INHERITANCE &

UNWANTED OUTCOMES

why new inheritance and gift tax rules are a disincentive for foreigners to live and work in Japan

GIFT TAX

Background

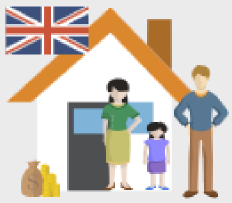
Amendments to the Japanese inheritance tax rules, which took effect in April 2013, have had a significant negative effect on the attractiveness of Japan as a place for foreigners to come to work. These amendments are also a disincentive for foreign nationals already residing in Japan to remain in the country.

The primary intention of the 2013 inheritance tax changes appears to have been aimed at targeting Japanese citizens who might have been considering giving up their citizenship to avoid Japanese inheritance taxes. But the rule change has had a number of possibly unintended consequences for non-Japanese nationals.

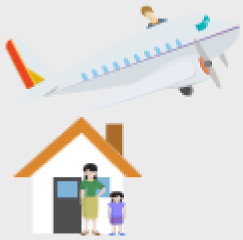
UNWANTED OUTCOMES

Japanese inheritance tax

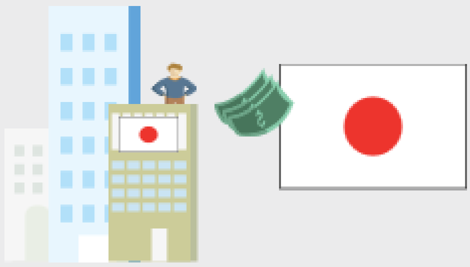
Episode 1



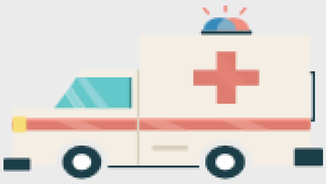
Robert Green was a 45 year old UK national living in his own house with his wife and one daughter in the UK.



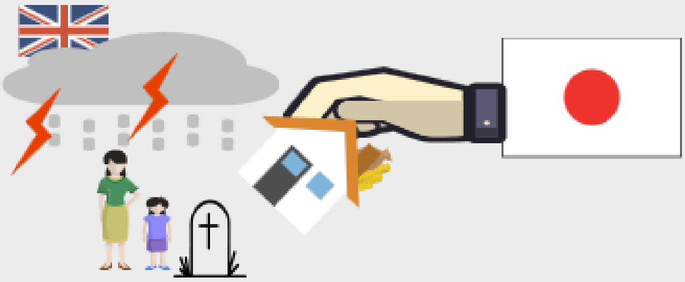
Robert moved to Japan for work but his family stayed in London so that his daughter could continue with her education in the UK.



Robert started to work for a Japanese company and became a Japanese income tax payer.



Two months after arriving Robert had a heart attack and died in Japan.



All Robert's world-wide assets above a threshold were subject to the Japanese inheritance tax.

To pay the Japanese tax authorities, Robert's wife had to sell their family home in London causing significant financial turmoil and disruption to the family.

An example of how this may happen can be found on page 7.

This would not have happened if Robert had not moved to Japan as in the UK his wife would have been exempt from inheritance tax.

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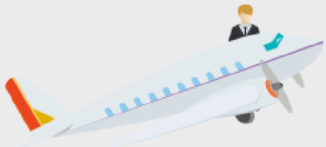
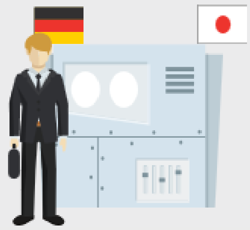
Episode 2

the Japanese inheritance tax

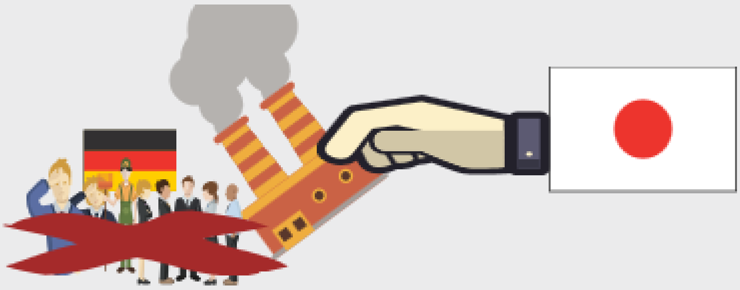
Hans (35) was part of a family who owned a well-established business in Germany.



The family decided to open a new factory in Japan to produce high tech goods.



Hans and his wife and son moved to Japan in January 2015 to manage the new factory. He acquired a business owner visa.



Assets (including Hans's 50% stake in the family owned €24 m business) became subject to Japanese inheritance tax. To pay the €5.1 m[1] tax bill, part of the business in Germany had to be sold. This led to the breaking-up of a 150 year old business and the loss of jobs.

(1) The assumed Japan Inheritance Taxable value of the family business is ¥1.6 bn (€12 m). The resulting inheritance tax is ¥712.9 m (@140 = €5.092 m), as Hans was married with one child. The spousal tax credit is not applicable as under the family rules, Hans's shares were to go to his son.

After a few months, Hans went back to Munich for his winter holiday. He unfortunately had a skiing accident and died. His only son inherited the business under their family's business rules.

This would not have happened if Hans had moved his business to Singapore, as they abolished inheritance taxes in 2008. Germany exempts family owned businesses from Inheritance Tax .

Impact

If a foreigner dies after moving to Japan and becoming a Japanese tax resident, their heirs (including those living outside and having no relationship with Japan) become subject to Japanese inheritance tax. This applies to all assets, both in Japan and overseas, including property.

The 2013 amendment to the Inheritance Tax reform extended the tax to non-resident heirs inheriting non-Japanese assets. This has triggered serious concerns amongst foreigners who are currently working in Japan but also among those who are considering coming to Japan either to work or to bring business and foreign direct investment. The unintended message is: *"that we do not want to encourage foreign nationals to come or stay in Japan, even those not intending to stay permanently in Japan"*.

Inheritance and gift taxes are already having an impact on Japan’ s attractiveness

We are aware of cases where people have decided not to take up employment offers in Japan because of this tax change. And some foreign workers have already left Japan after considering their situation. It is becoming an issue in recruiting skilled and experienced workers from overseas.

To potentially mitigate the situation individuals or firms may take out life insurance coverage to protect against this liability but this would be a major additional cost, and one they do not have to bear in other countries. But this will not cover all cases. For example, an expatriate will not be able to obtain life insurance coverage for elderly parents.

Japanese firms may also be affected

Major Japanese companies are also affected by this tax regime when it comes to hiring senior foreign nationals in their Japanese offices. With the goal of internationalising they are likely to want to attract foreign talent to work for them in Japan.

Japan is an outlier

The trend among a number of foreign countries is to abolish inheritance tax and there are many examples of countries doing this:

Australia—abolished estate tax in 1979
Hong Kong—abolished estate duty in 2006
India—abolished in 1985
Israel—abolished in 1981
New Zealand—abolished in 1992
Norway - abolished in 2014

Russia—abolished in 2006
Singapore—abolished in 2008
Sweden—abolished in 2005
US - Louisiana—abolished in 2008
US - New Hampshire—abolished in 2008
US-Utah—abolished in 2005

Japan compares unfavourably to all the other G7 countries:

G7 State	Tax rates for close relatives	Deductable threshold for surviving spouse and one child
Japan	**10-55%**	**¥42m for a family with one child. The spouse tax credit is limited to 50%.**
US	18-40%	US$ 5.43 m on the estate. 100% spouse exemption.
France	5-45%	100% spouse and €200k child exemption.
Italy	4%	€3m exemption.
UK	0-40%	100% spouse and £325k exemptions apply.
Germany	7-30%	€1.3 m exemption.
Canada		Abolished in 1972.

On Tokyo competitiveness

Foreign residents in Japan make a choice to be residents of a country where they are subject to higher income taxes compared to neighbouring nations including Hong Kong and Singapore. Inheritance and gift tax are a potential additional liability which may discourage new prospective residents from moving to Japan and encouraging others to leave the country.

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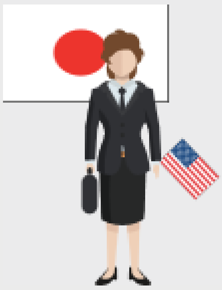
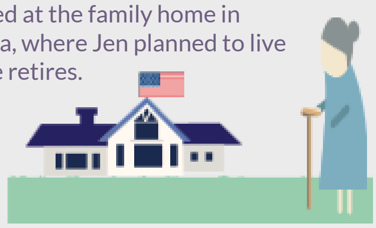
Episode 3

Japanese gift tax

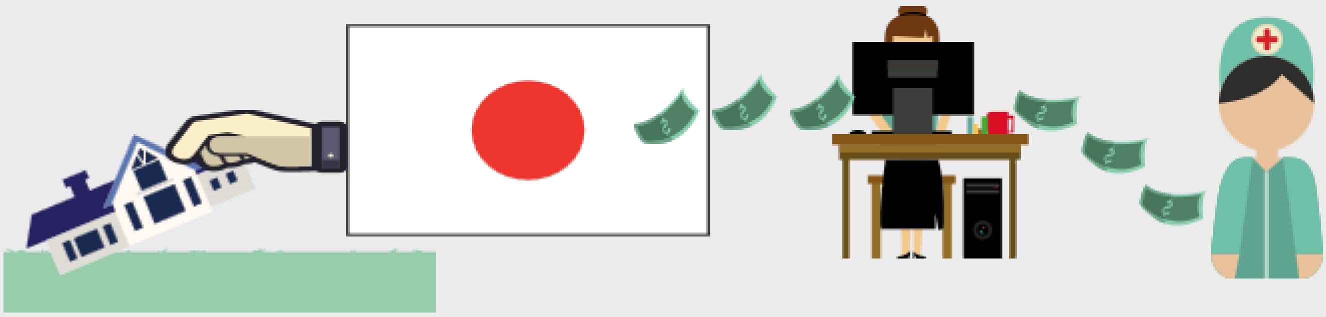


Jen's mother (who is in her mid-70's) lived at the family home in Louisiana, where Jen planned to live once she retires.



Jen is a 50 year old US citizen working in the pharmaceutical industry who was transferred to Yokohama for a 3-year assignment.

A year after moving to Japan, Jen`s mother was diagnosed with Alzheimer's disease and she decided to make an inter vivos transfer of her house to Jen. The house was valued at US$ 600 k and she had US$ 1.4 m savings. This was to be used against Jen assuming the obligation to pay US$ 125 k p.a. for nursing home fees and medical bills.



Jen is an only daughter. Upon the inter-vivo transfer, the assets assumed by Jen after deduction of the US$ 1 m liability towards her mother's nursing fees (1) became subject to tax in the top 55 % Japan gift tax bracket.

In order to pay over US$490k in Japan Gift Tax, plus nursing home fees and medical bills (which she is not sure how long she will have to pay for), Jen had to sell the Louisiana family house and set aside all of her mother's remaining savings for future medical expenses. Jen now needs to make new arrangements for her own retirement plans, which could have been avoided only by declining her mother's wish to act as her guardian and to wait for an inheritance of the remaining assets after her mother`s death.

(1) US$ 125k nursing fees and medical bills p.a. over an estimated statistical life expectancy of another 8 years.

If Jen was not a Japanese taxpayer this would not have happened as the size of the gift would not have resulted in US federal gift tax and the State of Louisiana repealed gift tax in 2008.

How Japanese nationals are treated abroad

How are Japanese expatriates living overseas affected by the inheritance tax rules of the country in which they live; are they in a better or worse position than a non-Japanese national living in Japan?

In the following 34 countries it is as follows:

Australia, Austria, Canada, China, Czech Republic, Hong Kong, India, Israel, Mexico, New Zealand, Norway, Portugal, Russia, Singapore and Sweden
Inheritance tax is not imposed or has been abolished in these 15 countries and a Japanese expatriate seconded to them will therefore not be subject to inheritance tax.

UK, Ireland and Turkey
Expatriates, including from Japan, staying for a few years in the UK, Ireland or Turkey are not subject to inheritance tax upon their world-wide assets.

Belgium, Denmark, Finland, Germany, Indonesia, Italy, Luxembourg, Netherlands, Philippines, Poland, South Africa and Spain
In these 12 countries, an inheritance tax of 34% (but often much less) is imposed on children and spouses of Japanese expatriates (or an expatriate inheriting from parents or a spouse); this is significantly lower than the Japanese inheritance tax.

US and France
While nominal inheritance rates in the US and France can be as high as 40% there are offsetting measures. In the United States 5.43 mil US$ are tax exempt and in both countries spouses are entitled to a 100% tax credit. In both these countries a Japanese expatriate or their heirs will pay much less tax than in Japan.

South Korea
Only in South Korea will a Japanese expatriate or their family be taxed at a similar type of level as in Japan.

Japanese nationals seconded to work and live overseas in any of the above countries, except South Korea, would be in a more favourable position than nationals from these countries living in Japan.

The Government's role

The Japanese government and the Tokyo Metropolitan Government has set out ambitious goals to attract talent to Japan with the vision of further making Tokyo a major global financial centre and encouraging direct foreign investment.

The imposition of additional tax liabilities, which are more onerous than near neighbours or other G7 countries, is likely to discourage foreign workers from choosing Japan as their residence. The Government of Japan needs to consider how its individual tax policy is supporting its internationalisation goals.

A possible solution

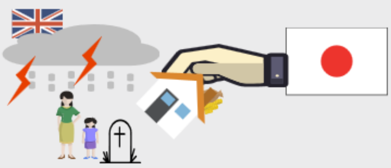
A possible simple solution is adopting the same policy that was applied to foreign nationals in Japan when introducing the Exit Tax regime.

Under the scheme adopted in 2015, foreign nationals - other than permanent residents, spouses of permanent residents, and spouses of Japanese nationals - were exempted from the Exit Tax. The non-exempted foreigners were given a five-year period to review their circumstances. Options open to them include changing their visa to one of the exempted categories, leaving the country, divest their assets or maintaining the status quo.

This Exit Tax policy solution could also be applied to the Japanese inheritance and gift tax regime.

The reasoning behind the Exit Tax policy was not to disincentivise skilled foreign nationals from moving to Japan to work or to remain in Japan. The same rationale should apply to the inheritance and gift tax rules. More people are potentially affected by these rules, because of the lower thresholds, compared to the Exit Tax.

Episode One: a worked example



Robert Green died in Spring 2016 soon after moving to Japan.

He owned a house in London and paid £1.5m for it ten years ago and financed the house by taking out a £1.0 m loan in 2006 paying the rest out of his savings. At the time of his death, the value of the property had more than doubled to £3.2 m .

Robert's world-wide property assets added up to ¥566.4 m (1) . His wife and daughter were able to claim exemptions of ¥42 m and deduct a 50% spousal credit. The total Japan inheritance tax liability was about ¥71 m(1) .

In order to pay this tax and to settle the outstanding £500 k balance on the loan, Robert's wife had to sell their family home in London. This caused significant financial turmoil and disruption to the family.

This would not have happened if Robert had stayed in London, because in the UK his wife would have been exempted from inheritance tax(2).

There are many examples that could be made using different scenarios and figures, but the outcome would in many cases be the same: an unexpected hardship as a result of Japanese inheritance tax rules.

(1) Exchange rate of 177 JPY/GBP on Jan 1st 2016

(2) While in Japan Robert`s daughter was entitled to a legal share subject to a marginal tax rate of 45%, even though Robert's wife was supposed to inherit the house as set out in the couple's will.

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