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Japan tax newsletter

Ernst & Young Tax Co.

2022 Japan tax reform outline: taxation related to finance and real estate

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The 2022 tax reform outline (hereinafter, "Outline") was released on 10 December 2021 by the LDP-Komeito ruling coalition.

This newsletter introduces the major reforms specific to finance- and real estate-related tax rules, financial institutions, and insurance companies contained in the Outline.

For a general overview of the Outline, please refer to the EY Japan tax newsletter "2022 Japan tax reform outline", dated 27 December 2021.

Please note that the contents of the tax reform proposals mentioned in this newsletter may be revised in response to future Diet deliberations concerning the reform bill.

Building a better working world

1. Financial services taxation

(1) Revision of withholding tax rules related to dividends of wholly owned subsidiary shares

Under the current rules, payments of dividends are subject to withholdings of income tax and reconstruction income tax at a tax rate of 15.315% — in addition to a local tax of 5% in the case of dividends on listed shares — and 20.42% — without the imposition of local tax in the case of dividends on shares other than the listed shares. The withholding of taxes is also applied on dividends related to shares of wholly owned subsidiaries — which are wholly excluded from taxable income — and any credits that remain after offsetting income taxes in the corporate tax return gives rise to tax refunds and interest on tax refunds.

Due to this year's reform, income tax will not be levied on the dividends depicted below and that is to be received from certain domestic companies, on or after 1 October 2023. Additionally, income tax will not be withheld at source in relation the following dividends:

(i) Dividends related to the shares deemed as shares of a wholly owned subsidiary (i.e., 100% shareholding ratio)

(ii) Dividends related to the shares of another domestic company whose shares are directly owned by a domestic company (limited to those owned with the domestic company as the registered holder; same hereinafter) as of the record date related to the payment of dividends, provided that the ratio of outstanding shares against the total shares of that other domestic company exceeds one-third

The term "certain domestic companies" above refers to domestic companies, other than those categorized as general incorporated associations, general incorporated foundations (excluding public interest incorporated associations and public interest incorporated foundations), associations without legal personality, or companies other than companies deemed as public interest corporations pursuant to laws other than the Corporation Tax Act.

(2) Measures related to Nippon Individual Savings Account (NISA)

To encourage more citizens to take advantage of installment-type and diversified investments, in the 2020 tax reform, a tax-exemption measure — the new NISA program — pertaining to specified tax-exempt cumulative investment agreements was introduced to replace the ordinary NISA stipulated under the current rules. Starting from 2024, individual investors will be able to choose between the new NISA program or the installment-type NISA program stipulated under the current rules. The new NISA program consists of a specified cumulative investment account — first tier — which is a tax-exemption limit for installment-type investments and a specified tax-exempt management account — second tier — which is a tax-exemption limit for investments identical to that of the ordinary NISA stipulated under the current rules. Individuals will generally be required to make a first-tier installment-type investment, prior to use of the second-tier tax exemption.

In regard to the criteria pertaining to the placement of listed shares in the second tier, when specified cumulative investment listed shares have been placed in the first tier, this year's reform will deem that said criteria is fulfilled in the event that the specified cumulative-investment-listed shares are placed in the first tier within six months prior to the date when the listed shares are scheduled for placement in the second tier and in the year prior to the year in which the said date falls.[1] Excluding cases when experienced investors invest only in listed shares in the second tier, the current rules stipulate that in the case when individual investors have not placed specified cumulative-investment-listed shares in the first tier in a given year within six months prior to the date when the listed shares are scheduled for placement in the second tier, the listed shares acquired may not be placed in the second tier.

[1] Article 37-14, paragraph (5), item (vi) of the Act on Special Measures Concerning Taxation (hereinafter, "ASMT"), and Article 25-13, paragraph (25), item (iv) (a) 1. of the Order for Enforcement of the ASMT (hereinafter, "ASMT Order").

Additionally, with respect to the above rules, operational measures will be implemented to enable a resident to confirm whether a tax-exempt account has been opened in their name. Various measures will be established, so that the investors will immediately be able to confirm whether their NISAs have already been opened, instead of waiting for the screenings conducted by the tax office to be completed during the financial institutions' process of opening NISAs.

(3) Measures concerning the formats of files submitted via e-Tax

The formats of the following files that are submitted to the district director of a tax office, on or after 1 January 2024, via a method using an electronic data processing system (e-Tax) will be limited to Extensible Markup Language (XML) or comma-separated values (CSV):

(i) Application form for (special) tax-exempt savings;

(ii) Application form for changes in the limit of (special) tax-exempt savings;

(iii) Application form for changes concerning (special) tax-exempt savings;

(iv) Application form in the event a business transfer has occurred at the financial institution;

(v) Application form for cancellation of (special) tax-exempt savings;

(vi) Notification of the deemed cancellation of (special) tax-exempt savings;

(vii) Death notification of the (special) tax-exempt saver;

(viii) Notification concerning the office of the financial institution;

(ix) Detailed statement pertaining to non-application of withholding tax levied on distributions of profit received by the financial institution; and

(x) Application form for the non-application of withholding tax related to distributions of profit received by the financial instrument business operator, that bought beneficial interests pertaining to publicly offered stock-investment trusts.

(4) Revision of the criteria defining major shareholders of the special measure concerning the taxation of the dividend income related to the listed shares

Under the current rules, a special measure has been established to permit a nonresident who owns a permanent establishment in Japan or a resident (hereinafter, "resident, etc."), who receives dividends of listed shares to be subject to a withholding tax rate of 15.315% for national income tax and special income tax for reconstruction, and to select either comprehensive taxation or separate self-assessment taxation, but a resident, etc. who owns shares equivalent to 3% or more of the shareholding ratio as of the record date of the dividends (i.e., a major shareholder) is ineligible for application of the special measure, and is subject to a withholding tax rate of 20.42% for national income tax and special income tax for reconstruction, as well as to comprehensive taxation.

For this reason, even if a resident has ownership of additional shares through a company owned or controlled by said resident, so long as the shareholding ratio of the resident as an individual is less than 3%, said individual is permitted to apply the special measure and select the separate self-assessment taxation.

In view of this situation, this year's reform will introduce the following measures related to dividends of listed shares, that is to be received on or after 1 October 2023:

(i) In the case of dividends related to listed shares received from a domestic company, if the ratio of outstanding shares owned by a resident, etc. (hereinafter, "shareholder") and a family company, when said shareholder is selected as the main shareholder to evaluate whether that company is a family company (i.e., shareholding ratio) against the total shares of said domestic company equals 3% or more, then the dividends received by said shareholder will be subject to comprehensive taxation.

(ii) A domestic company that pays dividends related to listed shares must submit a report that includes the name, personal identification number (or My Number), shareholding ratio and other relevant data of shareholders who comprise 1% or more of the shareholding ratio, as of the record date pertaining to the payment of those dividends to the district director presiding over the tax office of the head office or principal office of the domestic company within one month from the date the payment was finalized (i.e., resolution date).

(iii) Other necessary measures will also be established.

Caution is required by residents who own private investment companies, since the determination of whether said resident is subject to comprehensive taxation will be made based on the shareholding ratio of the shareholder group.

In addition, domestic companies that pay dividends related to listed shares will be obligated to submit a report concerning individual shareholders who own 1% or more of its listed shares in the near future. Although they will have a slight amount of time to make preparations ahead of the application of this reform, they will be required to establish and develop a process for preparing the report.

2. Corporate taxation

(1) Revision of the special provisions concerning the catastrophic loss reserves of insurance companies

The catastrophic loss reserves of insurance companies are extensively used and exhausted due to the increasing frequency and severity of natural disasters, such as typhoons and floods. To secure sufficient reserve balances to be established, the following revisions will be made to the special provisions concerning the catastrophic loss reserves pertaining to fire insurance and other disaster insurance:

(i) The reserve rate stipulated by special provisions pertaining to fire insurance and other disaster insurance

The reserve rate of catastrophic loss reserves of non-life insurance companies is 6% of the insurance premiums due to a transitional measure implemented under the current rules.[2] But this year's reform will divide fire insurance and other disaster insurance into the three categories listed below, and a reserve rate will be set for each category.

The reserve rate stipulated by special provisions for fire insurance, and storm and flood insurance will be raised to 10%. The liability insurance will be excluded from the scope of said special provisions and the application period of the special provisions will be extended by a period of three years.

Current rules (effective until 31 March 2022)		Post-revision rules (effective until 31 March 2025)	
Category	Reserve rate	Category	Reserve rate
Fire insurance, storm insurance, flood insurance, comprehensive property insurance, construction insurance, cargo insurance, freight insurance and liability insurance	6% (transitional measure)	(a) Fire insurance, storm insurance and flood insurance	10% (transitional measure)
		(b) Comprehensive property insurance, construction insurance, cargo insurance and freight insurance	6% (transitional measure)
		(c) Liability insurance	2% (No special measure provided by a transitional measure)

(ii) The reserve rate stipulated by special provisions in relation to mutual aid fire insurance plans and fire mutual aid cooperatives

Under the current rules, the reserve rate of the catastrophic loss reserves of mutual aid fire insurance plans is set at 4% (in contrast to the basic rate of 2%) of insurance premiums due to the transitional measure that is effective until 30 March 2022.[3] However, its application period will be extended by a period of three years.

As a result of this year's reform, caution is required regarding the need to divide and manage the relevant insurances into each bucket, in accordance with their respective applicable loss reserve rates when filing tax returns and calculating taxes, since reserve rates for catastrophic loss reserves will be divided into several categories, such as the fire insurance rate.

[2] Article 33-12, paragraph (5), item (ii) of the ASMT Order (basic rate) and paragraph (20) of the ASMT Order (reserve rate stipulated by special provisions).

[3] Article 33-2, paragraph (5) of the ASMT Order (basic rate) and paragraph (19) of the same (reserve rate stipulated by special provisions).

(2) Revision of the calculation method of deemed dividends

A decision by the Supreme Court of Japan on 11 March 2021 indicated its interpretation of the provisions concerning the calculation method of the portions corresponding to shares or contributions, in cases when dividends of surplus sourced from both retained earnings and capital surplus (hereinafter, "mixed-source dividends") are paid. The following revisions will be implemented in regard to the calculation method of deemed dividends in relation to the return of capital from a corporate tax and income tax perspective:[4]

(i) The investment principal repayment – which serves as the basis for calculating deemed dividends related to the return of capital – and the amount of reduced capital – which serves as the basis for calculating the amount of capital for tax purposes – will be capped at the amount of capital surplus decreased due to said return of capital.

It should be noted that the same will apply regarding the calculation of deemed dividends related to the return of capital and the amount of capital reduction.

(ii) In the case when a company that issues multiple classes of shares repays capital, the investment principal return – which serves as the basis for calculating deemed dividends – and the amount of reduced capital – which serves as the basis for calculating the amount of capital for tax purposes – must be calculated based on the amount of stated capital of each class of shares related to the said return of capital.

The above treatment had been indicated on the National Tax Agency website on 25 October 2021. It is stated therein that the above treatment may be applied retroactively to past years to which retroactive application is permissible under tax laws and regulations.

In addition, caution is required because if the tax profit reserve of the company returning the capital has a negative balance, then the investment principal repayment that is calculated may exceed the (actual) capital surplus that was reduced due to the return of capital.

Furthermore, interested parties will be required to confirm the details of laws and regulations that will be enforced as examples for clarification concerning the actual calculation method of deemed dividends related to the return of capital carried out by a company that issues multiple classes of shares.

(3) Clarification of the limit on advanced depreciation by reduction of book value of fixed assets acquired using subsidies

Under the current tax system, the National Tax Agency explains the treatment of national subsidies received for the acquisition of fixed assets in its examples of written responses. Going forward, said treatment – whose details are listed below – will be transformed into law:

(i) Rules concerning the deductibility of advanced depreciation conducted by reduction of book value of fixed assets acquired using national subsidies

(ii) Rules concerning the deductibility of advanced depreciation conducted by reduction of book value of fixed assets acquired using construction payments by the users

(iii) Rules concerning the deductibility of advanced depreciation conducted by reduction of book value of fixed assets acquired by non-contribution partnerships using allotted money

(iv) Rules concerning the deductibility of advanced depreciation conducted by reduction of book value of fixed assets acquired using insurance proceeds

(v) Special taxation measure for the acquisition of substituted assets due to expropriation

[4] Article 23, paragraph (1), item (iv) of the Order for the Enforcement of the Corporation Tax Act and Article 61, paragraph (2), item (iv) of the Order for Enforcement of the Income Tax Act.

(4) Revision of rules concerning the deductibility of the acquisition price of low-value assets used for leasing

In the cases of the special measure for deduction of the acquisition price of low-value depreciable assets and the special measure for deduction of lump-sum depreciable assets, any such assets used for leasing (excluding that conducted as a primary business) will be excluded from the scope of assets eligible for said measures.

Furthermore, in the case of the special measure for deduction of the acquisition price of low-value depreciable assets for small and medium enterprises (SMEs), any such assets used for leasing — excluding that conducted as a primary business — will be excluded from the scope of assets eligible for said measure. Additionally, the application period will be extended by a period of two years, to 31 March 2024.

> This revision will not affect low-value assets leased by leasing companies and low-value assets leased together with rooms leased by real-estate leasing companies. However, interested parties will be required to confirm the details of tax laws and regulations that will be enforced as examples for clarification concerning "that conducted as a primary business."

(5) Special measure for the taxation pertaining to the Banks' Shareholding Purchase Corporation

In the case of the special measure for the taxation pertaining to the Banks' Shareholding Purchase Corporation, the application period of the special measure concerning the maximum deduction of net operating losses (NOLs) will be extended by a period of four years.[5] In addition, the special measure concerning the period when NOLs may be carried forward and the special measure concerning the maximum deduction of NOLs will be incorporated as provisions of the Act on Special Measures Concerning Taxation.

[5] Article 58 of the Act on Limitation on Shareholding by Banks and Other Financial Institutions.

3. International taxation

(1) Revisions to the earnings stripping rules

Under the current tax rules, regarding a foreign company, the earnings stripping rules are only applied to the applicable interest expenses of businesses conducted by that foreign company via its permanent establishment (PE) in Japan.

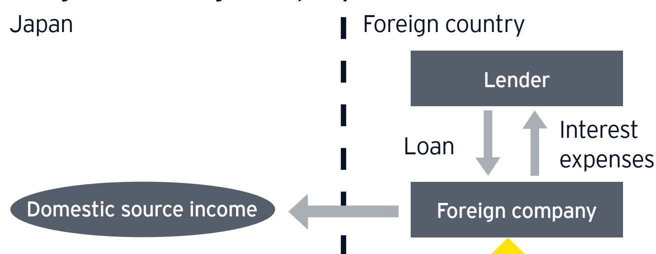
Due to this year's reform, the earnings stripping rules will apply to income related to the following types of domestic source income, subject to the corporate tax of foreign companies:

(i) Domestic source income not attributable to PE income generated by foreign companies that have a PE in Japan

(ii) Domestic source income generated by foreign companies that do not have a PE in Japan

Furthermore, necessary measures will also be implemented regarding corporate inhabitant tax and corporate enterprise tax, in accordance with the revisions of the earning stripping rules implemented at the national tax level.

(Diagram: A foreign company without a PE)



Current rules: Not in the scope of application of the earnings stripping rules (interest expenses are deductible without limit)
Outline: Included in the scope of application of the earnings stripping rules

> Caution is required in the case where foreign companies receive compensation for leasing domestic real estate or generate capital gains on share transfers considered similar to business transfers, which is the income not attributable to their PEs).
>
> Furthermore, since the earnings stripping rules are applied to income attributable to PEs of foreign companies under the current tax rules, interested parties will be required to confirm the content of tax laws and regulations that will be enforced as examples for clarification concerning the details of provisions related to the application of the earnings stripping rules to domestic source income not attributable to PE income generated by foreign companies.

(2) Revision of the special measure for Japanese controlled foreign company (J-CFC) rules made available to insurance companies and insurance holding companies

In the case of the determination of specified foreign-affiliated companies which are eligible for application of the special measure for insurance consignors, the requirement of being a foreign-affiliated company whose outstanding shares are directly or indirectly owned by a single insurance company, or an insurance company that has a specified capital relationship with the single insurance company, will be revised as follows, for fiscal years beginning on or after 1 April 2022 for foreign-affiliated companies:[6]

(i) Added to the scope of "a single insurance company" stated above will be domestic companies (excluding insurance companies) whose total outstanding shares are directly or indirectly owned by an insurance company (hereinafter, "eligible domestic companies") and that fulfill each following requirement:

(a) The sole business of the eligible domestic company is business management and businesses incidental thereto on behalf of a foreign-affiliated company (limited to those in whom the eligible domestic company directly or indirectly owns all or a part of their outstanding shares) whose primary business is the insurance business or a relevant business, and over 50% of whose outstanding shares are directly or indirectly owned by a 100% capital relationship domestic company group (i.e., the eligible domestic company and all domestic companies that have a specified capital relationship with the eligible domestic company).

(b) The other domestic companies that are related to the 100% capital relationship domestic company group stated in (a) above – limited to those that directly or indirectly own all or a part of the outstanding shares of the foreign-affiliated company stated in (a) above and excludes insurance companies; the same applies in (ii) – only carry out business management of that foreign-affiliated company and businesses incidental thereto.

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[6] Article 39-14, paragraph (3), item (i) of the ASMT Order. Special provisions for insurance consignors in relation to the substance criteria employed in the determination of shelf controlled foreign companies.

(ii) Added to the scope of "an insurance company that has a specified capital relationship with the single insurance company" stated above will be the other domestic companies that are related to the 100% capital relationship domestic company group stated in (i) (a) above, and that only carry out business management of the foreign-affiliated company stated in (i) (a) above and businesses incidental thereto.

It should be noted that an "insurance company" refers to a domestic company whose primary business is the insurance business or an insurance holding company. A "specified capital relationship" refers to a relationship where one of two companies, directly or indirectly, owns all or a part of the outstanding shares of the other company.

It should also be noted that the revisions identical to the ones described above will be applied to the Lloyd's special measure employed in the determination of specified foreign-affiliated companies (applicable if insurance underwriting subsidiaries and management subsidiaries in the UK's Lloyd's market that are incorporated in accordance with local laws and regulations act as a unit to operate an insurance business).

Furthermore, necessary measures will be implemented regarding corporate inhabitant tax and corporate enterprise tax in accordance with the revisions of the Japanese CFC rules implemented at the national tax level.

Subsequent to this year's reform, it will become possible for certain foreign-affiliated companies that are owned by a domestic company via a domestic intermediate holding company and that do not fall under the category of insurance businesses or insurance holding companies, to fulfill the shelf company substance criteria under Japanese CFC rules.

(3) Clarification of the treatment of income generated by the settlement of derivative transactions

Tax laws and regulations will be modified to clearly state that income generated by the settlement of listed derivative transactions or over-the-counter (OTC) derivative transactions defined under the Financial Instruments and Exchange Act will not fall under "domestic asset managing or holding income" – a category of domestic source income under the Income Tax Act and the Corporation Tax Act.

The same treatment will be applied to "foreign asset managing or holding income" – a category of foreign source income used to calculate foreign tax credits.

Since this year's reform clarifies treatment of the above income, interested parties will be required to confirm the details of tax laws and regulations that will be enforced as examples for clarification concerning its impact on the treatment of the above income of past fiscal years, including the treatment of income generated from transactions other than derivatives.

(4) Extension of the application period of the tax exemption rules pertaining to Japanese sukuk

As a tax incentive to attract Islamic money from overseas, the 2011 tax reform established tax exemption rules for dividends from book-entry beneficial interests in specified purpose trusts, in the form of corporate bond-type beneficial interests – known as Japanese sukuk – that are received by nonresidents or foreign companies.[7]

This year's reform will extend the application period of these tax exemption rules, which are set to expire on 31 March 2022, by a period of two years.

[7] Article 5-3 of the ASMT.

4. Other

(1) Burden adjustment measures for fixed asset tax and city planning tax levied on land

The taxable bases of fixed asset taxes are determined based on revaluations of land conducted once every three years and the said taxable bases are applied for the following three consecutive years. A burden adjustment measure on commercial land effective until the year 2023 has been established to suppress the sudden increase of tax burdens caused by surging land prices.

Burden ratio(*1)	Land price trend	Taxable base of the current fiscal year after the burden adjustment
More than 70%	Decreasing or slightly increasing	Valuation for fixed asset taxation x 70%
60% to 70% (inclusive)(*2)	Further increasing	Pegged to that of the previous fiscal year (FY)
Less than 60%	Surging	Taxable base of the previous FY (after the burden adjustment) plus valuation for fixed asset taxation x 5% (a minimum of 20% of the valuation amount and a maximum of 60% of the same)

**1 = ratio derived by dividing the taxable base of the previous FY(after the burden adjustment) by the taxable base of the current FY(prior to the burden adjustment)*

**2 = 65% or less in the case of Tokyo prefecture*

As a temporary measure limited to 2022 for the purpose of ensuring economic recovery, only the taxable base of commercial land (limited to land whose burden ratio is less than 60%) for 2022 will be set as the sum of 2.5% (as opposed to 5% under the current rules) of the assessed value for 2022 and the taxable base of 2021. (However, if said sum exceeds 60% of the assessed value, then an amount equivalent to 60% must be used. On the other hand, if said sum is below 20% of the assessed value, then an amount equivalent to 20% must be used.) The treatment of residential land and agricultural land will remain unchanged.

(2) Extension of the reduction measure of stamp duties levied on real estate purchase and sales agreements

The application period of the special tax measure for the reduced tax rates of stamp duties pertaining to agreements related to the transfers of real estate will be extended by two years, to 31 March 2024.

(3) Trust tax report for each individual beneficiary

Under the current rules, in the case of the trust tax report for each individual beneficiary (by settlor), an exception was made, such that if it is extremely difficult to calculate the value for inheritance tax purposes that is to be entered into the field – "value of the trust property" – then the report can be submitted without that information. However, as the reports are frequently submitted without "value of the trust property" values, the tax authorities are not able to effectively utilize the reports for their review and tax audits.

In the case of the reports that are to be submitted on or after 1 January 2023, this year's reform will require that an estimated value be entered in the field – "value of the trust property" – if it is extremely difficult to calculate the value for inheritance tax purposes.

(4) Stamp duties of loan agreements in relation to special loans provided due to the COVID-19 pandemic

Currently, stamp duties of loan agreements prepared on or before 31 March 2022, in relation to loans provided by public lending institutions or financial institutions to enterprises whose management has been impacted by measures to prevent the spread of COVID-19 under especially advantageous terms compared with the terms of other cash loans, are tax exempt. The application period of this tax exemption measure will be extended by a period of one year.[8]

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[8] Article 11 of the Act on Special Measures to Temporarily Revise National Tax-related Acts in Response to the Impact of COVID-19.

(5) Measure for the taxation method pertaining to dividend income of listed shares

Under the current rules concerning individual inhabitant tax, there are three methods available for taxing specified dividends and capital gains on specified share transfers, which are:

(i) Comprehensive self-assessment taxation

(ii) Separate self-assessment taxation

(iii) Separate withholding taxation (i.e., returns do not need to be filed)

The 2017 tax reforms made it possible for taxpayers to elect different taxation methods regarding individual income tax and individual inhabitant tax.

This year's reform will require that the taxation method of income pertaining to specified dividends and capital gains on specified share transfers are in accordance with that of national individual income tax.

As a result, the following measures will be introduced:

(i) Provisions will be established such that eligibility requirements concerning the use of capital losses pertaining to listed shares for offsetting dividend income of listed shares and carrying them forward as deductible losses are in accordance with those for national individual income tax.

(ii) Other necessary measures will also be established.

This revision will apply to individual inhabitant tax for 2024. Thereafter and furthermore, the requisite transitional measures will be implemented.

(6) Unification of financial income taxation pertaining to derivative transactions (item for consideration)

The Outline states that, while carrying out discussions regarding all aspects of the ideal form of financial income taxation, the Central Government will promptly carry out discussions concerning the further unification of financial income taxation pertaining to derivative transactions, in view of previous discussions concerning policies to prevent intentional tax avoidance acts.

For additional information with respect to this alert, please contact the following:

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