The Impact of the Reforms to the Taxation of Securities in Japan

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On 2 October, 2001, the government coalition finalized its proposed amendments to the system of taxing securities. The main amendments are as follows:

- The requirement that investors must declare any capital gains on the sale of securities if they wish to have them taxed separately from income (and the abolition of the option to have such gains automatically taxed separately) will be brought forward to January 2003.
- Following this, a system of carry-forward allowances for capital losses on the sale of securities will be introduced.
- The tax rate for listed equities will be 20% as a rule, but this will be reduced to 10% until the end of 2005 for shares held for more than 12 months.
- Listed equities purchased during 2002 (with a maximum value of ¥10 million) will be exempt from capital gains tax if they are sold between 2005 and 2007.
- The special allowance of ¥1 million for long-term shareholdings will be extended until the end of 2005.
- An investor may choose to have the acquisition cost of listed equities purchased before 30 September, 2001, and disposed of between 2003 and 2010 calculated as 80% of their value on 1 October, 2001.

There are hopes that these amendments, which are aimed at retail investors, will reinvigorate the stock market, and the reaction of such investors will be followed with considerable interest.

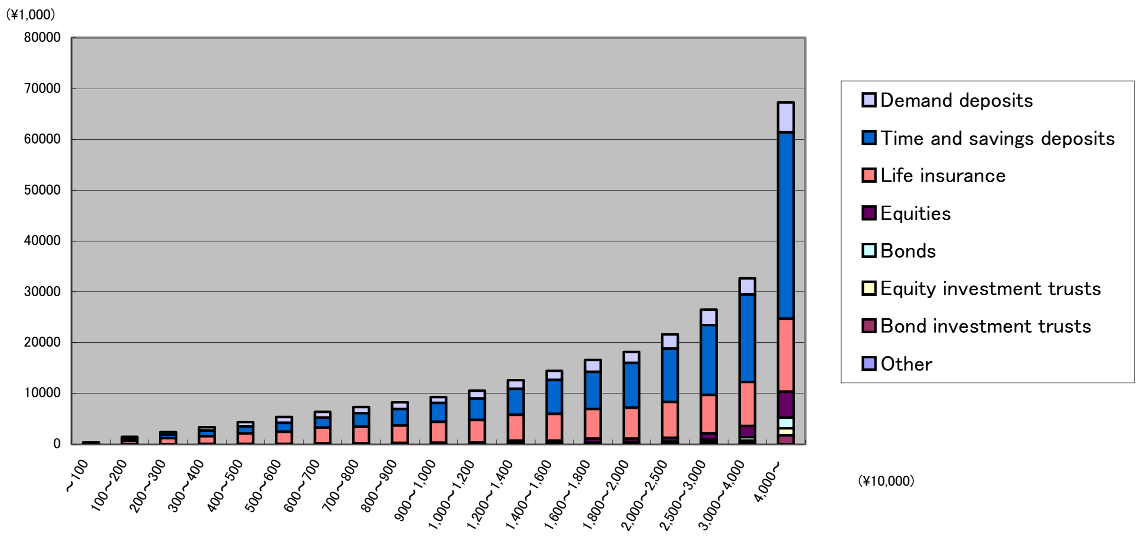
This report considers the likely impact of the amendments and how they might be improved.

1. Current State of Japanese Household Finances

In the 15 years since the end of 1986, Japanese personal financial assets have increased from roughly ¥650 trillion to ¥1,400 trillion. During this period the share of cash and (savings) deposits has remained more or less the same at 50%-59%. The share of insurance has risen from about 15% to just under 30%, while that of equities has declined from about 10% to about 5%. The share of cash and (savings) deposits has hardly altered in spite of the asset boom of the late 1980s, the bust that followed and the start of Japan's Big Bang program of financial reform. The average Japanese household has ¥17.37 million in financial assets, ¥8.13 million (or 47%) of which is in the form of time and savings deposits and ¥1.75 million (or 10%) in the form of demand deposits. The share of demand deposits has varied between 7% and 10% when viewed at five-yearly intervals.[1]

According to a survey of household financial assets carried out this year, 62.6% of those interviewed replied in response to the question what effect low interest rates had had on their savings behavior that they had not had any particular effect. As a result of this inertia, half of all personal financial assets have remained in the form of cash and (savings) deposits. A breakdown of personal financial assets by the level of household savings (see Figure 2) shows that, the more assets a household has, the higher the share of time and savings deposits is likely to be and the lower that of demand deposits, while equities are likely to account for a significant share.[2]

Figure 1 Breakdown of Personal Financial Assets by Product Value and Savings Level



Source: NRI, from the Management and Coordination Agency's Survey of Savings Trends (2000).

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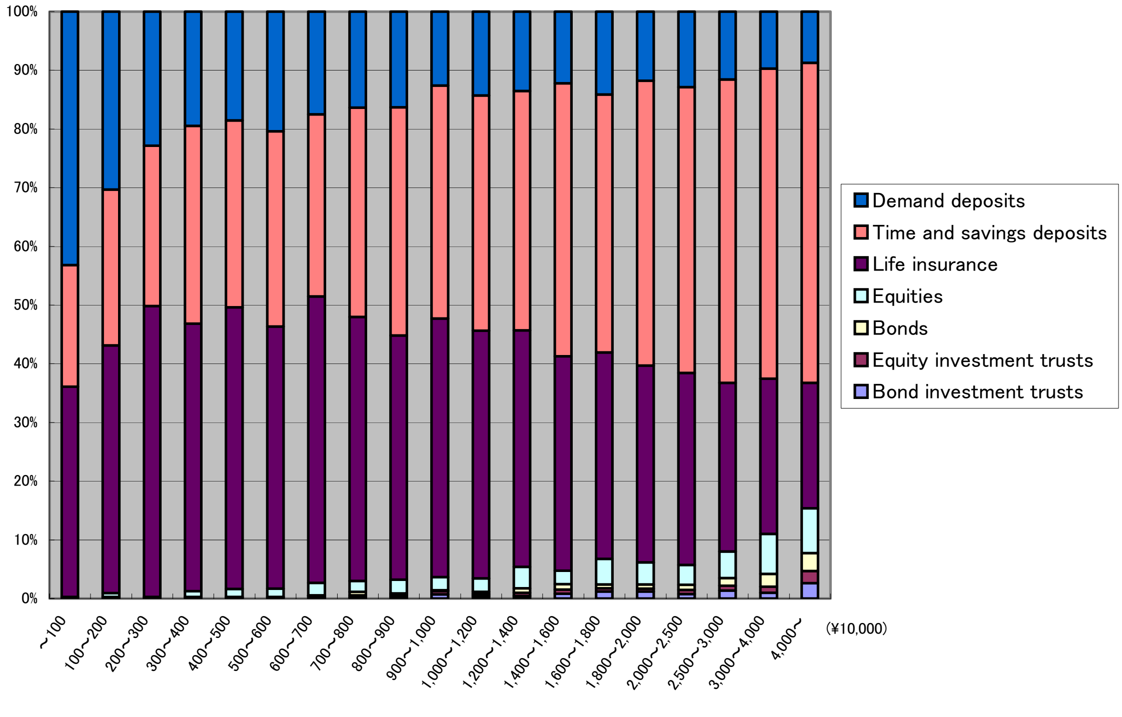
1 Data are taken from the Management and Coordination Agency's Survey of Savings Trends (2000).

2 For further information about changes in personal financial assets since Japan's Big Bang program of financial reform, see Masanobu Iwatani, "The Composition of Personal Financial Assets in the Wake of Japan's 'Big Bang'," Capital Research Journal, Spring 2001.

Figure 2 Breakdown of Personal Financial Assets by Product Ratio and Savings Level



Source: NRI, from the Management and Coordination Agency's Survey of Savings Trends (2000).

2. Impact of the Taxation Reforms on Japan's Securities Markets

1) The changes in securities taxation

First, the impact on the stock market from increased capital inflows as a result of tax reductions (e.g., the reduction in the tax on capital gains from the sale of securities from 26% to 20% and the reduced rate of 10% for the first three years) is expected to be limited. While some investors may defer selling securities until after 2002 in expectation of the lower rate of taxation of capital gains declared and taxed separately from income, others will feel that they are paying a higher rate of tax on capital gains of 5.6% or more[3] (as a result of the abolition of the option to have such gains automatically taxed separately) in spite of the risk they are taking, and the overall effect may be to reduce investors' appetite for risk. There may also be a rush to sell by long-term holders of securities whose acquisition costs are considerably lower than current market prices before the option is abolished—just as there was the last time this decision was made.

3 Calculated on the following basis: taxable amount of capital gains on the sale of securities declared and taxed separately from income = taxable amount of capital gains on the sale of securities automatically taxed separately from income; i.e., acquisition cost × percentage gain × 20% = acquisition cost × (1 + percentage gain) × 1.05.

The establishment of a system of carry-forward allowances for capital losses will allow investors to offset against gains any losses on securities sold after 31 December, 2002. They will be able to carry forward to the following three years (2004-2006) any losses that exceed the annual allowance. This is the system now used in the United States and Europe, and it accords with the principle that investors should have the opportunity to realize an after-tax return on their investments that reflects the risk involved. Unlike the United States and the United Kingdom, however (where capital loss allowances can be carried forward indefinitely), it is proposed to limit this to three years in Japan—something that perhaps needs to be reconsidered.

The measure that will perhaps have the most immediate impact on the stock market is the proposal for a ¥10 million tax-free limit on purchases of securities as an emergency investment incentive.

Investors who purchase listed equities between the date the amendments come into effect and the end of 2002 will be exempted from tax on gains from the first ¥10 million of their investment if they realize the gains in 2005-2007. Given (1) the fact that this window of opportunity will be open for only 12 months or so and that this may induce some investors to bring forward purchases that they might otherwise have made later and (2) the fact that, although investors are cautious, the stock market is at a low level, this could prove an effective incentive. The ¥10 million limit is equivalent to 70% of per capita personal financial assets in Japan—considerably more than the tax-free limit on personal equity plans (PEPs) in the United Kingdom (equivalent to 15% of UK personal financial assets when PEPs were introduced), although the UK limit can be rolled over.

2) Likely impact of ¥10 million tax-free limit

The Survey of Securities Savings by the Japan Institute for Securities Information and Public Relations gives a picture (broken down by householder income and age) of how interested Japanese households are in purchasing equities. The data can also be used to estimate the likely response by retail investors to the tax-free limit that has been proposed. In the following we shall consider this in terms of (1) annual income (namely, the likely amount of money available for investment) and (2) age (namely, the likely investment period). Strictly speaking, both criteria should produce the same result, but we shall endeavor to be as realistic as possible by introducing a qualitative element.

The Survey of Securities Savings indicates that, in terms of annual income, households are more likely to be interested in purchasing equities the higher their income is. Using the survey's data, we shall estimate how much money interested households are likely to invest in the stock market, assuming that they make the investments during the period the tax-free limit is available and use some of the money they previously held in the form of time and savings deposits.

Households whose income is zero but which have inherited considerable assets and those whose assets have increased temporarily in relation to their income as a result of retirement have also been included. These statistics may therefore give an inflated picture of the savings of low-income households. Similarly, the fact that, in order to be eligible for the tax-free limit, households will have to complete a tax return may mean that some investors who are not used to this will be deterred. We have tried to allow for this in our estimate of the likely inflow of money into the stock market by weighting the statistics by a factor of 0.8 for households with an income of less than ¥5 million, 0.9 for those with an income of ¥5 million-¥15 million, and 1.0 for those with an income of more than ¥15 million.

Table 1 Breakdown of Level of Savings and Interest in Investing in Equities by Householder Income

Income (¥10,000)	～200	200～300	300～400	400～500	500～700	700～1,000	1,000～1,500	1,500～
Number of households (10,000)	129.0	339.3	536.0	560.1	1029.4	959.6	612.4	223.8
Savings level (¥1,000)	9,046	12,741	14,558	15,270	14,770	17,875	23,396	43,108
Demand deposits	951	1,632	1,606	1,678	1,639	1,842	2,771	4,492
Time and savings deposits	5,064	6,556	7,876	7,701	6,948	8,310	10,604	18,429
Life insurance	2,604	3,539	3,791	4,095	4,713	5,407	6,862	11,058
Equities	164	285	475	606	598	822	1,890	4,146
Bonds	12	86	237	411	266	243	552	820
Equity investment trusts	39	60	138	198	217	166	263	990
Bond investment trusts	22	87	79	112	123	233	242	1,635
Loan trusts	66	497	241	377	157	129	120	390
Interest in investing in equities	1.4%	1.7%	2.4%	2.4%	5.2%	6.3%	7.7%	14.8%
Likely inflow into stockmarket (¥100 mil)	732.0	3,078.3	8,147.0	8,244.7	33,293.4	45,162.6	44,104.2	61,272.1

Note: The figures for the savings level and each product are for households in units of ¥1,000.

Source: NRI, from the Management and Coordination Agency's Survey of Savings Trends (2000) and the Survey of Securities Savings by the Japan Institute for Securities Information and Public Relations.

According to our estimate, some ¥20 trillion[4] of household financial assets can be expected to be diverted to the stock market on this basis. Moreover, our calculations suggest that households with an income of more than ¥15 million are likely to purchase an average of ¥2.7 million of equities—an amount easily accommodated by the ¥10 million tax-free limit. Also, given that the average savings of these households is more than ¥40 million, it would not be surprising if the tax-free limit were to make a significant number of those who replied that they were not very interested in investing in equities but were considering the possibility begin to make investment plans if they expect their income to remain at the same level.

Next let us estimate the likely inflow of household financial assets into the stock market by using the statistics on the age of householders.

Table 2 Breakdown of Level of Savings and Interest in Investing in Equities by Householder Age

Age (years)	～24	25～29	30～34	35～39	40～44	45～49	50～54	55～59	60～
Number of households (10,000)	16.2	131.7	308.2	414.9	387.6	491.2	574.2	491.6	1574.2
Household income (¥1,000)	3,515	4,764	6,095	6,263	7,650	8,733	8,992	9,612	5,946
Savings level (¥1,000)	1,058	4,911	6,472	8,969	11,378	13,536	15,749	20,775	26,357
Demand deposits	489	837	1,223	1,301	1,261	1,370	1,713	2,247	2,771
Time and savings deposits	248	1,814	2,314	3,187	4,554	5,461	6,890	9,423	13,791
Life insurance	318	1,776	2,249	3,110	4,362	5,052	5,608	6,587	6,083
Equities	0	199	155	263	428	530	715	1,192	1,531
Bonds	0	2	80	44	115	86	211	290	613
Equity investment trusts	0	18	41	39	44	73	69	200	425
Bond investment trusts	0	79	54	571	98	86	54	220	427
Loan trusts	0	0	18	8	44	84	123	131	459
Interest in investing in equities	0%	1.2%	3.6%	4.4%	3.3%	3.6%	5.0%	5.9%	5.4%
Likely inflow into stockmarket (¥100 mil)		258.0	2,310.5	5,235.6	5,242.9	7,726.0	15,825.3	21,868.2	93,786.8

Note: The figures for the savings level and each product are for households in units of ¥1,000.

Source: NRI, from the Management and Coordination Agency's Survey of Savings Trends (2000) and the Survey of Securities Savings by the Japan Institute for Securities Information and Public Relations.

4 This was calculated by aggregating the amount of money expected to be diverted to the stock market by each income group. The latter amount, in turn, was calculated as follows: Amount of savings held by each household in the form of time and savings deposits × percentage interested in purchasing equities × number of households in each income group × percentage estimate

If we assume that incomes are equal, younger age groups should be expected to have a greater tolerance towards the risk of investing in equity products simply by virtue of the fact that their investment horizon will be longer. In fact, the results of the survey show that this is not necessarily the case. However, given that the tax-free limit will apply for only a limited period, it is perfectly possible that those households that have never invested in equities but are at an age where they would be expected to start to build up their financial assets might bring forward a decision to become equity investors. We have tried to allow for this in our estimate of the likely inflow of money from time and savings deposits into the stock market by weighting the survey results to reflect the likely risk tolerance of each age group: by a factor of 0.9 for households aged under 45 (and likely to have a high risk tolerance), and by a factor of 0.8 for those aged over 45 (and likely to have a low risk tolerance).

According to our estimate, some ¥15 trillion[5] of household financial assets can be expected to be diverted to the stock market on this basis.

The results also vary considerably according to age group. Although this partly reflects the fact that the over-55s own half of all personal financial assets, the conservative investment attitude of the younger age groups also appears to be an inhibiting factor.

In fact, although the degree of interest of the younger age groups in equity investment is surprisingly low, the data from the same survey on the attitude of households to investing in investment trusts (i.e., Japanese mutual funds) shows that the percentage of householders who felt more at ease with the prospect of investing in investment trusts than in equities is higher among the younger age groups. This suggests that extending the tax-free limit to cover investment trusts might induce younger households to invest in equities indirectly.[6] In the United Kingdom, the extension of PEPs (see above) to cover unit trusts (i.e., UK mutual funds) has made the scheme even more effective, and a similar move should be considered in Japan.

5 This was calculated by aggregating the amount of money expected to be diverted to the stock market by each age group. This amount, in turn, was calculated as follows: Amount of savings held by each household in the form of time and savings deposits × percentage interested in purchasing equities × number of households in each age group × percentage estimate

6 The proposed tax measures apply to "listed equities, etc." This includes exchange-traded funds (ETFs) and real estate investment trusts (REITs) as well as equities.

3. Likely Reaction of Retail Investors

Our calculations of the amount of money that might be diverted to the stock market and of the period over which this might occur suggest that the total amount could be between ¥15 trillion and ¥20 trillion.

At the same time, however, the abolition of the option to have capital gains on the sale of securities automatically taxed separately from income could lead to a wave of selling by investors trying to beat the deadline. The last time the decision to abolish this option was made, the amount of equities sold by retail investors in 1999-2000, when the reaction to the decision was greatest, increased, reaching ¥39,203.7 billion in 2000—3.88 times as much as in 1998. This compares with an increase of 2.18 times by professional investors, who were not affected by these taxation changes. The difference between the two figures can be attributed to the changes. This suggests that retail investors sold roughly ¥17 trillion[7] of equities more than they would otherwise have done—the equivalent of 18% of the equities held as personal financial assets as of the end of 1999.

If we assume that the proposed changes to the taxation system will have the same effect as last time the decision was made to abolish the option to have capital gains automatically taxed separately from income, we should expect retail investors to sell about ¥11 trillion of equities (on the basis of the amount of equities held as personal financial assets at the end of 2000). However, given the fact that TOPIX has already fallen to the same level as it stood in 1986 and that the amount of equities held as personal financial assets is now 10% less than it was then, the scale of any selling as a result of the proposed changes is unlikely to be greater than in 2000. If we also take into account the likely effect of the tax-free limit mentioned above on inflows into the stock market, there is likely to be a net inflow of between ¥4 trillion and ¥9 trillion,[8] depending on how the stock market fares until the end of 2002.

This amount is equivalent to 0.28%-0.65% of personal financial assets, but we consider this perfectly possible for a very brief period as a result of some kind of incentive—similar, for example, to the kind of stock market boom that occurred in 1987 when NTT was privatized and retail investors were net purchasers of ¥5.4 trillion of equities (equivalent to 0.7% of personal financial assets at that time).

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7 This was calculated by multiplying the value of equities sold by retail investors in 1998 (¥10,089.8 billion) by the ratio of professional sales in 2000 to that in 1998 (i.e., 2.18) to give an adjusted figure for sales by retail investors in 2000 and by deducting this figure from the actual figure.

8 This was arrived at by subtracting the assumed increase in sales produced by the proposed tax changes (¥11 trillion) from the assumed inflow of personal financial assets into the stock market (¥15-20 trillion).

4. Conclusion

In this report we have considered a number of points concerning the proposed changes to the system of taxing securities. In this section we shall consider the extent to which this may help to reinvigorate Japan's securities markets, and conclude with some comments and suggestions.

First, the abolition of the option to have capital gains on the sale of securities automatically taxed separately from income will leave investors feeling that they will be worse off under the current proposals (where they will be required to file a tax return if they wish to have such gains taxed separately) if they have gains of 5.6% or more. Similarly, investors not accustomed to filling in tax returns may be deterred. For reasons such as these, there is a risk that some investors may realize their gains on securities before the proposals come into effect.

Second, although the reduction in the rate of capital gains tax from 26% to 20% is to be welcomed because it treats capital gains in the same way as interest, the measure is unlikely to do much to reinvigorate the stock market.

Third, the establishment of a system for allowing capital losses on equities to be carried forward is both necessary and welcome because it treats equities as risk capital. However, the decision to limit the carry-forward period to only three years needs to be reconsidered in view of experience in the United States and the United Kingdom, where investors are allowed to carry forward such losses indefinitely. Also, consideration should be given to treating equity investment trusts in the same way as equities as far as capital loss allowances are concerned. Following the introduction of individually based accounts, there is no problem determining acquisition costs.

Fourth, if the acquisition costs are unknown, investors may elect to have them deemed to be 80% of their market value as of 1 October, 2001. This is a considerable improvement over the previous system, where they were deemed to be 5% of their disposal value, and should go some way towards alleviating investors' concern about the abolition of the option to have capital gains on the sale of securities automatically taxed separately from income.

Fifth, as this report has suggested, the creation of a temporary ¥10 million tax-free limit should go some way towards reinvigorating the stock market. However, if this effect is not just to be short-term, the measure should be made permanent and the tax-free limit extended to include dividends (as in the United Kingdom). In addition, it should be extended to cover investment trusts, which are also a risky product, in order to appeal to a wider range of investors. Similarly, just as investors who invest in several stocks in large amounts have the option (when they file their tax return) of using their tax-free limit for the ones which have gained the most, those who invest on a smaller scale should be allowed (as in the United Kingdom) to opt for the convenience of having the limit applied when they make their investments so that they do not have to go through the unfamiliar process of filing a tax return. Hopefully, this will lead to the kind of "convenient means of paying taxes" mentioned in the notes to the proposed amendments.

Although the proposed amendments have some shortcomings and could be improved in some respects, overall they have more positive than negative aspects and are to be welcomed. In addition, they will, hopefully (as suggested in the previous section), induce retail investors to move some of their financial assets into the stock market. When all is said and done, however, they will be of no avail if Japanese equities lack fundamental appeal.