

Tax Incentives Programme of Dialogue and Co-operation with China

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A. Japanese Case

I. Introduction

In Japan also, various tax incentives, such as tax credits, special depreciation allowances and reserves, are provided to achieve specific policy objectives. To this end, after the war in 1946, the Special Taxation Measures Law was put into effect to replace the Temporary Taxation Measures Law of 1938 which served the war purposes. The special taxation measures granted under the Law were inclined to proliferate. The 1949 recommendations of the mission headed by Prof. Carl S. Shoup stopped this trend from the equity point of view. Nevertheless, since 1961, a variety of tax incentives were introduced one after another

Under the circumstances, in 1957, the Special Taxation Measures Law was totally revised by consolidating the then existing diverse tax incentives. The purposes of these tax incentives were accumulation of capital, encouragement of savings, repletion of retained earnings, modernization of equipment, promotion of exports, etc. However, as time went on, there arose criticisms, such as on the efficacy of these tax incentives. To address such issues, attempts were made to streamline and rationalize them but progress was not so impressive.

On the other hand, a variety of special tax incentives have been newly brought in the measures for small- and medium-sized enterprises, land, pollution control, energy conservation, regional development and others. It is alleged that since these tax measures favor specific taxpayers or specific types of income, e.g. income from capital or business income, they run counter to the principles of equality of burden and neutrality. In addition, they make the tax system more complex and distort the decision-making of each individual.

II. Change in Policy Objectives

The underlying philosophy of the Special Taxation Measures Law is that any tax incentives are allowed to exist so long as their merits of serving the intended policy purposes outweigh the demerits of being against the principles of equity and neutrality. Therefore, such tax incentives have been under the strict and constant review on the basis

of the latter principles. The policy objectives which the tax incentives serve have thus far considerably changed as Japan has undergone an economic and social transformation.

Immediately after the war when the economic reconstruction was of an overriding necessity and the subsequent fast economic growth was to begin, priority was given to industrial policy at somewhat cost of the principles of equity and neutrality. The revenue loss due to the special taxation measures more than doubled from 65.8 billion yen in fiscal year 1954 to 140.7 billion yen in FY 1960.

However, in the late 1950s, reassessment of the tax incentives was called for and undertaken both by the Tax Commission, an advisory organ to the government, the Tax Bureau of the Ministry of Finance. Especially, it was alleged that major tax incentives, such as tax free reserves and accelerated depreciation allowances are mainly used by large corporations. In response to the this allegation, the Tax Commission conducted a series of sample surveys in 1959. The surveys revealed that during 1957 and 1959, while for small corporations (capitalized at 50 million yen or less) the special taxation measures made 91.2% of their gross income taxable, for large corporations these measures made 79.5% of their gross income taxable. This may suggest that the use of the available tax incentives was lopsided in favor of large corporations.

In those days, nearly 90% of the special taxation measures for repletion of firms' retained earnings and modernization of equipment were accounted for by the following three reserves: (1) reserve for bad debts; according to the survey mentioned above, in FY 1959, in manufacturing industry, large corporations had 2.0% reserve of their total outstanding receivables while small ones had only 1.48% reserve of their total outstanding receivables, (2) reserve for price fluctuations which was created on the basis of conservatism of business accounting in 1951 and grew rapidly after 1953; and (3) reserve for retirement allowance which was introduced by the FY 1952 tax reform to make up for the raise of corporation tax rate from 35% to 42%.

The same policy purpose was served by the special depreciation allowances. In addition, from the viewpoint of equity of taxation, accelerated depreciation allowances may be more acceptable than tax-free reserves. there were two types of the special depreciation allowances as follows: (1) 50% depreciation allowance in the first year and (2) 50% additional allowance for the first three years. Again, the above-mentioned survey revealed that, in 1958, the special depreciation allowances as a percentage of the total depreciation allowances were 5.2% for large corporations and 1.0% for small ones. Here, also inequality in the benefits from the special taxation measures between large and small corporations is evident.

Thus, the reduced tax rate for small corporations (35% for corporations of annual taxable income of 500, 000 yen or less as against the basic rate of 40%) was for the first time introduced in 1955 to compensate small businesses for their insufficient benefits from the special taxation measures as compared with large corporations.

After the war, when export was urgently needed, the deduction of income from export introduced in 1953 contributed a lot to the growth of Japan's exports, and hence improvement of its international balance of payments throughout the 50s but was declared against

the provision of the General Agreement on Tariffs and Trade (GATT, now WTO) ruling out subsidies and eventually abolished in 1964. This was replaced by additional depreciation allowances for overseas transaction business expansion of deduction for income from technical service export and creation of reserves for overseas market development, for overseas investment loss and for overseas market development for small businesses. However, as the Japanese economy phenomenally changed in its report on the FY 1971 tax reform, the Tax Commission for the first time advised to review the policy of export promotion. Since then, emphasis of the tax incentives has been gradually shifted from export to import of manufactured goods.

For some time after the war, nylon and other chemical fabric-related products, coal and other mineral products and electric power were three major items which enjoyed the tax exemption for important products. As the underlying philosophy of tax expenditure indicates, the tax exemption is in substance equivalent to provision of subsidies. Moreover, the tax exemption system does not give benefit to those firms which post a low profit or suffer a loss and, instead, grant them tax exemption when their profits are so high they don't need subsidies. This system is rare in advanced industrialized countries and involves difficulties in selecting its subjects. In Japan, this is a time-honored system which existed since 1913 and was renamed as "tax exemption for new important products" in 1961. The FY 1966 tax reform put an end to this 55-year-old system since it had accomplished its tasks.

III. Recent Developments

1. Encouragement of Savings

The revenue loss of the national government due to the special taxation measures as a percentage of the total national tax revenues almost consecutively declined from 7.3% in FY 1963 to 3.3% in FY 1973 and to 1.6% in FY 1998. In FY 1963 the revenue loss due to encouragement of savings accounted for 59.4% of the total tax revenue loss due to the special taxation measures but turned to decline since 1970, recording 38.1% in FY 1973. Nevertheless, encouragement of savings had been the single most important subject of the special taxation measures until FY 1993 when its share in the total revenue loss reached 76.3%. After that, encouragement of savings has been taken place of by housing measure as leading the list of the special taxation measures.

The following are the tax measure used in Japan as an incentive to savings:

- (1) Interest on deposits — separate withholding taxation at source on deposit interest and tax exemption for interest on certain kinds of deposits, such as postal savings, subject to the limit of amount.
- (2) Profits from redemption — special tax treatment of the discount amount between face value and issue price of discount bonds.
- (3) Dividends — application of reduced rates for withholding tax at source on dividends and tax credit for dividends.
- (4) Capital gains from securities — sales of stocks and other securities were made exempt from income tax as from FY 1953 and, instead, made subject to securities transaction tax.

- (5) Insurance premiums — A certain amount of insurance premiums may be deducted from taxable income.
- (6) Social insurance — From FY 1953, social insurance premiums are deductible.

From the mid-50s to 60s, taxation on interest and dividends was considerably reduced but afterwards taxation on savings was gradually tightened. In 1970, the system of elected separate withholding taxation at source was reinstated for the first time in 18 years since 1952, which may represent the first step toward comprehensive income taxation. Against this trend, however, in FY 1971, a new tax exemption for interest income from employees' assets formation savings earmarked for house acquisition for salaried workers was added to the existing non-taxable savings.

In 1982, the government attempted to institute the "green card system" to control the abuse of tax-free deposit accounts and terminate separate taxation for interest income. This system was comparable to the social security number of the United States although its coverage was much narrower. The proposed introduction of the green card system met a storm of opposition especially from some politicians. The government's attempt failed and the legislation was forced to be repealed by political pressures after it had actually been passed by the Diet in 1985.

As from April 1988, the traditional system of tax-privileged savings accounts, i.e. tax-exempt small savings and postal savings accounts and small-sum government bonds was replaced by the system under which the elderly (65 years or older) and disabled, etc. are eligible for tax exemption up to the outstandings of 3.5 million yen. This is an epoch-making change of tax treatment on interest income in the history of Japan's tax system.

2. Promotion of Small Business

As mentioned earlier, most of the special taxation measures were utilized by large corporations. Under the circumstances, introduction of the reduced corporation tax rate for small companies was intended, in some degree, to make up for the benefits which small businesses did not fully derive. Emphasis in the special taxation measures has been gradually shifted to small business.

In Japan, small- and medium-sized enterprise (SME) is defined by the SME Basic Law as follows: in mining & manufacturing and other industries, those with 300 or less employees or capitalized at 100 million yen or less; in wholesale, those with 100 or less employees or capitalized at 30 million yen or less; and in retail and service industries, those with 50 or less employees or capitalized at 10 million yen or less.

In 1996, in terms of number of establishments (excluding primary industries), SMEs account for 98.9% of the total and in terms of employees, they account for 77.6% of the total. In 1996, SMEs' market shares were 51.0% in manufacturing, 64.2% in wholesale trade and 75.7% in retail trade.

In view of the vital role of SMEs to play in the Japanese economy, a series of legislation have been made for them and, accordingly, special taxation measures have been provided to accommodate the necessary incentive since the 1980s. These laws include the Law on Temporary Measures for SMEs (the "New Castle Town" Law) of 1983, the Law Regard-

ing Promotion of Areas Where Highly Advanced Technology Industries Concentrated (the "Technopolis" Law) of 1983, the Law on Temporary Measures for SMEs in Areas Related to Specific Types of Industries (in Recession Areas) of 1983, the Law on Temporary Measures to Promote the Development of Technology by SMEs of 1985, the Law on Temporary Measures Regarding Business Conversions of Specific SMEs of 1986, the Law on Temporary Facilitation Measures for the Conversion of the Industrial Structure of 1987, the Law Regarding the Promotion of the Centralization of Specific Projects Contributing to the Upgradation of Local Industries of 1988, the Law on Temporary Measures to Facilitate the Execution of Specific New Businesses (the "New Business" Law) of 1989, the Law Regarding the Promotion of the Improvement of Employment Management to Ensure Manpower for SMEs (the Law "To Ensure Manpower") of 1991, the Law on Temporary Measures Regarding the Promotion of Furnishing the Concentration of the Specific Retail Businesses (the Law to Adjust the Commercial Concentration) of 1991, the Law Regarding SMEs' Wholesale Activities Efficiency Promotion by SMEs of 1992, the Law Regarding the Assistance for Specific SMEs by Societies of Commerce and Industry and the Chamber of Commerce of 1993, the Law on Temporary Measures for Specific SMEs Advancing into New Business Fields in Adjusting to Changes in Economic Structure of 1993, the Law on Temporary Measures Regarding the Facilitation of Business Innovation by Specific SMEs of 1995, the Law on Temporary Measures to Promote the Pioneering Activities of SMEs of 1995 (the Law on Temporary Measures to Promote the Development of Technology by SMEs (the "Technology" Law) of 1985 and the Law on Temporary Facilitation Measures for the Development of New Fields through the Collaboration of Expertise among SMEs in Different Fields (the "Fusion" Law) of 1988 were integrated into this Law), 1995 Revision of the New Business Law of 1989 to support venture business, making the employees' stock option possible, and the Law on Temporary Measures Regarding the Vitalization of the Concentration of Specific Industries of 1997.

After a drastic reassessment of all the special taxation measures, the FY 1995 tax reform which focused on the rationalization and consolidation of these measures deleted 8 items and added 4. Noteworthy is that, of these added 4, two were related to SMEs; one is venture business and the other is business innovation. As of now, among the 10 special taxation measures contributing in the greatest amount to the revenue loss of the national government, three are those for SMEs.

In the consumption tax introduced in 1989 also, SMEs are granted favorable treatments as follows: (1) An enterprise with annual sales of 30 million yen or less is exempt from taxation. (2) Simplified system — For those taxpayers with taxable annual sale of 200 million yen or less can choose the prescribed deemed rates of purchase ranging from 50% to 90% depending on industries. (3) Marginal deduction was applicable to small business whose annual sales were less than half a million yen until March 1997; (3) Those newly established corporations capitalized at less than 10 million yen are exempt from taxation for the first 2 years; (4) Taxpayers whose tax amount of the previous taxable year was less than 4 million yen are not required the 3 interim returns and installment payments. These preferential measures for small business were somewhat reduced in response to the outcry

of the alleged ekizei (use of the undue tax advantages) in April 1997 when the tax rate was raised from 3% to 5%.

In the FY 1998 tax reform, the corporation tax rate has been lowered from 37.5% to 34.5% and, accordingly, for small corporations capitalized at 100 million yen or less for annual income of 8 million yen or less the rate also has been cut from 28% to 25%. In order to make up for the resulting revenue loss, the tax base has been broadened especially by consolidating and rationalizing the tax-free reserves and reviewing the depreciation allowances. Nevertheless, for SMEs special treatments have been reserved in many ways.

Reserve for bad debts is a case in point. The allowance of prescribed percentage of receivable outstandings will be gradually abolished by 2002. However, corporations capitalized at 100 million yen or less can credit the amount 16% higher than the upper limit prescribed by the law for 3 years.

Entertainment and social expenses in context of the special taxation measures are an exception in that they incur revenue gains instead of revenue loss. But here again SMEs claim an exception. Revenues from taxation on entertainment and social expenses have been steadily increased by the special taxation measures. Such taxation first instituted in 1954 was addressed large corporations (originally capitalized at 5 million yen or more and in 1957 raised to 10 million yen) and in 1971 extended to all the corporations regardless of their size. But in 1979 when the fixed deduction was lowered from 4 million yen to 2 million yen, for medium-sized corporations capitalized at over 10 million yen but 50 million yen or less, that deduction was set at 3 million yen and for small-sized ones capitalized at 10 million yen, at 4 million yen.

In 1982, the total amount of entertainment and social expenses was made taxable, however for the medium- and small-sized corporations as defined above, 3 million yen and 4 million yen remained deductible, respectively. This was a 3 year temporary measure like most other special taxation measures. But later it was renewed every 2 years. In FY 1994, for medium- and small-sized corporations, 90% of, instead of all, the entertainment and social expenses disbursed were made deductible up to 3 million yen and 4 million yen, respectively. And in FY 1998, this inclusion in deductible expenses has been further reduced to 80%.

When SMEs acquire new machinery whose unit price is 2.3 million yen or more and use it for certain business purposes, they can depreciate it at the special rate of 11% in the first year. To promote investment in electronic equipment of SMEs (Mechatronics taxation), such as NC machine tools, industrial robots and computer-controlled production and distribution facilities, those who acquire or lease these facilities can make special depreciation of 30% of the acquisition value in the first (in the case of a lease, 7% tax credit for 60% of the total lease charges).

In the FY 1997 tax reform, the Law on Temporary Measures Regarding the Facilities of Business Innovation by Specific SMEs of 1995 was amended to create an angel taxation system for individual investors in venture business. Under the new system, capital loss incurred from investment in the 5 year or less old company whose expenditures on experiment and research are 3% or more than their annual sales may be carried over for 3 years.

When SMEs acquire or lease machinery and equipment whose acquisition value is 2.5 million yen or more (in the case of a lease, 3.4 million yen or more) as business founders covered by the same Law, they can make special depreciation of 30% in the first year or in the case of a lease, 7% tax credit for 60% of the total lease charges. Up to 18% of acquisition value of stocks of the companies designated by the Small Business Investment Companies Ltd may be credited to the Reserve for Investment Loss in Newly-formed SMEs.

3. Improvement of the Quality of Life

(1) Housing

In the 1970s, emphasis of the special taxation measures was shifted from promotion of industries and encouragement of savings to improvement of the quality of life, environmental protection and conservation of energy and resources.

With a view to increasing owner-occupied houses, in 1967, a 4% tax credit was instituted for savings for acquisition of dwelling houses within the upper limit of 10,000 yen for 3 years. As mentioned earlier, in 1971, the tax exemption system of interest income from employees' assets formation for house acquisition was created. This was followed by introduction of a 1% tax credit for standard acquisition cost of a dwelling house subject to the maximum limit of 20,000 yen for 3 years in 1972.

The tax credit for savings for acquiring houses which had logically been expanded was abolished in 1982. On the other hand, the tax credit for acquisition costs of houses which had undergone substantial changes to include mortgage was replaced by a new tax system to facilitate ownership of dwelling houses in 1986. Under the new system, a taxpayer who acquires a dwelling house is entitled to a tax credit of the prescribed amount based on (approximately 1% of) the outstanding of loans from financial institutions up to the upper limit of 350,000 yen for 6 years. Since FY 1995 the special taxation measures for housing are the single largest factor contributing to revenue loss of the national government. In FY 1998, the revenue loss due to the special taxation measures total 1,864 billion yen without taking into account the increased revenue from taxation on entertainment and social expenses amounting to 908 billion yen. By far the largest revenue loss is 619 billion yen due to the tax system to facilitate acquisition of dwelling houses, accounting for 33.2% of the total revenue loss. Moreover, it is to be noted that the tax exemption system of interest income from employees' assets formation for house acquisition is not included in "housing measures" but in "encouragement of savings".

(2) Pollution Control

Until the early 1960s, sporadic special taxation measures were taken to control environmental pollution. The FY 1969 tax reform included as fullfledged anti-pollution measures a special initial depreciation allowance of one-third of the acquisition cost for machinery and equipment to control air and water pollution and noise.

In 1972, a reserve for prevention of environmental pollution was established. A special initial depreciation allowance of one-third of the acquisition cost was introduced for manufacturing equipment of pollution-free machinery and for machinery and equipment for recycling wastes in 1973 and 1974, respectively.

In the light of the Polluter Pays Principle as announced by OECD in November 1974, in the FY 1976 tax reform, the special initial depreciation allowance for both manufacturing equipment of pollution-free machinery and equipment for recycling wastes was reduced from one-third of the acquisition cost to one-fourth, while that of the machinery for prevention of environmental pollution was kept unchanged at one-half. In 1978, the reserve for prevention of environmental pollution was abolished.

The special depreciation allowances of these machinery and equipment have been reduced amidst the trend of the consolidation and rationalization of the special taxation measures. For example, in FY 1980, the initial depreciation allowances were 27% for the machinery for prevention of environmental pollution and 20% for other two other above-mentioned machinery and equipment.

(3) Conservation of Resources and Energy

The special taxation measures for resources began with the creation of a mine prospecting reserve in 1965. Incidentally, the foreign mine prospecting reserve started 10 years later in 1975. Under both reserves, 12% of sales of minerals can be credited to the reserve and after 3 years should be added back to income. In 1970, a loss reserve for investment in petroleum development was instituted against the risk of the exploration of petroleum and in 1971 was reorganized into the loss reserve for investment in resource development. In 1973, this was integrated as the reserve for overseas investment loss. Under the system; (1) If a corporation acquires stocks of the specified companies engaged in overseas business or extends credits to such companies, the prescribed amount involved may be credited to the reserve. The amount may be held for 5 years and then should be added back to the income in the following 5 years and (2) When banks or insurance companies credit to this reserve an amount of 1% or less of the specified overseas loans to meet an expected loss from bad debt, such amount credited is deductible. The amount credited to the reserve should be added back in full to the income in the following taxable year.

As for the energy-related policy, selected preferential tax treatments have long been granted to electric power and gas companies. The drought reserve created in 1952 is intended to provide for losses by hydroelectric corporations caused by drought.

From the late 1960s, the policy of atomic power generation was actively pursued. In 1968, a depreciation reserve for construction of atomic power generation and special depreciation allowance were introduced. Later as experience gained, the reserve for reprocessing of spent nuclear fuel was added in 1983. Unfortunately, however, as far as the atomic power policy is concerned, things were not going well for a variety of reasons. Both depreciation reserve and special depreciation allowance created in 1968 were brought to an end in 1990. And in the same year, a reserve for the removal and disposal of atomic power generation was established. Under the circumstances, withdrawal of the policy is under serious consideration.

In the 1978 tax reform, for energy-saving equipment taxpayers were temporarily given option between a tax credit of 10% of the acquisition cost and the special depreciation allowance. In the 1981 tax reform, for energy-saving equipment, taxpayers were given option between a tax credit of 7% of the acquisition cost and the special depreciation

allowance of 30% of acquisition cost. The amount of the tax credit is limited to 20% of the corporation tax amount and the excess may be carried over for one year. This option between the tax credit and special depreciation allowances is effective as of now although standard acquisition costs by which the amount of both tax credit and depreciation allowances are calculated are somewhat adjusted.

B. Tax Rate Reduction

I. Introduction

Since the objective of tax incentives is to encourage the desired or targetted activities of the particular sector by granting favorable tax treatment, an across-the-board tax reduction which favors all the sectors does not constitute a "tax incentive" which we are discussing here today. In the final analysis, "favorable" or "unfavorable" is a matter of relativity or comparison. Low income people in the poor community don't necessarily feel unhappy and, on the contrary, high income people in the affluent society don't always feel happy, either. It is the low income people that sometimes feel unhappy and miserable.

This may be more or less true of the tax rates. The reduced rate for small business which is referred to on page 8 of the paper is a case in point. In the first place, let us remember that any tax incentives, which run counter to the principles of equity and neutrality should be kept to a minimum. In connection with the point made on page 11, in the modern tax system, the individual income tax is characterized by the progressive taxation. However, the progressivity does not apply to the corporation income tax. It is because, unlike a natural person, corporations can be split to avoid the progressive taxation. For the purpose of maintaining the tax equity, some kinds of enterprises such as electricity and railways which cannot be split by nature, the corporation tax rate is, in principle, a flat one.

II. Small Business Tax Rate

Nevertheless, in view of their vital role in the national economy, small- and medium-sized enterprises (SMEs) are granted reduced corporation tax rates in most countries. In Japan, the corporation tax rates are 25% for annual income of 8 million yen (as of 31 July 1998 1 RMB = ¥18.06) or less by corporations capitalized at 100 million yen or less as against 34.5% (basic rate) for others.

In the United States, the corporation tax, while its basic rate is 35%, is imposed at 25% for annual income from US \$ 50,001 to US \$ 75,000 and 15% for annual income of US \$ 50,000 or less. It is interesting to observe that the reduced tax for small business comes under the tax expenditures which are analogous to subsidies as mentioned on page 7. In the United Kingdom, in the supplementary budget for fiscal year 1997 of July last year, the basic rate and reduced rate for corporations with annual income of £ 30,000 or less were lowered from 33% to 31% and 23% to 21%, respectively. Furthermore, the fiscal year 1998 budget of March 1998 provides the following another cut of corporation tax; the basic rate to 30% and the reduced rate to 20% effective as from April 1999. It is to be noted that since in the U.K. there is no local tax on income, the effective tax rate on corporate business of the U.K.

is the lowest among the industrialized nations. That means the U.K. now enjoys the most international competitive advantage.

To go into details of Japan, under the SME Basic Law, SME is defined as follows: in mining & manufacturing and other industries, those with 300 or less employees or capitalized at 100 million yen or less in wholesale, those with 100 or less employees or capitalized at 30 million yen or less; and in retail and service industry, those with 50 or less employees or capitalized at 10 million yen or less. In 1996, in terms of the number of establishments (excluding primary industries), SMEs account for 98.9% of the total and in terms of employees, they account for 77.6% of the total. In 1996, SMEs' shares were 51.0% in manufacturing, 64.2% in wholesale trade and 75.7% in retail trade.

After the war, the tax incentives, most of which are provided for by the Special Taxation Measures Law to meet the needs for the economic reconstruction and fast economic growth increased to some extent at the cost of tax equity. In the late 1950s, reassessment of the tax incentives was called for and undertaken both by the Tax Commission, an advisory organ to the government, and the Tax Bureau of the Ministry of Finance. Especially, it was alleged that major tax incentives such as tax free reserves and accelerated depreciation allowances were mainly used by large corporations.

In response to this allegation, the Tax Commission conducted a series of sample surveys in 1959. The surveys revealed that during 1957 and 1959, while for small corporations (capitalized at 50 million yen or less), the special taxation measures made 91.2% of their gross income taxable, for large corporations, these measures made 79.5% of their gross income taxable. In 1958, the special depreciation allowances, another tax incentive, as a percentage of the total depreciation allowances were 5.2% for large corporations and 1.0% for small ones. These may substantiate that the use of the available tax incentives was lopsided in favor of large corporations.

Thus, the reduced tax rate for small corporations (35% for corporatic of annual taxable income of 500,000 yen as against the basic rate of 40%) for the first time was introduced in 1955 to compensate small businesses for their insufficient benefits from the special taxation measures as compared with large corporations. Since this rate differential was created for policy purpose, it was generally expected that such difference should be narrowed in the future.

The drastic reform of the corporation tax in fiscal year (FY) 1998 is a product of the intensive study of the Tax Commission. According to the report of its sub-committee, in FY 1996, the revenue loss due to the special taxation measures by size of enterprize is as follows:

(In billions of yen)

	Total revenue loss	Large corps. capitalized at over ¥100 mil.	SMEs capitalized at ¥100 mil. or less
Special depreciation allowances	103	47	56
Tax-free reserves	54	51	3
Tax credits	208	125	83
Total	365	223	142

Again, we should bear in mind that in 1996 large corporations (capitalized at 100 million yen or more) account only for 2.2% of the total in number but account for 65.2% in taxable income. Looking at the revenue impact of the tax incentives, as far as the special depreciation allowances are concerned, the benefits of SMEs exceed those of large corporations. This reflects the recent trends of exceptional favorable treatment of SMEs both in addition and elimination of the special taxation measures. The single largest special depreciation allowance that caused revenue loss was one for SMEs' machinery for structural reform accounting for 28% of the total. The similar tendency is noticeable also in the tax credits but SMEs don't yet catch up. A problem lies in the tax free reserves which, however, have become relatively small in amount. Some of them are almost exclusively utilized by large corporations

III. Recent Tax Reform

One of the main features of the FY 1998 tax reform is the most radical reform of corporation tax ever since 1965 which has been pending for the last two years. In this far-reaching tax reform, some of the above-mentioned reserves have been abolished to broaden the tax base to meet the fund needs to cut the corporation tax rates. It is just like the U. S. President Reagan's Tax Reform Act of 1986 a drastic cut of tax rates of which was made possible on a broader tax base by eliminating various tax incentives and tax privileges. I hope Mrs. Susan Himes shares this view.

Effective as from April 1998, the basic rate of the corporation tax has been lowered from 37.5% to 34.5% in view of the changing circumstances both at home and abroad. Taking into consideration the possibility of SMEs' being partially affected by the broadened tax base, the reduced rate for SMEs has been cut by the same 3 percentage points, while the reduced rate for cooperatives and others was cut by 2 percentage points, thereby narrowing the difference from the basic rate.

IV. Agricultural Income

On page 6, mention is made of agricultural income. Agricultural income for taxation purpose is extremely difficult to assess. Therefore, to represent the degree of grasp of taxable income of different types of income by tax authorities, there used to the words "*to-gosan* (10-5-3)" and "*ku-ro-yon* (9-6-4)". Both sound very rhythmical in Japanese. They mean that salary and wage income is 100% or 90% (practically all) taxed because it is withheld at source, about half (50% to 60) of business income is taxed because substantial part of living expenses may be deducted (by abuse) from taxable income but only 30% or 40% of agricultural income is taxed. These days, we don't often hear of such words. Perhaps, technologies of tax authorities to capture the income may have been much advanced.

Moreover, the surroundings of agriculture of Japan have undergone a spectacular change. Soon after the war when we suffered from an acute food shortage, farmers were forced to sell an allocated amount of rice to the government. Every year, the National Diet never failed to pass a bill for special taxation measures to lighten the tax burden on such sales proceeds. But now we have a glut of rice and other certain agricultural products. At

the same time, from abroad, Japan is under the strong pressure to import agricultural products owing to the WTO (formerly GATT) agreements. So the government is desperately trying to limit the domestic production of rice and other agricultural products. As in many other countries, in Japan, farmers are very powerful politically. Agricultural production vis-à-vis selfsufficiency of food is a hot political issue now in Japan.

C. Activities of Not-for-Profit Organizations

I. Introduction

To begin with, I feel obliged to make it clear that I don't believe I am well qualified to speak on this subject because I am from the country where non-profit-organizations (NPOs) have just emerged and are least developed among the industrialized countries. The long-awaited legislation for NPO was at long last approved by the National Diet in March this year after many turns and twists. To a great disappointment of proponents, the law has no tax exemption clause.

Organizations to be created on the basis of the new NPO Law which will come into force as from 1 December 1998 are juridical persons of a new type. Therefore, its bylaw provides that within three years from the date of enforcement necessary steps should be taken to improve the legislation. In this connection, on approving the bill, the Diet made resolutions that a conclusion should be reached within two years from the date of enforcement of the Law about the tax status of NPOs. Under the existing Law, NPOs will be treated for taxation purpose as non-juridical organizations which will be mentioned later.

There are a variety of profound reasons why Japan is an underdeveloped country in NPOs. I am aware the term "underdeveloped" is nowadays a taboo in the international community because it is discriminatory. Nevertheless, in my opinion, the term "developing" is sometimes misleading. Since this the tax course, I will refrain from going further. Now I am referring to my own country, I dare to use the jargon "underdeveloped."

In Japan, religion is not so well established as in other countries. Religious activities have not penetrated the Japanese society. By and large, the Japanese people are not so pious. Most Japanese, including myself, become *shintoists* on wedding ceremonies and buddhists at the funerals of our parents and children but atheists for all the rest of life. Recently, abnormal behaviors of some self-styled religious groups have led the general public to harbor deep scepticism about religion. Especially, the atrocities and massacre by the *aum* sect terrorized the innocent people and dealt a hard blow with the deliberation of the bill for NPOs which once gathered momentum on the occasion of the Hanshin Great Earthquake.

II. Charitable Contributions

There is no tradition of philanthropy in Japan. There is no super rich. Japan is one of the few countries where the inheritance tax works. The maximum rate is 70% and threshold is 50 million yen. In 1995, out of 100 cases of death, 5.4 paid the inheritance tax. Back in 1987, out of 100 cases of decease, as many as 7.9 paid the inheritance tax when the

threshold was 20 million yen. Generations change very rapidly. Almost all of the presidents of leading companies in Japan are promoted employees and not owners of these companies. It is usually impossible for the founder of a company, when grown big, to let his family succeed or even to control the company. Furthermore, although I cannot indicate by statistics off-the-cuff now, it is fairly recently that we Japanese are well off after achieving the fast economic growth. As a matter of fact, I cannot see people's life in the third world on television without remembering my child's days. As a whole, Japan could not afford such thing as philanthropy and charity.

On the contrary, in the Western countries, there is a long tradition of philanthropy and charity plays a major role in the society. In Japan, contributions or donations to (1) the national or local governments, (2) public institutions specifically designated by the Ministry of Finance, (3) private institutions officially recognized as contributing to the public cause and (4) political organizations which satisfy certain conditions are deductible in the amount exceeding 10,000 yen up to an amount equal to 25% of the total income. But I heard both in the United States and the United Kingdom tax treatment of charitable contributions is very generous.

In the U. S. because of their deductibility, the charitable contributions are logically included in the tax expenditures. As far as I understand it, the simple mathematical sum of all the items of U. S. tax expenditure sometimes would reach nearly 30% of the total tax revenues, which is rather unrealistic. My guess is that some items are duplicated. I was under the impression that in the table I found so many "deductibility of charitable contributions" that some of them are double accounted. To my knowledge, no total amount of tax expenditure is given by the authorities such as OMB or CBO while others from time to time tentatively try to do so. If I am wrong, Please Mrs. Susan Himes correct me. I am quite dark about the recent developments.

One of the informative and valuable OECD publications which Prof. Richard Vann has brought here this morning would shed a revealing light in this respect. According to the OECD's *Tax Expenditures: Recent Experiences, 1996*, the tax expenditure estimates for the U. S. 1996 include the following:

(In millions of US dollars)

	Revenue foregone	Outlay equivalent
Deductibility of charitable contribution (Education)	1,705	2,270
Deductibility of charitable contribution (Health)	2,210	2,950
Deductibility of charitable contribution (Other than education and health)	18,910	25,040

In this table, duplication is eliminated but the total is not given as before. Somewhere else, it states "tax expenditure estimates have become more reliable over time." This OECD publication covers 14 countries and some of them show the total and others don't. Incidentally, in connection with the comparison of effectiveness between tax incentives and subsidies, the above table shows the amount of revenue foregone is smaller than that of outlay equivalent.

III. Taxation on Various Organizations

Among the organizations exempt from corporation tax in Japan are the national government, its agencies and local public entities, such as prefectures, municipalities, etc., corporations established by contributions from the government and/or local public entities, such as the Housing Loan Corporation and the National Students' Aid Fund and other organizations listed in Schedule 1 of the Corporation Tax Law. Of course, these are not the kind of corporations which we are discussing here now.

In this regard, it may be interesting to note the Bank of Japan, the central bank of Japan, counterpart of People's Bank of China, is like the Bank of England of the old days, privately owned, to be more specific, 55% by the national government 45% by the private sector. Therefore, the Bank of Japan is subject to the corporation tax and sometimes tops the list of taxpayers, outranking Toyota Motor, Hitachi and other major companies. Last April, the Bank of Japan was reorganized on the basis of the new law in order to strengthen its independence. Nevertheless, the above-mentioned ownership has not been changed. The ownership is one thing and the independence is quite another. Needless to say, the activities of the Bank of Japan are not profit-making but in settling its accounts if any profits accrue, although unwanted, the Bank of Japan should pay the corporation tax like any other ordinary corporations.

The public interest corporations listed in Schedule 2 of the Corporation Tax Law are subject to corporation tax only on the income derived from the business defined as profit-making activity. For income derived from assets not pertaining to "profit-making activities," neither income tax nor corporation tax is levied in principle. Incorporated associations and foundations come under this category.

Agricultural cooperative associations, small enterprise cooperative associations and the like cooperative associations listed in Schedule 3 of the Corporation Tax Law are taxed at the reduced rate of 25% (lowered from 27% as from 1 April 1998).

A non-juridical organization which has either a designated representative or a manager is treated as a corporation for corporation tax and income tax purposes and only the income derived from "profit-making activities" is taxable. The organizations to be created based on the new NPO Law which will take effect as from 1 December 1998 will be treated as this type of organization for taxation purposes.

IV. NPOs in Japan

The Japanese Civil Code provides that with authorization of the government Ministry concerned, an incorporated organization or foundation designed for public interest may be created. The list of Schedule 2 of the Corporation Tax Law includes the selected above-mentioned organizations and foundations, and those established under the School Education Law, Religion Law and Social Welfare Law and some other specific laws. They are called "corporation in public interest" or "public interest corporations" in tax terms, totalling a little more than 254,000 at the end of 1995. They are subject to corporation tax only on the income derived from profit-making activity at the reduced rate of 25% (low-

ered from 27% as from 1 April 1998) as against the basic rate of 34.5% applicable to ordinary corporations.

Of the total public interest corporations numbering 254, 000, 27% are religious organizations, 10% are those based on the Civil Code and schools and colleges are 3%. A little more than 30% of all the qualified corporations are engaged in profit-making activities and for business year ending at the end of January 1995 a little more than 22, 000 tax returns were filed.

When public interest corporations transfer the assets from their profit-making business account to non-profit-making activity account, such transfer will be regarded as "donation" and may be deductible within certain limitation. For income derived from not pertaining to "profit-making activity", neither income tax nor corporation tax is levied in principle. In the FY 1996 tax reform, the deductibility of this donation transfer of the assets from the profit-making business accounts to non-profit-making activity accounts was reduced from 27% to 20% except for school corporations and social welfare corporations.

For the sake of achieving the tax equity on the increasing number of public interest corporations, in the FY 1996 tax reform also, public interest corporations, except those with annual revenue of 50 million yen or less, became required to submit the profit and loss statement within four months from the close of their business year even if they are not engaged in profit-making activities.

V. Profit-making Activities

With regard to the taxation of NPOs, what are "profit-making activities" is very critical and controversial. This is true not only in Japan but also perhaps in every other country. For instance, while I was in Washington, D. C. in the 1960s, there was a dispute between the Internal Revenue Service (IRS), U. S. counterpart of your SAT and the National Geographic Association, which enjoys the status of non-profit organization, IRS wanted to tax profits from the Association's monthly journal *National Geographic Magazine* because the membership fee was analogous to subscription fee. But the Association insisted that distribution of the *Magazine* was just one of the services rendered to the members, As a matter of fact, even I was under the impression that, taking advantage of its tax-exempt status, the Association was doing a fine job for dissemination of geographic knowledge and information with a landmark building downtown of D. C.. Practically all the major television stations, in the U.S. and Japan alike, were using the maps prepared by the Association. After heated discussions, as a compromise, both agreed that revenues from advertisements in the *Magazine* can be taxed. The *Magazine* contains plenty of advertisements particularly of cameras and films and they may be considered as profit-making activities.

Now turning back to my country, Japan, at present 33 types of activity are designated as profit-making. Profit from one of these 33 types of activity can be taxed if (i) it is conducted continuously and (ii) at a specific establishment (analogous to permanent establishment in tax treaties). However, the following are exempt from tax regardless of the type of activity: (1) organizations more than half of whose employees are physically handicapped or recipients of livelihood assistance and (2) organizations for welfare of mother

and child, In 1955, designated as profit-making were 29 types of activity ranging from sale and manufacturing to hotels, restaurants and theatres. Later in accordance with the change of the economy and society, new types have been added as follows: in 1957 real estate leasing, art and craft lessons and medical and health care were added and the whole system was rearranged; in 1965 real estate sale was added; in 1968 parking lot service was added; in 1976 credit guarantee was added; and in 1984 supply of intangible property right was added.

Revenue Loss of the National Government due to Special Taxation Measures Fiscal Year 1998
Total amount 1,864 billion yen

(In billions of yen)

Personal income tax 1,312 (70.4%)				Corporate income tax	Others
Tax system to encourage acquisition of dwelling houses	Deduction of insurance premiums	Tax exemption of savings by the aged, etc.	Others		Others
(33.2%) 619	(19.3%) 359	(4.6%) 85	(13.3%) 249	(19.1%) 356 [101]	(10.5%) 196

Remarks:

1. Increased revenue due to the special taxation measure on entertainment and social expenses is estimated to be 908 billion yen.
2. Figures in parentheses are percentages of the total.
3. Figure in brackets is an additional revenue loss due to tax reduction for investment under the economic package of April 1998.

Source: Tax Bureau, the Japanese Ministry of Finance

Table 1 Revenue Loss of the National Government due to Special Taxation Measures

(In billions of yen)

Fiscal Year	1989	1992	1995	1997	1998
I. Encouragement of savings					
1 Tax exemption of interest on small savings for the aged, etc.	492	486	274	910	850
2 Special treatment of dividends	54	53	48	36	38
3 Deduction of life insurance premiums	215	275	302	322	338
4 others	14	18	19	20	21
Subtotal development	775	832	643	469	482
II. Environmental improvement and regional					
5 Special taxation rule for housing measures	293	503	615	789	729
6 Special taxation rule for regional development	28	43	27	22	24
7 Special taxation rule for anti-pollution measures	13	18	18	15	17
8 Others	10	25	26	26	15
Subtotal	344	589	686	852	785
III. Exploitation of resources					
9 Reserve for reprocessing of spent nuclear fuel	55	16	22	46	17
10 Others	7	1	1	2	1
Subtotal	62	17	23	48	18

Table 1 Revenue Loss of the National Government due to Special Taxation Measures (Continued)
(In billions of yen)

Fiscal Year	1989	1992	1995	1997	1998
IV. Promotion of technology					
11 Tax credit for incremental expenditures for research and experiments	95	114	89	53	44
12 Taxation for facilitation of investment for structural reform of supply and demand of energy	69	74	60	53	44
13 Taxation for promotion of investment in new technologies by small- & medium-sized enterprises (SMEs)	54	52	38	39	41
14 Taxation for strengthening the base of SMEs	29	22	15	10	8
15 Special depreciation allowances or tax credit for acquisition of equipment for commercialization	—	—	—	1	1
16 Special deduction for income from overseas technical service transactions	17	10	9	8	5
17 Special depreciation allowances for special facilities	7	15	9	8	5
18 Special depreciation allowances for innovation equipment	1	0	0	6	5
19 Special depreciation allowances for special telecommunication equipment	—	5	8	9	6
20 Special depreciation allowances for machinery and the like for SMEs	55	67	54	56	50
21 Reserve for guaranteeing quality of computer program	15	24	14	0	0
22 Others	66	3	3	3	3
Subtotal	408	386	299	246	212
V. Repletion of retained and reinforcement of firms					
23 Special deduction for blue returns	—	—	65	63	77
24 Unusual risk reserve	2	11	11	14	22
25 Special treatment of bad debts reserves for SMEs	3	4	2	1	32
26 Others	71	73	10	5	4
Subtotal	76	88	88	83	135
VI. Others					
27 Special rule in calculating taxable income for medical fees under social insurance system	34	32	28	22	25
28 Special rule in calculating taxable income for business income of domestic workers	48	50	43	31	28
29 Special rule for exemption for the handicapped and aged	48	62	66	62	71
30 Special incentive measures for promotion of manufactured product imports	—	67	22	19	25
31 Others	41	60	136	162	82
32 Special rule for taxation on entertainment and social expenses	+867	+1042	+1077	+932	+908
Subtotal	+696	+771	+782	+636	+676
total	969	1141	957	1062	956

Source: Tax Bureau, the Japanese Ministry of Finance

Table 2 Revenue Loss of Corporation Tax due to Special Taxation Measures (Fiscal Year 1998)
(In billions of yen)

I. Special Depreciation Allowances	
1. Special depreciation on qualified equipment	23
(1) Machinery and equipment used for prevention of environmental pollution and recycling machinery and equipment to promote efficient use of resources	(16)
(2) Machinery and equipment for underground electric transmission cable systems	(7)
2. Special depreciation on manufacturing machinery used in underdeveloped areas	11
3. Special depreciation on machinery and equipment acquired by small- and medium-sized enterprises	24
4. Special depreciation on medical appliances	14
5. Special depreciation on special telecommunication equipment	6
6. Special depreciation on industrial equipment in the area of high technology	6
7. Special depreciation on innovation equipment	5
8. Additional depreciation allowances for machinery used for structural improvement of small- and medium-sized enterprises	4
9. Others	6
Subtotal	99
II. Reserves	
10. Special rule on bad debts reserve for small- and medium- sized enterprises	32
11. Unusual risk reserve	22
12. Reserve for reprocessing of spent nuclear	17
13. Reserve for removal and disposal of atomic power generation	13
14. Others	3
Subtotal	87
III. Tax Credits and Deductions from Taxable Income	
15. Tax credit for incremental expenditures for research and experiments	44
16. Tax measures to promote investment in improvement of market structure of energy	44
17. Taxation measures to promote investment by small- and medium-sized enterprises in equipment utilizing electronic devices	41
18. Taxation measures to strengthen the base of small- and medium-sized enterprises	8
19. Special deduction for income from overseas technical service transactions	5
20. Additional depreciation allowance or tax credit for manufacturing machinery in case manufactured product imports have increased	24
21. Others	4
Subtotal	170
Total	356
22. Special rules for taxation on entertainment and social expenses	+908
Net total	+552

Source: Tax Bureau, the Japanese Ministry of Finance

Table 3 Taxation Measures as Percentage of the Total Corporation Tax Revenues

(In one hundred thousand of yen and percentage)

Fiscal year (F. Y.)	Total revenues of corporation tax (Initial Budget) (a)		Revenue loss due to business-related special taxation measures (exc. entertainment & social expenses) (b)		(b)/(a)
	Amount	Change from previous F.Y.	Amount	Change from previous F.Y.	
1965	10,357	102.0	752	115.9	7.3
1970	24,203	130.3	1,794	137.1	7.4
1975	61,410	124.6	3,040	113.9	5.0
1980	85,040	129.3	2,320	87.9	2.7
1985	125,460	114.1	4,060	111.5	3.2
1989	183,630	131.8	5,070	110.9	2.8
1990	197,110	107.3	5,640	111.2	2.9
1991	192,670	97.7	6,300	111.7	3.3
1992	181,220	94.1	5,700	90.5	3.1
1993	159,520	88.0	5,200	91.2	3.3
1994	138,130	86.6	4,320	83.1	3.1
1995	137,260	99.4	3,920	90.7	2.9
1996	135,480	98.7	3,650	93.1	2.7
1997	144,320	106.5	3,830	104.9	2.7
1998	152,740	105.8	3,560	93.0	2.3
1999	104,280	68.3	7,580	212.9	7.3

Source: Tax Bureau, the Japanese Ministry of Finance

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(非常勤講師)