The Private Wealth & Private Client Review

Seventh Edition

Editor
John Riches

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PREFACE

I INTRODUCTION

As I reflect on the developments of the last 12 months, the overriding theme is that of continuing regulatory change in the private wealth arena. A sense of increasing pace and convergence in particular stand out in comparison with earlier years.

The pace component is best seen in the introduction of new regimes or the updating of existing rules. The theme of convergence is based upon how centrally significant the concept of 'beneficial ownership' is becoming to many of the initiatives. A third strand is an increasing divergence between the European Union and the United States in this arena: the European Union continues to force the pace on transparency, while the United States proceeds at a much more leisurely speed and gives greater weight to privacy concerns than its European neighbours.

Clients whose assets are fully declared and are in compliance with their tax obligations are becoming increasingly sensitive to the massive complexity and increased regulatory burden that falls upon service providers and the attendant costs that they are obliged to meet. This is leading to a mindset in which additional elements of complexity in asset-holding structures are being viewed with a greater degree of scepticism. In some cases, it is also leading to a review as to whether existing structures, whether trusts or holding companies, are still the best means of achieving the family's objectives and warrant additional cost and regulation.

While these compliant families fully understand the need for transparency to tax and regulatory authorities, there is growing concern about the pressure for public disclosure in the context of beneficial ownership registers when the disclosure relates not to businesses that trade and engage with the public at large, but to family asset-holding structures.

A review of the preamble to the EU's Fifth Anti-Money Laundering Directive (5 AMLD) shows that, while apparent lip service is paid to respecting an individual's right to privacy, the argument that greater public or quasi-public access to information with respect to many private asset-holding structures is required to combat the fight against terrorism and money laundering appears to hold sway. The fact that any private asset-holding structure of this type will be obliged to provide comprehensive and detailed beneficial ownership information to regulated service providers such as banks, trust and corporate service providers, legal advisers and accountants is not regarded as sufficient by EU policymakers.

5 AMLD also exemplifies a mindset in which those whose family structures (such as trusts and foundations) are managed outside the EU are subjected to a greater degree of transparency than for EU-managed structures. The rationale for this approach is that, as non-EU jurisdictions have not embraced the same degree of transparency for corporate

registers, it is necessary to render the entities that hold assets with an EU connection, such as real estate, or those with an ongoing EU 'business relationship', to public scrutiny. I deal with this in greater depth below.

Tax authorities have been swift to fasten onto the increased scope of these measures. While fighting terrorism and drug-smuggling was their original purpose, they have enabled tax authorities to widen the net of information that is collected and reported on citizens who are neither terrorists nor drug barons but who hold significant wealth in complex asset-holding structures.

In the rest of this foreword, I will consider two specific areas:

a the Organisation for Economic Co-operation and Development (OECD)'s revised Common Reporting Standard (CRS) Commentary with a focus on trust guidance; and

b the wide-reaching implications of the EU's 5 AMLD and the meaning of 'control' in a trust context with regard to UK and Maltese trust registers.

i CRS Revised Handbook (April 2018) with a focus on the amendments to trust guidance

CRS applies to trusts when:

a a trust is a reporting financial institution (RFI); or

b a trust is a passive non-financial entity (NFE) that maintains an account with an RFI.

One of the key issues under discussion under the CRS and the first version of the CRS Commentary was the status of 'protectors'.

The CRS framework provides for reporting in the context of trustees who are RFIs to be made of persons who are treated as having an 'equity interest' in the trust fund. In this context, Section VIII.C.4 of the CRS states that an equity interest is held 'by any person treated as a settlor or a beneficiary of all or a portion of the trust or any other natural person exercising ultimate effective control over the trust'.

By contrast, in relation to a trust that is a passive NFE, it is necessary to identify controlling persons in relation to the trust. In the CRS, Section VIII D.6 defines 'controlling person' on the basis that the expression is intended to correspond to the term 'beneficial owner' as described in Recommendation 10 and the interpretative note on Recommendation 10 of the Financial Action Task Force (FATF) guidance as adopted in February 2012. In the case of a trust, controlling persons means 'settlor, the trustees, the protector (if any), the beneficiary or class of beneficiaries and any other natural person exercising ultimate effective control over the trust'.

In its FAQ issued in June 2016, the OECD took the position that, where a trust is an RFI, a protector 'must be treated as an account holder irrespective of whether it has effective control over the trust'. This response does not address the clear distinction in the CRS itself between the holders of equity interests in a trust that is an RFI (which only includes protectors if they actually exercise ultimate effective control; see above) when contrasted with the 'controlling persons' definition of a trust that is a passive NFE (which includes protectors regardless of the powers they hold; see above).

The Secretariat of the OECD previously confirmed that it is their intention that protectors of trusts that are RFIs should be reported, and the FAQ was discussed in and approved by the relevant working party of the OECD.

The second version of the Commentary has amended Paragraph 253 to read:

> *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* ***and the protector*** *as an Equity Interest Holder.*[1]

Until the legal basis for this is made clear in the CRS treaty itself, it is considered that there is a reasonable basis for forming the opposite conclusion.

The new Commentary also provides further clarity on what reporting is required when an account is closed or a beneficiary removed:

> *Where an account is closed during the year, the fact of closure is reported (****in addition to any distributions made prior to closure****). A debt or Equity Interest in a trust could be considered to be closed, for example, where the debt is retired, or where a beneficiary is* ***definitely*** *removed.*[2]

The other main amendments to the Commentary relate to the obligation to look through equity interest holders and controlling persons, which are themselves entities. Paragraph 256 has been amended to read:

> *Where an Equity Interest (such as the interest held by a settlor, beneficiary* ***or any other natural person exercising ultimate effective control over the trust****) is held by an Entity, the Equity Interest holder will instead be the Controlling Persons of that Entity. As such, the trust will be required to look through a settlor,* ***trustee, protector*** *or beneficiary that is an Entity to locate the relevant Controlling Person. This look through obligation should correspond to the obligation to identify the beneficial owner of a trust under* ***domestic*** *AML / KYC procedures.*[3]

The new Commentary notes that, in looking through entities,

> *The Controlling Persons of Passive NFE are defined in the CRS as natural persons exercising control over the Entity. The CRS definition of the term Controlling Person corresponds to the term beneficial owner as set out in Recommendation 10 and the accompanying Interpretative Note of the 2012 FATF Recommendations.*
>
> *The identity of beneficial owner of a legal person is defined as any natural person who ultimately has controlling ownership interest which is usually defined on the basis of a threshold. Footnote 30 to the Interpretative Note to Recommendation 10 of the 2012 FATF Recommendations (as printed in March 2012) gives an exemplary ownership threshold of 25%.*

[1] Emphasis added.

[2] Emphasis added.

[3] Emphasis added.

Although, earlier in the Commentary it notes that:

> *It is important to point out that the ownership threshold for legal persons of 25% that is specified in footnote 30 in the Interpretative Note to Recommendation 10 of the 2012 FATF Recommendations (as printed in March 2012) is only indicative.*
>
> *Should the ownership structure analysis result in doubt as to whether the person(s) with the controlling ownership interest are the beneficial owners or where no natural person exercises control through ownership interest the analysis shall proceed to identifying any other natural person(s) exercising control of the legal person through other means. As a last resort, if none of the previously mentioned tests result in identification of the beneficial owner(s), the senior managing official(s) will be treated as the beneficial owner(s).*

Various examples are given on how to look through entities. Unfortunately, the new Commentary does not cover more complex structures that had previously been raised with the OECD, such as where a purpose trust owns a private trust company.

ii Trust registers: implications of 5 AMLD and the meaning of 'control'

The key text for 5 AMLD was published in December 2017 and endorsed by a legislative resolution of the European Parliament on 19 April 2018. It was then adopted by the EU Council on 14 May 2018. On 19 June 2018, the text for 5 AMLD was then published in the Official Journal of the European Union. EU Member States must transpose 5 AMLD into their national law by 10 January 2020.

Enlarged scope of registration

4 AMLD limits the scope of trusts requiring registration on a domestic trust register in the relevant EU Member State to those that generate tax consequences; 5 AMLD widens this scope to all trusts that 'reside or are established' in the Member State concerned. It also applies to *fiducie*, *treuhand* or *fideicomiso* as well as to foundations (which fall within the concept of legal arrangements). In practice, in the case of trusts, this will be the place where the trustee resides and not referenced to the governing law of the trust itself.

Non-EU resident trusts: registration

There is a requirement for non-EU resident trusts to register in two instances. The proposed new Article 31(3a) of 5 AMLD, for a trust established or residing outside the European Union, reads:

> *Member States shall require that the beneficial ownership information of express trust and other types of legal arrangements when having a structure or functions similar to trusts shall be held in a central beneficial ownership register set up by the Member State where the trustee of the trust or similar legal arrangement is established or resides.*

> *Where the place of establishment or residence of the trustee of the trust or similar legal arrangement is outside the Union, the information referred to in paragraph 1 shall be held in a central register set up by the Member State where the trustee enters into a* ***business relationship*** *or* ***acquires real estate*** *in the name of the trust or similar legal arrangement.*[4]

On business relationships, the existing text of Article 3(13) of 4 AMLD, which is not amended by draft 5 AMLD, states: 'a business relationship means a business, professional or commercial relationship that is connected with the professional activities of an obliged entity and which is expected, at the time when the contact is established, to have an element of duration.'

It is unclear what these words mean in practice. In the broader sense, they could be taken to include sourcing professional advice from a counterparty in an EU Member State. It is understood that the intent at the time 4 AMLD was finalised was to focus on 'business trusts'. The European Union was informed at the time by STEP and other commentators that this expression did not have any well-established meaning given that the vast majority of business activity conducted in a trust context would, for reasons of liability protection, be conducted through the mechanism of underlying companies. It remains to be seen what sort of guidance will be provided on this topic. If given a wide meaning, it could mean any use of professional advisers for legal, tax accounting or investment advice within the EU could trigger a requirement to register.

So far as the acquisition of real estate is concerned, it would seem this is confined to situations of EU real estate held at the trust level alone and not where such real estate is held via an underlying entity.

The regulations make provision to allow a trust to provide evidence of registration in one Member State through a 'certificate of proof of registration or an excerpt . . . of the register' to avoid the need for duplicated registration.

Public access

5 AMLD allows for a modified form of public access to the trust register by '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'.

At present, there is no clearly understood meaning as to what constitutes 'legitimate interest'. The implications of the 5 AMLD preamble are, however, that NGOs and investigative journalists with anti-corruption profiles should normally be seen as being able to assert a legitimate interest. This may well be a matter where different EU jurisdictions take a variety of approaches.

There is also a requirement to interlink the various EU registers by 2021, and a requirement to provide mechanisms for the verification of data. The absence of any verification mechanism to date has been seen as a major limiting factor in the utility of beneficial ownership registers. How this verification will be policed is unclear.

The qualified public access on the basis of legitimate interest needs to be contrasted with circumstances where full public access is proposed. This is in the case of use of a non-EU holding company by a trust that either resides in an EU Member State or, it would seem, becomes registrable as a result of an EU business relationship or holding of EU real estate as noted above.

[4] Emphasis added.

Article 31(4) of 5 AMLD considers the situation for trusts owning a controlling interest in a non-EU company:

> *The central register shall ensure timely and unrestricted access by competent authorities and FIUs, without alerting the parties to the trust concerned. It may also allow timely access by obliged entities, within the framework of customer due diligence in accordance with Chapter II. Member States shall notify to the Commission the characteristics of those national mechanisms to ensure that the information on the beneficial ownership of a trust or a similar legal arrangement is accessible in all cases to:*
>
> *a. competent authorities and FIUs, without any restriction;*
>
> *b. obliged entities, within the framework of customer due diligence in accordance with Chapter II;*
>
> *c. any person or organisation that can demonstrate a legitimate interest;*
>
> *d.* ***any person that files a written request in relation to a trust or similar legal arrangement which holds or owns a controlling interest in any corporate or other legal entity other than those referred to in Article 30(1), through direct or indirect ownership, including through bearer shareholdings, or through control via other means.***[5]

Article 30(1) is the requirement for EU companies to maintain a public register of beneficial owners. Thus, for all non-EU companies, any person can, on written request, obtain information on an EU-resident trust that controls it. It is understood at this stage that privacy may be afforded to EEA-resident companies that maintain a public register. This would mean Liechtenstein companies may not fall within the scope of sub-paragraph (d) as it is an EEA member.

It is not clear how an individual would in the first instance learn of the existence of a trust in these circumstances. There is also no recognition in these rules that non-EU companies may be subject to any form of public beneficial ownership register in their own jurisdiction (given the UK's recent proposals to extend public registers of corporate entities to its overseas territories).

iii The UK's position: Brexit transition

A recent UK parliamentary report stated:

> *Although these dates all fall after the UK's projected exit from the EU in March 2019, it now appears likely the Government will agree to a post-Brexit transitional period during which EU law would continue to apply in the UK as if it were still a Member State. In those circumstances, the new AMLD would have to be implemented if its transposition dates occur within that period (which, considering the Prime Minister has said the transition is likely to be "around two years", is likely to be the case for all three types of register).*

It is therefore anticipated, given the imminent application of 5 AMLD, that the United Kingdom will be obliged to comply with it, at least during the transitional period. Given that the United Kingdom has also been within the vanguard of transparency initiatives with its European neighbours, it would be unsurprising if it continued to apply 5 AMLD in some

[5] Emphasis added.

form once the Brexit transition has concluded. Whether the public access component for trusts would be watered down remains to be seen. It is understood that the Labour Party advocates full public access to the UK trust register.

It is also unclear whether UK companies will be regarded as 'non-EU' for this purpose post-Brexit, but it is assumed they will be regarded as equivalent.

iv Meaning of 'control' in the context of EU trust registers

FATF 2012 Recommendations: Recommendations 10, 24 and 25 require trustees and financial institutions to identify 'the ownership and control structure of the customer'. I now turn to the two examples of trust registers in the EU that have been implemented under 4 AMLD, the forerunner to 5 AMLD. This throws an interesting light upon the extraordinary width of whom should be regarded as a beneficial owner in the context of a trust.

Section 5(2) of the UK's Money Laundering, Terrorist Financing and Transfer of Funds (Information on the Payer) Regulations 2017, which came into force on 26 June 2017, require that trustees register:

a a settlor;
b trustees;
c named beneficiaries;
d beneficiaries who have received a distribution from the trust; and
e anyone who exercises 'ultimate control' over the management of the trust.

Section 2(1)(e) Malta's Trusts and Trustees Act (Register of Beneficial Owners) Regulations (the RBO Regulations), which came into force on 1 January 2018, require that trustees register:

a a settlor;
b trustees;
c named beneficiaries;
d a protector; and
e anyone exercising 'ultimate and effective control over the trust by any means', including any other person:
  - whose consent is to be obtained; or
  - whose direction is binding in terms of the terms of the trust instrument or of any other instrument in writing, for material actions to be taken by the trustee.

FATF 2012 Recommendation 10: financial institutions must identify 'any other natural person exercising ultimate effective control over the trust'.

In the context of the EU's 4 AMLD and the trust register, Her Majesty's Revenue and Customs have stated that '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 approve proposed trust distributions;
c vary or terminate the trust;
d add or remove a person as a beneficiary or to or from a class of beneficiaries;
e appoint or remove trustees or give another individual control over the trust; and
f direct, withhold consent to or veto the exercise of a power mentioned above.

In the context of the 4 AMLD and the beneficial ownership register for trusts, Malta's RBO Regulations have stated that 'control' means anyone exercising 'ultimate and effective control over the trust by any means', including any other person whose consent is to be obtained; or whose direction is binding in terms of the terms of the trust instrument or of any other instrument in writing, for material actions to be taken by the trustee.

The definition of 'material actions' means the following actions or any other actions achieving the same result:

a the amendment of the trust instrument;

b the addition or removal of any beneficiary, or any person from a class of beneficiaries, or any action affecting the entitlement of a beneficiary;

c the appointment or removal of trustees or protectors or to give another individual control over the trust;

d the acceptance of an additional settlor as may be applicable in terms of the terms of the trust instrument;

e the change of the proper law of the trust; and

f the assignment or transfer of all or most of the assets of the trust or the termination or revocation of the trust.

CRS imports into the concept of 'controlling persons' a direct link to the FATF defined terms of 'beneficial owners'. The CRS Commentary states at Paragraph 132:

> *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),* ***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.***[6]

On this basis, it is highly likely that the expanded definition of control that is implicit in the UK and Maltese trust registers in an anti-money laundering context that flows from the FATF 2012 framework will, over time, result in more significant disclosure being required in a CRS tax information exchange context. This is an example of the aforementioned convergence theme (see Section I).

As a separate matter, the FATF has recently been reviewing the 2008 Guidance to Trust and Corporate Service Providers. It is possible that the amended text will also give more detailed guidance on the meaning of a 'natural person exercising effective control' in a trust context. This will have a direct impact on CRS reporting for trusts in the light of the linkage mentioned above in the CRS model treaty.

The significant extensions are most likely to impact influence exercised:

a by committees where, to date, it has been argued that no one individual can personally decide upon a course of action;

b in an indirect manner by a family individual who does not serve as a protector as such but instead has a power to appoint or remove protectors; and

c by those with negative 'veto' powers but without positive powers to decide upon specific matters that impact the relevant trust.

[6] Emphasis added.

It could be timely, therefore, for advisers to consider whether current governance arrangements for the oversight of trusts are still 'fit for purpose' or not.

II CONCLUSION

What can be said at this stage is that advisers must continue to keep themselves informed on the important changes to the regulatory and transparency arena. There is no sign that the pace of reform is slowing at this point, quite the opposite.

In the longer term, it remains to be seen whether the degree of transparency and attendant public disclosure that the EU has embraced will be adopted more widely in the rest of the developed world. It is clear that the United States has been much slower to adopt measures that override privacy in such a sweeping manner.

John Riches
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August 2018

Chapter 26

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., value added tax) 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

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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 since 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. Publicly listed corporations 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: 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; that particular Japanese-resident individual owns, directly or indirectly, 10 per cent or more of the foreign corporation; and 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 with little substance or cash-box company). This CFC rule has been overhauled and tightened by the 2017 tax reform, in response to the Base Erosion and Profit Shifting Action Plan 3, and is effective as of 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: 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 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, 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 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 and Switzerland. To prevent high net worth resident individuals from doing this and so preventing the loss of Japan's tax revenue, an 'exit tax' regime was introduced, effective from 1 July 2015, by an amendment to the Income Tax Act. In general, Japanese-resident individuals owning certain financial assets (shares, bonds, derivatives, etc.) of ¥100 million or more (on a fair market value basis) are now 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 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 non-resident) who have to file a tax return and have: taxable income exceeding ¥20 million to be reported; and 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).

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 Japanese nationals but not Japanese residents are taxed only on Japanese assets (but not on foreign assets), unless either the deceased or donor, 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 Japanese nationals nor Japanese residents are taxed also only on Japanese assets, unless the deceased or donor 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 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 between the spouse who takes two-thirds of the estate and the lineal ascendants who take a 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: a will written in the testator's own hand (a holographic will); a will by notarised document; and 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, a third of the estate will be reserved for them and otherwise, half of the estate will be reserved.

Under the bill of amendments to the Civil Code currently deliberated in the Diet, various amendments to the succession system will be made, including the following:

a the spouse of the deceased may continue to live at the residence of the deceased so long as he or she is alive;

b holographic wills may be deposited at legal affairs bureaus;

c a provisional payment from bank deposits of the deceased will be permitted in urgent cases where it is necessary to do so (see Section III.ii);

[2] Supreme Court Decision, 4 September 2013, Minshu 67-6-1320.

[3] Supreme Court Judgment, 28 April 1967, Minshu 21-3-780.

d gifts made 10 years or more before the commencement of succession will not be counted in the calculation of the statutory reserved portion of the estate for certain heirs; and

e an heir's succession of estate beyond its statutorily predetermined portion may not be perfected against third parties unless such succession is registered.

ii Recent Supreme Court change of rule

Under a previous judgment of the Supreme Court,[4] 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[5] 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 between 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:

a the laws of country where the will is executed;

b the laws of the country of the testator's nationality when the will is executed or the testator is dead;

c the laws of the country of the testator's domicile when the will is executed or the testator is dead;

d the laws of the country of the testator's habitual residence when the will is executed or the testator is dead; or

e in the case of a will regarding immovable property, the laws of the country where such immovable 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

[4] Supreme Court Judgment, 8 April 1954, Minshu 8-4-819.

[5] Supreme Court Judgment, 19 December 2016, Hanta 1433-44.

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.

IV WEALTH STRUCTURING AND 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 companies and non-public companies. The shares of a public company shall be limited to transfer-unrestricted shares. Meanwhile, the shares of a 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 a 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 two children and a spouse, 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 Japanese operating company to the Japanese asset 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 a third of the outstanding shares of the Japanese operating company generally for six months or more before 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 Japanese operating 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 Japanese operating 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 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 Japanese operating 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 Japanese operating company as transferred from the owner or individual, as a stable shareholder that would prevent hostile takeovers of the Japanese 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).

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, 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: verify the counterparty of the transaction; prepare and preserve records of such verification and transaction; and report any suspicious transactions to the relevant authority.

In 2016, responding to the Financial Action Task Force's critical statement, the Criminal Proceeds Act was amended in various points, such as:

a an amendment to the procedures for assessment of suspicious transactions;

b SBOs were obliged to confirm that a new counterparty of transactions had adopted a similar level of internal anti-money laundering measures;

c expanding SBOs' obligations upon adopting internal anti-money laundering measures; and

d a requirement of strict verification when making transactions with foreign politically exposed persons, etc.

As a result of such amendments, anti-money laundering legislation became closer to other developed nations' anti-money laundering regimes. In 2018, the Japanese Financial Services Agency also adopted the 'Guideline on Anti-Money Laundering and Counter-Terrorist Financing', which requires financial institutions to facilitate their internal risk management systems on risk-based approach.

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 OUTLOOK AND CONCLUSIONS

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, regarding taxpayers, 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 the 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.

Appendix 1

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