Tax System Reform to Invigorate Japanese Securities Markets: Encouraging Securities Investments among Private Individuals

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On June 4, 2001, the Capital Market Research Department of Nomura Research Institute announced that it had produced a report concerning Japanese tax system reform. It includes several important proposals on taxation related to securities transactions. The following is a summary of the report.

To invigorate Japanese securities markets and to enhance the role of the direct financing system allocating financial resources through market mechanisms, the taxation system governing securities transactions needs to be redesigned. The reform plan should not be simply a proposal of preferential treatment for securities transactions. Instead, it should aim to establish the principle that securities investments should always result in appropriate risk-adjusted returns after tax deduction.

According to the comprehensive income tax theory, which has been generally supported in Japan, financial income derived from securities transactions should be subject to progressive income tax. However, as financial assets move swiftly out of a country once taxation is tightened, we consider it is more desirable to adopt a dual income tax system that separates financial income from wages and imposes upon it a flat rate of tax. Taking this as our basis, we have discussed each issue focusing on individual income tax.

1. Capital gains tax on stock transactions

Great arbitrariness is involved in the current system enabling a choice of withholding tax at source and self-assessed income tax separated from other income. Furthermore, the calculation of deemed income subject to withholding tax is highly problematical. If, however, the self-assessed income tax is the only method of taxation on capital gains derived from stock transactions, ordinary employees not accustomed to filing tax returns are likely to avoid stock investments. It should also be noted that competing financial products such as bank deposits and investment trusts are only subject to a 20% withholding tax. We therefore propose that any income derived from transactions carried out through a controlled securities account (we shall call it "my account") be exempt from final return filings if certain conditions are fulfilled. We assume that those conditions are fulfilled if a securities company knows the exact purchasing and selling prices of stocks traded through the account.

Also we propose that a securities company pays taxes at a flat rate tax based on its annual profit. Any trade on "my account" should be subject to preferential treatment, including tax deductions on long-term profits or carry-forwards of losses. A final return, however, would be necessary if an individual holds several accounts with different securities firms or the exact purchasing prices cannot be established. The tax rate applied to capital gains on stock transactions should be 15 percent (national tax at 10 percent and local tax at 5 percent), which is the lowest rate of progressive income tax.

2. Double taxation on dividends

We consider the current system of tax credits for dividend income to be a proper method for eliminating double taxation on corporate profits and individual income. It is undesirable to introduce an imputation system to eliminate double taxation, since the idea is based on comprehensive income tax theory.

3. Transactions on government and corporate bonds

We propose that the "my account" system discussed above should also be applied to income and capital gains derived from bond transactions. Securities firms and banks should deduct withholding tax from "my account" holders, and the obligation to file final returns should be abolished. If a transaction is carried out outside the controlled securities account, income gain would be subject to withholding tax and a final return would have to be filed in order to receive tax credits for losses. However, as far as transactions between institutional investors in bond markets are concerned, withholding tax should be abolished to enhance the liquidity of the markets and strict measures to detect tax evasion (such as a taxpayer identification number system) should be implemented.

4. Investment trusts

We propose that "my account" be used to introduce a tax to offset realized losses against gains from transactions on investment trusts. Carry-forwards of losses to following years should also be recognized.