

**Tax-exempt individual savings account introduced to encourage investment**

On March 29 2013 the Tax Reform Bill 2013 was passed. The bill provides for a Japanese version of an Individual savings account (ISA) system, which will almost certainly be implemented on January 1 2014. Like the UK ISA system, the Japanese ISA system will allow taxpayers to invest a certain amount of money through an ISA without taxation (ie, a tax-exempt account).

**Background**

For the past few years, preferential tax treatment has been given to dividends and capital gains arising from certain securities (eg, listed shares of stock or convertible bonds and publicly offered beneficial interests in an investment trust (excluding a bond investment trust)). This preferential tax treatment was introduced in 2003 for the purpose of promoting a shift "from savings to investment" and bolstering the stock market. It was initially a temporary measure, but has been extended several times and has lasted more than 10 years. The temporary separate tax rate of these dividends and capital gains had been 10% before January 1 2013, and since then has risen to 10.147% because of the special income tax for reconstruction.

However, this system has been criticised as preferential treatment for wealthy individuals. To address this criticism, this ostensibly temporary reduced tax rate will revert to the unreduced rate of 20.315% (including the special income tax for reconstruction) on January 1 2014. In exchange, the ISA will become available as a tax exemption on the same date for only a small amount of investments, with the express purpose of facilitating the participation of individual investors in the stock market.

The ISA was originally legislated by the Tax Reform Bill 2010, but was substantially revised by the Tax Reform Bill 2013.

**ISA in detail****Tax-free treatment**

Under the ISA, an eligible individual taxpayer may open a tax-exempt account, through which the individual may invest his or her money in certain securities. As long as the securities are held in the tax-exempt account,

dividend income from such securities and income from the transfer of such securities (ie, business income, capital gains or miscellaneous income) are not subject to income taxes. On the other hand, losses arising in relation to the securities held in the tax-exempt account cannot be deducted from income or capital gains arising outside the tax-exempt account.

**Eligible taxpayers**

An individual taxpayer is eligible for an ISA if he or she is:

- a resident or non-resident with a permanent establishment in Japan; and
- at least 20 years old as of January 1 of the year in which he or she makes the investments (ie, a taxpayer who is 20 years old is ineligible unless his or her birthday falls on January 1 of the year in question).

In order to open the tax-exempt account, the taxpayer must receive confirmation from the district director of his or her relevant tax office, an application for which must be filed between October 1 of the previous year and September 30 of the relevant year.

**Account provider**

To open a tax-exempt account, the taxpayer must enter into a contract with an account provider. Eligible account providers are 'Type 1 financial instrument business operators', 'registered financial institutions' and 'settler companies of investment trusts', all of which must be registered under the Financial Instruments and Exchange Act. A 'Type 1 financial instrument business operator' is typically a broker-dealer, while a 'registered financial institution' is typically a commercial bank that is allowed under the act to conduct certain securities-related business. An 'investment trust' is the Japanese version of a mutual fund or unit trust, while a 'settler company' is an asset management company that enters into a trust agreement with a trustee to establish an investment trust.

**Maximum investment amount**

The maximum amount that a taxpayer may invest through the tax-exempt account is Y1 million each calendar year. Any unused portion of this maximum amount cannot be carried over to the next year. Furthermore, this amount is not reusable; even if a taxpayer sells securities held in the tax-exempt account, the maximum amount that may be invested without taxation does not reset and he or she loses preferential tax treatment.

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**Tax-free period**

The tax-free period is not unlimited. The securities held in the tax-exempt account must be transferred to another account before expiry of the five-year period from January 1 of the year in which the investment was made. Investments made on January 1 of a certain year are subject to a five-year tax-free period; however, an investment made on December 1 would have a tax-free period of only four years and one month.

If an investor invests the Y1 million maximum through the tax-exempt account every year and does not dispose of the securities in the account, he or she may thus hold securities with a total acquisition cost of Y5 million in that account at one time.

The securities held in the tax-exempt account may be transferred to either a taxable account or another tax-exempt account. The acquisition cost of the securities transferred to another tax-exempt account will be determined based on their value at the time of transfer.

**Eligible investments**

The securities in which a taxpayer may invest through his or her tax-exempt account are limited to those specified in the law, which include listed shares of stock or convertible bonds and publicly offered beneficial interests in investment trusts (excluding bond investment trusts). 'Listed shares of stock or convertible bonds' include shares of stock or convertible bonds of both domestic and foreign companies listed on an exchange outside Japan. Shares of company-type foreign mutual funds are included in the definition of 'shares of stock'. 'Beneficial interests in investment trusts' include beneficial interests in both domestic and foreign contractual-type mutual funds and unit trusts, but do not include interests in domestic or foreign partnerships.

Unlike the UK ISA system, the Japanese ISA does not allow for cash savings accounts. In addition, debt securities (including interests in bond investment trusts) are ineligible for the Japanese ISA, while shares of a company (including units in company-type foreign mutual funds) that invests mainly in bonds are eligible as shares of stock as long as the shares are listed on an exchange.

**Effective date and expiration date**

Taxpayers may open an account on or after January 1 2014. However, the Japanese ISA is legislated as a temporary measure and the tax-free treatment will be applicable to investments made by December 31 2023 under the current law. Nonetheless, Japanese securities firms and the Financial Services Agency hope that it will become a permanent measure.

**Potential effects****Market size**

The potential market size of the ISA is large. As the tax rate on dividends and capital gains arising from certain securities will be doubled on January 1 2014, many eligible taxpayers are expected to use the ISA. In Summer 2012 the government stated that the target total investment amount through the ISA for 2020 is Y25 trillion (current household financial assets are estimated at Y1,500 trillion).

Based on this expectation, the majority of financial institutions seem to be preparing to provide tax-exempt accounts. Some financial institutions consider the ISA a good chance to expand their client base, but others are concerned about procedural burdens and will limit the securities in which taxpayers may invest through their tax-exempt account.

**Investment trends**

Because of its non-reusable nature, the ISA will provide an incentive for taxpayers to make long-term investments. In addition, since the after-tax profits of securities on which dividends are reinvested will be larger than those on which dividends are made, Japanese investors may come to focus on capital gains even though they have preferred to invest in securities paying high dividends.

**Comment**

The ISA may have a significant impact on financial institutions conducting retail securities business. Although foreign financial institutions cannot provide tax-exempt accounts unless they are registered with the Financial Services Agency, the ISA may have an impact on them as well. As discussed above, securities eligible for the ISA include certain foreign securities. In addition, eligible securities include interests in domestic investment trusts that invest in foreign securities. Therefore, foreign financial institutions will have chances to expand their business as a result of the introduction of the ISA, accompanied by the broad participation of individual investors in the stock market.

Due to so-called 'Abenomics' – the economic policy advanced by Prime Minister Shinzo Abe – the Japanese securities market seems to be recovering. It is hoped that the ISA will further revitalise the Japanese market and securities business.

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