The Latest Revisions to Japan's Securities Taxation System: A First Step towards the Uniform Treatment of Financial Income in Japan

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The ruling coalition's Tax Proposals for 2003 (drawn up at the end of 2002) include sweeping changes to the system of securities taxation. The general direction of the proposals (which include a flat rate of tax on capital gains, dividends and distributions, and more scope for investors to offset losses against gains) is to be welcomed, and they will hopefully be a first step towards the uniform treatment of financial income in Japan.

1. Changes to the System of Securities Taxation

The ruling coalition's Tax Proposals (drawn up at the end of 2002) include sweeping changes to income tax deriving from securities transactions. The main changes are as follows:

(1) All capital gains from the sale of shares must now be declared separately from other personal income and will be taxed at 20%. Between April 2003 and March 2007, however, the rate will be only 10%.

(2) Dividend payments from listed companies do not need to be declared, and such dividends will be taxed at source at 20%. Between April 2003 and March 2007, however, the rate will be only 10%.

(3) Beginning in 2004, distributions by equity investment trusts will be taxed in the same way as share dividends (i.e., they will not normally have to be declared and will be taxed at source at 20%, except between April 2004 and March 2008, when the rate will be only 10%). Investors will also be able to offset losses from redemptions of equity investment trusts against capital gains from sales of shares.

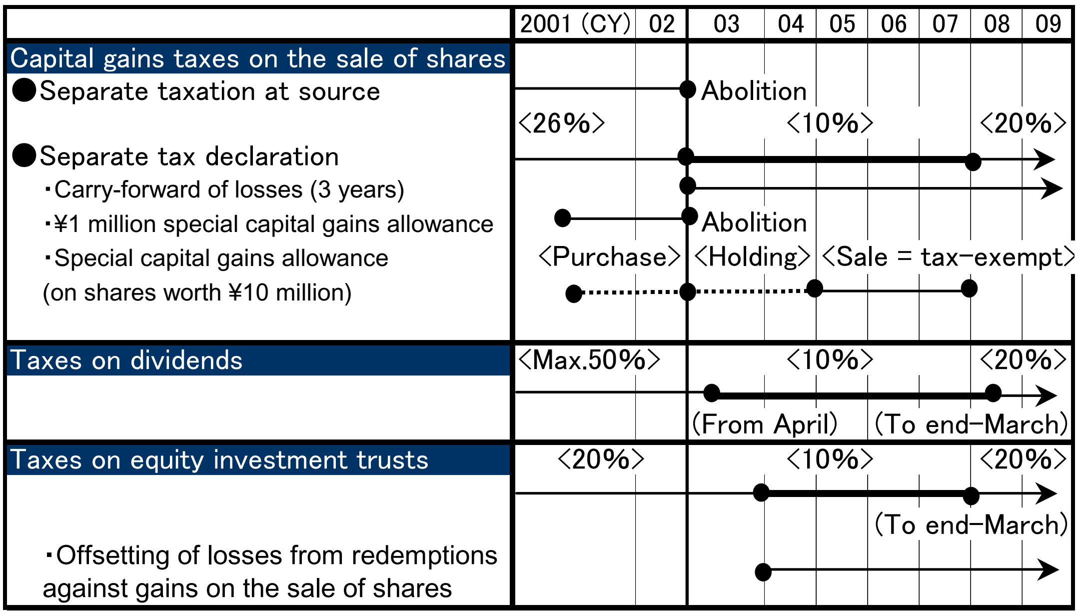
(4) The "special account" system, whereby securities companies are assumed to have the details of gains and losses from share sales and investors are spared the bother of having to file a final tax return, will be improved. Also, the arrangements whereby, for example, (1) securities companies refund investors any excess tax they have paid during a year, (2) investors are exempted from having to file an

annual transaction report to their tax office and (3) investors can transfer shares and other securities to a special account at either the actual acquisition cost or the assumed acquisition cost (i.e., 80% of the closing price as of 1 October 2001) will be extended to the end of 2003.

(5) A series of preferential measures introduced in 2001, whereby, for example, investors are exempt from tax on the first ¥1 million in capital gains from the sale of shares they have held for more than 12 months, will be abolished.

As a result, individuals investing in shares, exchange-traded funds or real estate investment trusts, for example, will be taxed at only 10% (from April 2008 at 20%) on any dividends or capital gains.[1] Also, they will be able to carry forward for up to three years any annual net loss from the sale of shares. Moreover, by setting up a special account, they will, in most cases, be spared the bother of having to file a final tax return.

Figure Proposed Revisions to the Securities Taxation System



Note: The percentages in angular brackets are tax rates (national tax + local tax), while the thick lines indicate the duration of temporary tax arrangements.

Source: Nihon Keizai Shimbun, 27 December 2002.

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[1] Principal shareholders (i.e., holders of 5% or more of a company's shares), however, will not be exempted from having to declare their dividend income. They will have to file a final tax return and declare this income as part of their overall income. However, they will be eligible for an allowance on their dividend income.

2. The Need for Reform of the System of Securities Taxation

In recent years there has been much discussion about Japan's system of securities taxation, and a number of measures have been adopted. The driving force behind this has been the realization that Japan needs to radically reform its tax system, which has been biased in favor of savers, in order to break the impasse in which the country's traditional financial model now finds itself and which is symbolized by the banking sector's mountain of bad debt. Japan needs to make the transition from this model, where most personal financial assets take the form of savings accounts, to a market-based model where people are more willing to invest in securities such as shares, bonds and investment trusts.

The first decisive tax measure to encourage individuals to invest in securities, following the economic stimulus package of March 2001, was the June 2001 amendment to the Special Taxation Measures Law. As a result of the amendment, investors are exempt until the end of 2003 from tax on the first ¥1 million in capital gains from the sale of shares they have held for more than 12 months.

However, such temporary exemptions tend to be problematical. For example, even if exempting capital gains from tax does have the potential to stimulate demand for shares, this is unlikely to be translated into actual purchases unless investors can expect to make a profit within a certain period. Investing in securities has always been a risky business, and there is no guarantee of success. Therefore, unless any tax relief on capital gains is supplemented by some provision for capital losses, such as carrying forward of losses for certain period of time, investors will not receive an after-tax return commensurate with the risks that they are expected to take and may decide that they are better off simply putting their money in a savings or deposit account.

Nor is the lack of tax relief on equity investment the sole reason why the Japanese tax system has come to be seen as biased in favor of savers: the fact that the tax on savings and deposits is a straightforward 20% withholding tax whereas the taxation of shares, bonds and investment trusts is forbiddingly complicated (with different products and different types of income being treated differently) is also a major factor.

In an attempt to find a solution to this problem, NRI published a proposal document entitled "Reforming the Tax System in Order to Revitalize the Securities Markets: How to Encourage Participation by Individual Investors" on 4 June 2001. The document proposes (on the assumption that accurate information on capital gains and losses is available) (1) that capital gains from the sale of securities such as shares, bonds and investment trusts should be taxed at a lower rate than interest income from savings and deposits, (2) that investors should be allowed to offset gains and losses on the sale of different types of securities and carry forward any losses, and (3) that securities companies should be allowed to set up so-called "managed accounts" in order to simplify the process of filing final tax returns.[2] Although the document assumes a global income tax (based on the theory of comprehensive income taxation) as the norm, it recommends a dual system of income tax (with a flat rate for all financial income) in view of (1) the fact that income from most financial products is currently taxed separately from other income and (2) the risk that any attempt to impose a global income tax on all financial products would lead to capital flight.

3. The Introduction of a System of "Special Accounts" and Criticism of It as "Complicated"

Fortunately, the document's proposals received a generally favorable response, and the 2002 amendments to the tax system included the decision to introduce in 2003 a system of "special accounts," whereby securities companies would be expected to keep a record of customers' capital gains and losses and to deduct tax on the net gains at source. The aim of this was to make it simpler for investors to file their final tax returns when all capital gains from the sale of shares were required to be declared separately from other income, beginning in 2003. At the same time, the Financial Services Agency's Study Group on Financial Taxation discussed the fundamentals of treating financial income in a uniform way.[3]

The basic concept of a system of special accounts is in line with the contents of NRI's proposal document. Indeed, this system, which, while adhering to the principle that financial income should be declared separately from other income, seeks, in practice, to make it easier for investors to file their tax returns by neatly solving the problem of how to keep track of their capital gains on the sale of shares (something that in the past observers have considered a major obstacle) by having financial institutions do this and tax the net gains at source, has been praised by experts as "a global standard made in Japan."[4]

2 See Sadakazu Osaki, "Tax System Reform to Invigorate Japanese Securities Markets: Encouraging Securities Investments among Private Individuals," Capital Research Journal, Autumn 2001.

3 See the Study Group's June 2002 report "Kongo no Kin'yu Zeisei no Arikata ni Tsuite: 'Nigenteki Shotokuzei' o Meguru Giron no Ronten Seiri o Chushin to Shite" [The Taxation of Financial Income in Japan: The Pros and Cons of a System of Dual Income Tax]. The report can be viewed on the Financial Services Agency's Web site (http://www.fsa.go.jp/singi/singi_zeisei/ronten/f-20020628_ze.pdf).

4 See Shigeki Morinobu, "Gutaiteki Kento no Sojo ni Nobotta Kin'yu Zeisei Ichigenka: Tokutei Koza no Motarasu Imi" [The Uniform Treatment of Financial Income Now on the Agenda: The Significance of Special Accounts], Gekkan Shihon Shijo [Monthly Capital Markets], November 2002, pp. 27-34, p. 30.

However, no matter how good a concept may be, it will be useless if it proves difficult to put into practice. As details of the special account system began to emerge in June 2002, harsh words were said about such aspects as (1) the fact that investors who found at the end of the year that they had paid too much tax would have to file a return to have the excess amount refunded, (2) the fact that investors who had bought shares at the peak of the bull market in the late 1980s would actually make a loss if, when they tried to transfer them to a special account, their shares were valued at the assumed acquisition cost, and (3) the fact that treatment under the residents' tax and treatment under the national tax were different. The new system of securities taxation was branded a "monstrosity," and concern was expressed that it might scare away investors.[5]

Even before that, doubts had been expressed about the contents of the 2002 amendments to the tax system—especially the capital gains tax exemption on shares (with a purchase value of up to ¥10 million) purchased and sold within a certain period of time. However, these doubts turned to vehement criticism as soon as it became clear that the special account system, which was supposed to make it easier for investors to pay their taxes, was extremely complicated. As a result, there were even calls for the system of taxing at source the assumed profits from the sale of shares to be continued in spite of the fact that its abolition was supposed to be a *sine qua non* of the introduction of the new system.

In response to this, the Ministry of Finance, the National Tax Administration Agency and the Ministry of Public Management, Home Affairs, Posts and Telecommunications set up a project team to deal with these problems as a matter of urgency. Even though the system had not yet been fully adopted, the team set about its work, sounding out the Japan Securities Dealers Association and securities companies. When the team's findings were collated in November, they were translated into action in the form of amendments to government and ministerial ordinances.

In September, while all this was going on, securities companies had started to brief their customers on the special account system and to invite applications to open accounts. Many investors, unaware that the system would be revised in November, hurriedly sold shares they had kept for many years. Therefore, although this led to a vastly improved and much more user-friendly system, the system that was originally announced caused considerable confusion among investors—something for which all those involved bear a heavy responsibility.

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5 For further details of complications and difficulties posed by the new system at that stage, see Nihon Keizai Shimbunsha (ed.), "Shinshokenzeisei wa ko Norikire: Jitsurei de Wakaru Anata no Kabu no Zeikin" [How to Cope with the New System of Securities Taxation: Realistic Examples of How Shares Will Be Taxed], Nihon Keizai Shimbunsha, September 2002.

4. The New System's Merits and Shortcomings

1) The Tax Proposals for 2003

The Tax Proposals for 2003 are a fine achievement inasmuch as their provision for tax relief for securities investors takes account of the urgent need to revitalize Japan's securities markets while trying (1) to ensure that risk-takers are not penalized by the tax system and (2) to return to the basics of tax reform by creating a system of securities taxation that is both fair and simple.

More specifically, (1) they apply the same rate (20%) to tax on capital gains, dividends and distributions as to interest income from savings and deposits, thereby ensuring that risk-takers are not penalized; (2) they encourage investment in securities by applying an extremely modest rate (10%) to tax on capital gains and dividends, albeit for a limited period of five years; and (3) they reduce the need for investors to file final tax returns by making the new special accounts more user-friendly. Also, (4) by allowing investors to offset losses on equity investment trusts against gains from the sale of shares, they give investors the opportunity to cut their losses and switch into other investments.

As for the question whether it was a good idea to abolish preferential measures, whereby investors were exempt from tax on, for example, (1) the first ¥1 million in capital gains from the sale of shares they had held for more than 12 months or (2) shares purchased and sold within a certain period of time (up to a value of ¥10 million), it is probably fair to say (with regard to the latter) that this might have helped to attract some money into the stock market, assuming that investors understood it properly.[6] However, as was suggested above, temporary tax concessions tend to be problematical. Moreover, the number of such concessions led to the new system originally being branded a "monstrosity." Therefore, by reducing the number of such concessions and applying a flat (10%) rate, the Tax Proposals are a step in the right direction.

However, there are some who have believed for some time that these tax concessions were inadequate. Indeed, many, including the Japan Securities Dealers Association, have called for all capital gains taxes on shares to be abolished. If one shares this view, it is possible to argue that to abolish these concessions without abolishing capital gains taxes on shares is a big step backwards.

6 See Toshio Sugioka, "The Impact of the Reforms to the Taxation of Securities in Japan," Capital Research Journal, Winter 2001.

However, it is very doubtful whether the abolition of all capital gains taxes on shares would really encourage equity investment. It should be remembered that between 1953 and 1989 capital gains on the sale of shares in Japan were normally tax-exempt. However, this does not appear to have broadened the country's retail investor base or helped very much to encourage investment in securities and thereby the accumulation of financial assets.[7]

If equity investors are to be offered proper incentives, they need to be able to achieve an after-tax return that matches the risk that they are taking. That means not just reducing (or abolishing) capital gains tax but ensuring that their tax liabilities are also reduced if they make a loss when the stock market declines.

One way of doing this would be to allow investors to offset capital losses against their earned income.[8] However, so long as capital losses were taxed on a realization basis, such a system would inevitably encourage investors to time the sale of shares on which they had an unrealized loss and to adjust their taxable income arbitrarily. This is why it is often suggested that capital loss allowances should be limited to allowing investors to offset losses against gains. The problem with that view, however, is that it would be impossible to grant any allowances for capital losses if all taxes on capital gains were abolished.

In theory this leaves the option of assessing taxes and allowances for capital gains and losses before these are realized. However, this would present considerable practical obstacles (e.g., the need to know the market value of all an investor's shares).

Another issue is whether it is a good idea to tax dividends separately at source (in theory at a rate of 20%, in practice at a rate of 10% for the time being). Initially this was warmly welcomed as a way of encouraging investors seeking dividend income to be long-term investors—especially in view of the fact that this might well attract dividend-seeking investors who had forsaken savings and deposits that now pay near-zero interest rates. However, in the wake of President Bush's January 2003 announcement that in future, in order to abolish double taxation of dividends, retail

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7 This is also true of Germany, which, at one time, was a much-talked-about example in Japan. As far as the author knows, capital gains on the sale of shares by retail investors have always been tax-exempt in post-war Germany. However, he would appreciate it if any of those who claim that tax concessions encouraged investment in shares by German retail investors could inform him of when shares were exempted from capital gains tax in Germany. For more about the situation in Germany, see Daisuke Ochiai, "Sekkyokka Suru Doitsu Kojin Toshika no Shoken Toshi" [The Growing Interest in Shares among German Retail Investors], Shihon Shijo Kuwotari [Capital Market Quarterly], Summer 2001.

8 This is allowed to a certain extent in a number of countries, including the United States.

investors in the United States would normally not have to pay tax on dividends, this measure may now no longer be considered enough.

This raises the question how serious double taxation of dividends really is and how complicated any attempted solution should be allowed to be in order to abolish double taxation.

Even in the United States, the intention was simply to abolish double taxation, so individuals with dividend income from companies not paying corporate income tax still have to pay tax on that dividend income at a progressive rate. It means that taxpayers have to find out whether the companies from which they receive a dividend income are paying corporate income tax and file their tax returns accordingly. In Europe an imputation system has been adopted to deal with double taxation, but the complicated nature of the system and its failure to allow for nonresidents have meant that it is now under review.

The approach that has been proposed in Japan is to tax dividends at a low rate and to, in a sense, ignore possible double taxation. If one believes that dividend income should be subject to a global tax at a progressive rate, one could even argue that this approach goes a long way to mitigating double taxation. Indeed, one could argue that the fact that dividend income from companies that pay no corporate income tax at all is taxed at a low rate means that this "mitigation" is excessive. Be that as it may, the issue needs further consideration as it involves the relationship between corporate and personal income tax, and it would be wrong to jump to conclusions from a comparison of the situation in Japan and the United States.

2) Shortcomings of the Proposals: Need for a uniform treatment of financial income in Japan

However, the Proposals are not without their shortcomings (or, to put it another way, they leave a number of questions unanswered).

The main problem is the fact that the only losses that can be offset against gains are (1) losses on the sale of shares against gains on the sale of shares and (2) losses from redemptions of equity investment trusts against gains on the sale of shares. The principle of allowing losses on securities investments to be offset against gains has been applied in only a limited fashion. It is to be hoped that in the near future investors will at least be allowed to offset (1) losses on the sale of equity investment trusts against similar gains and (2) losses on the sale of shares against gains on the sale of equity investment trusts.[9]

For this to be possible, however, equity investment trusts would need to be taxed in exactly the same way as shares (i.e., gains would have to be declared separately from other income). In other words, the present system of taxing distributions by equity investment trusts at source separately from other income would have to be abandoned. Clearly, any attempt to do this overnight would cause chaos and lead to investors deserting equity investment trusts. However, if an effort was made to encourage wider use of special accounts by allowing banks and other financial institutions that already market investment trusts to their customers to open such accounts, there is no reason why it should not be possible to make the transition to a system where distributions by equity investment trusts are taxed at source separately from other income.

Similarly, the possibility of offsetting losses from the sale of shares against share dividends should also be considered. Given the current situation, where many investors receive their dividends directly from trust banks acting as agents, it would be unrealistic to pay dividends solely through special accounts. However, given that in the next few years shares are expected to be dematerialized, there may be changes in the way that dividends are paid.

However, if one is prepared to argue that far, one also needs to reconsider the current system of classifying income and the very principle of a global income tax, and there are those who argue vociferously that a system of dual income tax (or, at least, a system where financial income is treated uniformly) is needed in order to make the current system, which has become quite complicated as the tax treatment of different products and classes of income has diverged, fairer and simpler.

By invoking the principle that capital gains from the sale of shares, share dividends and distributions by investment trusts should be taxed at the same (20%) rate as interest income from savings and deposits, the current revisions to Japan's securities taxation system could well be the first step towards treating the taxation of financial income in a uniform way. Rather than regard the revisions as the final chapter in the reform of the Japanese securities taxation system, they should encourage further consideration of the issue in theoretical terms and reconsideration of the entire income tax system.

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9 For more on the difficulties of taxing investment trusts, see Sadakazu Osaki, "Toshi Yugu Zeisei e no Tenkan ni Mukete no Kento Kadai" [Issues to Be Considered in Allowing Tax Concessions to Investors], Zeimu Koho [Bulletin of Taxation], April 2002.

Also, if the thoroughgoing adoption of a system of uniform taxation of financial income is not to be an excessive burden on taxpayers (especially when it comes to filing their final tax returns), consideration will have to be given to making fuller use of the system of special accounts that has recently been introduced.[10] Consideration should perhaps also be given to introducing a system of identity numbers (at least for financial income) so that the tax authorities know exactly what income to tax. If the authorities do decide to do this, hopefully they will learn from their recent experience and take the advice of the securities industry sooner rather than later to ensure that any new system will work in practice.

Hopefully, the Tax Proposals will all be adopted and, hopefully, this will lead both to greater investment in securities by retail investors and to a thorough review of the need for the uniform treatment of financial income.

10 See Shigeki Morinobu, Footnote 4 above.