

Financial Services Tax News

2014 Tax Reform Proposal for the financial services industry and real estate market in Japan

December 2013



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The 2014 tax reform proposals were released on December 12, 2013. This newsletter reviews the principal effects the 2014 tax reform proposals will have for the financial services industry and real estate market in Japan.
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The 2014 tax reform proposals (known as Taiko) submitted by the Government's Ruling Party's Tax Commission ("2014 Tax Reform Proposal") were released on December 12, 2013. These proposals will now be submitted to the lower house of Parliament (Diet) for consideration and review. The 2014 Tax Reform Proposal is not law and may change following public and parliamentary review.

Amongst the changes to be brought in by the 2014 Tax Reform Proposal, this newsletter provides a summary specifically affecting Japan's financial services industry and real estate market. A broader summary of the 2014 Tax Reform Proposal is published in our accompanying and complementary Japan Tax Update.

Tax Reform Proposal for the financial services industry

1. Shift in the principle of international taxation (Introduction of attribution rule)

According to the 2014 Tax Reform Proposal, the current Japanese tax principle of international taxation based on the entire entity approach will be amended, and an attribution approach will be introduced in line with the 2010 update to the OECD's model tax convention. Under the attribution approach, income attributed to a permanent establishment ("PE") of a foreign company will be included in domestic source income of the PE.

The contents regarding international taxation under the 2014 Tax Reform Proposal are drawn up substantially in line with the report on potential amendments to the taxation of permanent establishments from the current entire method to the attribution method ("Report") published by the government's tax commission (zeisei chosakai) on October 24, 2013; as summarised in our earlier newsletters regarding introduction of attribution rule to the taxation of PEs. However, there are some additions and changes from the Report including the following items specific to the financial services industry:

- (i) Interest from Tier 2 capital such as subordinated debt paid by a foreign bank / securities company (i.e., Type 1 Financial instruments business) allocated to a PE in Japan of a foreign bank / securities company in accordance with the attributable capital of the PE shall be deductible for the purposes of calculating the attributable income of the PE; and
- (ii) Where the investment assets actually allocated to a PE of a foreign insurance company is less than the investment assets allocated to the PE in Japan in accordance with premium reserve, etc., the investment revenue corresponding to the deficient shall be included in the taxable income of the PE in Japan.

As to the meaning of foreign source income, which is defined as income other than domestic source income under the current tax law, the scope of foreign source income will be defined as: (i) attributable income of foreign PEs; (ii) income from operating, maintaining foreign assets; (iii) income from transferring foreign assets; (iv) interest on bonds issued by foreign corporations; and (v) dividends paid by foreign corporations, etc. When calculating foreign source income of a foreign PE specific to the financial services industry, the following may be taken into account:

- (i) Japanese banks may calculate risk-weighted assets using only credit risk for finance receivables when determining the capital to be attributable to a foreign PE;
- (ii) Interest from the Tier 2 capital such as subordinated debt paid by a Japanese bank / securities company (i.e., Type 1 Financial instruments business) allocated to a foreign PE of the bank / securities company in accordance with the attributable capital of the PE shall be deducted for the purposes of calculating the attributable income of the foreign PE; and
- (iii) Where the investment assets actually allocated to a foreign PE of a Japanese insurance company exceeds the investment assets allocated to the foreign PE in accordance with premium reserve etc., the investment revenue corresponding to excess shall be excluded from the taxable income of the foreign PE.

The attribution rule above will be effective for fiscal years starting on or after April 1, 2016 for corporation tax purposes, and for the year 2017 for individual tax purposes.

For more details, refer to the October 2013 and December 2013 issues of our Japan Tax Update:
<http://www.pwc.com/jp/en/taxnews/pdf/jtu93-aoa-e.pdf>
<http://www.pwc.com/jp/en/taxnews/pdf/jtu94-aoa-e.pdf>

2. Tax exemption rule for listed shares managed in NISA

According to the 2014 Tax Reform Proposal, an individual who holds/had held but terminated an exempt account may reopen a new exempt account with the same or another securities company (i.e., the exempt account known as the Japanese ISA or NISA, a tax free individual savings account), subject to specified procedures, within each of the specified periods for opening exempt accounts (i.e., from January 1, 2014 to December 31, 2017, January 1, 2018 to December 31, 2021, and January 1, 2022 to December 31, 2023).

3. Special measures on Specified Government and Corporate Bonds applicable to family corporations

In the context of unification of financial income taxation for individuals, Specified Government and Corporate Bonds will be treated as similar to listed stocks (e.g., the capital gain/loss can be offset with capital gain/loss arising from listed stocks) including bonds issued on or before December 31, 2015. Under the 2014 Tax Reform Proposal, however, bonds issued by family corporations at the time of issuance will be excluded. This amendment will be applied to any sales made on or after January 1, 2016.

Further, interest on bonds issued by family corporations on or before December 31, 2015 paid to shareholders, etc., on or after January 1, 2016 will be excluded from the scope of withholding taxation on interest income at the flat rate of 20% (national tax 15% and inhabitants tax 5%), and will instead be subject to comprehensive taxation (i.e., at progressive tax rates) as interest income.

Tax Reform Proposal for the real estate market

1. Specific measures for J-REITs

To coincide with revisions to the Order for Enforcement of the Law concerning Investment Trust and Investment Corporation ("Law"), the 2014 Tax Reform Proposal will add more conditions to the dividend deductibility tests for J-REITs and special investment trusts. That is, in order to satisfy the dividend deductibility tests, it will now also be required that the value of specified assets stipulated by Article 2 (1) of the Law other than electricity production facilities utilizing renewable energy and concessions of public facilities of a J-REIT must be more than 50% of total assets. However, this additional requirement will not apply to a J-REIT which acquires and leases an electricity production facilities utilizing renewable energy from the revision date of the Order through March 31, 2017 for fiscal years ending within 10 years from the date when the J-REIT leases the facilities, provided that the following conditions are met:

- (i) The value of concessions of public facilities of the J-REIT does not account for more than 50% of total assets;
- (ii) Issuance of shares at the establishment of the J-REIT is by public offer or where the shares are listed; and
- (iii) The certificate of incorporation (*kiyaku*) of the J-REIT for electricity production facilities utilizing renewable energy is held solely for the purpose of leasing.

Provided that the laws concerning investment corporations will be revised, the 2014 Tax Reform Proposal will also revise the terms of one of the dividend deductibility tests which requires a J-REIT to distribute more than 90% of its distributable profit ("Distributable Profit"). This reform is that 70% of depreciation of positive goodwill (*sei-no-noren*) will be excluded from the meaning of Distributable Profit of a J-REIT.

2. Review of book-tax differences and taxation of J-REITs

According to the 2014 Tax Reform Proposal, in order to limit differences arising from book-tax adjustments, taxation for J-REITs including the scope of specified assets held by J-REITs and the relationship between accounting and taxation will be reviewed for consideration within the 2015 tax reform proposals, taking into account the scope of J-REIT activities, research on taxation systems and cases in foreign jurisdictions, and the principle of fair taxation between ordinary corporations and J-REIT.

For more detailed information, please do not hesitate to contact your financial tax services representative or any of the following members:

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