

Islamic Finance & Markets 2020

Contributing editor
John Dewar



Publisher

Tom Barnes
tom.barnes@lbresearch.com

Subscriptions

Claire Bagnall
claire.bagnall@lbresearch.com

Senior business development managers

Adam Sargent
adam.sargent@gettingthedealthrough.com

Dan White

dan.white@gettingthedealthrough.com

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Law Business Research Ltd
Meridian House
34-35 Farringdon Street
London, EC4A 4HL
Tel: +44 20 7908 1178
Fax: +44 20 7229 6910

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Islamic Finance & Markets 2020

Contributing editor**John Dewar****Milbank**

Lexology Getting The Deal Through is delighted to publish the seventh edition of *Islamic Finance & Markets*, which is available in print and online at www.lexology.com/gtdt.

Lexology Getting The Deal Through provides international expert analysis in key areas of law, practice and regulation for corporate counsel, cross-border legal practitioners, and company directors and officers.

Throughout this edition, and following the unique Lexology Getting The Deal Through format, the same key questions are answered by leading practitioners in each of the jurisdictions featured. Our coverage this year includes chapters on Philippines and Switzerland.

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Every effort has been made to cover all matters of concern to readers. However, specific legal advice should always be sought from experienced local advisers.

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Japan

Takashi Tsukioka

Nagashima Ohno & Tsunematsu

OVERVIEW

Policies

- 1 | In general terms, what policy has your jurisdiction adopted towards Islamic finance? Are Islamic finance products regulated differently from conventional instruments? What has been the legislative approach?

Japan's attitude towards Islamic finance is to encourage its establishment in Japan through adjustments of existing laws and regulations that are compatible with the existing fundamental regulatory framework, to achieve a level playing field with its conventional equivalents. Islamic finance products are regulated under the same framework as that applicable to conventional instruments in Japan. Therefore, basically, Islamic finance products are governed by existing legislation applicable to conventional finance products in Japan, while some amendments thereon have been made to accommodate the unique qualities and characteristics of Islamic finance.

Market development

- 2 | How well established is Islamic finance in your jurisdiction? Are Islamic windows permitted in your jurisdiction?

Because of the small Muslim population in Japan and the lack of a sufficient customer base for *shariah*-compliant products in the domestic market, there is currently no Islamic financial institution operating in Japan. Conventional financial institutions and products remain dominant in the Japanese market. However, the establishment of IFIs is not prohibited in Japan. As for Islamic windows, the scope of business that regulated financial institutions (such as banks and insurance companies) can conduct, and thus the types of Islamic finance transactions they can carry out, is limited to the extent explicitly permitted under the laws and regulations of Japan; yet it is permissible for those institutions to carry out Islamic finance transactions to that extent. A recent amendment to a banking regulation guideline has made it clear that Japanese banks themselves (not just through their subsidiaries and affiliates) can now offer certain types of *shariah*-compliant banking products, including lending and deposit-taking equivalents offered in compliance with applicable regulations. In addition, certain types of Islamic financial business can be conducted through their subsidiaries (including sister companies). For example, under Japanese banking regulations, conventional banks can own subsidiaries offering certain Islamic finance products that are similar to lending (among others, *murabahah* and *ijarah*) based on *fatwahs* rendered by *shariah* supervisory boards. Conventional insurance companies can also take advantage of this framework under Japanese law. It is understood that several Japanese bank subsidiaries conduct *shariah*-compliant businesses outside Japan based on this rule. Japanese bank subsidiaries are also active in conducting cross-border Islamic finance transactions

and making investments in Islamic finance products that are available in foreign markets.

Legislation

- 3 | What is the main legislation relevant to Islamic banking, capital markets and insurance?

Japan has no legislation specifically addressing Islamic finance. Islamic banking, capital markets and insurance are basically subject to general finance laws and regulations in Japan as well as the tax treatment that applies to their conventional equivalents. However, several amendments have been made to existing laws and regulations to specifically facilitate Islamic finance transactions in Japan. One example is the regulation allowing conventional banks and insurance companies to conduct Islamic finance businesses on their own and through their subsidiaries (see question 2). In addition, Japanese securitisation law was amended so that its trust framework can be used for the issuance of *sukuk* utilising a lease and sale-back scheme (*sukuk al-ijarah*) under Japanese law. At the same time, a tax reform was made to achieve tax neutrality between Japanese *sukuk* under the revised securitisation law and conventional bonds, through which a tax exemption applies to coupon payments to foreign investors and repurchase of real estate as a *sukuk* asset from the trustee if the relevant *sukuk* meet certain requirements.

SUPERVISION

Principal authorities

- 4 | Which are the principal authorities charged with the oversight of banking, capital markets and insurance products?

The Financial Services Agency of Japan (FSA), led by the Minister for Financial Services, is the principal authority charged with the oversight of banking, capital markets and insurance products in Japan. In addition, depending on the regulations and relevant products, other organisations such as the Securities and Exchange Surveillance Commission of Japan and stock exchanges in Japan may have certain oversight responsibilities. With respect to the tax system applicable to those financial products, Japan's Ministry of Finance is the responsible authority. As the policymaking perspective of the Ministry of Finance is not always in line with that of the FSA, the relaxing of certain regulatory requirements concerning Islamic finance has not been followed by tax reforms corresponding to such changes.

Guidance

- 5 | Identify any notable guidance, policy statements or regulations issued by the regulators or other authorities specifically relevant to Islamic finance.

Apart from the laws and regulations mentioned under question 3, there is no guidance, policy statement or regulation issued by Japanese regulators or other authorities specifically relevant to Islamic finance. Having said that, prior to adopting these amendments to laws and regulations to accommodate Islamic finance, the Japanese government solicited comments from the public on the bills proposing such amendments and made public its views on those comments. These comments and the views of the Japanese government give some guidance on the laws and regulations addressing Islamic finance.

Central authority

- 6 | Is there a central authority responsible for ensuring that transactions or products are *shariah*-compliant? Are IFIs required to set up *shariah* supervisory boards? May third parties, related parties or fund sponsors provide supervisory board services or must the board be internal?

There is no central authority responsible for ensuring that transactions or products are *shariah*-compliant. IFIs are not required to set up *shariah* supervisory boards internally or externally as a matter of Japanese law. However, IFIs established as bank or insurance company subsidiaries that are subject to the regulations explained under question 2 must have *shariah* supervisory boards under applicable regulations. The functions of *shariah* supervisory boards can be outsourced to third parties, but additional supporting material might be required to rely on the relevant *fatwah* in certain cases such as where an IFI relies on a *fatwah* rendered by a *shariah* supervisory board set up by other IFIs or borrowers.

Board approval

- 7 | Do members of an institution's *shariah* supervisory board require regulatory approval? Are there any other requirements for supervisory board members?

In general, there is no requirement for regulatory approval or any other requirements for *shariah* supervisory board members under Japanese law. The only requirements applicable to members of *shariah* supervisory boards set up by IFIs established as banking or insurance company subsidiaries in accordance with Japanese regulations are that they must be knowledgeable about *shariah* and a board must consist of at least two members.

Authorisation

- 8 | What are the requirements for Islamic banks to be authorised to carry out business in your jurisdiction?

There is no regulatory framework specifically applicable to Islamic banks in Japan. On the other hand, for an Islamic bank to carry out its business as a bank in Japan, it must be licensed as a qualified bank (or a branch office of a foreign bank) under Japanese banking regulations and, similar to conventional Japanese banks, it will be subject to strict supervision.

Entities not subject to banking or insurance regulations would also be able to offer credit facilities utilising *murabahah* and *ijarah* concepts in Japan. They might still be required to register as moneylending companies with the authorities under the Money Lending Business Act. They would be prohibited from taking deposits.

Foreign involvement

- 9 | May foreign institutions offer Islamic banking and capital markets services in your jurisdiction? Under what conditions?

In many cases, foreign institutions seeking to offer Islamic banking and capital markets services in Japan would be subject to substantially the same regulatory framework as that applicable to Japanese domestic institutions. Foreign institutions can conduct banking, moneylending or securities brokerage businesses in Japan through their Japanese subsidiaries or branch offices. To conduct each of those businesses, certain requirements must be met for licensing or registration, as applicable. For example, in the case of registration for a moneylending business, the requirements include, among other things, the establishment of a certain internal control system to properly conduct the moneylending business and assets whose net value is at least ¥50 million. In the case of a banking licence and a securities brokerage business registration, the applicable requirements are much stricter than those for a moneylending business. However, foreign securities brokers conducting business outside Japan in accordance with foreign regulations would be exempted from such registration requirements if the scope of their business in Japan is limited to certain types of business, as specified in the relevant regulations, such as transactions with financial institutions and certain transactions for which a broker does not solicit customers.

Takaful and retakaful operators

- 10 | What are the requirements for *takaful* and *retakaful* operators to gain admission to do business in your jurisdiction?

Takaful and *retakaful* operations would fall within the definition of insurance business under Japanese financial regulations and would be subject to licensing requirements under Japanese law. Under the current framework, however, Japanese insurance laws and regulations only contemplate conventional insurance businesses and *takaful* or *retakaful* business may not fully fit into this legal framework. Therefore, it would be difficult to conduct such operations in Japan under the current regime.

Foreign operators

- 11 | How can foreign *takaful* operators become admitted? Can foreign *takaful* or *retakaful* operators carry out business in your jurisdiction as non-admitted insurers? Is fronting a possibility?

In general, a foreign insurance company is required to open a branch office in Japan and be licensed by the appropriate Japanese authority to operate an insurance business in Japan. This requirement is applicable to foreign *takaful* operators as well. However, to obtain this licence a foreign *takaful* operator would face the problem briefly explained in question 10. There is a possibility that a foreign *takaful* operator would need to be licensed in Japan even if it only underwrites risks in Japan through fronting insurance companies licensed in Japan. Foreign insurance companies are allowed, by an exemption under the Insurance Business Act of Japan, to provide reinsurance to Japanese insurance companies without obtaining a licence in Japan, but it is uncertain whether *takaful* underwriting risks in Japan through fronting companies would be deemed to be reinsurance for the purpose of taking advantage of this exemption.

Disclosure and reporting

- 12 | Are there any specific disclosure or reporting requirements for *takaful*, *sukuk* and Islamic funds?

There is no disclosure or reporting requirement specifically applicable to *takaful*, *sukuk* or Islamic funds. For each of these products,

disclosure requirements applicable to conventional equivalents would also apply to them.

Sanctions and remedies

13 | What are the sanctions and remedies available when products have been falsely marketed as *shariah*-compliant?

If financial products have been falsely marketed as *shariah*-compliant, investors might be able to seek damages arising from such misstatements although there is no court precedent confirming the legality of such action. The amount of damages would be calculated based on the economic loss incurred by the investor. Generally, an investor as a plaintiff has the burden of proving his or her right to the damages sought in court proceedings.

If a securities offering is made through a public offering involving statutory disclosure documents such as securities registration statements or registered prospectuses, and those disclosure documents describe the products in question as *shariah*-compliant, and this constitutes a material misstatement or omission for the purpose of Japanese securities regulations, special liabilities under the regulations would arise. In such situations, the issuer, its directors, underwriters and certain other parties might be liable to investors who acquired the products at the offering. The issuer would be held strictly liable for the misstatement or omission and the other parties would need to prove that they did not know of the misstatement or omission after exercising due care to avoid this liability. Also, the investor would benefit from a statutory presumption regarding the amount of damages the issuer would be required to pay. The issuer might be subject to criminal proceedings as well as an administrative surcharge.

Jurisdiction in disputes

14 | Which courts, tribunals or other bodies have jurisdiction to hear Islamic finance disputes?

In Japan there is only one court system consisting of, among others, the Supreme Court of Japan, high courts and district courts. These courts have jurisdiction to hear Islamic finance disputes as well as conventional finance disputes.

CONTRACTING CONCEPTS

Accommodation of concepts

15 | *Mudarabah* – profit sharing partnership separating responsibility for capital investment and management.

A possible structure to implement a *mudarabah* transaction is a Japanese trust arrangement. In this framework, a settlor entrusts its asset to a trustee who manages it in accordance with the trust agreement. The beneficiary of the trust (who may or may not be the settlor) will receive profits generated from the trust asset, while losses will also be borne by the beneficiary (unless there is any mismanagement by the trustee) as the value of the trust asset decreases. So long as the trust asset is properly segregated from the trustee's own assets, the trust asset will not be included into the trustee's bankruptcy estate in the case of the trustee's bankruptcy (bankruptcy remoteness). The beneficial interest of a trust may constitute a 'security', which is subject to Japanese securities regulations. Only licensed trust companies and trust banks are qualified to conduct a trust business in Japan.

An anonymous partnership (TK) would be an alternative vehicle for the purpose of implementing a *mudarabah* transaction. In this arrangement, an investor contributes its asset to an entrepreneur for the entrepreneur's business, and the entrepreneur agrees to distribute a portion of the profits generated from the business to the investor in

accordance with the TK agreement between them. On the other hand, losses will generally be borne by the investor only to the extent of its contributed asset. In a TK, only the entrepreneur will carry out the business while the investor has only limited control with respect to it. Unlike the trust arrangement as stated above, the investor's interest in the assets contributed for a TK arrangement will not be protected in the event of the bankruptcy of the entrepreneur and such assets will constitute part of the entrepreneur's bankruptcy estate. TK entrepreneurs do not require trust licences. However, they might be subject to securities regulations depending on the activities they conduct. In addition, a TK interest is deemed to be a security subject to securities regulations.

16 | *Murabahah* – cost plus profit agreement.

Murabahah transactions can be generally implemented under Japanese law. However, there is no special tax exemption applicable to *murabahah* transactions and thus taxes (such as consumption tax, registration tax and real estate acquisition tax, where applicable) may be charged for each transfer of the relevant assets.

In regard to financial regulations in Japan, those who implement *murabahah* transactions may need to be registered under the Money Lending Business Act of Japan depending on the structure of the relevant transactions (see question 8). Banks can conduct lending and deposit-taking businesses involving commodity *murabahah* to the extent the relevant transactions meet certain requirements under the applicable banking regulation guideline. Banks can also carry out lending equivalent activities utilising *murabahah* through their subsidiaries as a matter of Japanese banking regulations.

Creditors under *murabahah* transactions may take collateral to secure indebtedness arising therefrom.

Murabahah transactions with retail consumers may be subject to consumer protection regulations under the Instalment Sales Act of Japan, if they involve certain goods and services as well as a certain method of payment. In such case, an IFI conducting a *murabahah* transaction must comply with the various requirements of that act, including the duty to provide its customers with a written and detailed explanation of the various aspects of the transaction.

17 | *Musharakah* – profit sharing joint venture partnership agreement.

Musharakah can be created through a partnership under the Japanese Civil Code. A partnership agreement is entered into among partners, and each will jointly make contributions to the business in accordance with the agreement. As opposed to a TK, each of the partners will be able to participate in the partnership's business activities even though such power might be delegated to one or more managing partners with no specific formality requirement. Profits and losses would be shared among the partners in accordance with the provisions of the partnership agreement, which may or may not be proportionate to their contributions. Care should be taken in setting up a Civil Code partnership because each partner's liability to creditors of the partnership will be unlimited, which means that the creditors will have rights of recourse that extend beyond each partner's contribution and to the partner's individual assets if necessary.

An investment limited partnership (LPS) is an alternative structure that can be used to secure limited liability in relation to a transaction. An LPS is a partnership among one or more general partners and limited partners, the purpose of which is to jointly make investments. Certain matters in relation to an LPS, such as the scope of its business and the names and addresses of its general partners, must be registered with a legal affairs bureau. The scope of business that an LPS can conduct is limited to certain investment activities such as acquisition of shares

and monetary claims and thus this vehicle can be utilised for limited activities. As in the case of a Civil Code partnership, profits and losses would be shared among the partners in accordance with the provisions of the partnership agreement, which may or may not be proportionate to their contributions. However, limited partners of an LPS will enjoy limited liability and thus they will not incur losses beyond their contributions. Limited partners may not actively participate in the LPS's business activities. On the other hand, general partners of an LPS, who have unlimited liability in relation to the claims of the LPS's creditors, will have the full control over the LPS's business.

Both Civil Code partnership interests and LPS interests will be deemed to be securities subject to Japanese securities regulations. In addition, financial institutions whose scope of permissible businesses is restricted, might be prohibited from joining partnerships conducting businesses that are not permitted under applicable regulations. Also, ownership of voting shares in companies above a certain threshold by financial institutions (the current threshold is generally 5 per cent for banks) is restricted unless such ownership is permitted under a statutory exemption. Share ownership through partnerships or LPSs could be covered under an exemption if it meets certain requirements.

18 | *Ijarah* – lease to own agreement.

Ijarah would constitute leasing transactions in Japan, and, in general, would be valid. At present, there is no law that specifically regulates the leasing industry. However, if, at the end of a leasing period, ownership of the leased asset is transferred to the lessee (*ijarah wa iqtina*), such a transaction may be subject to the Instalment Sales Act (one of Japan's consumer protection laws) as in the case of *murabahah* (see question 16).

Banks may conduct certain types of leasing businesses under Japanese banking regulations, but the terms of such leases are strictly limited. Lease agreements entered into by banks should not contemplate a transfer of the leased assets to the lessee at the end of the lease term, which would prohibit banks from carrying out *ijarah wa iqtina* transactions. Therefore, *ijarah* transactions conducted by banks using a lease framework may not be flexible enough to accommodate various needs of customers. On the other hand, bank subsidiaries can carry out *ijarah* transactions subject to compliance with banking regulations as in the case of *murabahah* (see question 2).

19 | *Wadiah* – safekeeping agreement.

Wadiah, if appropriately drafted, might be treated as bank deposits for the purpose of Japanese deposit insurance regime, although no such agreements currently exist. However, Japanese banking regulations allow only licensed banks and similar organisations to conduct a deposit-taking business. Therefore, *wadiah* transactions should generally only be carried out by licensed banks in Japan. In relation to deposited cash, it is generally understood that banks do not owe a fiduciary duty to depositors under Japanese law. Additionally, the possibility of making gifts (*hibah*) to depositors in lieu of interest has yet to be tested in Japan. Although it may not be impossible, such gifts may be limited in value to the maximum amount set by Japanese consumer protection law. As long as the gift's payment is at the bank's discretion, it would not be protected by Japanese deposit insurance.

Financial products designed under the concept of sharing risk and profit (ie, products whose principal amount cannot be guaranteed) are not contemplated to be covered by Japanese deposit insurance.

PRODUCTS

Securities structuring

- 20 | *Sukuk* – Islamic securities. Have *sukuk* or other Islamic securities been structured and issued in your jurisdiction to comply with Islamic principles, such as the prohibition of interest?

We are not aware of any *sukuk* issuance publicly announced in Japan to date. However, as explained in question 3, amendments to the Japanese securitisation law and certain tax laws have accommodated the issuance of *sukuk al-ijarah* (*sukuk* utilising a lease and sale-back structure) through the Japanese trust structure, which allows for profit distributions rather than interest payments. This framework is expected to be used not only by Japanese issuers but also by foreign issuers issuing *sukuk* in the Japanese market.

Legal position

- 21 | What is the legal position of *sukuk* holders in an insolvency or a restructuring? Are *sukuk* instruments viewed as equity or debt instruments? Have there been any court decisions or legislation declaring whether *sukuk* holders are deemed to own the underlying assets?

There is no court decision, legislation or official Japanese securitisation law guideline in Japan concerning or clarifying the legal position of holders of *sukuk* issued in accordance with Japanese securitisation law (*J-sukuk*) in the event of the insolvency or restructuring of the issuer. It is anticipated that many *J-sukuk* issuance schemes will be structured with the expectation that *J-sukuk* will be treated in the same manner as conventional bonds in the case of the issuer's insolvency.

Generally, trust certificates tend to be seen as equity instruments in Japan. However, for the purpose of Japanese taxation, *J-sukuk* (although they are trust certificates) that are designed to meet certain requirements to be economically similar to conventional bonds would be treated as if they were debt instruments. In this way, tax neutrality with conventional bonds would be achieved.

In Japan, it is understood that title to trust assets is held by the trustee as opposed to the beneficiaries (ie, investors), yet beneficiaries can benefit from the trust assets in accordance with the trust agreement even in the case of a trustee's bankruptcy (in other words, creditors of the trustee will have no recourse to the trust assets). As *J-sukuk* are based on Japanese trust principles, they should be treated in the same manner as explained above.

Insurance

- 22 | *Takaful* – Islamic insurance. Are there any conventional cooperative or mutual insurance vehicles that are, or could be adapted to be, *shariah*-compliant?

It would be difficult to find an insurance vehicle suitable to undertake a *takaful* business under Japanese law because of Japanese insurance regulations (see question 10).

- 23 | Which lines of insurance are currently covered in the *takaful* market? Is *takaful* typically ceded to conventional reinsurers or is *retakaful* common in practice?

Currently, there is no *takaful* market within the Japanese insurance market. Conventional insurance is dominant in Japan.

MISCELLANEOUS**Regulatory obstacles**

24 | What are the principal regulatory obstacles facing the Islamic finance industry in your jurisdiction?

Generally, businesses involving the purchase, sale or lease of certain goods or products (such as medical equipment and real estate) would be subject to registration and licensing requirements under sector-specific regulations. Those regulations would also apply when an IFI conducts *murabahah* or *ijarah* transactions. To facilitate the entry of Islamic finance into Japan, those financing transactions should be exempted from the registration and licensing requirements.

In addition, some people argue that new accounting standards need to be adopted in Japan, as Japan's current accounting standards are not entirely appropriate for *shariah*-compliant transactions.

Shariah law

25 | In what circumstances may *shariah* law become the governing law for a contract or a dispute? Have there been any recent notable cases on jurisdictional issues, the applicability of *shariah* or the conflict of *shariah* and local law relevant to the finance sector?

There is currently no judgment by a Japanese court addressing whether *shariah* law would be the appropriate governing law for a contract made in Japan or a dispute arising in Japan. However, in light of Japanese civil procedure, it is unlikely that general *shariah* principles (which are not the law of any specific country) would be recognised as the governing law for a contract or a dispute under Japanese conflict-of-laws rules even if the parties to the relevant contract so designate.

Institutional takeover

26 | Are there any special considerations for the takeover of an Islamic financial institution, outside the requirements of the general merger control regime?

Although there is no precedent in this regard, there would not be any special considerations for the takeover of an Islamic financial institution outside the requirements of the general merger control regime as a matter of Japanese law.

Other notable features

27 | Are there any notable features of the Islamic finance regime and markets for Islamic finance products in your jurisdiction not covered above?

Recently, Japanese financial institutions have become more and more active in the global Islamic finance market. It is reported that several Japanese financial institutions have successfully arranged Islamic credit facilities and other types of *shariah*-compliant products in the markets, particularly in Asia and the Middle East. It is very much expected that they will accumulate experience in offering *shariah*-compliant products and, with such accumulated experience, will be able to better assist foreign and Japanese market players interested in Islamic finance in the near future.

NAGASHIMA OHNO & TSUNEMATSU**Takashi Tsukioka**

t_tsukioka@noandt.com

JP Tower
2-7-2 Marunouchi
Chiyoda-ku
Tokyo 100-7036
Japan
Tel: +81 3 6889 7000
Fax: +81 3 6889 8000
www.noandt.com

UPDATE AND TRENDS**Key developments of the past year**

28 | Are there any proposals for new legislation or regulation, or to revise existing legislation or regulation? If so, please give a reference to any written material, whether official or press reports. Are there any other current developments or trends that should be noted?

An amendment to Japan's tax laws which seeks to establish equal tax treatment of *J-sukuk* with conventional bonds has been implemented on a temporary basis. Among other things, a tax exemption on coupon payments to foreign investors and repurchase of real estate as a *sukuk* asset from the trustee was established, and such exemption was to expire at the end of March 2019. However, in light of the expectation that *J-sukuk* would be issued in the near future, this period was recently extended to the end of March 2022.

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