iv) Article 11, relating to the qualification of financial institutions for elimination of source-country withholding taxes on interest income. The record describes the technical application of the conditions in the context of a financial business that operates through a multiple entity group.

2. Procedures are released on exemption from withholding tax, which may apply to Japan source income received by non-residents and foreign corporations having a permanent establishment in Japan, including changes to the presentation of certificates from filing/submission of certificates. The non-residents and foreign corporations are required for certain books of records. This applies to Japan source income received on or after July 1, 2004.

### 3. Thin Capitalization legislation

The Japanese thin capitalization rules allow the normal 3:1 debt-equity threshold to be exceeded where it can be demonstrated that a comparable third party has a higher gearing. Previously, a taxpayer was required to consider a comparable company's financial information for a year. This rule has been relaxed to allow a taxpayer to refer to a single selected fiscal year out of the past 3 years of the comparable company. This change is applicable to fiscal years ending on or after April 1, 2004.

### **III. "Real Estate" Investment Company**

An investment company, established under the Law of Japanese Investment Trust and Investment Company with its main business being investment into real estates (i.e., Real Estate Investment Trust or J-REITs), may take a special benefit for corporation tax purposes (dividend deduction) even when the J-REIT acquires and holds 100% of the preferred stocks of a Special Purpose Company (i.e., Tokutei Mokuteki Kaisya or TMK) under the Law on the Securitization of Assets provided qualifying conditions are satisfied. However, at the J-REIT's level, a certain amount of dividends received from preferred stocks of TMK acquired on or after April 1, 2004, are not deductible from taxable income. This treatment is applied for the TMK's preferred stocks acquired on or after April 1, 2004 and may be applicable for the fiscal years ending on and after

April 1, 2004.

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Topics provided in this Financial News Letter are based only on general case studies. For practical application to an individual case or a transaction structure, please refer to your usual PwC contact.

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