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Taxation of Cross-Border Interest Flows: Japanese Responses

I. Introduction

Will capital income taxation survive in the twenty-first century? Commentators in many countries share this concern.¹ Japan is no exception.

This article examines the Japanese responses to a growing pressure from global financial markets. It focuses on the taxation of cross-border interest flows, first from the perspective of a resident state (II), and next from the viewpoint of a source state (III). It concludes with an appeal for international cooperation (IV). This article is based on the information as of the end of November 1999.²

II. Capturing the Income of Japanese Residents

1. The Significance of Interest Income

After the Second World War, Japanese residents have accumulated huge stock of financial savings. In June 1999, the Japanese household held 1,333 trillion yen in total in the form of financial assets.³

This large sum of money is broken down into several different components. The biggest slice is cash and deposits. According to the same statistics, the Japanese household held as much as 732 trillion yen in cash or in bank deposits. This amount is equivalent to 55 % of the total financial assets held by households.

¹ Jack Mintz, *Is There a Future for Capital Income Taxation?* Canadian Tax Journal, Vol. 42, No. 6, 1496 (1994); Vito Tanzi, *Taxation in an Integrating World*, 130 (1995); Charles McLure, *Tax Policies for the XXIst Century*, in IFA, *Visions of the Tax Systems of the XXIst Century*, 44 (1997); Reuven Avi-Yonah, *Memo to the Congress: It's Time to Repeal the U.S. Portfolio Interest Exemption*, 17 Tax Notes International 1817 (1998).

² See <http://www.j.u-tokyo.ac.jp/~masui> for links to updated information.

³ See the Flow of Funds Accounts at <http://www.boj.or.jp>.

This is a surprisingly high figure by the standard among industrialized countries. Insurance and pensions took the second largest slice of 27 %. The share of stocks and bonds was relatively small.

The above figure has a clear implication for tax policy. Because people save overwhelmingly in the form of bank deposits, interest income is a big revenue tap. In fiscal year 1997, interest income generated 1.3 trillion yen in terms of national income taxes withheld at source.⁴

2. Reliance on Withholding

The Japanese system with regard to interest income is characterized by its extensive use of a final withholding tax.

Under current law, interest income generally is subject to a separate taxation at source at the rate of 20 %.⁵ In other words, interest income is taxed separately from other sources of income. The 20 % withholding tax is final. This tax rule represents a schedular element within the global system of income taxation. The Japanese Income Tax Law itself defines personal income on a global basis under a progressive rate structure. With regard to interest income, however, a taxpayer does not have a chance to file a tax return and to aggregate all his personal income.

The separate taxation at source has a long history.⁶ Its origin dates back to 1889, when interest on public and corporate bonds was made subject to withholding at source at a 2 % flat rate. The scope of withholding expanded gradually. In 1923, for example, interest on bank deposits and interest on trust loan were generally subject to a 3 % final withholding tax.

In 1940, the Japanese income tax adopted a dual system of schedular income tax and global income tax. 40 % of the interest income was taxable under the global regime. At the same time, taxpayers were able to elect a separate taxation at source at a flat rate of 15 %. This dual system continued until 1947, when the income tax law underwent an overhaul. It was not until 1950, however, that the optional separate taxation at source was abolished for interest income. The 1950 reform was a response to the Report of the Shoup Mission that strongly argued for a global and progressive income tax system.

The 1950 reform was short-lived. In 1951, the optional separate taxation at source was restored. The case for the restoration was to encourage savings and to accumulate capital, in the face of War in the Korean Peninsula. Pressures

4 See the statistics at <http://nta.go.jp>

5 The national tax rate is 15 % and the local tax rate is 5 %. Special Taxation Measures Law Article 3 and Local Tax Law Article 71-6.

6 Hiroshi Kaneko and Yoshihiro Masui, *Taxation of Interest Income in Japan – History and Current Situation*, in FAIR, *A Final Draft Report from FAIR to the World Bank on “Taxation and Economic Growth”* (Asian Miracle Project), 85, at 90 (1993).

continued to reduce tax on interest income. In 1953, the former elective system was replaced by the separate taxation at source at a flat 10 % rate. In 1954, the interest from long-term savings was subject to a reduced 5 % rate. In 1955, all the interest income was exempted from taxation. The separate taxation at source was reintroduced in 1957 for short-term savings and in 1959 for long-term savings. Coupled with a generous tax-free savings system, the preferential treatment of interest income became a notable feature of the Japanese income taxation during the era of rapid economic growth.

¶ On the legislative front, various attempts were made in order to cut back the preferential treatment accorded to interest income. In the course of the 1970s and early 1980s, they failed one after another. It was in 1987 that a sweeping tax reform virtually eliminated the tax-free savings system, replacing it with the 20 % final withholding tax at source. The 1987 reform laid down the basis of current law with regard to interest income taxation.

¶ The current treatment of interest income thus reflects a long political struggle. More than ten years have passed since the 1987 reform, reaching a state of impasse in the legislative process. The scope of final withholding is widely defined so as to achieve an equal footing among similar forms of financial savings. It includes interest from fixed-term deposits and bonds, interest from demand deposits, and distribution of profits from jointly administered investment trusts and from bond investment trusts.

3. Lack of Taxpayer Identification Number

¶ The Japanese tax system does not have a taxpayer identification number (hereafter "TIN"). Policy options with regard to interest taxation have been constrained by the lack of TIN.

¶ Since the late 1970s, the Japanese government has been considering the introduction of a TIN. In 1979, the Tax Committee recommended to introduce a "green card" system. Its aim was to check the identity of a saver and to prevent a nominee from using the tax-free savings system. Further, the system was supposed to go a long way towards detecting tax evasion.

According to the original plan, a "green card" was to be distributed to each person who wished to save in a tax-free savings account. Financial institutions and postal banks would verify the identity of the saver. When those institutions paid interests on such savings account, they would file an information return with a description of the card number. In this manner, tax officers would be able to see if a saver was putting money under disguised names, or if he was saving in excess of the ceiling amount of tax exemption.

The 1980 tax reform introduced the "green card" system that was supposed to be effective from the beginning of 1984. However, its critics gained power before the effective date. In 1982, facing political pressures, the Cabinet decided to amend the Cabinet Order for the purpose of freezing the distribution date of

green cards. In 1983, the Special Taxation Measures Law was amended to postpone the introduction of "green card" system for three years. In 1985, the "green card" system was finally repealed by the Diet.

The abolition of the "green card" system was a sour lesson for the proponents of a global income tax. The tax policy alternatives with regard to interest income became narrow in the face of political reality. Seen from this perspective, the 1987 reform opted for the separate taxation at source precisely because the final withholding tax was enforceable without the introduction of a TIN.

The Tax Committee did not lose time to consider the introduction of a full-fledged TIN system. A small committee on TIN was organized within the Tax Committee.⁷ In 1988, the committee submitted a report, discussing various design issues of the TIN system. The report did not make a specific proposal, but welcomed lively discussions on the issue. In 1991, the committee restarted its deliberation, resulting in its second report in 1992. The second report examined the design issues more closely in the context of a Japanese legal setting.

In 1997, the Tax Committee set up a small committee on financial taxation. The objective of the committee was to reexamine relevant tax rules in response to a changing financial environment. The speed of such a change had been accelerated by deregulation, sometimes called a Japanese version of "financial big bang." The committee report again emphasized the need to gain understanding among the Japanese citizens for the TIN system.

4. Capturing Cross-Border Interest Flows

With the globalization of financial markets, more people start to save abroad. At the present stage, Japanese residents save for the most part within the border. As of the end of October 1999, Japanese residents (including corporations, individuals and local governments) deposited 3.08 trillion yen at overseas branches of private financial institutions.⁸ This figure apparently is insufficient because the statistics covers only those banks that are domestically licensed. Yet, the figure of 3.08 trillion yen seems rather small compared with the total household savings of 1.333 trillion yen.

Money runs fast, however. Starting from April 1998, the Foreign Exchange Law was drastically liberalized. Under previous law, the foreign exchange regulation placed a certain check on the cross-border flows of income. It had the side effect of supplementing tax enforcement by giving an indication to tax officials about possible tax avoidance and evasion. Under the new law, however, non-tax border control would be gone.

7 The committee was headed by Professor *Hiroshi Kaneko* of the University of Tokyo.

8 See <http://www.boj.or.jp/en/siryostat/depo9910.htm>

It was against this background that a new law was introduced in 1997.⁹ Under the new law, a person sending money abroad or receiving money from abroad must submit to financial institutions a paper that describes her name and address. The financial institution must verify the identity of the person by referring to a copy of her residential record. When the amount of remittance exceeds 2 million yen, the financial institution must submit to the tax office a paper with the description of the client's name and of the amount of remittance.

These measures might not be sufficient. As indicated above, the Japanese system relies extensively on withholding without adopting a TIN system.

Withholding device works smoothly when a payer of interest is located inside Japan. Suppose that a Japanese resident deposited a certain amount in dollar at an overseas branch of a Japanese commercial bank. After a year, the interest is accrued on her deposit and remitted to her account at the Tokyo branch of the bank. In this case, the 20 % withholding tax applies because her interest income is "paid within Japan." The Japanese commercial bank must withhold 20 %.¹⁰ For another example, suppose that a Japanese investor buys a bond that has been issued abroad. He receives interest through a securities company that is "in charge of payment within Japan."¹¹ The 20 % tax applies in this case, even though the interest accrued abroad. Thus, even in a cross-border setting, the final withholding tax proves to be an effective compliance tool as long as the payer is inside Japan.

The situation is different when interest flows in other forms. In some cases, a withholding mechanism does not function due to geographical limitation. Suppose that a Japanese resident buys foreign bonds. He asks a foreign investment bank to keep the bond on his behalf and receives the interest at his foreign account. In this case, the foreign investment bank is not an institution that is "in charge of payment within Japan." Therefore, the 20 % tax does not seem to apply. In other cases, the income flow in question is simply outside the scope of the present withholding scheme. For example, an original issue discount with regard to bonds and to deep discount instruments is classified as "other income" rather than interest income under the Japanese Income Tax Law. Taxpayers are expected to declare such income on a voluntary basis.

In cases where withholding mechanism does not work, Japanese tax auditors would have a hard time tracing the cross-border income flows of a resident recipient. The question is if they are equipped with effective enforcement measures.

9 The Law with regard to submission of the information return for sending money abroad, with the aim to maintain fair enforcement of domestic taxes (Law No.110 of 1997).

10 Special Taxation Measures Law Article 3 and Income Tax Law Article 181.

11 Special Taxation Measures Law Article 3-3 Clause 1 and Clause 3.

III. Exempting the Income of Non-Residents

1. The Interest Withholding Rule and Its Critics

As in many other jurisdictions, non-residents are taxable in Japan on the interests that they receive from a Japanese source.

Under the current Income Tax Law, interests paid to a non-resident are sourced to Japan if they qualify as one of the following.¹²

a) Interest on bonds issued by Japanese government, local public entities, and Japanese domestic corporations.

b) Interest on deposits that was kept at a business office located within Japan.

c) Distribution of profits from jointly administered investment trusts and from bond investment trusts, when they are entrusted at a business office located within Japan.

Such interests are subject to a 15 % withholding on a gross basis, for both individual and corporate non-residents,¹³ when they do not maintain a permanent establishment within Japan. The withholding tax is final in relationship with the Japanese government. Japanese tax treaties often reduce the withholding rate to 10 %, but not to zero.

Critics argue that the above treatment is overly broad. Their dissatisfaction centers upon a withholding tax on a gross basis. First, a gross base tax would hit businesses hard. Their tax payments may become so large even at a 10 % rate that they would easily exceed the foreign tax credit limitation in the resident state of the interest recipients. Second, Japanese tax treaties keep the 10 % withholding rate on interest, in accordance with the OECD Model.¹⁴ This treaty policy is charged as reminiscent of the time when Japan used to be a capital importer. Time has changed, and Japan is now a net capital exporter. At the end of 1998, the Japanese economic sectors (both private and public) held 133.273 billion yen in net foreign assets.¹⁵ Third, under current law, some interests are taxable, some subject to a reduced rate, and others sometimes exempt. The coexistence of different rates on the same instruments disrupts the secondary market for bonds. These critics claimed that Japan as a source state should exempt or zero-rate portfolio interest outflows.

12 Income Tax Law Article 161 No. 4.

13 Income Tax Law Article 169 No. 1, Article 170, Article 178, and Article 179 No. 3.

14 OECD Model Convention Article 11 Paragraph 2.

15 See the statistics at <http://www.mof.go.jp/houkoku/1c018c.htm>.

2. Losing Nexus in a Global Environment

A source state tends to lose its taxing point to interest flows under a global financial environment.

Consider the case of interest from corporate bonds. Generally speaking, such interest may be considered to have a connection with a particular source state under the following tests.

- a) If the bonds are issued by a domestic corporation.
- b) If the bonds are issued in the market governed by the source state.
- c) If the payment is made within the source state.

Like shifting sands, global financial transactions escape the conditions under these criteria. Let us take an example of Japan as a source state. The interest on corporate bonds issued by a foreign corporation is not a Japanese source income in the first place. Even when it was a domestic corporation that had issued the bond, the corporation might have opted for a more lucrative foreign market rather than a Tokyo market. In such a case, it would be difficult for the Japanese government to enforce a withholding mechanism both in terms of nexus and of practical procedure. If the payment were made outside Japan, it would involve an extraterritorial enforcement if Japan wished to compel a foreign payer to withhold.

In reality, Japan collects relatively small revenue from interest paid to non-residents. In fiscal year 1997, the withheld amount was merely 7,506 million yen with regard to interest on bonds and deposits.

3. The Need to Compete

Global competition strongly affects the ability of a source state to tax interests that are paid to non-residents.

The introduction of portfolio interest exemption in the United States in 1984 is well documented.¹⁶ If only the United States alone exempted portfolio interest in the whole world, investment may flee toward the United States from other capital markets. Many OECD countries started to exempt a withholding tax on interest paid to non-residents.

The Japanese government made its responses only gradually. In 1984, domestic corporations were permitted to publicly issue foreign bonds denominated in yen. Previously, from time to time, special exemption measures (or tax rate

16 According to the General Explanation of the Tax Reform Act of 1984, "Congress believed it important that U.S. businesses have access to the Eurobond market as a source of capital. Congress believed that the imposition of a withholding tax on portfolio interest paid on debt obligations issued by U.S. persons might impair the ability of U.S. corporations to raise capital in the Eurobond market." Cited in *Charles I. Kingson*, *International Taxation* 229 (1998).

reduction) had been granted to interests on foreign bonds issued by domestic corporations. However, such measures had been limited to bonds denominated in foreign currency. In 1984, the Japan-U.S. yen/dollar committee discussed the liberalization of the Japanese financial market. Based on its conclusion, the 1985 tax reform exempted certain yen-denominated bonds. This formed the origin of the income tax exemption on interest on foreign bonds issued by domestic corporations.¹⁷

In 1985, another measure was taken with regard to corporate tax. Under prior law, an income tax exemption had been granted only to an original issue discount for foreign bonds denominated in foreign currency. The 1985 amendment extended the exemption to interest and original issue discount on foreign bonds denominated in yen.¹⁸ After the amendment, no corporation tax was to be imposed on interest and the original issue discount that were paid to foreign corporations for foreign corporate bonds, except in cases where such interest is attributable to a Japanese permanent establishment of the receiving corporation.

In 1986, the Foreign Exchange Law was amended to create a Tokyo offshore market. The policy goal was to internationalize the use of yen by enabling Euro-yen transactions in Tokyo. To support such policy objectives, interest was exempted from withholding tax, if a foreign corporation deposited money in an offshore account with a certification of its non-resident status.¹⁹ At the same time, corporation tax was exempted for the interests in an offshore account, even when the receiving foreign corporation maintained a branch or a factory within Japan.²⁰ Note, however, that such interest was still taxable if it was attributable to a permanent establishment within Japan. The rationale for the above measures was that the offshore market had a firewall that separated it from domestic financial markets and that money was supposed to flow only from abroad to abroad.

Meanwhile, the basic tax regime was kept intact with regard to interest paid to non-residents.

4. Preventing Abuse

Granting an exemption to non-residents requires a mechanism to ascertain the non-resident status of beneficiaries.

Prior to the 1997 amendment, there was no procedure to verify the non-resident status of a recipient of interest on corporate bonds that have been issued abroad. After the liberalization of foreign exchange law, some Japanese

17 Special Taxation Measures Law Article 6.

18 Special Taxation Measures Law Article 68.

19 Special Taxation Measures Law Article 7.

20 Special Taxation Measures Law Article 67-13.

residents might have a chance to benefit from an income tax exemption by purchasing the exempt bonds under the name of a non-resident. To prevent abuse, the new law required that the interest recipient must submit an application form stating her name and address, to a tax office via financial institutions.²¹ Alternatively, the following mechanism was introduced for "specified foreign bonds," to accommodate the environment in the Eurobond market.²² Financial institutions, entrusted with the bond from a non-resident, would notify an interest payer about the fact that the interest recipient had a non-resident status. The interest payer would create a paper that states the following: status of the recipient, amount of interest payment, name of relevant specified foreign bond, date of interest payment, and name and address of the payer itself. In addition to the above measures, an exceptional regime was created for those jurisdictions where bank secrecy law precludes the notification of a status of interest recipients.²³

In 1998, an income tax exemption was introduced for the interest on certain registered national bonds when the interest was received by non-residents.²⁴ The intention of the legislature was to promote the international use of yen. The insertion of elaborate identification requirements was notable in this legislative step. To benefit from the exemption, the recipient non-resident must submit an application form and a paper describing the ownership period.²⁵ Financial institutions must check the application form and keep a unified book for the bonds.²⁶

These compliance tools were created in order to prevent abuse by a Japanese resident to utilize the interest exemption that was originally targeted at non-residents. The effect of such tools would have been enhanced if they were combined with the TIN system.

IV. Conclusion

This article examined the Japanese responses to the growing pressure from global financial markets, focusing on the taxation of cross-border interest flows. The particular case of Japan highlights a universal challenge that is shared by many other jurisdictions: how to tax capital income in an integrating world.

In an ideal world, the elimination of a source state tax on interest outflows should result in an offsetting revenue increase at the resident state of interest

21 Special Taxation Measures Law Article 6 Clause 4.

22 Special Taxation Measures Law Article 6 Clause 7.

23 Special Taxation Measures Law Article 6 Clause 10. Switzerland is designated as qualifying under this rule. Special Taxation Measures Law Cabinet Order Article 3-3 Clause 21.

24 Special Taxation Measures Law Article 5-2.

25 Special Taxation Measures Law Article 5-2 Clause 1.

26 Special Taxation Measures Law Article 5-2 Clause 6 and Clause 9.

recipients. In a real world, the resident state cannot fully capture the income of its residents who earn worldwide.

The development of a global market weakens the ability of the resident state to tax cross-border interest flows, for two reasons. First, the linkage is lost between the withholding tax in a source state and the foreign tax credit in a resident state. If the linkage existed, an interest recipient might well be induced to declare his interest income in order to credit his foreign taxes. However, many countries have already exempted portfolio interests. Second, a barrier of sovereignty retards the exchange of information. Despite efforts under the present treaty network, there are severe limitations to the information exchange.²⁷ Moreover, many jurisdictions, including offshore financial centers, are outside the treaty network.

The author is not aware of an estimate of the magnitude of an international fiscal vacuum, that is to say the amount of interest income that is both exempt at the source state and not declared at the resident state. However, the lively discussion concerning tax competition underscores the importance of the issue.²⁸ The analysis above suggests that one solution would be to revitalize the link between source and resident states by reintroducing backup withholding and by strengthening exchanges of information.²⁹ Despite political difficulties, international cooperation would be essential if we were to maintain a tax on capital income.

27 OECD, *Tax Information Exchange Between OECD Member Countries, A Survey of Current Practices*, Paragraph 44 (1994).

28 OECD, *Harmful Tax Competition, An Emerging Global Issue*, Paragraph 12 (1998). For the discussions on savings income within the EU, see <http://www.europa.eu.int/eur-lex>.

29 Taxpayer identification number would play a large role to match information internationally. *Hiroshi Kaneko, Sozeiho 537* (7th Edition 1999) suggests that "in order to adjust the TIN system to a global environment, it should be necessary to develop an international TIN system under which a three digit national number is attached (for example, 001 for the U.S. and 081 for Japan), at the stage when many countries adopt their national TIN systems."

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