

# Small Business Taxation in Japan

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## I. Definition of SMEs

### 1. Conventional Definition

Small- and medium-sized enterprises (SMEs) in Japan are defined by the Small and Medium Enterprise Basic Law promulgated in 1963 and other SMEs related laws. According to the Basic Law (before the amendment of December 1999), they are as follows: in mining and 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 10 or less employees, or capitalized at 10 million yen or less. However, for the purpose of implementing the policies set forth in the Law. "Small Scale Enterprises" are specifically defined as follows: in manufacturing and other industries, those with 20 or less employees; and in commerce and services, those with 5 or less employees. The original law was amended regarding capital size in 1973. Before that modification, the capital size for mining and manufacturing and other industries was 50 million yen or less and that for commerce and service was 10 million yen or less.

It is to be noted that besides the above-mentioned the Basic Law other legislation defines SMEs for its own policy purpose separately. The Law on the Prevention of Delay in the Payment of Subcontracting Charges and Related Matters is a case in point. It is designed for protection of subcontracting subsidiaries.

The Small Business Credit Insurance Law also defines "Small Enterprises" as follows: in manufacturing, individuals or corporations with 5 or less employees; and in commerce and services, individuals or corporations with 2 or less employees. For these small enterprises, the Small Business Credit Insurance Corporation provides the special small sum insurance to loans without collateral or surety. Effective as from June 5, 1998, the Small Business Credit Insurance Law was amended to expand the definition of SMEs in terms of capital size. The maximum amounts of capital of eligible corporations have been raised as follows: in retail and service industries, from 30 million yen to 50 million yen; and in wholesale industry, from 30 million yen to 70 million yen.

### 2. Expansion of the Definition

Since the last amendment of the Small and Medium Enterprise Basic Law to raise the capital size criteria to define SMEs in 1973, as the economy has developed, the average capital amount of enterprises has grown three to five times depending on the types of industry, and also the economy has become more diversified and service-oriented. As a

result, some enterprises no longer come under the definition of SEMs as given by the Basic Law and, hence, disqualify the favorable treatments, such as low interest and long term loans, by the government affiliated agencies.

With a view to coping with this situation and to better achieving the objectives of SME policies, in June 1998 the Small and Medium Enterprise Agency asked its advisory organ, the Small and Medium Enterprise Policy Study Group, to study the situation and appropriate policies. Based on this one year's study in response to the Prime Minister's request, on September 22, 1999, the Small and Medium Enterprise Policy Council, an advisory organ to the Minister of International Trade and Industry (MITI), submitted a report on what SMEs should be in the 21st century. The bill to amend the Small and Medium Enterprise Basic Law on the basis of this report was approved by the National Diet in the 146 the Extraordinary Session (from October 29 to December 15, 1999) and promulgated on December 3, 1999.

By the amendment to the Basic Law, the definition of SMEs has been expanded as follows:

Industry	Nos. of employees		Capital size in million yen	
	Old	New	Old	New
Mining & manufacturing and others	300 or less	300 or less	100 or less	300 or less
Wholesale	100 or less	100 or less	30 or less	100 or less
Retail	50 or less	50 or less	10 or less	50 or less
Service	50 or less	100 or less	10 or less	50 or less

Besides the change in the Basic Law, in the 146 the Diet Session another bill to further expand the definition of SMEs for policy purposes.

The definition of SME in some industries under the Small Business Credit Insurance Law and the Law Regarding Small and Medium Enterprises Mutual Relief has been changed as follows:

- ① For manufacturing, etc., the capital size has been raised from 100 million yen to 300 million yen.
- ② For wholesale industry, the capital size has been raised from 70 million yen to 100 million yen.
- ③ For service industry, the number of employees has been raised from 50 to 100.

## II. SMEs-related Legislation

The background of the amendment of SMEs-related laws is that in the early 1960s as a by-product of fast economic growth, the Japanese economy was characterized by the dual structure of big firms on one hand and small-enterprises on the other. The Small and Medium Enterprise Basic Law was intended to rectify the disparities between the two by protecting SMEs. Since then, the economic environment has much changed and the small business is no longer considered a weaker sector. The new Law is designed to secure equal opportunities for SMEs. Especially, at present, amidst a protracted economic slump in Japan, SMEs are expected to make a major contribution to revitalization of the Japanese economy and creation of new employment opportunities.

The 146 Extraordinary Session was called the “SMEs Diet Session”, placing high hopes on SMEs for the recovery of the Japanese economy. During the session as many as 33 SMEs related-bills were newly made or amended. Besides the amendment to the Basic Law, one of the most important pieces of legislation is the Law for Facilitating the Creation of New Business which was promulgated on December 22, 1999. The Industrial Structure Improvement Fund to be established under this Law provides the authorized venture business with necessary funds which are not covered by the Small Business Credit Insurance System.

Another is the Law for Vitalizing the Business Activities of Small and Medium-Enterprises which was also promulgated on December 22. This Law purports to amend the relevant laws in order to support the vitalization of business activities and venture business of SMEs. Thus, amendments have been made to, in particular, the Small Business Credit Insurance Law, the Credit Guarantee Corporation Law, the Small Business Credit Corporation Law, the Small and Medium Enterprise Modernization Assistance Loan Fund, etc. Law, the Small and Medium Enterprises Association Organization Law and the Temporary Law Concerning Measures for the Promotion of the Creative Business Activities of Small and Medium Enterprises.

### **III. Importance of SMEs in the Japanese Economy**

#### **1. Before the Amendment of the Definition**

Even according to the Conventional definition before the amendment in 1999, as symbolized in the significant share not only in the number of enterprises but also in the amount of shipments and the number of employees, Japanese SMEs have played a very important role in every area of the economy and the society of Japan.

When viewing their importance in our economy, 1996 statistics revealed that out of a total of 6.50 million business establishments SMEs (excluding primary industries) accounted for 6.43 million with 98.9% share. (Reference 1)

Their number of employees amounted to 44.49 million people, which was 77.6% of a total of 57.35 million (excluding primary industries). (Reference 1)

Regarding the market share held by SMEs by industry in 1996, they occupied 51.0% of total shipment in the manufacturing industry, 64.2% of the total sales amount in wholesale trade and 75.7% in retail sales. (Reference 2)

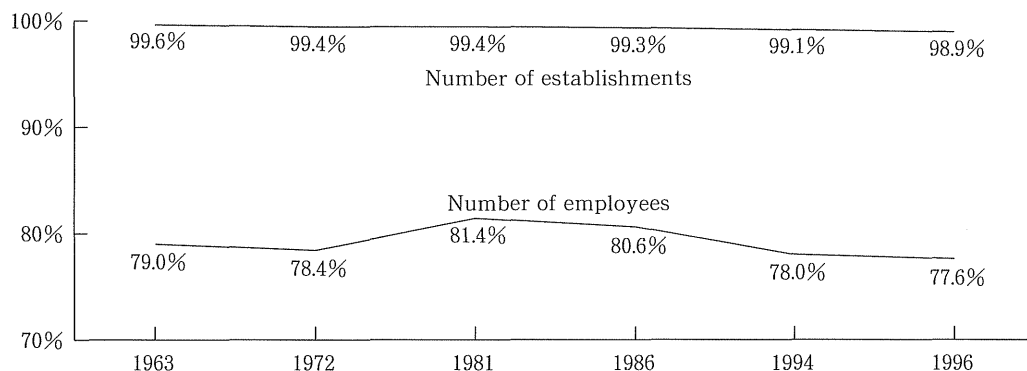
With the significant share of SMEs in the Japanese economy, the above ratios have not been greatly changed for about 30 years since the enforcement of the Small and Medium Enterprise Basic Law.

This could be regarded as a proof for the fact that SMEs have continued to perform well, demonstrating their unique flexibility and creativity, even at the time of recession experienced by Japanese economy.

#### **2. After the Amendment of the Definition**

Thanks to the expansion of the definition of SME by the amendment to the Basic Law, the shares of SMEs have increased according to the most recent statistics available, as follows:

**Ref. 1** Share of SMEs in the Japanese economy  
(Number of establishments and employees)



(Note) Number of establishments.

SMEs are defined as enterprises employing 300 or less employees (100 or less in wholesale and 50 or less in retail and services).

Source: Management and Coordination Agency, "Census of Japanese Establishments"

① Number of establishments (non-primary industries)

Scale of enterprise \ Year	1963	1972	1981	1986	1994	1996
SMEs	3,883,573 (99.6%)	5,083,270 (99.4%)	6,229,572 (99.4%)	6,448,123 (99.3%)	6,470,532 (99.1%)	6,433,557 (98.9%)
Large enterprises	16,605 (0.4%)	30,453 (0.6%)	39,499 (0.6%)	46,218 (0.7%)	61,448 (0.9%)	63,367 (1.1%)
Total	3,900,178	5,113,723	6,269,071	6,494,341	6,531,980	6,502,924

(Notes) 1. SMEs are defined as establishments employing 300 or less employees (100 or less in wholesale and 50 or less in retail and services).

2. Data are collected from non-primary industries except of agriculture and fisheries.

3. Figures in ( ) are component ratio where the total is 100. (Hereinafter in the same manner)

Source: Management and Coordination Agency, "Census of Japanese Establishments"

② Number of employees (non-primary industries)

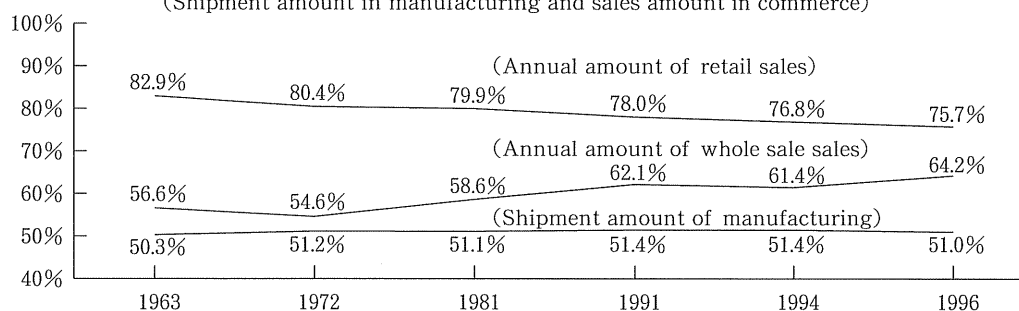
Scale of enterprise \ Year	1963	1972	1981	1986	1994	1996
SMEs	21,526,247 (79.0%)	30,400,491 (78.4%)	37,206,159 (81.4%)	39,505,716 (80.6%)	42,273,745 (78.0%)	44,492,576 (77.6%)
Large enterprises	5,715,218 (21.0%)	8,393,392 (21.6%)	8,514,031 (18.6%)	9,489,508 (19.4%)	11,890,062 (22.0%)	12,854,194 (22.4%)
Total	27,241,465	38,793,883	45,720,190	48,995,224	54,163,807	57,346,770

(Notes) 1. SMEs are defined as establishments employing 300 or less employees (100 or less in wholesale and 50 or less in retail and services).

2. Data are collected from non-primary industries except of agriculture and fisheries.

Source: Management and Coordination Agency, "Census of Japanese Establishments"

**Ref. 2 Share of SMEs in the Japanese economy**  
(Shipment amount in manufacturing and sales amount in commerce)



(Notes) 1. Definition of SMEs is same as Reference 1

2. For wholesale and retail data for 1963 and 1981, that for 1964 and 1982  
(Commercial survey years) was used due to statistic restrictions.

Source: Ministry of International Trade and Industry, "Industry Statistics", "Commercial Statistics"

① Shipment amount in manufacturing

(Unit: ¥1 billion)

Year	1963	1972	1981	1993	1994	1996
Scale of enterprise						
SMEs	11,977 (50.3%)	41,455 (51.2%)	115,042 (51.1%)	160,836 (51.4%)	153,400 (51.4%)	159,523 (51.0%)
Large enterprises	11,845 (49.7%)	39,507 (48.8%)	109,670 (48.9%)	150,363 (48.6%)	145,300 (48.6%)	153,546 (49.0%)
Total	23,822	80,962	224,712	311,119	298,700	313,068

(Note) SMEs are defined as establishments employing 4 to 299 employees and large enterprises as those employing 300 or more employees.

Source: Ministry of International Trade and Industry, "Industrial Statistics"

② Sales amount in wholesale

(Unit: ¥1 billion)

Year	1964	1972	1982	1991	1994	1996
Scale of enterprise						
SMEs	21,987 (56.6%)	58,326 (54.6%)	233,416 (58.6%)	355,807 (62.1%)	315,966 (61.4%)	307,835 (64.2%)
Large enterprises	16,843 (43.4%)	48,454 (45.4%)	165,121 (41.4%)	217,358 (37.9%)	198,351 (38.6%)	171,855 (35.8%)
Total	38,830	106,780	308,530	573,165	514,317	479,691

(Note) SMEs are defined as establishments employing 100 employees and large enterprises as those employing 100 or more employees.

Source: Ministry of International Trade and Industry, "Commercial Statistics"

③ Sales amount in retail

(Unit: ¥1 billion)

Year	1964	1972	1982	1991	1994	1997
Scale of enterprise						
SMEs	6,926 (82.9%)	22,756 (80.4%)	75,121 (79.9%)	109,668 (78.0%)	110,131 (76.8%)	111,859 (75.7%)
Large enterprises	1,424 (17.1%)	5,337 (19.6%)	18,851 (20.1%)	30,971 (22.0%)	33,194 (23.2%)	35,895 (24.3%)
Total	8,350	28,293	93,971	140,638	143,325	147,754

(Note) SMEs are defined as establishments employing less than 50 employees and large enterprises as those employing 50 or more employees.

Source: Ministry of International Trade and Industry, "Commercial Statistics"

(1) Number of Establishment and Employees

The 1996 statistics, as revised, indicate the following gains of SMEs:

The total number of business establishments (excluding primary industries) of SMEs has increased from 5.07 million to 5.09 million. Accounting for 99.4% and 99.7%, respectively, of all the establishments (excluding primary industries) totaling 5.10 million. By type of industry, service industry is the single largest sector accounting for 52.3% of the increase in the total number of establishments.

Their number of employees has increased from 37.81 million persons (65.9% of the total) to 41.68 million persons (72.7% of the total). By type of industry, again the service industry is the most important factor accounting for 52.2% of the increase.

(2) Market Shares

According to the MITI's "Industrial Statistics" in 1998, the shares of SMEs in the total sales value have increased in manufacturing industry from 32.3% to 37.5%, in wholesale trade from 27.2% to 42.1% in retail sales from 41.8% to 55.7% and in all the SMEs from 31.7% to 42.5%.

## IV. Some Relevant Developments

### 1. Japanese Economy and SMEs

Real gross domestic product (GDP) in the last quarter of 1998 declined as compared with the previous quarter by 0.8% (down 3.2% at an annual rate) for the fifth consecutive quarter. The ratio of completely unemployed persons in March 1999 reached 4.8%, which is the worst since 1953 when the survey started. Every economic indicator shows the plight of the current Japanese economy. Our most urgent task is to escape the present grave economic situation and to put the economy back on a path to recovery as soon as possible.

In the long run, the business opening ratio (number of establishments of which opening year is in the period from the previous survey to the present survey/number of establishments at time of the previous survey/number of years (%)) of SMEs which was approximately 7% in the decade from 1965 to 1974 is recently around 4%, reflexing a general trend of decline. Especially, since the 1989-91 survey the reversal in which the business closing ratio (business opening ratio minus the ratio of increase) exceeds the business opening ratio has been occurring.

However, the above-mentioned figures covering all the types of industry are awfully misleading. Observation of the 1994-96 Census figures will reveal another story. In sharp contrast to manufacturing industry which suffers the business closing ratio of 4.0% far exceeding the opening ratio of 1.5%, service business enjoys the business opening ratio of 3.2% against the closing ratio of 2.8%. In other words, discrete entrepreneurs are withdrawing from declining industries and entering growing ones.

Under the circumstances, SMEs have an important role to play in revitalizing the stalled Japanese economy and creating jobs. Particularly, if the Japanese economy is to return to clear positive growth in fiscal year 1999, adaptability and creativity of SMEs should be fully mobilized. The White Paper on SMEs for FY1998 published by the Small and Medium

Enterprise Agency on 20 April 1999 points out that, contrary to the generally accepted perception, SMEs are not so uniformly weaker than big enterprises.

In the ongoing recession, while many enterprises are running a deficit, some SMEs are posting strong earnings. Notably they are making strenuous efforts in one way or another to distinguish themselves. To mention a few, they are taking advantage of information technology; they lay special emphasis on research and development, patent, registration of trade marks; and they diversify themselves into new business and collaborate with firms in other industrial sectors.

## **2. Special Credit Guarantee for SMEs**

Since the collapse of the bubble economy, land prices have been falling sharply. As the collateral value of real estate is declining, financial institutions are taking increasingly cautious attitude. In light of the international trends, the Japanese government embarked upon a drastic reform of the Japanese financial systems and markets similar to Britain's "Big Bang" by the year 2001. As a first shot, the foreign exchange market has been almost completely liberalized since April 1998. Those banks which are engaged in international business are expected to improve their soundness in order to meet the further progress of deregulation and intensification of competition, under the BIS (Bank for International Settlements) regulation requiring the capital adequacy ratio of 8 percent for banks. Thus, they are forced to cut down on loans, causing the credit crunch, or the reluctance of financial institutions to extend loans which particularly adversely affected the SMEs.

In view of the prolonged deep recession, high hopes are pinned on the Credit Supplementation System for SMEs, which consists of two interrelated subsystems: the Credit Guarantee System and Credit Insurance System. This two tier structure is unique by international comparison.

The Credit Guarantee Corporations (CGCs), which have been established in each prefecture (the largest unit of local administration) as public institutions provide financial institutions with guarantees for their loans to SMEs. The Small Business Credit Insurance Corporation of Japan (Japan CIC) is government-affiliated institution with 100% of its capital provided by the national government. The Japan CIC reinsures the guaranteed liabilities of the CGCs. If SMEs are unable to fulfill their obligations by the due date, the CGCs which have guaranteed the loans must pay the money (subrogated payment). The Japan CIC pays 70% for loans with collateral and 80% for those without collateral of the subrogated payments made by CGCs to the financial institutions. The remaining 20% or 30% is taken as a loss by the CGCs.

On the basis of the Guidelines in Measures for Credit Crunch Facing Small and Medium Enterprises adopted by the Cabinet in August 1998, a newly created Special Credit Guarantee System for financial stabilization of SMEs came into force from 1 October 1998. With this aim the total amount of 20 trillion yen was set aside until the end of March 2000. Under the system, financial institutions extend loans of up to 50 million yen to SMEs without collateral and if collateral is offered, the maximum amount of loan is increased to 250 million yen. Another feature is quick processing of loan applications.

Thus, by the end of March 1999, in six months since its inception, the total amount of the loans under this system reached 14,422.1 billion yen, of which 13,503.1 billion yen, accounting for 94% of the total, is without collateral. This means that, on the average, about 90 cases a day in each prefecture were approved.

Of course, this extraordinary measure has been a great help to SMEs but it cannot be denied that this has been implemented so hastily that screening of loan applications has not been carried out carefully enough and some alleged abuses are reported. The subrogated payments for SMEs which have used this system jumped from 144 million yen at the end of January of 1999 to 770 million yen at the end of February, one month later.

Faced by the credit crunch still annoying SMEs, in October 1999, the government decided that the Special Credit Guarantee which was a temporary measure effective until March 31, 2000 will be extended for another year and additional 10 trillion yen will be appropriated in the second supplementary budget for fiscal year 1999.

From October 1998 when the Special Credit Guarantee was instituted to the end of February 2000, the Credit Guarantee Corporations approved 1,172,234 applications in the amount of 20,036.1 billion yen, making an average amount of per each approved guarantee 17,090,000 yen.

As experience is gained, the application are being screened more carefully. The first year's records suggest that the subrogated payments as a percentage of the total guaranteed amount has not been so high, taking into consideration of the authorized 10% allowance for such a loss ratio under the extraordinary system.

## **V. Tax-related Measures**

In order to rectify the disparities between large enterprises and SMEs, it is necessary to strengthen the management bases of the enterprises themselves. From this viewpoint, various special measures have been taken to reduce the tax burden of SMEs compared to that of large enterprises, so that they can increase their internal reserves, strengthen their management bases and improve their productivity.

### **1. General Measures for Individual Proprietors**

- (1) Salaries of full-time family employees, etc.
  - (a) For blue return taxpayers, a full amount may be deducted from the taxable income.
  - (b) For white return taxpayers, 350,000 yen (860,000 yen for a spouse) may be deducted from the taxable income. Blue return taxpayers and white return taxpayers will be discussed later at some length.
- (2) The special deduction to which blue return taxpayers who keep formal account books are entitled will be raised from 450,000 yen to 550,000 yen in the FY 2000 tax reform.
- (3) Premiums for the Small Enterprise Mutual Relief System are deductible. The Second, Category Mutual Relief is treated as one of the life insurance premium deduction, and the benefits of the first Category Mutual Relief are treated as a kind of retirement allowance.



- (4) A deduction of the local enterprise tax for proprietors of individual business was raised from 2.7 million yen to 2.9 million yen as from April 1, 1999.

## 2. General Measures for Corporations

In order to mitigate the tax burden of the Japanese businesses in the interest of international competitiveness, the tax rates have been recently reduced as follows:

	FY 1997	FY 1998	FY 1999
Corporation tax (National)	37.5%	34.5%	30.0%
Corporate enterprise tax (Local)	12.0%	11.0%	9.6%
Combined effective tax rate	49.98%	46.36%	40.87%

### (1) Reduced corporate tax rates

In view of the vital role to play by small and medium enterprises (SEMs) on one hand, and their limited ability to pay tax on the other, for corporations whose capital is 100 million yen or less and annual income is 8 million yen or less, the tax rates are reduced as follows:

	FY 1997	FY 1998	FY 1999
Corporation tax (National)	28.0%	25.0%	22.0%
Corporate enterprise tax (Local)	6.0%	5.6%	5.0%

In the FY 1998 tax reform, taking into consideration the possibility that SMEs were affected by the broadened tax base, reduced rate for SMEs was cut by the same 3 percentage points, while the reduced rate for cooperative and others was cut by only 2 percentage points, thereby narrowing the difference from the standard rate.

### (2) Amount deductible against taxable reserves of family business

When a family business reserves its profit, the largest of the following amounts (35% of the income, 15 million yen per year, or one-fourth of the capital at the end of the term less the reserves at the end of the term) is deductible and then the remaining becomes taxable:

30 million yen or less	10%
Over 30 million yen to 100 million yen	15%
Over 100 million yen	20%

This tax will not be imposed on specified SMEs and authorized businesses under the Law for Facilitating the Creation of New Businesses as explained 3. (2) below.

### (3) Reduced local enterprise tax

At the local level, effective as from April 1, 1999, the standard rates of enterprise tax on corporations (prefectural) were reduced as follows:

Annual income	FY 1998	FY 1999
Over 8 million yen	11.0%	9.6%
Over 4 million yen but not more than 8 million yen	8.4%	7.3%
4 million yen or less	5.6%	5.0%

(4) Special treatment for the reserve for bad debts

According to the Corporation Tax Law, the tax-free bad debts reserve is the expected loss of receivable to be valued individually and those of each category to be calculated by the empirical rate on the last 3 years' record of the bad debt. However, corporation whose capital is 100 million yen or less are allowed to choose the application of statutory percentage of receivables by category of business to be phased out by 2002 under the FY 1998 tax reform. Moreover, under this option the amount which may be credited to the reserve is increased by 16%.

### 3. Venture Businesses

(1) With a view to helping new start-ups, the FY 2000 tax reform will introduce the following special tax treatment on capital gains from stocks of specified SMEs:

Special taxation of capital gains from stocks of specified SMEs (stocks eligible for the "Angel Taxation Scheme" by taxing only half the amount of such capital gains; provided that the stocks had been held more than 3 years as of the date when the stockholding company was listed and were sold within a year of the date of listing (additional conditions apply).

This will be combined with the existing special measure for capital gains of entrepreneurs, under which the capital gains from the sale of stocks which had been held for more than 3 years as of the date when the stockholding company was listed, and which have been transferred within a year of the date of listing, special taxation is applied under which only half the amount of taxable capital gains is taxed. Thus, together, tax on the capital gains from the sale of stocks of specified SMEs will be reduced to one quarter.

(2) Special tax treatment on the retained income of family (closely-held) corporations

The special additional tax on retained income of family corporation mentioned in 2. (2) above will not be imposed for 2 years on (i) SMEs as defined in the Law for Facilitating the Creation of New Business less than 10 years old and (ii) the authorized businesses under the said Law.

For the purposes of the said Law, SMEs are as follows:

- Manufacturing: A company with capital of less than 300 million yen or a total of 300 employees or less
- Wholesale: a company with capital of less than 100 million yen or a total of 100 employees or less
- Service and retail: a company with capital of less than 50 million yen or a total of 100 (service)/50(retail) employees or less

(3) Measure to facilitate business succession

Reduction in inheritance tax for succession of business

For calculation of tax base of inheritance tax with respect to small-sized sites for business, 20%, or 50% of the value is treated as the taxable value. In the FY 1999 tax reform, the upper limit of the land used for specified business purposes, for which the preferential methods in calculating the tax base are applied was expanded from 200 m<sup>2</sup> to 330 m<sup>2</sup>.

(4) Appraisal of non-traded stocks

In connection with encouragement of venture businesses, rationalization of appraisal method of non-traded stocks for the purpose of inheritance tax is increasingly important. It may be implemented in the following ways:

- Review the adjustment rate for the appraisal of such stocks under the “comparison with similar businesses” method.
- Review the criteria for the number of employees to examine the size of small corporations.
- Allowing (optional) use of the “comparison with similar businesses” method for stocks of companies that lack two of the elements needed for the appraisal of non-traded stocks.

#### 4. Entertainment and Social Expenses

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 are given a favorable treatment. The taxation on entertainment and social expenses introduced in FY 1954 was first addressed large corporations and in FY1971 extended to all the corporations regardless of their size.

But in FY1979 when the fixed deduction was lowered for medium and small corporations capitalized at 50 million yen or less but over 10 million yen that deduction was set at 3 million yen and for those capitalized at 10 million yen or less, at 4 million yen. In FY 1982, the total amount of entertainment and social expenses was made taxable. But for corporations capitalized at 50 million yen or less, 3 million yen and for those capitalized at 10 million yen, 4 million yen remained tax deductible, respectively. This was a 3 year temporary measure, but later it was renewed every 2 years. In FY1994, for corporations capitalized at 50 million yen or less, 10% of the fixed deduction was made taxable while the total amount that exceeded the fixed deduction was subject to taxation. In FY 1998, this fixed deduction was further reduced from 10 % to 20%. In the FY 1999 tax reform, this was renewed for another 2 years.

#### 5. Measures to Promote Equipment Investment

In addition to the above-mentioned general measures for individual proprietors and corporations, from the viewpoint of promoting equipment investment and technological development, the following special measures regarding the taxation system for SMEs have been taken to provide incentives for enterprises to make voluntary efforts:

The following tax incentives are available for SMEs to introduce machinery, equipment, etc.:

- (1) Special initial depreciation allowance of machinery or equipment acquired by SMEs. 11% of the acquisition costs of machinery or equipment acquired by SMEs, and whose price is 2.3 million yen or more may be written off in the first year of use.
- (2) The tax system to promote investment in new technological achievements of SMEs (mechatronics tax incentive)

When SMEs acquire machinery or equipment that uses electronics devices and computers, they are entitled to a special depreciation allowance of 30 % of the acquisition costs. In addition, corporations, proprietors or cooperative associations capitalized at 30 million yen or less can elect a 7% tax credit up to 20% of the tax liability for the credit year. Regarding rental assets, the 7% tax credit is applicable with respect to 60% of the lease charge.

In the FY 2000 tax reform, these mechatronics tax incentives have been extended to March 31, 2002.

- (3) The tax system for the enhancement of business foundations of SMEs  
SMEs that qualify:
  - (a) Certain SMEs (approved by the plan based on the Law Concerning the Improvement of Employment Management Aimed at Securing a Labor Force for Small and Medium Enterprises, the Law on Extraordinary Measures for Vitalizing Group-sitting of the Specific Small and Medium Enterprises, and the Law Concerning Measures for Smooth Adaptation to Structural Changes in Economy by Advancement of Specified Small and Medium Enterprises to New Fields)
  - (b) Wholesalers, retailers, restaurants and service businesses  
Equipment that qualifies: Machinery and equipment costing 2.4 million yen or more per unit (1 million yen or more for appliances and fixtures)  
When qualified SMEs acquire machinery or equipment, they are entitled to a 30% special depreciation allowance of the acquisition costs. For leasing, a 7% tax credit is applicable with respect to 60% of the lease charge for a total of 3.2 million yen (1.4 million yen or more for appliances or fixtures).
- (4) Promotion of investment in reforms of energy supply and demand structure through the tax system (energy reform tax incentives)  
Those who have acquired the equipment which may contribute to the reform of energy supply and demand are entitled to a special depreciation allowance of 30% of the acquisition costs (15% in case of mining rights on the oil wells abroad). In addition, qualified SMEs capitalized at 100 million yen or less can elect a 7% tax credit up to 20% of the tax liability for the credit year. These incentives will be extended to March 31, 2002 after reviewing the scope of equipment to be covered.
- (5) Promotion of investment in industrialization equipment through the tax system.  
SMEs who have acquired specific machinery or equipment whose price is 2.3 million or more are entitled to a special depreciation allowance of 30% of the acquisition costs. In addition, those SME capitalized at 100 million yen or less can elect a 7% tax

credit up to 20% of the tax liability for the credit year. Regarding rental assets, the 7% tax credit is applicable with respect to 60% of the lease charge.

It is to be noted that as part of the Comprehensive Economic Package in 1998, this special tax treatment was expanded, for example, trucks eligible for this measure were changed from ones of 8 tons to ones of 3.5 tons, and extended by one year to May 31, 2000. In the FY 2000 tax reform, this preferential tax treatment will continue to be applied until May 31, 2001.

In the FY 2000 tax reform,

- (6) With regard to the special depreciation of the specific telecommunication equipment, a special depreciation allowance of 20% of the acquisition costs will be added for the security devices to prevent illegal access acquired by SMEs between April 1, 2000 and March 31, 2002.
- (7) SMEs will also benefit from a one-year extension of the expensing of the acquisition costs of certain communication- and information-related equipment introduced in FY 1999. This is a full deduction during the accounting period of acquisition of the acquisition costs of certain equipment, including personal computers, is less than one million yen of value until March 31, 2001.

## **6. Measures to Promote Experiments, Research and Development**

- (1) Enhancement of technology foundations of SMEs through the tax system

- (a) Special credit for increased research expenses

The research credit is, in general, 15% of the excess of research expenses over the base amount. The base amount is the average of annual research expenses for the 3 years of the highest expenses in 5 years preceding the credit period. The maximum amount is, in principle, 12% the corporation tax liability for the credit year. But with respect to R&D by ESMs in the accounting period starting between April 1, 1985 and March 31, 2001, a tax credit of 6% (10% until the accounting years starting by March 31, 2000) of the R&D expenses is allowed instead the above-mentioned amount. For this purpose, experiment and research costs include the following : (i) materials costs, labor cost and expenses related to research and development, (ii) consigned research and development expenses, (iii) dues imposed by the industrial associations and (iv) dues imposed by the associations covered by laws, such as the Law for Promoting the Modernization of Small Businesses. The upper limit of such credit is 15% of the corporation tax liability for the credit year.

In order to improve the technological foundation of SMEs, this special tax treatment (the rate of tax credit for R&D expenses is increased to 10%) will continue to be applied for R&D expenses of the business years starting before March 31, 2001.

- (2) The tax deduction system for additional costs incurred by experiments and research  
A 20% tax deduction for additional costs incurred by experiments and research
    - (3) Tax incentives based on individual laws
      - (a) In the case that approved cooperative associations impose allotments on members,

depreciation of the amounts paid is optional.

- (b) These allotments can be translated into costs for experiments and research in either (1) (a) or (1) (b).
- (c) Fixed assets acquired by cooperative associations for the purpose of experiments and/or research using these allotments are calculated after subtracting subsidies.

### **7. Special Measures for Cooperative Associations**

While tax rate on income over 1 billion yen of certain cooperative associations was reduced in FY 1999 from 30% to 26%, the reduced rate for cooperative associations was lowered in FY 1998 from 27% to 25% and further in FY 1999 to 22%.

A cooperative association can account for the distribution of surplus as a tax deductible expense if such distribution is made to its members proportionate to each member's usage of the cooperative association.

It also enjoys other preferential tax treatments such as reduced enterprise tax, exemption from property tax, etc.

### **8. Other Measures**

- (1) Special measures for modernization, structural improvements, business upgrading of SMEs
  - Extra depreciation allowance (18%) for machines, equipment, and factory buildings in connection with the businesses based on the Small and Medium Enterprise Modernization Promotion Law
  - Special deduction in connection with the income obtained from the transfer of land for the Business Upgrading Programs for Small and Medium Enterprises
- (2) Measures to promote small and medium retail enterprises
  - Special depreciation of commercial facilities, etc.
- (3) Measures to support newly established businesses
  - In the case where an investment company subscribes for the shares of a corporation that has been newly established or established in the past five years retains the reserves for investment losses in newly established SMEs, up to 16% of the amount subscribed for can be included in financial losses.
- (4) Other measures
  - Premiums paid into the Mutual Relief System for Small-scale Enterprises run by the Japan Small Business Corporation are deductible from income.
- (5) Support for SMEs that take the lead in management innovation
  - The establishment of a tax system with respect to "the Law of Supporting Management Innovations of Small and Medium Enterprises": System of premium depreciation (premium rate of 27%)
  - Reimbursement of financial losses, application of the Tax System for the Enhancement of Business Foundations of Small and Medium Enterprises, etc.

## VI. The Japanese Problems Regarding Small Business Taxation

### 1. Consumption Tax and Small Business

The consumption tax which was introduced in 1989 after many turns and twists at a very low rate of 3 percent but broadly based with few exceptions has now rooted in the Japanese tax system, accounting for about 18 percent of the total national tax revenues. In sharp contrast to the corporation tax, the consumption tax is not much influenced by business fluctuations. With the rapidly aging society approaching, high hopes are placed on the consumption tax as an important financial resource of social security.

The consumption tax is the Japanese approach to the value added tax (VAT). However, taking into consideration the current practice of SMEs and in the interest of the prompt approval of the draft bill, many concessions have been made for SMEs.

The measures to alleviate the tax burden of SMEs were as follows:

- (1) SMEs whose taxable annual sales is 30 million yen or less may be tax exempt.
- (2) Simplified System—For the taxpayers with sales of 500 million yen or less the following deemed rates of purchase may be applied: wholesale 90% and others 80%.
- (3) Marginal Exemption—For the taxpayers with taxable sales of 60 million yen or less, this device was introduced was to narrow the gap between the taxable and tax exempt enterprises.
- (4) To reduce the compliance costs of SMEs, only keeping of purchase books is required to claim tax credit on purchase.
- (5) A newly established corporation is not subject to the consumption tax for the first 2 years.

Obviously, some of these measures for SMEs are too generous and gave rise to the issue of *ekizei* (undue gains from tax). An attempt has been made to correct the situation.

Effective as from October 1, 1991, the following amendments were made:

- (1) Simplified System—Upper limit for qualification was lowered from 500 million yen to 400 million yen. The deemed rates of purchases are broken down into the following four types of business: 90% for wholesalesm 80% for retails, 70% for agriculture, forestry, fishery, mining, construction, manufacture, and electricity, gas, heat, or water supply and 60% for other businesses.
- (2) Marginal Exemption—Upper limit for qualification was lowered from 60 million yen to 50 million yen.

The FY 1994 tax reform made the following amendments which came into force on April 1, 1997:

- (1) The rate is raised from 3% to 5%, one percentagepoint of which is a newly created "local consumption tax".
- (2) The upper limit for qualification for the Simplified System is lowered from 400 million yen to 200 million yen.
- (3) Marginal Exemption system is abolished.
- (4) Those newly established corporations with capital of 10 million yen or more are subject to the consumption tax even for the first 2 years while smaller entities remain

to be exempt for the first 2 years as before.

- (5) For tax credit purposes, in addition to the currently required book-keeping, an invoice method is adopted under which bills, receipts, invoices and other documents supporting the trade will be required.

Under the tax reform for fiscal year 1996, for the Simplified System a fifth type of business was newly created for which the deemed rate of purchase is 50%. Real estate, transportation, communications and service industries come under this category.

## **2. Tax Treatment of Remuneration to Family Employees**

The tax treatment of salaries and wages paid to family employees has been one of the most controversial issues in Japan. Most proprietors of family business (e.g. farming) actually don't pay salaries or wages as such to family employees living with them. Furthermore, such proprietors customarily have the right to dispose of the earnings from common family undertakings. The reduced ability of such taxpayers to pay taxes has been taken into consideration in instituting the allowances for dependents.

Some proprietors of small- and medium-sized enterprises (SMEs), however, do actually pay salaries or wages to family employees. Taking this fact into account and for the purposes of keeping in balance the tax burden between enterprises run by individual proprietors and those in corporate form, salaries or wages paid to family employees were made deductible as expenses up to a certain amount for taxpayers filing blue returns, meeting book-keeping requirements in 1952.

Since then, in response to the persistent demand for more liberal allowance for such salaries and wages to eliminate the discrimination against individual proprietors relative to family corporations. Eventually, in 1968, this legal limitation was lifted. Thus, taxpayers who file returns are allowed as an expense any amount of salaries or wages which may be deemed reasonable while they must keep proper books and records.

On the other hand, those taxpayers who are unable to file a blue return ("taxpayers filing a white return") requested deduction of family employees' salaries and wages to a certain extent in order to mitigate their tax burden. As a result, in 1962, a deduction for family employees' salaries and wages for taxpayers filing white returns was introduced. In 1995, the upper limits of such deductible salaries and wages were raised from 800,000 yen to 860,000 yen for the spouse of the proprietor and from 470,000 yen to 500,000 yen per person for other family employees, respectively, whether actually paid or not.

## **3. Individual Proprietors vs Corporations**

Japan is also facing the problem of conducting business by especially SMEs in company form from tax consideration. After the war in the 1950s and 1960s, there was a spate of incorporation of individual proprietorships. Salaries and wages for directors and employees paid by the companies are subject to withholding income tax at source. Overall, the incorporated form is then considered to be able to enjoy a lighter tax burden than the unincorporated form.

Thus, strangely enough, giant corporations such as Toyota and Mitsubishi and grocery



stores on the street are governed by the same Commercial Code. Of course, some of SMEs are based on the separate legislation, the Japanese version of *Gesellschaft mit beschränkter Haftung* of 1938. When the Commercial Code was amended in 1990 so as to raise the minimum capital to 10 million yen, not a few companies disappeared simply because they could not meet this capital amount requirement.

At the moment, the perennial issue of conducting SMEs business in company form or individual proprietorship form does not seem so keen, although far from solved. As of now, the number one problem of the corporation tax in Japan is nearly 65% of the total companies are running deficit for taxation purposes.

In 1973, the “deemed corporation taxation system” was introduced. Under the system, individual proprietors filing blue returns can opt to be treated as “corporation” for taxation purpose. Taking advantage of this, some taxpayers paid too much remuneration to the proprietors to reduce the profits of their enterprises. To cope with this practice, effective as from 1988, that part of remuneration which exceeds 80% of the average of previous 3 years’ income was denied as expense because it is excessive. After several years’ experience, this “deemed corporation taxation system” was eventually abolished in 1992. The deduction of 100,000 yen for taxpayers filing blue returns who did not opt corporation taxation was changed to a new “blue return deduction” which is applicable to any taxpayer filing a blue return. In addition, newly created is a “special blue return deduction” of 350,000 yen for the taxpayers who satisfy the requirements of book-keeping and records. This special blue return became applicable as from 1993 and its maximum amount was increased to 450,000 yen in 1998.

#### 4. Blue Returns

The blue tax return system was introduced in 1950 with a view to improving taxpayers’ book-keeping and encouraging honest self-assessment. When the self-assessment system was first adopted immediately after the war in 1947 as a democratic way of taxpayment, a large number of taxpayers did not follow modern accounting practices, nor did they keep proper accounting records. To assure the success of the self-assessment system, improvement of taxpayers’ accounting practices was of vital importance. To this end, those who maintain proper accounts, as required under the blue return system, and report their income correctly based on those books and records are given certain privileges as mentioned below:

- (a) A reasonable amount of wages paid to the relatives living with the taxpayer in the same household (family employees) is deductible as expenses.
- (b) Entitled to the “special blue return reduction” of 450,000 yen if the taxpayer keeps proper accounting books and records or the “blue return reduction” of 100,000 yen. In the FY2000 tax reform, this “special blue return reduction” will be increased to 550,000 yen to be applicable to income tax after CY2000.
- (c) Deduction is allowed for the amounts credited for various tax-free retentions such as the reserves for bad debts and loss on returned goods unsold.
- (d) Special depreciation for plant and equipment is allowed.

- (e) Net losses may be carried over to offset income for 3 succeeding years and may be carried back to offset the income of one preceding year.
- (f) Tax authorities may adjust the income only when errors are found in the calculation of taxable income based on the taxpayer's books and records. As a result, tax authorities, in making corrections of the tax amount, should attach a statement explaining the grounds for such action.
- (g) A taxpayer earning 3 million yen or less of income from real estate and business income before deducting salaries to family employees during the 2 preceding taxable years may calculate his income on the cash basis instead of the accrual basis.

It is to be noted that taxpayers may use a simplified accounting system in lieu of the complete accounts required for eligibility to file a blue return. The simplified accounts consist mainly of a cashbook and sales and purchase records.

〔後記〕 本稿は、1999年5月10日～14日、トルコのアンカラにあるOECDのMultilateral Tax Networkで行われたTax Systems for Small Businessesにおける筆者のプレゼンテーションに基づき、その後の展開、特に中小企業基本法等の改正、にかんがみ加筆したものである。特に第V章Tax-related Measuresは、中小企業庁の資料を基礎にはしたが、筆者が平成12年度の税制改正も取り入れ、手を加えた部分が少なくない。

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