The Private Wealth & Private Client Review

Sixth Edition

Editor
John Riches

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THE PRIVATE WEALTH & PRIVATE CLIENT REVIEW

SIXTH EDITION

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PREFACE

I INTRODUCTION

At a macro level, the dominant trend affecting the private wealth arena in the last 12 months continues to be the impact of various supranational initiatives seeking greater transparency with respect to anti-money laundering regimes and tax information exchange. I propose to focus in this year's introduction on the central importance of the concept of 'beneficial ownership' and the theme of convergence in the increasingly interconnected arenas of anti-money laundering policy and tax information exchange.

The clearest examples of this trend can be found in the introduction of centralised beneficial ownership registers, especially in the European Union and the Crown Dependencies and Overseas Territories of the United Kingdom (generally collectively referenced as CDOTs).[1] There are two specific manifestations of this:

a corporate beneficial ownership registers; and
b trust beneficial ownership registers.

In parallel, 2017 has witnessed the first substantive reporting by the first wave 'adopters' of the Common Reporting Standard (CRS) in the context of the 2016 calendar year.

I would like to first reference the common definitions that connect CRS with beneficial ownership registers and then refer in detail to the UK domestic trust register that was introduced by Regulations adopted in June 2017[2] (2017 MLR) before noting some key developments in the CRS domain.

i Common use of beneficial ownership concept

The key 'source document' with respect to the concept of beneficial ownership is the Financial Action Task Force (FATF) 2012 Recommendations.[3] These recommendations were introduced as part of the international anti-money laundering policy but have been adopted as an essential element of the international tax information exchange policy implemented by the CRS.

1 These jurisdictions includes Jersey, Isle of Man, Guernsey, Cayman Islands, Bermuda and British Virgin Islands.
2 To give them their full title, 2017 No. 692, The Money Laundering, Terrorist Financing and Transfer of Funds (Information on the Payer) Regulations 2017.
3 FATF/OECD (2013), International Standards on Combating Money Laundering and the Financing of Terrorism and Proliferation, The FATF Recommendations February 2012, FATF/OECD, Paris, available on www.fatf-gafi.org/media/fatf/documents/recommendations/pdfs/FATF_Recommendations.pdf.

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This is clearly confirmed in a CRS context by the CRS Commentary on the concept of controlling persons. Paragraph 132 of the interpretive notes to Recommendation 10 on Customer Due Diligence, states:

> *Subparagraph D(6) sets forth the definition of the term 'Controlling Persons'. This term corresponds to the term 'beneficial owner' as described in Recommendation 10 and the Interpretative Note on Recommendation 10 of the Financial Action Task Force Recommendations (as adopted in February 2012), 13 and* ***must be interpreted in a manner consistent with such Recommendations, with the aim of protecting the international financial system from misuse including with respect to tax crimes.***[4]

The FATF recommendations lead to a position where one essentially moves away from a strict legal definition of who might be entitled to enjoyment of an asset as a beneficial owner to an expanded concept. Under these rules, if it is not possible to identify a beneficial owner based on 'ownership interests' it is necessary to identify a beneficial owner based on 'control' even though the person or persons who control a legal entity have no capacity to call for the assets of the entity for their own personal benefit. In addition, as a last resort, if no 'ownership' or 'control' test can be satisfied, the final step is to look to the 'senior managing official' of the entity at the top of the ownership chain. This three-level ordering of who is to be regarded as the 'beneficial owner' is taken from the interpretive notes to Recommendation 10 of the FATF 2012 Recommendations:[5]

> *Identify the beneficial owners of the customer and take reasonable measures to verify the identity of such persons, through the following information:*
>
> *(i) For legal persons:*
> *(i.i) The identity of the natural persons (if any – as ownership interests can be so diversified that there are no natural persons (whether acting alone or together) exercising control of the legal person or arrangement through ownership) who ultimately have a controlling ownership interest in a legal person; and*
> *(i.ii) to the extent that there is doubt under (i.i) as to whether the person(s) with the controlling ownership interest are the beneficial owner(s) or where no natural person exerts control through ownership interests, the identity of the natural persons (if any) exercising control of the legal person or arrangement through other means.*
> *(i.iii) Where no natural person is identified under (i.i) or (i.ii) above, financial institutions should identify and take reasonable measures to verify the identity of the relevant natural person who holds the position of senior managing official.*

The immediately following interpretive notes describe the steps to be taken to identify the beneficial ownership of a trust (or similar legal arrangement such as a foundation). In this case the approach is subtly different. They start with a composite list that blends together

4 Emphasis added.

5 FATF/OECD (2013), International Standards on Combating Money Laundering and the Financing of Terrorism and Proliferation, The FATF Recommendations February 2012, FATF/OECD, Paris, available on www.fatf-gafi.org/media/fatf/documents/recommendations/pdfs/FATF_Recommendations.pdf at pages 61-62.

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those who might benefit personally with those who are perceived to have some 'control'. They state:

> *For legal arrangements:*
> *(ii.i) Trusts – the identity of the settlor, the trustee(s), the protector (if any), the beneficiaries or class of beneficiaries, and any other natural person exercising ultimate effective control over the trust (including through a chain of control/ownership);*
> *(ii.ii) Other types of legal arrangements – the identity of persons in equivalent or similar positions.*

What is notable here is the introduction of a 'residual' concept of:

> *Any other natural person exercising ultimate effective control over the trust*

I will refer to this as the 'NPEEC' in the rest of this article.

Until recently, there has been a major problem with construing who might be regarded as an NPEEC in a trust context especially because there has been no guidance in a FATF or CRS context that sheds light on what is meant by 'control'. This has created uncertainty as to when a person has 'control' over a trust, for example, will it include someone who has power to remove a trustee, someone who can only exercise powers jointly with someone else or someone who holds only powers of veto rather than positive powers to act.

In the Anti-Money Laundering context, the 2017 MLR includes a definition of 'beneficial owner' and 'control' for the purposes of the Regulations. At Regulation 6 it states:

> *6.—(1) In these Regulations, 'beneficial owner', in relation to a trust, means each of the following—*
> *(a) the settlor;*
> *(b) the trustees;*
> *(c) the beneficiaries*
> *(d) where the individuals (or some of the individuals) benefiting from the trust have not been determined, the class of persons in whose main interest the trust is set up, or operates;*
> *(e) any individual who has control over the trust.*
> *(2) In paragraph (1)(e), 'control' means a power (whether exercisable alone, jointly with another person or with the consent of another person) under the trust instrument or by law to—*
> *(a) dispose of, advance, lend, invest, pay or apply trust property;*
> *(b) vary or terminate the trust;*
> *(c) add or remove a person as a beneficiary or to or from a class of beneficiaries;*
> *(d) appoint or remove trustees or give another individual control over the trust;*
> *(e) direct, withhold consent to or veto the exercise of a power mentioned in sub-paragraphs (a) to (d).*

A critical point to note here is that the mere existence of one of the relevant powers with respect to a trust is sufficient to be regarded as control even in circumstances where that power is not actually exercised. This is substantially different from the idea of a person who exercises effective management of a trust or a company in many tax contexts, The more conventional concept is a facts and circumstances test that requires the actual exercise of powers rather than the mere capacity to exercise them for control to be attributed to a person.

What is striking here is that in Regulation 6(2), both the holding of joint powers and that the withholding of consent or ability to veto the exercise of key powers is to be equated

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with 'control'. I will return to the specific implications for CRS Reporting in the context of trusts later – for now, it is sufficient to note the expansive definition of beneficial ownership which sits behind the various regimes.

A final point to note is that the scope of powers that can be held with respect to a trust that come within this incredibly wide concept of control extend substantially beyond the power to appoint and remove trustees.Thus powers that relate to changing the class of beneficiaries, varying or terminating the trust and powers to invest or deal with trust property are also to be equated with control.

ii UK Trust Register

I now turn to the UK Trust Register in its own terms. The reason I wish to consider this piece of domestic UK legislation in detail is because, as far as I am aware, it represents the first instance where a major 'onshore' jurisdiction with a domestic trust law has introduced a centralised beneficial ownership register for trusts. The 2017 MLR effectively implements the UK's obligations under the EU Fourth Money Laundering Directive ((EU) 2015/849 (4AMLD)) to introduce a UK trust register. The regulations have a wide context with respect to the combating of terrorist financing and the fight against organised crime more generally. It seems likely that they will be widely copied, especially by trusts administered in the CDOTs where the UK has substantial influence.

The Regulations require the UK tax authority (HMRC) to maintain a trust register. The trust register will principally apply to trusts with UK resident trustees. However, trusts with non-UK resident trustees are also within the scope of the register if they hold UK situate assets that generate the obligation to report to UK HMRC with respect to certain taxes, including income and capital gains tax, inheritance tax and stamp duty land tax. The scope of the register requires more extensive information to be reported and maintained than that required to be disclosed under CRS.

In addition to the information which would typically be disclosed for the purposes of CRS (see paragraph 11 above) it also necessary to provide HMRC with the following information:

a The trustees must provide information about certain professional advisers to the trust, namely those who provide 'legal, financial or tax advice[6]' to the trust.

b There is a requirement to provide 'a statement of accounts for the trust, describing the trust assets and identifying the value of each category of the trust assets'. CRS, in contrast, only requires a composite value for the notional 'account value' of the trust fund of the trust without breaking this value down into categories.

c In considering who might be regarded as a beneficiary, Regulation 44(5)(b) states that trustees must report information 'about any other individual referred to as a potential beneficiary in a document from the settlor relating to the trust such as a letter of wishes'. This means that reference has to be made to documents other than the trust deed itself which, in the longer term, is likely to create a significant degree of confusion and uncertainty over reporting given that there is no current requirement to undertake such an exercise that I am aware of in any CRS or other equivalent tax reporting context with regard to persons who are not named as current beneficiaries.

6 See regulation [ ] of 2017 MLR.

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The UK Trust Register will (subject to the caveat noted below) only be accessible by law enforcement agencies in the UK and throughout the rest of the EU/EEA – the issue of what happens to this EU/EEA access post Brexit is presently unclear. The categories of persons with access to the UK Trust Register under 2017 MLR are arguably narrower than those described in Article 14 of 4AMLD. Article 14 states that:

> *persons who are able to demonstrate a legitimate interest with respect to money laundering, terrorist financing, and the associated predicate offences, such as corruption, tax crimes and fraud should also have access to beneficial ownership*

It is, therefore, possible that NGOs and investigative journalists with an anti-corruption profile could seek access to the UK Trust Register on the basis that the UK (as a current EU member) has failed to implement 4AMLD in full.

iii Trustee obligations under the UK Register

A trustee of a relevant trust[7] is obliged to:

a maintain an up-to-date register of the 'beneficial owners' of and advisers to the trust;

b provide HMRC with detailed information about the beneficial owners on an annual basis and with respect to the assets of the trust and their capital value;

c inform relevant persons[8] of:
- its status as a trustee;
- the beneficial owners of the trust; and
- any change of beneficial owners (within 14 days of the change occurring).

d respond to any request for information from any law enforcement agency with respect to the trust within the reasonable period specified in the notice of request.

iv Information about the trust under the UK Trust Register

With respect to the trust itself, it will be necessary to confirm:

a the name of the trust and its date of creation;

b a statement of accounts for the trust, describing the trust assets and identifying the value of each category of the trust assets;

c the place where the trust is administered;

d a contact address for the trustees; and

e the full names of any advisers who are being paid to provide legal, financial or tax advice in relation to the trust.

With respect to individuals identified as beneficiaries or NPEECs it will be necessary to provide:

a full name and date of birth;

b details of the individual's role or roles in relation to the trust; and

c unique tax reference number of the individual.

7 Essentially a trust within scope of reporting.

8 Essentially financial in institutions and other professional persons with reporting regulations under AML rules.

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Where a corporate entity is involved in a trust, one is obliged to 'look through' that entity and identify the individual(s) who control it; they are subject to disclosure in their own right.

v CRS developments

In a CRS context, I would like to consider two key areas. The first is the issue of local guidance and fragmentation, especially with respect to trust reporting. The second is the vexed issue of reporting protectors and its overlap with the NPEEC concept.

vi Fragmentation

On fragmentation, it is notable that during 2017, many jurisdictions issued their own local guidance on certain issues. To take a few examples:

a Canada: as in the case of the Foreign Account Tax Compliance Act (FATCA), Canada takes the position that other than in certain instances where banks or similar entities are concerned, most trusts with professional trustees are to be regarded as passive non-financial entities (NFE) not reportable financial institutions (RFI).

b Singapore: Singapore has issued guidance that permits settlors who are excluded as beneficiaries to report a nil value in terms of the value of their equity interest in the notional account represented by the trust fund.

c Bermuda: a trust where the settlor reserves a right to direct investments is not to be regarded as an RFI even though its trustee is a financial institution.

d Cayman Islands: all financial institutions are required to file a nil report even though they are non-reporting FIs. This is contemplated in CRS but is likely to create a significant degree of extra reporting in large and complex trust structures.

The concern here is that there will be substantial confusion over what to report where local guidance generates positions that contradict OECD's own commentary or the position taken in other jurisdictions generally. It is also likely that a pattern of jurisdictional arbitrage will emerge.

vii Protectors

On the issue of reporting protectors, it is well known that there is an inconsistency in the class of persons who are to be identified as the controlling persons of a trust when compared with those who to be identified as holding an equity interest in a trust. The two lists of persons are substantially similar except that the latter makes no express reference to 'protectors'. This has led to a great deal of confusion and divided opinion on when protectors are required to be reported. OECD in an FAQ issued in June 2016 takes the view that protectors must always be reported but a strict reading of the wording of the Model Treaty leads to the conclusion that they should only be disclosed as holders of an equity interest where they satisfy the test as a NPEEC.

What is interesting is that, in the context of the UK Trust Register, 2017 MLR do not make express reference to protectors either. Instead, as noted above, they refer to 'any individual who has control over the trust' and then refer to the powers over the trust that are to be equated with 'control'.

viii NPEECs and control

I would like to consider the question of who is to be regarded as 'exercising control' and who might be regarded as an NPEEC for CRS purposes if one follows the approach adopted in 2017 MLR.

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It is interesting to note that, in commenting on the issue of control under the Controlling Persons heading in the CRS Handbook at paragraph 227, the OECD states:

> *The account held by a trust will also be reportable if it the trusts has one or more Controlling Persons that are Reportable Persons. The concept of Controlling Person used in the CRS is drawn from the 2012 FATF Recommendations on beneficial ownership. As such, the Controlling Persons of a trust are the settlor(s), trustee(s), beneficiary/ies, protector(s) and any other natural person exercising ultimate effective control over the trust.* ***This definition of Controlling Person excludes the need to inquire as to whether any of these persons can exercise practical control over the trust.***[9]

It is reasonable to conclude that OECD's intention was to follow the FATF expansive definition of beneficial ownership which is not based on a conventional legal analysis of matters such as control but, instead, to ensure that those persons reported under CRS include those with the capacity to exercise substantial influence over how a trust is run.

This approach is echoed in OECD's comments at paragraph 214 of the Handbook with respect to those to be regarded as holding an equity interest in an RFI Trust. This states:

> *The Equity Interests are held by any person treated as a settlor or beneficiary of all or a portion of the trust, or any other natural person exercising ultimate effective control over the trust.* ***The reference to any other natural person exercising ultimate effective control over the trust, at a minimum, will include the trustee as an Equity Interest Holder.***[10]

The fact OECD uses the phrase 'at a minimum' is confirmation of this expansive approach.

My view is that the definition of control from MLR 2017 could well be widely adopted in a CRS context to assist in defining NPEECs with respect to trusts. If this does indeed happen, it will mean that virtually all protectors with significant powers with respect to trusts will be reportable as NPEECs, thus rendering the debate about whether protectors of RFI trusts are reportable as such largely academic.

II CONCLUSION

The year 2017 has witnessed some important developments in beneficial ownership reporting. The convergence of the expanded concept of who is to be regarded as a beneficial owner or exercising control in the tax reporting and AML arena looks set to be a dominant trend in the years ahead. Advisers should be very conscious of this, not only in advice on existing wealth ownership structures but also in the design of new ownership structures.

John Riches
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London
September 2017

9 Emphasis added.
10 Emphasis added.

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Chapter 24

JAPAN

Masayuki Fukuda and Yushi Hegawa[1]

I INTRODUCTION

Japan has the world's third-largest economy, having achieved remarkable economic growth after the Second World War, and private wealth management among business owners and wealthy families has become popular in Japan. However, Japan may not be such a favoured jurisdiction for private wealth management compared to others, largely owing to the significant tax burdens of personal income tax and inheritance and gift tax for wealthy individuals, and there being little room for effective tax planning to lawfully avoid these taxes. Recently, tax reforms have been made to increase the tax burden of wealthy individuals, such as establishing a new marginal tax bracket for personal income tax of taxable income exceeding ¥40 million (45 per cent) and the new 'exit tax' regime. On top of this, the recent enforcement attitude of the Japanese tax authority towards wealthy individuals has become very active and rigorous: the media frequently reports that wealthy individuals, e.g., business owners, who planned to avoid taxes were audited and subject to a tax bill of billions of yen as the tax authority did not respect the position taken. These examples seem to be enough to warn wealthy individuals and professional tax advisers against aggressive tax planning, setting aside the option of subsequently disputing the assessment in the courts. The Japanese government's recent enforcement attitude is probably partially politically motivated, so that in exchange for raising the rate of the consumption tax (i.e., VAT) from 5 per cent to 8 per cent in April 2014, then from 8 per cent to 10 per cent in October 2019, to be borne by the general public, any dissatisfaction or feeling of unfairness of the general public towards the seemingly low tax burden of wealthy individuals must then be mitigated.

In such an environment, Japanese tax planning considerations for high net worth individuals would inevitably have to shift towards utilising ready-made measures offered by tax laws, rather than using creative or novel structures or techniques – presumably considered by the Japanese tax authority as deviating from the original intent of the relevant tax provision – to pursue no or little tax burden.

II TAX

i Personal income taxation

Resident individuals

Generally, Japanese resident individuals are taxed at regular progressive rates on all types of income under the Income Tax Act (Act No. 33 of 1965, as amended), subject to the

1 Masayuki Fukuda and Yushi Hegawa are partners at Nagashima Ohno & Tsunematsu.

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special tax rules discussed below under the Act on Special Measures Concerning Taxation (Act No. 26 of 1957, as amended). The marginal tax rate of individual income taxation is 55.945 per cent (comprised of 45 per cent national individual income tax, 0.945 per cent special reconstruction income surtax and 10 per cent local inhabitants tax) until 2037. The marginal rate applies to the portion of the taxable income exceeding ¥40 million; this new marginal rate bracket has been effective from 2015. Among others, business income and employment income (including directors' and officers' remuneration) are subject to the regular progressive taxation.

Special rules apply to income from financial assets, which are significant for Japanese high net worth resident individuals. Japanese resident individuals are taxed on capital gains arising from sale of securities (shares, whether private or publicly listed, and bonds for which sufficient disclosures are made) at the flat rate of 20.315 per cent, substantially lower than the 55.945 per cent marginal rate. As for dividends, if the Japanese corporation distributing the dividends is a private or non-listed corporation, Japanese resident individuals are subject to withholding tax at the rate of 20.42 per cent, and at the same time are subject to the regular progressive taxation to be reported by filing a tax return. In the case of a publicly listed corporation, they are subject to withholding tax at the rate of 20.315 per cent, and will be subject to the separate taxation at the rate of 20.315 per cent to be reported by filing a tax return; provided that, for individual shareholders who own 3 per cent or more of the total issued shares of the publicly listed corporation (typically owners or founders of the business), the treatment will substantially be the same as that for a private or non-listed Japanese corporation mentioned above.

Japanese resident individuals are subject to the Japanese anti-tax haven or controlled foreign corporation (CFC) rules. As is common with wealthy Japanese resident individuals, when he or she owns shares of a foreign corporation (e.g., as a holding company), he or she will be subject to these rules and taxed on a *pro rata* portion of the profits earned by the foreign corporation (i.e., to be aggregated with his or her own income), if, in general: (1) Japanese resident individuals (including non-resident individuals having certain special relationships with them) and Japanese corporations collectively own, directly or indirectly, more than 50 per cent of the foreign corporation; (2) that particular Japanese resident individual owns, directly or indirectly, 10 per cent or more of the foreign corporation; and (3) the effective tax burden in a fiscal year of the foreign corporation is less than 20 per cent (less than 30 per cent if the foreign corporation is a certain shell company or cash-box company). This CFC rule has been overhauled and tightened by the 2017 tax reform, in response to the BEPS action plan 3, and will take effect from April 2018.

Non-resident individuals

Non-resident individuals are taxed in Japan only on certain specifically enumerated types of Japanese source income. Non-resident individuals having no permanent establishment in Japan are, in general, not subject to Japanese taxation on capital gains arising from sale of shares of a Japanese corporation, unless such non-resident individual, together with certain related persons (its affiliates and related parties, etc.) as defined in Japanese tax laws and partnerships in which it is directly or indirectly a partner: (1) owns or owned 25 per cent or more of the total shares of the Japanese corporation at any time during a period of three years on or before the end of the calendar year in which the sale of such shares took place; and (2) sells 5 per cent or more of the total shares of the Japanese corporation in that calendar year. This exceptional rule is commonly referred to as the '25/5 rule' in practice. If this applies,

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non-resident individuals are subject to income tax at the flat rate of 15.315 per cent, to be reported by filing a tax return. Special rules apply if the Japanese corporation at issue is a certain real property holding corporation, e.g., Japanese REITs.

As for dividends, if the Japanese corporation distributing the dividends is a private or non-listed corporation, non-resident individuals having no permanent establishment in Japan are subject to withholding tax at the rate of 20.42 per cent. In the case of a publicly listed corporation, it is subject to withholding tax at the rate of 15.315 per cent; provided that, for individual shareholders who own 3 per cent or more of the total issued shares of that publicly listed corporation, the 20.42 per cent withholding tax rate will apply. This taxation is finalised only by the withholding tax, i.e., there is no need to file a tax return.

The foregoing Japanese taxation in Japan on foreign individuals having no permanent establishment in Japan can be modified by an applicable tax treaty between Japan and the country of residence of that foreign individual.

Exit tax for resident individuals

Because income taxation for non-resident individuals on financial assets is limited as compared to that for resident individuals, particularly taxation on capital gains arising from sale of shares of a Japanese corporation as discussed above, this acts as an incentive for high net worth resident individuals to exit Japan to avoid taxation on the capital gains. Popular destinations for this purpose include Singapore, Hong Kong, Switzerland, etc. In order to prevent high net worth resident individuals from doing this and so preventing the loss of Japan's tax revenue, an 'exit tax' regime has been introduced effective 1 July 2015 by an amendment to the Income Tax Act. That is, in general, Japanese resident individuals owning certain financial assets (shares, bonds, derivatives, etc.) of ¥100 million or more (on a fair market value basis) will be taxed on the unrealised gains on these financial assets at the time of the exit from Japan to be a non-resident individual, as if they had sold such financial assets. While there are some exceptions, e.g., in the case of a temporary job assignment to overseas followed by re-entry to Japan within a certain period, this exit tax is now a significant deterrent for high net worth resident individuals to migrate to foreign low-tax jurisdictions.

Information reporting and disclosure requirements

The 2012 tax reform introduced a regime of 'statement of foreign assets', where Japanese resident individuals who have foreign assets exceeding ¥50 million (on a fair market value basis) must disclose details of their holdings in the statement of foreign assets. Similarly, the 2015 tax reform introduced a regime of statement of assets and liabilities, where individuals (resident or on-resident) who have to file a tax return and have: (1) taxable income exceeding ¥20 million to be reported; and (2) assets of which the total fair market value as of the end of a calendar year is ¥300 million or more or assets that are subject to the 'exit tax' regime of which the total fair market value as of the end of a calendar year is ¥100 million or more. In the statement of assets and liabilities, individuals must disclose details of their holding of assets and liabilities. Failure to submit these statements will entail a surtax of 5 per cent on top of the penalty tax rate that otherwise applies. These are intended for the Japanese tax authority to collect information on high net worth individuals to effectively enforce the relevant tax laws. These regimes are based on the Act on Submission of Statement of Overseas Wire Transfers for Purpose of Securing Proper Domestic Taxation (Act No. 110 of 1997, as amended).

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ii Inheritance and gift taxation

Inheritance tax and gift tax are imposed based on the Inheritance Tax Act (Act No. 73 of 1950, as amended) as follows:

a Japanese national and resident taxpayers, if they are an heir or a donee, are subject to Japanese inheritance and gift tax on worldwide (i.e., Japanese and foreign) assets that they acquired by the inheritance, bequest or gift;

b taxpayers who are a Japanese national but are not a Japanese resident are taxed only on Japanese assets (but not on foreign assets), unless either the deceased or the heir or donee used to reside in Japan at any time during the 10-year period preceding the commencement of the inheritance, bequest or gift; and

c taxpayers who are neither a Japanese national nor a Japanese resident are taxed also only on Japanese assets, unless the deceased used to reside in Japan at any time during the 10-year period preceding the commencement of the inheritance, bequest or gift.

This means that an attempt to avoid inheritance and gift taxation on foreign assets by becoming a non-resident or even a foreign national has become impractical, since it mandates a 'waiting period' of 10 years. Indeed, aiming to discourage such an attempt, the waiting period in the case of (*b*) above has been extended from five years to 10 years by the 2017 tax reform, and the 2017 tax reform has set a new 10-year waiting period in the case of (*c*) above.

The marginal inheritance tax rate is 55 per cent if the total value of the inherited assets succeeded to by an heir as a taxpayer exceeds ¥600 million, effective from 2015. Also, effective from 2015, standard deductions for inheritance tax were significantly reduced. This is obviously intended to expand the tax base of the inheritance tax and to increase taxation of high net worth families. The marginal tax rate of gift tax is 55 per cent if the total value of the gifted assets of a donee as a taxpayer exceeds ¥30 million; as such, gift tax can be significantly burdensome when assets of a significant value are gifted, and hence is a deterrent for succession of a business to the next generation.

The value of assets for inheritance and gift tax purposes is measured in accordance with the Asset Valuation Basic Circular of the Japanese tax authority (the Circular). Because room for creative tax planning is rather limited, a major part of the planning in practice is to try to reduce the value of the assets, taking advantage of the Circular. However, the Circular contains a general anti-avoidance provision called General Rule Paragraph 6, and this has been actively invoked by the Japanese tax authority to disallow 'creative' (in its view 'abusive') tax planning to reduce the value of the assets.

III SUCCESSION

i Overview

After the Second World War, the succession system was transformed in Japan. There are two kinds of succession: testate and intestate. In the case of intestate, the surviving spouse is always an heir. Children of the deceased are heirs of the first rank, the lineal ascendants (parents and grandparents) are heirs of the second rank, and the siblings (brothers and sisters) come the third. If there is a spouse and children, the spouse will take half the estate and the remaining half is equally divided among the children, and heirs of the second and third rank have no share in the estate. If there is a spouse but no children, the estate is divided among

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the spouse who takes two-thirds of the estate and the lineal ascendants who take one-third. If the lineal ascendants have already died, the spouse takes three-quarters and the siblings take a quarter.

The share of an illegitimate child used to be half of that of a legitimate child. However, the Supreme Court declared[2] that the relevant provision of the Civil Code of Japan (Act No. 89 of 1896 as amended) (the Civil Code) is unconstitutional and invalid and, thereafter, such discriminatory treatment was abolished.

If a prospective heir dies before the deceased, such heir's lineal descendant will become the heir (in addition, where a child's lineal descendant also dies before the deceased, such lineal descendant's lineal descendant will become the heir).

An heir will have a choice to accept or renounce succession. An heir may also accept succession with a reservation by declaring that he or she is liable for the debts of the deceased only up to the amount of the inherited estate. Renunciation or acceptance with reservation will have to be made within three months after he or she has become aware of the death of the deceased and of the fact that he or she is to succeed the estate. He or she must prepare an inventory of the estate and declare renunciation or acceptance at the family court in order to effect renunciation or acceptance with reservation. When an heir fails to renounce or accept succession with reservation within three months, he or she is deemed to have accepted the succession.

If there is no will, the estate of the deceased as well as his or her debts pass directly to the heirs. Until the estate is distributed among the heirs, it will be jointly owned by the heirs and each heir may dispose of its own share. The division of the estate will take effect retrospectively upon the death of the deceased, but the division may not affect the third party who acquires an interest in the estate before the division. Therefore, if an heir sold its share in the succeeded land to a third party before the division, such sale is valid even after the division[3].

If there is a will, the distribution of the estate will be effected in accordance with the will. Any person over 15 years of age is capable of making a will. A will must follow the strict formalities set forth in the Civil Code. There are three kinds of ordinary wills: (1) a will written in the testator's own hand (a holographic will); (2) a will by notarised document; and (3) a will by a sealed secret document. A will can be revoked at any time by the testator. However, certain categories of heirs (children, spouses and lineal ascendants, not including siblings) have a secured portion of the estate that they cannot be deprived of, even by will. If the lineal ascendants are the only heirs, one-third of the estate will be reserved for them and otherwise, half of the estate will be reserved.

Whether or not a lease of a flat or a house may be succeeded or not has been discussed. For example, where the deceased was living with a *de facto* wife, after the death of the deceased she may be evicted by the heirs, if the status as the lessee is to be inherited by the heirs. Regarding the claim of eviction from a landlord, the Supreme Court has held[4] that a *de facto* wife may exercise the right of the heir against the landlord.

Whether or not an insurance payment should form part of the estate subject to succession has been also discussed. As for an insurance payment, in general, when an heir has been designated as a beneficiary of insurance, it will not be included in the estate and

2 Decision of the Supreme Court, September 4, 2013, Minshu 67-6-1320.
3 Judgment of the Supreme Court, April 28, 1967, Minshu 21-3-780.
4 Judgment of the Supreme Court, February 22, 1963, Minshu 17-1-235.

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the designated heir may receive the insurance payment separately from the succeeded assets. Similarly, in the case of a death allowance paid by the company the deceased worked for, the beneficiary receives such allowances separately from the succeeded assets.

ii Recent Supreme Court change of rule

Under a previous judgment of the Supreme Court,[5] the bank deposit in the estate of the deceased was automatically divided in proportion to the statutorily determined ratio of succession and belonged to the statutory successors upon the death of the deceased. However, in 2016, the Supreme Court[6] changed its former view and held that the bank deposit in the estate of the deceased will not be automatically divided upon the death of the deceased and shall be dealt with by the division of the estate agreed or conciliated among the heirs or adjudicated by the family court.

iii Conflict of law rules

Under the Japanese conflict of law rules, in general, the succession is governed by the laws of the deceased's nationality. The execution and effect of a will shall be governed by the laws of the testator's nationality when the will is executed. However, Japan has ratified the Convention of 5 October 1961 on the Conflicts of Laws Relating to the Form of Testamentary Dispositions and pursuant to the domestic law enacted thereunder, a will be legally valid if a will complies with: (1) the laws of country where the will is executed; (2) the laws of the country of the testator's nationality when the will is executed or the testator is dead; (3) the laws of the country of the testator's domicile when the will is executed or the testator is dead; (4) the laws of the country of the testator's habitual residence when the will is executed or the testator is dead; or (5) in the case of a will regarding immoveable property, the laws of the country where such immoveable property is located.

iv Applicable changes affecting personal property

While prenuptial agreements are not very popular in Japan, a couple may execute an agreement regarding their properties (couple's property agreement) prior to the filing of their marriage notice to the authority pursuant to the Civil Code. Such agreement shall be registered at the Legal Affairs Bureau so that it may be legally claimable against their heirs or other third parties.

No legislation has been made regarding same-sex marriage and, therefore, no particular legal protection has been given to same-sex couples in Japan. Recently, some local municipalities enacted certain local regulations under which the municipality commenced to issue 'partnership certificates' to same-sex couples, although the legal effect of such certificates is not clear; arguably, a same-sex couple with such certificate might be treated the same as a *de facto* heterosexual couple.

5 Judgment of the Supreme Court, 8 April 1954, Minshu 8-4-819.

6 Judgment of the Supreme Court, 19 December 2016, Hanta 1433-44.

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IV WEALTH STRUCTURING & REGULATION

i Vehicles and structures

Asset holding companies

Companies and corporations are the most widely used vehicles for wealth management in Japan. Typically, two types of companies will be available: a stock company and a limited liability company. Equity-holders of these companies are responsible for the financial obligations of the companies only to the extent of the subscription price paid for the equities owned by such equity-holders. A stock company is divided into two types: public company and non-public company. The shares of public company shall be limited to transfer-unrestricted shares. Meanwhile, the shares of non-public company may include transfer-restricted shares that may not be transferred without the company's permission. The term public or non-public as used here is a technical term, and is not equal to whether the company's shares are publicly listed or not. A limited liability company is modelled after a US LLC and may be converted into stock company, which makes it a useful vehicle for start-up companies. When the shares in listed companies are transferred to asset holding companies, a large volume of shareholding reports or their amendment reports or extraordinary reports may be required to be filed with the financial authority and may also be subject to TOB regulations and insider trading regulations under the Financial Instruments and Exchange Act (Act No. 25 of 1948, as amended). To prevent disputes among family members in the future succession, it is recommended that the number of asset holding companies is the same as the number of family members (e.g., if there are a spouse and two children, three asset holding companies should be set up).

For high net worth individuals who own a business in the form of shares of a Japanese company operating the business (in many cases this is a publicly listed company), a Japanese asset holding company privately owned by the owner-individual is widely used. This is because dividends paid by the operating Japanese company to the holding company will be (except for a portion corresponding to interest on debts) exempt from corporation tax at the asset holding company's level (i.e., dividend received deduction), if the asset holding company owns more than one-third of the outstanding shares of the operating Japanese company generally for six months or more prior to the record date for the relevant dividend. This effectively enables deferral of taxation at the level of the owner or individual on the dividends paid by the operating Japanese company, and he or she can avoid the 20.42 per cent withholding tax and the regular progressive taxation had he or she owned the shares directly. In addition, from a viewpoint of valuation for inheritance and gift tax purposes under the Circular, if the asset holding company is well structured so that it will not fall under a certain specified share or real property holding company, the valuation of the shares of the private asset holding company may be made by taking into consideration the share prices of some other similarly situated listed companies, without being bound solely by the market price of the underlying shares of the publicly listed operating Japanese company, which may result in a substantially lower valuation under the Circular. We should note, however, that the tax authority has recently often challenged structures using shell holding companies with a view to reducing the valuation under the Circular, by invoking the General Rule Paragraph 6 and by looking to the economic substance of such structures.

There are cases where an owner or individual has a private asset holding company that is a foreign company in some tax-favourable jurisdictions. In this case, the foremost concerns

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include application of the CFC rules as tightened by the 2017 tax reform, and a permanent establishment risk in Japan (where the owner manages everything for the holding company in Japan).

Associations and foundations

Associations and foundations are also popular vehicles for a family's wealth management in Japan. An association or foundation that does not intend to distribute its surplus may be established as a general-association judicial person or a general-foundation judicial person by just registering them without having to demonstrate their public purpose. They may apply for non-profit status as a public-interest-association judicial person through the office of the Prime Minister or a regional governor of prefecture, which then will establish committees consisting of private sector specialists to examine the public interest character of the applicant.

The gift or donation of an asset to public-interest-association judicial persons will generally be deductible as a qualified donation for the donor's income or corporation tax purposes. The gift or donation of appreciated assets (e.g., shares of the operating Japanese company) by a resident individual to public-interest-association judicial persons (and certain other qualifying corporations) may be exempt from capital gains taxation subject to a specific approval of the tax authority. Public-interest judicial persons are generally not subject to corporation tax on income from non-profit public activities. As such, public-interest-association or foundation judicial persons are often used as a vehicle to own the shares of the publicly listed operating company as transferred from the owner or individual, as a stable shareholder that would prevent hostile takeovers of the operating company. Also, by doing so, the owner or individual can alienate these shares from his or her inheritance estate to reduce the future inheritance tax burden.

Trusts

Traditionally, trusts have been used as substitutes for bank deposits and securities investments or as vehicles for securitisation or other commercial transactions. Recently, however, they have become popular as vehicles for succession of business from the owner to its families (as substitute for a will) or for other wealth management purposes.

Trusts may be set up under the Trust Act (Act No. 108 of 2006 as amended). If the granter entrusts its properties to a trust, such properties will not be affected by the bankruptcy of the grantor or the trustee (bankruptcy remoteness) and the trusted properties are managed and disposed of solely by the trustee pursuant to the trust certificate. By setting up the trust, the grantor acquires the trust beneficial interests and may transfer such interests to a third party more smoothly than the trusted assets such as securities or real estates.

For tax purposes, a plain-vanilla trust (defined as a 'beneficiary-taxed trust') is, in general, treated as a conduit, i.e., a holder of the trust's beneficial interests will be deemed to directly own the underlying entrusted property. That is, a beneficiary-taxed trust cannot generally achieve deferral of taxation on income arising from the entrusted property, or alienation of the underlying entrusted property from the inheritance estate for tax purposes. Although there are two other types of trust, the tax regime is so strict and straightforward that there is little room for creative and effective tax planning using trust (including a beneficiary-taxed trust).

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ii Anti-money laundering and other regimes

In Japan, money laundering of proceeds from certain serious crime is prohibited under the Narcotics Special Provisions Act (Act No. 94 of 1991 as amended) and the Punishment of Organised Crimes and Control of Crime Proceeds Act (Act No. 136 of 1999 as amended). Furthermore, in order to prevent money laundering and terrorist financing, the Criminal Proceeds Transfer Prevention Act (Act No. 22 of 2007 as amended, the Criminal Proceeds Act) requires that specified business operators (SBOs) such as financial institutions and real estate agents: (1) verify the counterparty of the transaction; (2) prepare and preserve records of such verification and transaction; and (3) report any suspicious transactions to the relevant authority.

In 2016, responding to the Financial Action Task Force's (FATF) critical statement, the Criminal Proceeds Act was amended in various points, such as: (1) an amendment to the procedures for assessment of suspicious transactions; (2) SBOs' were obliged to confirm that a new counterparty of transactions had adopted a similar level of internal anti-money laundering measures; (3) expanding SBOs' obligations upon adopting internal anti-money laundering measures; and (4) a requirement of strict verification when making transactions with foreign PEPs (Politically Exposed Persons), etc. As a result of such amendments, anti-money laundering legislation became closer to other developed nations' anti-money laundering regime.

While not yet enacted, it is reported that the government is planning to introduce reporting obligations for tax professionals and promoters who are involved in certain tax planning, in response to the BEPS Action Plan 12.

V CONCLUSIONS & OUTLOOK

The current direction is to tighten taxation on wealthy individuals in Japan, both as a matter of tax policy and legislation and enforcement. As to enforcement, the tax authority has recently established divisions specialising in monitoring and auditing wealthy individuals; as such, the enforcement is expected to be much more active and rigorous. On the other hand, on taxpayers' side, the issue is not limited to tax or money – many wealthy individuals care about their reputation and so want to avoid sensational press reports that they under-reported their tax liability. This reputational risk tends to deter wealthy individuals from creative or novel tax planning at the outset, because of the press coverage that appears once they are subject to an assessment, and even if they later win in the courts, it would not necessarily lessen the damage to their reputation. Therefore, in Japanese wealth management practice, what is sought from professional tax advisers may not be technical ability or creativity, but a way of ascertaining whether the Japanese tax authority is likely to find the planned transaction as abusive or excessive tax planning.

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Appendix 1

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