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Corporate Taxation in Japan*

H. W. T. Pepper**

IF THE VARIOUS desiderata for a tax system, stability — which quality would fall within Adam Smith's wider canon of certainty — is one of the more important. Almost any tax system can be lived with if the taxpayer is reasonably sure that radical change in incidence is unlikely for the immediate and near future and that such changes as are made are likely to be remedial of fiscal drag and anomalies or to extend incentives and

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concessions and, if anything, moderately reduce tax rates. Such indeed has been, broadly speaking, the state of the Japanese corporate tax regime over the past two decades. It may be that the stability of the Japanese tax system accounts for a good deal of the apparently smooth economic progress and willingness to make very long-term plans, *e.g.*, for the import of mineral ores, which have highlighted the Japanese scene in Western eyes for some years past.

It is true that a long series of post-war tax reforms has taken place in Japan, notably the "Second Tax Reform" as recently as 1971, and a further reform in 1972, but they have not altered materially the structure of corporation tax as laid down under the 1950 reconstruction. Broadly speaking, the various "reforms" since 1950 have reduced tax rates or introduced new reliefs or incentives; and, although a few of the new reliefs have subsequently been abolished, sufficient remain to provide a wide spectrum of corporate reliefs.

The "reasonableness" of the rates of national income tax on corporations in Japan is, however, somewhat modified by the existence of local income taxes (especially the enterprise tax) which add to the corporate burden. On the other hand, Japan has a few additional reliefs which are not always encountered in Western tax systems. The term "corporation" in this article is used to cover lim-

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ited stock companies (*kabushiki kaisha*), private stock companies (*yūgen kaisha*) and all other forms of corporate enterprise.¹

I. SOCIAL ORIENTATION

Corporation tax in Japan may be said to be socially oriented in some limited ways; for example, lower tax rates are charged upon corporations with small incomes and capital. Such "graduation" (see table on page 5 below) is usually interpreted as betokening a government's desire not to discourage adoption of the corporate form by small enterprises, when it may be easier for them to mobilise risk and investment capital. The lower tax rate on distributed profits (26 per cent as against 35 per cent) is intended positively to encourage distributions to shareholders.

The theory is, of course, that reasonably full distributions attract investors (especially the small man) to the stockmarket. If a company distributes fully, it will have to raise fresh equity capital by new or "rights" issues, which involves it in making a much fuller statement of its position and submitting itself to the judgment of the stockmarket. This is in contrast to the company which ploughs back most of its profits and invests its reserves without having to put its plans under a spotlight. It is clear that a regime of high distributions and regular rights issues is potentially healthier for the stockmarket but it is not so clear that companies can be influenced in their corporate behavior by tax differentials.

Another social feature of corporate tax in Japan is that special depreciation is granted for plants used in the provision of commuter rail services to relieve urban road congestion, for the provision of new housing for rent, for fire-proofed new commercial buildings, and to promote development in underdeveloped areas in the country.

¹ The types of corporate entities permissible in Japan can be listed as follows:

<i>Type of Entity</i>	<i>Membership</i>
Limited stock company (<i>kabushiki kaisha</i>)	At least seven
Private stock company (<i>yūgen kaisha</i>)	Not more than 50
Family corporation	More than 50 per cent of capital to be owned by not more than three shareholders, together with their relatives or affiliates.

Public interest corporations
Co-operative societies

Japan, in common with many other countries, has also provided special depreciation for anti-pollution plant and equipment.

II. FOREIGN CORPORATIONS IN JAPAN

Corporations in Japan are subject to a national income tax called the Corporation Tax, and the following local income taxes: the Prefectural Inhabitants Tax, the Municipal Inhabitants Tax and the Enterprise Tax. A corporation which has its head office in Japan is a resident ("domestic") corporation and is taxed on its world wide income. A corporation which has its head office outside of Japan is a non-resident ("foreign") corporation and is subject to tax in Japan only on its Japan-sourced income.

A non-resident individual or corporation is taxable at 20 percent on income arising from Japan; but where the non-resident is carrying on business in Japan, he (or it) must pay tax on the same footing as a resident on the income derived from the business. A foreign corporation is regarded as carrying on business in Japan if it has a "permanent establishment" there, *i.e.* if it has a branch, office, factory, mine, quarry, or other fixed place of business in Japan.² A foreign corporation which carries on a construction, installation or assembly project in Japan for more than one year, or supervises or superintends such an operation, is also regarded as carrying on business in Japan. Moreover, where a foreign corporation has an agent in Japan who has, and habitually exercises, authority to conclude contracts in Japan on behalf of his principal, the foreign corporation is itself regarded as doing business in that country.

III. CORPORATE TAXATION

A. *The Legal Basis*

Article 30 of the Japanese Constitution³ provides that all national and local tax legislation must be enacted by the Diet. Proposed legislation, which is drafted by the Tax Bureau of the Ministry of Finance, is introduced in the House of Representatives, where the bills are referred for study to the Standing Committee for Finance. Once passed by the House of Representatives, the bills are presented to the House of Councilors of the Diet and become law when approved.

² See Convention Between Japan and the United States of America for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, art. 14 (July 7, 1973).

³ KEMPO (Constitution), art. 30 (Japan 1947).

The Ministry of Finance has responsibility not only for drafting tax legislation but also for its administration. The Ministry of Finance issues Cabinet Orders and Ministerial Ordinances to implement the national tax laws.

The principal Japanese tax laws can be characterized as follows:

- (a) Income Tax Law, Law No. 33 of 1965, *as amended* — levies income taxes on individuals.
- (b) Corporation Tax Law, Law No. 34 of 1965, *as amended* — levies income taxes on corporations.
- (c) Local Tax Law, Law No. 226 of 1950, *as amended* — empowers localities to assess and collect taxes, principally on incomes of individuals and corporations.
- (d) General Law of National Tax, Law No. 66 of 1962, *as amended* — contains procedures for determination of liability, methods of payment, dispute settlements, etc.
- (e) Special Taxation Measures Law, Law No. 26 of 1957, *as amended* — provides special tax concessions designed to achieve national economic goals.

B. *Split-Level Corporate Taxation*

The Japanese income tax system taxes undistributed corporate income more heavily than distributed income. In this respect the Japanese system is something like that in West Germany, except that the difference between the rates is smaller. In general the object, as in Germany, is to encourage distributions of dividends to shareholders.

In the case of "family" (close) corporations,⁴ the tax penalty for inadequate distribution is even heavier, but the additional tax only applies above certain levels.

The national tax rates applicable (as distinct from prefectural and municipal taxes, which are considered later), are as follows:

Companies (other than family corporations)	Undistributed profits per cent	Distributed profits per cent
(a) Where income does not exceed ¥3 million and capital does not exceed ¥100 million -----	28	22
(b) Other companies -----	36.75 ⁵	26
(c) Public interest corporations -----	23	19
Co-operatives -----	23	19

Family corporations are taxable as above, plus an extra charge on

⁴ See note 2 *supra*.

⁵ Being 35 per cent plus a 5 per cent temporary surcharge which is due to end after 1974.

excess undistributed profits. The permitted level of retained profits is the largest of:

- (a) 35 percent of the income of the business year;
- (b) ¥5 million; or
- (c) the amount required to bring cumulative retained income up to a ceiling of 25 percent of the paid-in capital.

The excess is taxed thus:

First ¥30 million	— 10 per cent
Next ¥70 million	— 15 per cent
Remainder	— 20 per cent

(¥300 approximately = US\$1).

C. *Capital Gains*

1. *Corporations.* — As far as corporations are concerned, capital gains are included in taxable income for corporation tax purposes regardless of whether they are short-term or long-term gains. As from 1973, capital gains from the disposal of land are subject to ordinary corporation tax at 36.75 per cent (35 per cent plus a 5 per cent temporary surcharge), and in addition to a new tax of 20 per cent introduced for the purpose of discouraging speculation in land. There are, however, various ameliorations of the charge in respect of capital gains in certain circumstances.

2. *Special Relief for Expropriated Property.* — Special relief is granted to corporations where disposal is involuntary, e.g., where land has been expropriated for public or governmental use. The corporation may opt, where it acquires a new asset within one year to replace the old, to bring in the new asset at the cost of the old with no taxable gain being charged on the enforced disposal of the old asset meantime. The alternative option is to be taxed on the profit from disposal with a deduction of ¥20 million.

If replacement has not been effected within a year of the expropriation the proceeds must be shown in a separate account and dealt with in the subsequent period when the purchase of the new asset takes place.

3. *Other Special Reliefs.* — Where land is sold to the Japan Public Housing Corporation, or to the national or local government under the laws relating to land, a deduction of ¥10 million may be made in computing the taxable gain.

Where the corporation sells land to persons who carry on the business of developing land for housing, a deduction of ¥5 million is made.

4. *Individuals.* — Capital gains by individuals are divided into long-term (over five years between acquisition and disposal) and short-term, and also into those derived from land and buildings and those from "movable assets" (all assets other than land and buildings, except those held for sale in the ordinary course of business).

A standard deduction of ¥400,000 (or the amount of the gain, if smaller) is granted for both short- and long-term gains on movable assets, and for short-term gains on land and buildings. Where there are both short- and long-term gains, the ¥400,000 deduction is given, once only, and primarily against the short-term gains.

5. *Roll-Over Relief.* — Roll-over relief is highly developed in Japan, and capital gains tax liability is deferred where old fixed assets are replaced by new ones of the same type used for the same purpose. Where assets are sold in one business year and new assets not purchased until the following year (so long as they are put into business use within a year of acquisition), roll-over relief is still applied provided the new assets are of types such as the following:

- (a) in the case of land and buildings disposed of in the areas of Tokyo, Osaka and Nagoya where the new assets (including land) are acquired outside those areas;
- (b) replacement of facilities causing air, water, or noise pollution in controlled areas by fixed assets in non-controlled areas;
- (c) replacing land acquired before 1969 and disposed of after more than five years, by new depreciable business assets; or
- (d) acquisition of new fixed assets either with insurance moneys for loss of or compensation for expropriation of the old assets.

D. *Deductible Reserve Provisions*

Sums put to various types of permitted reserve are deductible in computing corporate income for tax purposes. The profusion of such reserves suggests that the administration is attentive to the pleas of various sectors of industry when introducing its legislative amendments. A generous policy in admitting reserves for tax purposes is beneficial to the cash flow position of corporations, in enabling tax liability to be deferred.

Exports are encouraged by the Overseas Market Development Reserve which may be created out of deductions based on provisions varying from 0.5 per cent to 2.3 per cent of the export value of goods purchased from others and exported overseas. The reserve is reclaimed by a "clawback" of one-fifth in each of the five years

following that in which the deduction is given. Overseas investment is encouraged by permitting a loss reserve to be made of one-tenth of the cost of acquiring newly issued shares of certain types of overseas corporations, provided certain conditions are satisfied.

The search for natural resources is stimulated by a permitted maximum annual provision of 15 per cent of the proceeds of the sale of mineral products by way of a mine prospecting reserve, and 30 per cent of the cost of acquiring stock in a minerals exploration company is deductible. The latter reserve may be held for five years and one-fifth of the sum is then restored to taxable profits annually in years 6 to 10.

E. *Contingent Expenditure*

A corporation may reserve up to 50 per cent of the cumulative total of its liability to pay retirement allowances to existing employees (assuming they all retired at the end of the business year). Reserves are also permissible for future bonuses to staff who received such bonuses in the past.

A corporation which sells computers to firms which lease them out subject to a repurchase guarantee by the corporation, may claim sums put to repurchase loss reserve, up to a maximum of 20 per cent of gross revenue; a hydro-electric concern may claim a drought reserve if its water supplies are threatened by drought. An electric generating company may charge up to 25 per cent of the cost of constructing an atomic power plant. The clawback provision is that one-tenth of the reserve should be restored in each of the ten years after the first year of business use of the plant.

Another "sectional" reserve is that permitted for returned unsold goods to publishers, and to suppliers of medical goods, and a further one is the reserve permitted to construction companies and certain manufacturing companies which have a continuing liability to repair defects in their work or products after delivery.

A more general reserve is that permitted to cover price fluctuations in inventories or securities up to a maximum of 4 per cent for inventories (stock-in-trade) or securities in general, and 6 per cent for designated commodities which are exposed to extreme price fluctuation.

A further example of a deductible reserve provision is that relating to the control of pollution. In this case the deduction is based on a percentage of income, and applies to a corporation with

fluctuating income which may find it onerous to cope with expenditure on abating and controlling pollution.

F. *Reliefs and Deductions*

Japan provides for certain deductions to be made in computing corporate taxable income which are additional in some cases to the usual deductions permissible in Britain or in the United States. Depreciation deductions are dealt with separately, as are deductions for reserves of various kinds which enable tax to be deferred.

Trading losses may be carried forward five years or back one year, and prefectural enterprise tax (but not inhabitants tax) is deductible in computing taxable income.

A deduction for "casualty loss" may be due when the fixed assets and trading stock ("inventory") of a corporation are damaged by earthquake, storm, flood or fire and any unrelieved portion may be carried forward for five years. A casualty loss deduction is also allowed to corporations not rendering "blue" tax returns.⁶

Various types of expenditure incurred in setting up a business may be claimed as a deduction; details are given under the heading of amortization and depreciation below.

Bad debts provisions for specific debts are dealt with in an orthodox manner, but a corporation may also deduct fixed percentages by way of general reserve against the general debts outstanding at the end of the business year.

A wide choice is available of methods of valuing stock-in-trade. Apart from the usual "cost or market value whichever is lower," a corporation may adopt FIFO, LIFO, moving average cost, or several other variations, including any special method approved by the tax administration.

For the period 1968 to 1974 inclusive, a corporation which spends more on experiment and research than in any previous year from 1966 onward, may claim a credit of 25 per cent of the increase, subject to a ceiling of 10 per cent of the income tax payable before granting the credit.

One of the many tax benefits favouring exports is the deduction made in computing income from overseas technological assistance transactions. A deduction of 70 per cent of the proceeds is made

⁶ Most corporations in Japan file a "blue return" which is permitted to companies maintaining their books and accounts with modern accounting practices and standardized procedures. Approval for filing "blue returns" must be obtained from the Chief of the National Tax Office.

in the case of fees for providing overseas clients with technical knowledge in the form of patents, know-how, etc., which the corporation itself has acquired. Thirty per cent is deducted from the proceeds from overseas alienating copyrights, including film copyrights, and 20 per cent where other services, such as research, surveys, planning, construction of buildings, machinery, ships, aircraft, and rolling stock are provided. There is an overall limitation, however, in that the allowances quoted in each case must not reduce the net profit by more than 50 per cent.

On the other hand, bonuses to directors are not deductible for Japanese corporation tax purposes, but instead are regarded as distributions — although if the director is also an employee the part of the bonus relating to the employment is deductible.

There is a restriction on the deduction of entertainment expenses, a statutory limit being set which is related to the capital and capital surplus of the corporation.

IV. AMORTIZATION AND DEPRECIATION

Certain expenses of a Japanese corporation may be "amortized," i.e. deducted in the year of disbursement or in subsequent years at the taxpayer's option. If the allowance is claimed in subsequent years it is granted on the straight-line method for the period over which the benefit from the expenditure accrues. The relief is known as "amortization of deferred expenses" although it is the relief rather than the expenditure which may be deferred. Expenditure qualifying for this relief includes a number of items which would not necessarily rank for relief in Britain or the United States, viz. the expense of opening a business or setting up a corporation, including the cost of issuing shares, debentures and bonds, the last of which may have been issued at a discount. Other qualifying items are interest paid to shareholders before a business becomes profitable, costs of developing new markets or new management systems, and cost of research.

Ordinary depreciation on machinery, buildings and vessels, and such intangibles as patents, trade-marks, goodwill and mining rights may be calculated in various different ways. For example, the declining balance method (under which 10 per cent of cost is regarded as the minimum final balance), the straight line method, or any other method which is officially approved, may be applied to tangible assets, though only the straight line method may be adopted for intangible assets.

Where depreciable assets are subjected to greater than average use, the ordinary allowance is increased pro rata to the number of hours of increased usage.

Special depreciation has a deliberate economic purpose, i.e. to encourage the type of economic activity favoured by the enhanced allowances. If there are signs of overheating in the economy, defined as when the official discount rate at the Bank of Japan exceeds 5.5 per cent per annum, the government may cancel the application of special depreciation.

Examples of the actual initial allowances for special depreciation are:

- (a) one-half of the acquisition cost of depreciable assets in the case of plant and equipment for prevention of air and sea pollution, for sewage disposal, smoke disposal, and prevention of noise;
- (b) one-third in the case of large plant and equipment for new and sophisticated manufacturing techniques, water supply, safety, and test equipment, plant and equipment for use in underdeveloped areas, and steel ships;
- (c) one-fourth for plant used in key industries, for atomic plant and large computers;
- (d) one-fifth for buildings in under-developed areas;
- (e) one-tenth for retail shops operated jointly by groups of retailers; and
- (f) for the first five years, allowances equal to the ordinary depreciation for new fire-proof business buildings, and equal to twice or three times ordinary depreciation (varying according to type of construction and year of building) for new housing for rent.

V. FILING TAX RETURNS

Japanese companies commonly prepare accounts on a six-monthly basis and are normally required to make an interim tax return within two months after the accounting period. As the "self-assessment" system applies, a payment of tax normally accompanies the tax return. The payment made after completion of the first six months of the business year is treated as a prepayment when the final payment is made after completion of the second six months' accounts for the business year. Where, exceptionally, the company prepares annual accounts only, it is required to make an estimate of tax for the first half-year, at the same time as other companies which prepare accounts six-monthly. The cash flow position of a newly-established company is relieved by the provision that no prepayment after the first six months is required during the company's first trading year.

Tax at the rate of 20 per cent is normally withheld from dividends paid by a Japanese corporation and a credit is allowed to the shareholder when computing his tax. Dividends paid by one domestic corporation to another are subject to withholding of income tax, but the tax thus withheld is credited against the corporate tax of the receiving corporation.

In Japan, as in Italy, withholding extends beyond the more traditional subjects of interest, dividends, etc., to professional fees payable by corporations to their professional advisers, *e.g.*, lawyers, accountants, architects and business consultants. The rate of 10 per cent is applied to gross payment, 20 per cent being charged on the excess over ¥500,000 paid to any particular person.

VI. LOCAL INCOME TAXES

In addition to the national corporation tax, corporations in Japan are subject to the following local income taxes: the Enterprise Tax, the Prefectural Inhabitants Tax and the Municipal Inhabitants Tax.

A. *Enterprise Tax*

The most important local tax in Japan, which applies to corporations, is the enterprise tax chargeable by the prefectures on the profits both of Japanese corporations and the joint ventures, subsidiaries, branches or permanent establishments of foreign companies. The normal rate of enterprise tax is 12 per cent on ordinary and liquidation income, but reduced rates apply to the lower range of income of smaller corporations, defined as those with less than ¥10 million capital and with premises in fewer than three prefectural territories. The enterprise tax rates are as follows:

Income up to ¥1.5 million p.a.	6 per cent
Income between ¥1.5 million and ¥3 million	9 per cent
Over ¥3 million	12 per cent

Enterprise tax is computed on broadly similar lines to those for the national corporation tax but there are some differences, for example: (a) a domestic corporation may exclude the profits of its overseas permanent establishments from the computation of enterprise tax; (b) enterprise tax may itself be deducted in the accounting period in computing taxable income subject to the national corporation tax and the enterprise tax; and (c) there is no provision for the carry-back of losses, no credit for foreign tax, and no deductions are permitted for overseas market development and overseas investment loss reserves.

The enterprise tax is payable to the prefecture where the corporation's business activities are conducted. The tax payable by a corporation with offices in two or more prefectures is apportioned to each prefecture, usually on the basis of the number of employees at each office. The enterprise tax is payable within two months from the end of the accounting period.

B. *Prefectural Inhabitants Tax*

Corporations are subject to a prefectural inhabitants tax in each prefecture where an office or place of business is maintained. The tax consists of a per-capita assessment of ¥600 (U.S.\$2) per annum (¥1000 if the corporation's capital is more than ¥10 million) plus a corporate assessment of 5.6 per cent of the company's national corporation income tax. In cases of financial necessity, prefectures can increase the assessment to 6.6 per cent. As with the enterprise tax, the prefectural inhabitants tax is due within two months after the close of the accounting period. The assessment must be pro-rated on the basis of number of employees in each prefecture if the corporation has an office or place of business in two or more prefectures. The prefectural inhabitants tax is not deductible in determining income subject to the national corporation tax.

C. *Municipal Inhabitants Tax*

The municipal inhabitants tax is similar to the prefectural inhabitants tax. The per capita assessment, payable to each municipality in which a corporation maintains an office or place of business, ranges from ¥2,400 to ¥4,000 (but can be increased up to ¥7,000). The corporate assessment is 9.1 per cent of the national corporation income tax, but the rate can be increased to 10.7 per cent. The municipal inhabitants tax is pro-rated among the municipalities involved (in the same manner as the prefectural inhabitants tax), must be paid within two months after the close of the accounting period, and is not deductible in calculating the national corporation tax.

VIII. CONCLUSION

For those who believe that economic growth and industrial development can be influenced by fiscal and taxation policies, the study of Japanese taxation — in view of that country's "economic miracle" since the destruction wrought by World War II — would appear to be virtually obligatory. Concerning corporation tax in Ja-

pan, the major points are the rather moderate rates, the variety of "special" reliefs, the stability of the corporate tax system (which has not changed in essence since the post-war reforms of 1951-53) and the use of an "imputation" system whereby a shareholder receives a credit for the corporate tax on the income out of which his dividends were paid.