

2022 Tax Reform Proposals: Financial Services Industry & Real Estate Market

December 13, 2021

In brief

The 2022 tax reform proposals (known as *Taiko*) submitted by the Government's Ruling Party were released on December 10, 2021. These proposals are submitted to the Japanese parliament (*Diet*) in early 2022.

A link to the *Taiko* (in Japanese) is as follows:

https://jimin.jp-east-2.storage.api.nifcloud.com/pdf/news/policy/202382_1.pdf

This newsletter provides a brief and immediate summary highlighting several significant developments, specifically of interest to Japan's financial services industry and real estate market. A broader summary of the 2022 tax reform proposals is published separately in our Japan Tax Update, with subsequent more detailed summaries to follow as the legislation is drafted and released in the New Year. A Japanese language version of this news item is also released separately.

In detail

1. Clarification of taxation on income derived from settlement of derivative transactions for non-residents

The 2022 tax reform proposals clarify that income arising from the settlement of market derivative and over-the-counter (**OTC**) derivative transactions under the Financial Instruments and Exchange Act are not classed as 'investment and holding income of domestic assets'; and thus should not be regarded as domestic source income stipulated in the income and corporate tax laws for any party who is a non-resident without a permanent establishment (**PE**) in Japan.

A similar conceptual approach will be taken when determining what is foreign source income for foreign tax credit purposes for residents.

2. Expansion of the application of earning stripping rules to foreign corporations without a PE in Japan

When a foreign corporation that has no PE in Japan earns certain domestic source income (such as through leasing of aircraft or investing in real estate in Japan), it should generally be required to file corporate tax returns and pay taxes in Japan. This income is not however subject to limitations on deductions of interest under the earning stripping rules. In order to be consistent with the treatment

for domestic corporations and also foreign corporations that earn domestic source income through their PEs in Japan, the earnings stripping rules will be extended in their scope.

3. Modifications of the CFC rules for insurance companies, etc.

An insurance company that conducts insurance business in a foreign country (**foreign insurance company**) without maintaining any office, etc., in that country, or outsourcing the management functions to an affiliated operating company, may fall within the Japanese controlled foreign corporation (**CFC**) rules if it is ultimately held by a Japanese corporation. Nevertheless, if such a foreign insurance company is directly held by a Japanese insurance company (Note) as a subsidiary, a special exception (**insurance consignor exception**) may apply when determining whether it can qualify as a special foreign related company, and if so, certain insurance consignors are not subject to the CFC rules. However, as the insurance consignor exception only covers insurance companies under the Japanese Insurance Business Act or foreign insurance companies directly held by Japanese insurance holding companies, foreign insurance companies indirectly held through domestic intermediate holding companies do not qualify for this exception.

The 2022 tax reform proposals expand the scope of the insurance consignor exception to include foreign insurance companies indirectly held by the Japanese insurance companies.

The amendments are effective for fiscal years beginning on or after April 1, 2022 of the foreign related company.

(Note) 'Insurance companies, etc.' above refers to those that are domestic corporations and whose main business is insurance business or that fall under the category of an insurance holding company.

4. Revisions of the calculation method for deemed dividends

Following the Supreme Court's judgment on March 11, 2021 regarding the methodology in calculating the 'portion corresponding to shares or capital contributions' for deemed dividends, deemed dividends funded by both retained earnings and capital surplus will be required to follow these revised calculations for both corporate and income tax purposes:

- (1) The capital reduction that is the basis for calculating deemed dividends related to capital repayments and the capital reduction that is the basis for calculating capital, etc., for tax purposes will be limited to the capital surplus reduced by the dividend payment.
- (2) The reduced capital that is used to calculate the capital equivalent to repayments, etc., and the capital, etc., as the basis for calculation of the deemed dividend in the case of a corporation issuing different classes of shares for the redemption of capital is to be calculated on the basis of each class of shares related to the refund of such capital.

5. Modifications to catastrophe reserve related to fire insurance, etc.

The following revisions will be made to the meanings of catastrophe reserve of insurance companies in order to prepare for the payment of insurance claims arising from significant natural disasters.

- (1) Certain types of insurance, such as fire insurance, etc., are reclassified as follows:
 - (i.) Fire insurance, storm and flood insurance
 - (ii.) Comprehensive premises and equipment, construction, freight and transportation insurance
 - (iii.) General liability insurance
- (2) The special reserve ratio for insurance listed in (1)(i) will be raised to 10% from 6%. The application period of the special reserve ratio will be extended by three years (the fiscal year starting on or before March 31, 2025). The insurance listed in (1)(iii) will be excluded from the eligible scope of the special reserve ratio.

- (3) The application period of the special reserve ratio related to fire mutual aid is extended by three years (the fiscal year starting on or before March 31, 2025).

6. Revisions of the taxation requirements of individuals as major shareholders holding shares in listed domestic corporations

Dividends paid by listed domestic corporations, etc., to an individual shareholder are subject to separate taxation as financial income if the shareholder's holding ratio is less than 3%, whereas an individual shareholder is subject to comprehensive taxation if the shareholding ratio is 3% or more.

In order to cover the scenario where an individual shareholder directly holds less than 3% in a listed domestic corporation, nevertheless whose actual holding (indirectly) ratio is 3% or more, such as when investing through other controlling corporations, the following measures will apply:

- (1) Dividends paid by listed domestic corporations, etc., to a resident individual (**Target person**) will be subject to comprehensive taxation if the percentage of the total number of outstanding stocks, etc., held by the Target person and a corporation that falls within a family corporation of the Target person (**Shareholding ratio**) is 3% or more.
- (2) A listed domestic corporation that distributes dividends shall submit a report describing the names, individual numbers, Shareholding ratio, and other matters of the Target person whose Shareholding ratio is 1% or more on the dividend record date to the Japanese tax authority within one month from the date on which the payment is determined.

The amendments are effective for dividends payable by listed domestic corporations, etc., on or after October 1, 2023.

7. Reforms of NISA System

- (1) Simplifying the checking process of an existing account

Individual investors who wish to open a Nippon Individual Savings Account (**NISA**) in a financial institution must verify by self-assessment whether they have any existing NISA in another financial institution. In order to streamline this confirmation process, investors will be able to check whether they have any existing NISA through access to the relevant database themselves.

- (2) Introduction of New NISA system

From 2024, a new dual account system (i.e., two accounts for each individual, one designed for cumulative investments (**First Account**) and the other for regular investment (**Second Account**)) will be introduced under the NISA system. The account holders must make an investment in the First Account and the Second Account in the same calendar year. Under the 2022 tax reform proposals, the account holders may make an investment in the Second Account in the next calendar year after their investment in the First Account is made, provided this is done so within six months of that First Account investment.

8. Revisions of procedures for applying income tax credit for housing loan interest

The procedures for individuals who are seeking to apply for the special credit for income tax on housing loan interest are to be revised as follows:

- (1) Application by individuals to financial institutions

An individual who wishes to apply for income tax credit for housing loan interest on or after January 1, 2023 is required to submit an application form (**Application Form**) to the

financial institution which provides the housing loans, etc., stating the individual's name and address, MyNumber, and other relevant information.

(2) Submission of reports by financial institutions

Financial institutions which receive an Application Form must by October 31 of each year following the year in which the applicant obtains the income tax credit for housing loan interest (or, for the first year, the following January 31), prepare a report that covers the applicant's information stated in the Application Form and the housing loan balance, etc. as of December 31 of that year, and submit it to the designated tax office of the financial institution's head office. The financial institutions are also required to record the details of each individual who filed applications and maintain such records.

As a result of the above changes, starting from January 1, 2023, individuals who seek to apply for the income tax credit for housing loan interest through their year-end adjustments, the certificate of year-end balance of borrowings related to housing loans will no longer be required to be attached to a special tax return for their year-end adjustments.

9. Conversion of data transmission formats from financial institutions to tax authorities

In order to promote digitization of tax filing procedures for financial institutions, certain documents, such as tax-exempt savings returns, must be submitted to the tax office in XML or CSV format via a designated electronic data processing system (e-Tax). This measure will be effective on or after January 1, 2024.

10. Tax exemption relating to the Japanese version of Sukuk - extended

The exemption on dividends received by a non-resident or foreign corporation in respect of the special purpose trust interest (formed as the Japanese version of *Sukuk* Islamic Finance) registered in the Japan Securities Depository Center, Inc. (or JASDEC) that falls under the category of corporate bond-type beneficial interest will be extended by two years (to be issued on or before March 31, 2024).

Let's talk

For a deeper discussion of how this issue might affect your business, please contact:

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