

# ClientAlert

## Tax

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## Tax Exemption for Foreign Holders of Japanese Corporate Bonds

Upon passage of the 2010 Tax Reform by the Diet at the end of March, a temporary measure to expand the exemption from Japanese withholding tax on certain bond to include certain onshore issuances of corporate bonds, as well as exempt so-called redemption gain on such bonds purchased at a discount, (the "Exemption") came into effect for interest accruing from June 1, 2010 on bonds issued prior to April 1, 2013.

As reported previously (see [White & Case Client Alert, September 1, 2009 and April 13, 2010](#)), in 2009 the Ministry of Economy, Trade, and Industry ("METI") and the Financial Services Agency ("FSA") proposed measures to promote the onshore bond market for Japanese issuers. The proposal would temporarily expand the exemption from Japanese withholding tax on onshore issuances to include corporate bonds and reduce the burden of the procedural requirements for obtaining the exemption. The Exemption is effective for interest accruing from June 1, 2010 on any qualifying bond issued before April 1, 2013, *including currently-issued bonds* (any bonds issued prior to April 1, 2010). (In this regard, it is similar to the limitation on the exemption for select Eurobonds, which limitation was repealed in the 2010 Tax Reform such that Eurobonds issued after March 31, 2013 will continue to qualify.) Thus, interest accruing after March 31, 2013 will still continue to qualify if the bond was issued prior to April 1, 2013. In addition, the Exemption also applies to so-called "redemption gain" (the difference between the proceeds received upon redemption of the bond by the issuer and the price paid for the bond) on bonds issued prior to April 1, 2013. Previously, such redemption gain was subject to ordinary income tax (up to 40% for individuals; 30% for corporations) for which a tax return was required to be filed.

Historically, Japanese companies have obtained the bulk of their financing either from the equity markets or domestic banks. As a result, the global market for bonds of Japanese issuers has remained sporadic and largely illiquid. The Exemption would allow Japanese corporations the option of issuing debt domestically, rather than having to go to the Eurobond market (for which only a limited group of issuers are eligible) or of having to obtain financing from domestic banks. The object of this measure appears to be to significantly expand the global market for yen-denominated debt and debt-financing for Japanese issuers. In addition, the Exemption is expected to further increase foreign interest in Japanese corporate debt by exempting redemption gain on distressed corporate debt.



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Prior to enactment of the Exemption, in the case of onshore issuances, only Japanese Government Bonds (“JGBs”) issued by the national government and bonds issued by local Japanese governments were exempt from the Japanese withholding tax of 15% that generally applies to interest on debt of Japanese issuers. In addition, the procedures for obtaining the exemption, especially in the case of local government issuers, require that the Qualified Foreign Intermediary (“QFI”) and relevant foreign investors submit documents to verify their status *with respect to each issuance*. With some 60-800 types of issuances, such a requirement has proved quite burdensome and is said to have inhibited foreign investor interest in Japan’s municipal and sovereign bond markets.

Effective for interest accruing from June 1, 2010 (for bonds issued prior to April 1, 2013), the tax exemption for certain onshore bond issuances has been temporarily expanded to corporate issuers, in addition to Japanese national and local governments, subject to certain limitations, and the procedures for applying for the Exemption have been simplified. Generally, the Exemption applies only to certain foreign “qualified bondholders” which are not in a “relationship of control” with the issuer. In addition, the issuer can be any domestic corporation (whether or not having issued publicly-traded securities), including TMKs (*tokutei mokuteki kaisha*), special purpose companies used for corporate rehabilitation. However, the Exemption does not apply to corporate bonds which are “profit-linked,” and the bond must be issued in paperless, book-entry transfer form through the Japan Securities Depository Center, Inc. (JASDEC), the statutorily-designated bond book-entry transfer institution.

**Qualified Bondholders.** Generally, the Exemption applies only to foreign bondholders which are individuals, corporations (*houjin*), or certain investment trusts (*gaikoku toushi shintaku*). Certain foreign trusts may be treated as either corporations or investment trusts based on certain criteria. A general description of the criteria and classification of various types of foreign trusts (as corporations or investment trusts) is available on the Ministry of Finance website at: [http://www.mof.go.jp/english/bonds/tax\\_fund-e.htm](http://www.mof.go.jp/english/bonds/tax_fund-e.htm) (Foreign Investment Trusts Eligible for Tax Exemption).

Bondholders which are classified for Japanese tax purposes as other types of trusts or other types of entities do not generally qualify. Based on this, it is unclear whether partnerships would qualify. Generally, a partnership (*nin'i kumiai*) for Japanese tax purposes is not treated as a separate entity, but as an aggregation of the interests of the partners. Thus, if a partner were an individual or corporation, such partner would generally be deemed to own a pro rata share of corporate bonds held by the partnership and thus, could qualify for the Exemption. However, based on informal

contacts with the tax authorities, it appears that partnerships bondholders cannot qualify. A possible solution would be for a partnership to form an special purpose corporation (a qualifying type of bondholder) through which the corporate bonds can be held to qualify for the Exemption.

**Relationship of Control.** The Exemption does not apply to a foreign bondholder which is in a “relationship of control” with respect to the issuer. A “relationship of control” generally means that either the issuer or bondholder has “control” directly or through attribution over the other, or the same person “controls” both the issuer and bondholder. “Control” generally refers to holding more than 50% of the total number or amount of issued shares, more than 50% of the voting rights, or more than 50% of the members of a general partnership (*gomei gaisha*), a limited partnership (*goshi gaisha*), or a limited liability company (*godo gaisha*).

**Profit-Linked.** The Exemption does not apply to interest which is linked to the underlying performance of the issuer. The Enforcement Order related to the statute provides that the amount of interest should not be calculated based on the following:

- (1) Profits or revenue of the issuer (or a person in a relationship of control with the issuer);
- (2) The value of the assets of the issuer (or a person in a relationship of control with the issuer); or
- (3) Dividends or other distributions of the issuer (or a person in a relationship of control with the issuer).

Thus, it would appear that interest on debt from certain repackaging programs for bonds would not qualify if the interest is generally determined based on the interest income or gain from the underlying bonds in the portfolio. *However, senior securities with a fixed payout or other arrangement which is unrelated to income from the underlying bonds would appear to qualify.*

**Simplified Procedures.** The procedural requirements simplify the procedures which had applied in the case of JGBs and other government-related bonds. Under the procedures, bondholders are only required to file a one-time application to certify their eligibility for the Exemption, instead of having to do so with respect to every issuance or interest payment on an issuance. Thus, once having submitted a one-time form with a Bond Book-Entry System Participant (“Participant”) or QFI, the bondholder does not generally need to file any additional forms with respect to any specific bond issuance held through such Participant or QFI, or with respect to interest received on such bond issuances.

The specific statutory procedural requirements include the following:

- (1) The bondholder must submit a claim for exemption form (*hikazei tekiyo shinkokusho*) (the "Claim for Exemption"), through a Participant or QFI, to the relevant tax office when the bondholder applies for the Exemption for first time, which Claim for Exemption form contains the following information:
  - (a) Name and address of the bondholder;
  - (b) Whether the exemption applies with regard to a book-entry corporate bond deposited in a transfer account with a Participant in Japan or a QFI;
  - (c) The name and address of the Participant or QFI; and
  - (d) Other relevant information.
- (2) Generally, prior to the interest payment date, the bondholder must also submit a details of holding period form (*shoyu kikan meisaiشو*) (the "Detail of Holding Period") through a Participant and interest paying agent, or a QFI, to the relevant tax office, which Detail of Holding Period form contains the following information:
  - (a) Name and address of the bondholder;
  - (b) The name and address of the Participant or QFI;
  - (c) Title of the bond;
  - (d) Holding period;
  - (e) The relevant interest payment date and the amount of interest; and
  - (f) Others relevant information.

However, if the corporate bond is deposited with a Participant or QFI in an account which can accommodate both exempt accounts and taxable accounts, and the Participant or QFI submits certain documents to the interest paying agent, the bondholder is deemed to have submitted the Detail of Holding Period form to the relevant tax office. *Thus, the bondholder does not need to submit the Detail of Holding Period form (which is generally required each time interest is paid on the bond) to qualify for the Exemption.*

- (3) A Claim for Exemption/Detail of Holding Period form submitted to the relevant tax office is deemed to have been submitted on the date received by the Participant or QFI.

- (4) The bondholder must present a document which proves that it is a foreign corporation (describes the name and address of the bondholder located outside of Japan) to the Participant or QFI, which must confirm the name and the address of the bondholder from such documents.
- (5) The Participant or QFI must keep a appropriate books and records, which contain certain information (*e.g.*, the date of book entry).
- (6) The QFI must provide certain information (*e.g.*, the date of book entry) to the Participant, which must keep a record of such information.
- (7) The bond issuer must submit to the relevant tax office of the bond issuer a document which contains the following information within two months after an interest payment date:
  - (a) The name and the address of the bond issuer;
  - (b) Whether or not there is any nonresident person or entity which is in a relationship of control with respect to the bond issuer; and
  - (c) The name and address of any such nonresident person or entity which is in a relationship of control with respect to the bond issuer.

Such declaration may be problematic for corporate issuers that are closely-held by individuals. This is because the general family attribution rules apply with respect to determining whether interests in an entity are attributed to an individual and, under these attribution rules, an individual is deemed to own assets owned by any family member within six degrees of relationship (three degrees of relationship by marriage). Thus, an individual shareholder which controls an issuer would need to disclose whether any relative within six degrees of relationship (three by marriage) is a nonresident or has a relationship of control with respect to any foreign entity.

It should be noted that the forms discussed above have not been released by the tax authorities. In addition, it is anticipated that the official explanation of the Corporate Bond Exemption will be released by the Ministry of Finance sometime in the middle of 2010. The Tokyo Financial Services and Tax Groups will continue to track this important development and will be updating this alert periodically as progress on the implementation of the Exemption occurs.

## White & Case in Tokyo

White & Case LLP was one of the first foreign law firms to open in Japan when the law was changed to permit such firms to establish offices in Japan in 1987. It now has more *gaikokuho-jimu bengoshi* (registered foreign lawyers) than any other law firm in Japan, as well as one of the largest groups of Japanese attorneys for a foreign-based law firm. White & Case LLP was the first foreign firm to establish a “joint enterprise” with Japanese attorneys. The Firm is unique in its success in integrating into the domestic Japanese legal scene by attracting both foreign attorneys with Japanese language ability and Japanese lawyers with international experience. Our established teams of Japanese and foreign professionals are effective in dealing in Japan’s bi-legal, bi-lingual and bi-cultural environment. The Tokyo office of White & Case LLP has over 100 professionals, including *gaikokuho-jimu bengoshi*, Japanese attorneys and licensed tax attorneys (*zeirishi*).

Within the Tokyo office, the Tokyo Financial Services Group has received numerous awards from various organizations, such as *Chambers & Partners*, *Legal 500*, *Chambers Global*, *Global Counsel*, and *AsianInvestor*, including:

- Best Law Firm for Asset Management  
—*Asia Asset Management*, 2009
- Band One Investment Funds: Foreign (Japan)  
—*Chambers Asia*, 2010
- Best Law Firm for Asset Management  
—*AsianInvestor*, 2009
- Best Law Firm for Alternative Assets (Japan)  
—*AsianInvestor*, 2009
- Firm of the Year (Japan) – Alternative Investment Funds  
—*Pacific Business Press Asian-Counsel*, 2009

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—*Asia Tax Awards of International Tax Review*, 2009
- Japan Transfer Pricing Firm of the Year  
—*Asia Tax Awards of International Tax Review*, 2009
- Band One Tax: Foreign (Japan)  
—*Chambers Asia*, 2010
- Tier One for Japan Tax (Foreign Firms)  
—*Asia Pacific Legal 500*, 2009/2010
- Firm of the Year for Japan – Taxation  
—*Pacific Business Press Asian-Counsel*, 2009

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