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# AN AGENDA FOR REVISING THE TAXATION OF PHILANTHROPY IN JAPAN

Koji Ishimura<sup>†</sup>

*Abstract:* As the size and scope of Japan's philanthropic activities have grown, so has the need to re-examine Japan's tax policies with regards to charitable giving and volunteerism. In particular, there is a need to review the classification of tax-exempt entities under the Corporate Tax Law to ensure that only bona fide non-profit activities are tax-exempt. Japan should also explore new tax incentives to encourage volunteerism, such as allowing deductions for out-of-pocket expenses incident to charity work, carryovers, and a liberalization of Japan's current system for specific itemized deductions. Finally, Japan's tax policies should be used to encourage more cross-border philanthropy given the nation's interest in increasing its presence in international affairs.

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- I. INTRODUCTION

In general terms, taxation on charity, or philanthropy, may be examined within the context of two major areas. One is tax treatment of "charitable entities."<sup>1</sup> The other is tax treatment of "charitable giving" to qualified entities. Tax policy on charitable entities and charitable giving may be judged as rational or legitimate under general circumstances when the policy of exempting charitable entities from taxation furthers "public benefit" and when charitable giving, which is essential to further the objectives of these charitable entities, is encouraged through tax incentives.

In Japan, a wide range of charitable entities is exempted from various taxes.<sup>2</sup> These exemptions are subject to varying limitations depending on the entity. The most important exemption is from the corporation tax.

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<sup>1</sup> Note that under Japanese jurisdiction even though corporate forms are most popular, trust forms are also available for charitable entities. See Art. 66 of Trust Law. In this study, the analysis extends only to charitable corporate forms.

<sup>2</sup> They include (i) corporation tax, (ii) income tax, (iii) inheritance tax, (iv) registration tax and license tax, (v) land price tax, (vi) consumption tax, and (vii) local taxes such as prefectural and municipal inhabitant taxes, the prefectural enterprise tax on corporations, prefectural property acquisition tax, the municipal property tax and the city planning tax. For a detailed explanation of these taxes, see Y. GOMI, GUIDE TO JAPANESE TAXES 1992-1993 (1992).

Contributions from individual and corporate donors to qualified tax-exempt charitable entities are also deductible, subject to varying limitations, as an indirect subsidy (or a tax expenditure) to philanthropy.

A “charitable contribution” may be defined as a transfer between a donor and beneficiaries with a charitable entity as an intermediary. The rationale for tax privileges for contributions and for exemption from taxation of charitable entities is that they provide a tax incentive to encourage or further their various primary objectives. To provide an incentive for charitable contributions, one of two forms may be used: “tax credits” or “deductions.” In recent years, tax incentives in Japan have been in the form of deductions.<sup>3</sup>

In general, deductions are allowed for contributions to organizations which are set up as corporations, and to “qualified contributions” to the organizations classified as charitable donees and specifically listed in Appendix I (Eligible Public Corporations List) of the Income Tax Law,<sup>4</sup> and Appendix I (Eligible Public Corporations List) and Appendix II (Eligible Public Benefit Corporations List) of the Corporation Tax Law.<sup>5</sup> Except for certain contributions which can be treated by business donors as business expenses, donations to unincorporated organizations or organizations which are not classified as charitable donees in these Appendices are not allowable deductions.<sup>6</sup>

Two forms of individual charitable giving exist: “money or property donation” and “time or service donation.” Donations of volunteer labor or time are an extremely important resource for charitable entities, comparable in value to donation of money or property.<sup>7</sup> Generally, however, in Japan only money or property are considered to be qualified contributions to the eligible organizations listed in the aforementioned Appendices.<sup>8</sup>

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<sup>3</sup> For an analysis of Japan’s policy underlying charitable taxation, the state of charitable taxation in Japan, and some suggested guidelines for reform, see KŌEKI HŌJIN KŌEKI SHINTAKU ZEISEI KENKYŪKAI, FIRANSOROPPI ZEISEI NO KIHONTEKI KADAI [AN AGENDA FOR THE TAXATION OF PHILANTHROPY] (1990) [hereinafter RTCCCT].

<sup>4</sup> Shotoku Zei Hō (Income Tax Law), Law No. 33 of 1965 [hereinafter ITL].

<sup>5</sup> Hōjin Zei Hō (Corporation Tax Law), Law No. 34 of 1965 [hereinafter CTL].

<sup>6</sup> The following so-called ordinary donations are specifically not deductible under the CTL: advertising expenses, costs of samples, entertainment expenses, reception expenses, and payments for employee welfare. See CTL Art. 37(5).

<sup>7</sup> The analysis in this study does not extend to the taxation of donations of property.

<sup>8</sup> See CTL Art. 37. Article 37 makes no mention of deductions for volunteer labor or “service.”

## II. CHARITABLE ORGANIZATIONS AND TAXATION

The general statutory source for the creation of charitable organizations in Japan is Article 34 (Incorporation of Public Interest Corporation) of the Civil Code.<sup>9</sup> The provision stipulates that “not-for-profit associations or foundations for worship, religion, benevolence, science, art and crafts or otherwise relating to the public interest may be incorporated with the approval of the relevant authority.”<sup>10</sup>

Since the enactment of Article 34 of the Civil Code in 1896, many developments have ensued in the Japanese non-profit sector. In response to the needs and desires of society, various legislation has been introduced that allows the creation of organizations independent from Civil Code Article 34. For example, organizations for “worship or religion” may be formed under the Religious Corporation Law,<sup>11</sup> “benevolent” organizations under the Social Welfare Services Law,<sup>12</sup> and organizations for “science, arts and crafts” under the Private School Law.<sup>13</sup> Consequently, corporations formed under Civil Code Article 34 these days are only those which are “otherwise relating to the public interest.”

Since the meaning of “otherwise relating to the public interest” is not precisely defined and questions as to eligibility as a Civil Code Article 34 Corporation are left to the discretion of the relevant authority, various non-profit organizations of ambiguous character continually come into being as public benefit corporations. This is the case with the semi-governmental “local land development corporation” which is reimbursed by the local government for administrative costs and personnel, as well as with “trade leagues” and “trade associations,” which are associations of persons who have some common business interest.<sup>14</sup>

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<sup>9</sup> Minpō (Civil Code), Law No. 89 of 1896.

<sup>10</sup> *Id.*

<sup>11</sup> Shūkyō Hōjin Hō (Religious Corporation Law), Law No. 126 of 1951.

<sup>12</sup> Shakai Fukushi Jigyō Hō (Social Welfare Services Law), Law No. 45 of 1951.

<sup>13</sup> Shiritsu Gakkō Hō (Private School Law), Law No. 270 of 1949.

<sup>14</sup> In Japan, the increasing growth of “public interest corporations” of ambiguous nature has gradually become a burden to philanthropic circles. Governmental bureaucrats are continually pressured by business and citizens’ circles to streamline unnecessary governmental operations in pursuit of the “small government” policy. To avoid or circumvent this pressure, the bureaucracy has set up considerable numbers of “public interest corporations” as a de facto part of government. It has long been a well-known practice in Japan for officials of the relevant authorities that approved the formation of a Civil Code Article 34 corporation to take up responsible positions in these corporations after their retirement. Consequently, in many Civil Code Article 34 corporations, the positions of president and/or top ranking officers are occupied by former government officials or employees.

Other types of public benefit corporations may be formed under specific laws. For example, the Japan Foundation is created under the Japan Foundation Law<sup>15</sup> and the Institute of Developing Economics under the Institute of Developing Economics Law.<sup>16</sup>

#### A. *Organizations Qualifying for Tax-Exempt Status*

In Japan, three major types of organizations qualify for tax-exempt status under the Corporation Tax Law: (1) Public Corporations, (2) Public Benefit Corporations, and (3) Unincorporated Organizations.<sup>17</sup>

##### 1. *Public Corporations (kōkyō hōjin)*

Public corporations are usually formed by legislative mandate, that is, through laws enacted for the specific purpose of establishing such corporations. In general, they are created to serve certain governmental functions and are publicly funded. Appendix I of the Corporation Tax Law enumerates these public corporations. Among them are the Japan Development Bank, formed under the Japan Development Bank Law,<sup>18</sup> and the Japan Highway Public Corporations, formed under the Japan Highway Public Corporation Law.<sup>19</sup>

Under the Corporation Tax Law, public corporations are not subject to corporation tax, even though they carry on profit-making activities.<sup>20</sup>

##### 2. *Public Benefit Corporations (kōeki hōjin)*

The Corporation Tax Law enumerates in Appendix II the organizations which are public benefit corporations. Unlike the United States and other jurisdictions, to qualify for tax-exempt status, an incorporated organization existing for public benefit is not required to have an independent screening by the tax authority in Japan. Any eligible public

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<sup>15</sup> Kokusai Kōryū Kikin Hō (Japan Foundation Law), Law No. 48 of 1972.

<sup>16</sup> Ajia Keizai Kenkyūsho Hō (Institute of Developing Economics Law), Law No. 51 of 1960.

<sup>17</sup> For a detailed analysis on organizations qualifying for tax-exempt status, see KOJI ISHIMURA, NICHIBEI NO KŌEKI HŌJIN KAZEI NO KŌZŌ [THE LAW OF TAX EXEMPT ORGANIZATIONS: A JAPANESE-AMERICAN COMPARISON] (1992).

<sup>18</sup> Nihon Kaihatsu Ginkō Hō (Japan Development Bank Law), Law No. 108 of 1951.

<sup>19</sup> Nihon Dōro Kōdan Hō (Japan Highway Public Corporation Law), Law No. 6 of 1956.

<sup>20</sup> CTL Art. 4(3).

benefit corporation listed in Appendix II which is incorporated with the approval of the relevant authority is automatically granted both corporation tax and income tax concessions.<sup>21</sup>

Public benefit corporations include “incorporated not-for-profit associations and foundations relating to the public interest” under Article 34 of the Civil Code and corporations under the Religious Corporation Law, the Social Welfare Law, and the Private School Law. Furthermore, Appendix II enumerates corporations or organizations created under specific laws. This listing includes the Chamber of Commerce and Industry created under the Chamber of Commerce and Industry Law,<sup>22</sup> the Japan Foundation under the Japan Foundation Law,<sup>23</sup> the Private School Personnel Mutual Aid Association under the Private School Personnel Mutual Aid Association Law,<sup>24</sup> the Northern Territories Issue Association under the Northern Territories Issue Association Law,<sup>25</sup> and the Farmers’ Pension Fund under the Farmers’ Pension Fund Law.<sup>26</sup>

Public benefit corporations listed in Appendix II are allowed, subject to varying limitations specified under the individual applicable law, to carry on profit-making activities. In contrast to the profit-making activities of public corporations, however, these inherently commercial activities are, with some exceptions, subject to corporation tax, even if they are related to the primary purpose for which the corporation received its tax-exempt status.<sup>27</sup> These taxable profit making activities are enumerated in the accompanying Cabinet Order<sup>28</sup> and are subject to corporation tax at a reduced rate of 27%.<sup>29</sup>

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21 Where an applicant organization is nationally operating, the relevant authority is the minister of the relevant Ministry designated under the applicable law; for example, the Minister of Education for educational, cultural or religious organizations. On the other hand, where an applicant is prefecturally operating, the relevant authority is the prefectural board of education for educational or certain cultural organizations, and governor of the prefectural government for others. The application has to be filed with the relevant authority of the prefecture where the main office of the applicant organization is located.

22 Shōkō Kaigisho Hō (Chamber of Commerce and Industry Law), Law No. 143 of 1953.

23 Kokusai Kōryū Kikin Hō (Japan Foundation Law), Law No. 48 of 1972.

24 Shiritsu Gakkō Kyōshokuin Kyōsai Kumiai Hō (Private School Personnel Mutual Aid Association Law), Law No. 245 of 1953.

25 Hoppō Ryōdo Mondai Taisaku Kyōkai Hō (Northern Territories Issue Association Law), Law No. 34 of 1969.

26 Nōgyōsha Nenkin Kikin Hō (Farmers’ Pension Fund Law), Law No. 78 of 1970.

27 CTL Art. 4(1). It is important to note that, unlike the U.S. or Germany, Japan does not follow a so-called “substantially related rule” for judging the taxability of business activities carried on by charitable entities.

28 There are presently 33 categories. Examples include: sales of goods, sales of real estate, lease of money, lease of goods, lease of real estate, manufacturing industries, communication services and transfer

### 3. *Unincorporated Organizations (jinkaku no nai shadan)*

In Japan, unincorporated organizations such as unincorporated associations or unincorporated foundations, although formed for a non-profit public benefit purpose, are ineligible for certain tax privileges. They are however, exempt from corporation tax unless they carry on profit-making activities.<sup>30</sup> Thus, membership fees or contributions paid or offered to the unincorporated organization in furtherance of its not-for-profit primary objectives are not subject to corporation tax.<sup>31</sup> Profit-making activities, on the other hand, are taxed at the standard corporation tax rate of 37.5%.<sup>32</sup>

#### B. *The Need for Restructuring*

As already mentioned, under the Corporation Tax Law, non-profit entities are classified into public corporations and public benefit corporations. The primary reason for this classification lies in the taxation policy regarding profit-making activities. Even though public benefit corporations are exempted from corporation tax, they nonetheless remain potentially taxable on any commercial income realized from their profit-making activities, unless cabinet orders and regulations specify exclusion.

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of intellectual property rights. Hōjin Zeihō Shikōrei (Cabinet Order for the Enforcement of the Corporation Tax Law), Seirei No. 97 of 1965, Art. 5 [hereinafter CTL Enforcement Order].

<sup>29</sup> CTL Art. 66(3). The standard tax rate for business corporations is 37.5% (28% on income of 8 million yen or less). CTL Art. 66(1). Also, surplus or liquidation income derived from the tax-exempt primary function of a "Public Benefit Corporation" is not subject to corporation tax. CTL 93(2)(2). Under ITL Art. 11(1), interest, dividends and certain other kinds of income derived from the tax-exempt primary function are not subject to the withholding income tax, whereas these incomes derived from taxable commercial activities are. The Government Tax Research Commission has for years suggested that investment income derived from the tax-exempt primary function of a "Public Benefit Corporation," except for certain kinds of entities such as a non-operating scholarship foundation, should be taxed. However, except for certain fully government-sponsored entities, such investment income is in fact a very important fund for Japan's most genuine charitable entities. Hence, it is likely to be difficult to introduce a tax on such investment incomes. For a more detailed introduction of this issue, see RTCCT, *supra* note 3, at 62.

<sup>30</sup> CTL Art. 4(1).

<sup>31</sup> *Id.* In addition, liquidation income that is derived from public benefit or the non-profit primary function of an unincorporated organization is not subject to corporation tax. CTL Art. 93(2)(2).

<sup>32</sup> CTL Art. 66(1).



For example, Appendix II classifies the National Space Development Agency of Japan<sup>33</sup> as eligible to be a public benefit corporation. If the Agency enters into licensing agreements and receives a royalty in return for the right to commercial use, payments are taxable as a rule. Both the cabinet order<sup>34</sup> and regulations that accompany the Corporation Tax Law,<sup>35</sup> however, stipulate that royalty income of the Agency is excludable. Incidentally, the Agency is almost entirely publicly funded and is therefore *de facto* a part of government.

On the other hand, public corporations are fully excludable from corporation tax, even though they carry on profit-making businesses. For example, the income of the Japan Highway Public Corporation, a public corporation under Appendix I, is totally tax-free, even though it operates a business as a substantial part of its primary activities.

Critics argue that the classification criteria of Appendices I and II is irrational. It is generally understood that both public corporations and public benefit corporations are theoretically the same as “private organizations for the public interest.” This means that public corporations are explicitly different from governmental entities. More careful scrutiny seems necessary to rationalize the present classification.<sup>36</sup>

### III. CHARITABLE GIVING AND TAXATION

In Japan, the mere fact that a charitable entity is exempted or excluded from taxation does not necessarily mean that a contribution to it will be deductible. A deduction is allowed only where the contribution falls within the definition of “qualified contributions.”

Unlike corporation tax on profit-making activities, public corporations under Appendix I of the Corporation Tax Law and public benefit corporations under Appendix II of the same law are basically treated on the same basis for purposes of charitable giving.

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<sup>33</sup> The Agency is created under the National Space Development Agency of Japan Law. Uchū Kaihatsu Jigyōdan Hō, Law No. 50 of 1969.

<sup>34</sup> CTL Enforcement Order Art. 5(1)33-b.

<sup>35</sup> Hōjin Zeihō Shikō Kisoku (Regulations for the Enforcement of the Corporation Tax Law), Ōkura Shōrei No. 12 of 1965, Art. 8-3(1) [hereinafter CTL Regulation].

<sup>36</sup> See RTCCT, *supra* note 3, at 42.

## A. *History of Deductions for Charitable Giving*

The privilege of claiming a deduction for charitable giving has gradually come to have an important influence on furthering philanthropy in the non-profit sector in Japan. To understand the development of philanthropy in Japan, an examination of the history of deductions for charitable giving provides some guidance.

### 1. *Deductions for Individual Charitable Giving*

Prior to 1962, the only tax privilege allowed for charitable contributions by individuals, especially individual business taxpayers, was the deductibility of contributions which could be considered business expenses.<sup>37</sup> In 1962, as an incentive for individual donations, an income tax "credit" was created for qualified contributions.<sup>38</sup> In 1967, the tax credit was replaced with the present deduction.<sup>39</sup> Individuals have since been allowed deductions for those charitable contributions which are qualified contributions.<sup>40</sup>

### 2. *Deductions for Corporate Charitable Giving*

In 1942, corporate charitable contributions were first allowed as business expense deductions.<sup>41</sup> This meant that charitable contributions were deducted under the guise of being business-related expenses. In 1964, business corporations first obtained the privilege of taking deductions for charitable contributions per se.<sup>42</sup> This enactment formed the substance of the present deduction for corporate charitable contributions.<sup>43</sup>

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<sup>37</sup> See, e.g., Sec. VII, CTL (1960); Art. 8 of the Enforcement Regulation, CTL (1960); JAPAN TAX GUIDE FOR ALIEN INDIVIDUALS & FOR. CORPS., No. 135, at 23 (Central Publishing Co., Tokyo 1961)[hereinafter JAPAN TAX GUIDE].

<sup>38</sup> See JAPAN TAX GUIDE, No. 151, at 3-4 (May 1962). About 50 organizations were designated as valid recipients of contributions, including the Tokyo Olympic Organization Committee. *Id.*

<sup>39</sup> See JAPAN TAX GUIDE, No. 209, at 6 (Mar. 1967). Deductions were allowed up to a maximum of 15% of taxable income. *Id.*

<sup>40</sup> For a more detailed analysis, see DHC KONMENTAARU SHOTOKU ZEI HÔ [DHC COMMENTARY ON INCOME TAX LAW] at 4781 (S. Takeda ed., Supp. 1992).

<sup>41</sup> For a discussion of Japan's tax policies during World War II, see SABURO SHIOMI, JAPAN'S FINANCE AND TAXATION: 1940-1956 53-61 (Columbia University Press 1957).

<sup>42</sup> For a more detailed analysis, see generally DHC KONMENTAARU HÔJIN ZEI HÔ [DHC COMMENTARY ON CORPORATION TAX LAW] at 2551 (S. Takeda ed., Supp. 1993).

<sup>43</sup> *Id.*

Under the existing Corporation Tax Law, qualified contributions are deductible charitable contributions only up to a certain limit. Theoretical interpretations of the law argue that charitable contribution deductions should be allowed only when there is no direct and apparent quid pro quo of goods or services for the contribution.<sup>44</sup>

### *B. Scope of Deductible Charitable Contributions*

Charitable contribution deductions are regulated under the Income Tax Law for individuals and under the Corporation Tax Law for business corporations.

#### *1. Individuals*

For individuals, qualified contributions (*tokutei-kifukin*) are deductible from the donor's total taxable income.<sup>45</sup> The maximum deduction allowed to individuals in any one year for qualified contributions is limited to 25% of the donor's total taxable income minus 10,000 yen.<sup>46</sup> This means that a minor contribution (less than 10,000 yen) is not deductible. Under the existing law, contributions in excess of the 25% limit cannot be carried forward to following years.<sup>47</sup>

Individual qualified contributions must fall within one of the following categories:

- (a) Contributions to the national government or to local governments
- (b) Contributions to a designated fund
- (c) Contributions to corporations of a public charity nature<sup>48</sup>

Contributions to a designated fund are contributions to Civil Code Article 34 public interest corporations and to incorporated or unincorporated entities for educational, scientific, social welfare or for some other public benefit. These are made in response to public fundraising

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<sup>44</sup> See RTCCT, *supra* note 3, at 20.

<sup>45</sup> ITL Art. 78.

<sup>46</sup> Note, however, that the "total taxable income" in this context includes retirement income and forestry income. ITL Art. 78.

<sup>47</sup> ITL Art. 78(1).

<sup>48</sup> ITL Art. 78(2).

efforts to deal with any urgent needs and those which are, on a single application basis, designated by notice issued from the Minister of Finance.

Contributions to corporations of a public charity nature are contributions to private schools, social welfare corporations, public corporations, public benefit corporations formed under Civil Code Article 34, and other corporations formed under specific laws. These are separately approved as significantly contributing to the advancement of education, science, social welfare or other public interest, by the relevant authority in consultation with the Minister of Finance, or both the Minister of Finance and the relevant authority, in accordance with the requirement of the law and the enforcement order.<sup>49</sup>

## 2. *Business Corporations*

There has been no in-depth analysis on the problem of separating a business-oriented corporate charitable contribution from a genuine corporate charitable contribution. In practice, business corporations in Japan may claim a wider range of charitable contribution deductions than individuals.

### a. *Charitable contributions as a business expense*

Corporate expenditures which are actually charitable in nature are deductible as business or business-related expenses. Corporations may deduct as a business-related charitable contribution up to the equivalent amount calculated according to the following formula:  $(2.5\% \text{ of taxable income} + 0.25\% \text{ of paid-in capital}) \times (0.5)$ . However, where a corporation does not have any paid-in capital, contributions totaling up to 2.5% of taxable income may be deducted.<sup>50</sup>

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<sup>49</sup> ITL Art. 78(2)(iii); Shotoku Zei Hō Shikōrei (Cabinet Order for the Enforcement of the Income Tax Law), Seirei No. 96 of 1965, Art. 217 [hereinafter ITL Enforcement Order]. (Definitions are the same as for CTL Art. 37(3)(iii) and CTL Enforcement Order Art. 77). In addition to these three categories, individual contributions to political parties or political funds organizations for political activities are "qualified contributions" under the Special Measure Taxation Law. Sozei Tokubetsu Sochi Hō, Law No. 26 of 1957, Art. 3. However, scholars are critical about this tax treatment because, in fact, a considerable portion of individual contributions have flowed into political entities under the guise of "charitable" or "qualified" contributions.

<sup>50</sup> CTL Art. 37(2); CTL Enforcement Order Art. 73. Note, however, that corporate "contributions" here include not only "charitable contributions" but "various economic benefits offered" such as free transfer of assets or transfer of assets at an unreasonably reduced price, or free provision of services (CTL Art.

Incidentally, this business-related charitable contribution deduction is allowed for contributions to unincorporated entities as well as incorporated entities.<sup>51</sup> This allows for deductibility of donations which do not fall within the classification of qualified contributions.

*b. Corporate qualified contributions*

Corporate qualified contributions must fall within one of the following categories:

- (a) Contributions to the national government or to local governments
- (b) Contributions to a designated fund<sup>52</sup>

Contributions to the national government or to local governments are fully deductible. That is, an unlimited deduction for corporate donors is allowed. Contributions to a designated fund have the same definition as for individual donors. This type of contribution is also fully deductible.

*c. Contributions to corporations of a public charity nature*

Contributions by business corporations to corporations of a public charity nature have the same definition as for individual donors. This type of contribution is deductible up to the equivalent amount calculated according to the following formula:  $(2.5\% \text{ of taxable income} + 0.25\% \text{ of paid-in capital}) \times (0.5)$ .<sup>53</sup> However, where a corporation does not have any paid-in capital, contributions totaling up to 2.5% of the taxable income may be deducted.<sup>54</sup> The limit to this type of contribution is the same as with business-related charitable contributions.<sup>55</sup>

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37(6) and (7)). Qualified political contributions are also included in "contributions" here. However, entertainment and welfare-related expenses are not.

<sup>51</sup> CTL Art. 37(3)(2).

<sup>52</sup> CTL Art. 37(3).

<sup>53</sup> CTL Art. 37(2); CTL Enforcement Order Art. 73.

<sup>54</sup> CTL Art. 37(2); CTL Enforcement Order Art. 73.

<sup>55</sup> CTL Art. 37(2); CTL Enforcement Order Art. 73.

### C. *Constructive Contributions*

As indicated earlier, a public benefit corporation is permitted to carry on profit-making business or activities. A public benefit corporation that carries on profit-making business, however, must keep separate books of account that indicate the income attributable to the “taxable profit-making business” and “tax-exempt primary function.”<sup>56</sup>

In computing the taxable income of a public benefit corporation that has been derived from profit-making business, up to 27% of the taxable income can be deducted as constructive contributions (*minashi-kifukin*) to the tax-exempt primary function.<sup>57</sup> For a social welfare corporation or a private school, the allowable deduction is the larger of up to 50% of the taxable income or 2 million yen.<sup>58</sup>

In addition, where property attributable to the taxable profit-making business is transferred to the tax-exempt primary function, the value of the property transferred is deemed to be a contribution to the tax-exempt primary function and is treated as a deductible constructive contribution up to the aforementioned limit.<sup>59</sup>

## IV. VOLUNTEERING AND TAXATION IN JAPAN

Many concepts of philanthropy and taxation adopted in Japan are very much influenced by Western ideas and practice in these areas. Although Japanese citizens and corporations have traditionally played a minor role in philanthropy, Japan’s economic rise in international society has gradually required that Japanese citizens and corporations also have a social impact in that society.<sup>60</sup> To promote charitable contributions or volunteerism, a study of the existing tax system, government policy and present state of philanthropy in Japan is imperative.<sup>61</sup>

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<sup>56</sup> Civil Code Art. 34; CTL Art. 37(7), (8).

<sup>57</sup> This tax treatment is based on the hypothesis that the “taxable profit-making business” and the “tax-exempt primary function” are each deemed an independent entity. CTL Enforcement Order Art. 73

<sup>58</sup> CTL Enforcement Order Art. 73(1)(iii).

<sup>59</sup> CTL Art. 37(4).

<sup>60</sup> See generally H. Shimada, *Nihonkei Firansoropii To Ha Nani Ka* [A Perspective on Japan’s Philanthropy], 22 KŌEKI HŌJIN, No. 1, 1993, at 4.

<sup>61</sup> For an introductory analysis of the present state of philanthropy and some suggested agenda for taxation in Japan, see Koji Ishimura, *Shimin No Shakai Kōken To Kōeki Kifukin* [Citizens’ Social Contributions and Charitable Donation Deductions], 41 ZEIMU KŌHŌ, No. 3, 1993, at 13.

### A. *Corporate Philanthropy and Volunteering*

There has been considerable development of corporate philanthropy in Japan. Corporations are reaffirming their social responsibilities and explicitly encouraging their employees to participate in various kinds of community work or international volunteering.<sup>62</sup>

#### 1. *State of Corporate Philanthropy*

As the Japanese economy has expanded, corporate contributions to philanthropy have expanded as well, although the recent economic slow-down has had some adverse effects on the progressive growth of corporate contributions. At the present stage, most major Japanese corporations have carried on regulated contribution programs of various kinds. Corporate contributions by these major corporations have tended to become increasingly uniform and usually average less than one percent of corporate disposable income, although the actual percentage has varied depending on the individual corporation.<sup>63</sup>

According to the recent statistics published by the Japanese tax authority, in 1990, individual contributions amounted only to 34,214 million yen, whereas corporate contributions were 541,900 million yen.<sup>64</sup> These figures seem partly to be the result of the existing one-sided tax treatment of charitable contributions, that is, the tax policy of treating corporate contributions more favorably than individual contributions.

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<sup>62</sup> An example of such international volunteering would be advancing technological productivity in developing countries. For details of the state of corporate philanthropy in Japan, see, for example, KIGYŌ NO SHAKAI KŌKEN [CORPORATE PHILANTHROPY] (Dentsū Sōken ed., 1991); NIHON NO KIGYŌ ZAIDAN '92 [JAPANESE CORPORATE FOUNDATIONS '92] (Kōeki Hōjin Kyōkai ed., 1992); KAIKA SURU FIRANSOROPPII [PHILANTHROPY THAT COMES INTO BLOOM] (H. Shimada ed., 1993).

<sup>63</sup> In May 1990, the Keidanren (Federation of Economic Organizations) established a Committee on Corporate Philanthropy, and in November 1990, inaugurated the one-percent club. Members are encouraged to contribute 1% of disposable income to support philanthropy and further public understanding. For a detailed analysis on the state of the one-percent club, see SHAKAI KŌKEN HAKUSHO [WHITEPAPER ON PHILANTHROPY] 234 (Keidanren ed., 1992). Since members of the Keidanren are larger corporations, the one-percent contribution does not seem particularly difficult. On the other hand, a survey conducted by the Tokyo Chamber of Commerce and Industry whose members are predominantly smaller businesses indicates that it would be difficult for its members to achieve a one-percent contribution level. See Tokyo Chamber of Commerce and Industry, A Survey Concerning Corporate Philanthropy (July, 1991).

<sup>64</sup> For a more detailed analysis, see KOKU ZEI CHŌ TŌKEI NENPŌSHO: HEISEI 2 NENDO HAN [NATIONAL TAX ADMINISTRATION ANNUAL STATISTICS REPORT: 1990] (Koku Zei Chō ed., 1992).

## 2. Corporate Programmed Volunteering

Many major corporations also make a range of contributions, including the use of corporate facilities and the performance of services which are not allowed to be deducted as charitable contributions for corporation tax purposes. Among regulated non-deductible corporate giving programs, contributions of substantial amounts of uncompensated time by corporate employees have recently become more popular. Many major corporations have policies that explicitly encourage their employees to participate in various kinds of community projects as well as international volunteering. Some corporations have established compensated volunteering programs or paid holiday programs to encourage employee volunteerism.<sup>65</sup>

For those corporations which set up these paid volunteering programs, volunteering is an easy and highly visible way to "buy" goodwill in the community at a relatively small expense. Those corporations pay limited expenses which become deductible for corporation tax purposes.

Critics contend that this type of corporate programmed volunteering is not real volunteerism because it involves paid programs that are somewhat induced and do not really leave the decision-making choice to the employees.<sup>66</sup> They argue that these programs should not be paid ones and are not collective, but rather, essentially private in nature.

It can be argued that one of the main reasons why corporate paid volunteering programs have become so popular in Japan is that, unlike in the United States,<sup>67</sup> uncompensated or unreimbursed expenditures incurred

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<sup>65</sup> See WHITE PAPER ON PHILANTHROPY, *supra* note 63, at 173.

<sup>66</sup> See CORPORATE PHILANTHROPY, *supra* note 62, at 173.

<sup>67</sup> See I.R.C. § 170(e) (1988). The regulations to I.R.C. § 170 define the boundaries of deductions for out-of-pocket expenses incident to volunteer services:

No deduction is allowable under section 170 for a contribution of services. However, unreimbursed expenditures made incident to the rendition of services to an organization, contributions to which are deductible may constitute a deductible contribution. For example, the cost of a uniform without general utility which is required to be worn in performing donated services is deductible. Similarly, out-of-pocket transportation expenses necessarily incurred in performing donated services are deductible. Reasonable expenditures for meals and lodging necessarily incurred while away from home in the course of performing donated services also are deductible.

26 C.F.R. § 1.170A-1(g) (1993). For a more detailed analysis, see 1991 FED. TAX COMPL. MAN. (CCH) ¶ 361.



in performing services for qualified charitable organizations may not constitute a deductible contribution under Japanese rules. Therefore, the ITL should be amended so that such unreimbursed expenditures can become a contribution deductible from the participant's taxable income. This amendment may also encourage private citizens to take part in volunteer work of a non-collective nature.

### *B. Individual Philanthropy and Volunteering*

According to recent statistics, Japanese corporations made donations of approximately 541,900 million yen in 1990, whereas individuals only donated 34,214 million yen.<sup>68</sup> Japanese private citizens have traditionally played a minimal role in philanthropy and are just now beginning to engage in genuine charitable or non-profit activities.

#### *1. Disincentives to Individual Monetary Contributions*

As mentioned earlier, various non-profit organizations of ambiguous nature came into being in Japan as public benefit corporations under Appendix II of the CTL. This is the case with various "de facto governmental units" or "trade associations" formed as Civil Code Article 34 Corporations or through enactment of other specific laws. These public benefit corporations are generally funded and/or reimbursed by direct national or local government grants or through fees and contributions which are deductible business expenses for corporate members.

According to recent statistics, there were approximately 247,000 public benefit corporations in 1992.<sup>69</sup> Of those, genuine charitable entities constitute probably less than 10,000.

Charitable contributions to those unincorporated entities by private citizens, whether individual or corporate, are not qualified contributions eligible for tax deduction. Under the present situation, individuals are obliged to make monetary contributions to those unincorporated NPOs (Non-Profit Organizations) or NGOs (Non-Governmental Organizations) without any tax incentives to reward their generosity. Despite the fact that many

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<sup>68</sup> See KOKU ZEI CHŌ TŌKEI NENPŌSHO: HEISEI 2 NENDO HAN [NATIONAL TAX ADMINISTRATION ANNUAL STATISTICS REPORT: 1990] (Koku Zei Chō ed., 1992).

<sup>69</sup> Concerning the figure, see H. Ikeda, *Kōeki Hōjin Gyōsei Ni Okeru Saikin No Jōkyō Ni Tsuite* [Recent Report on Public Interest Corporation Administration], 21 KŌEKI HŌJIN, No. 2, 1992, at 2.

Japanese citizens have been willing to contribute small amounts of money to genuine charitable entities, these "disqualified contributions" are not accurately reflected in government statistics so that figures on individual contributions tend to appear rather low.

## 2. *The Need for a New Approach*

Charitable entities, even those with truly charitable institutions, tend to easily accept large government subsidies and employ former government employees to obtain such subsidies. As a result, they become implementing agencies, a de facto part of government.

As a backlash against the "governmentalization" of philanthropy and in response to the real needs and desires of domestic and international societies, a considerable number of various types of NPOs or NGOs, independent from government control and privately funded, have recently emerged. Their numbers have been gradually increasing.

These NPOs or NGOs are, in many cases, unincorporated. Under Japanese jurisdiction, unincorporated entities are not eligible for tax privileges that incorporated non-profit entities generally enjoy.<sup>70</sup> These unincorporated entities are excluded from corporation tax only on their non-profit primary functions.<sup>71</sup> Accordingly, membership fees and contributions for the non-profit primary function, even if they are surplus not consumed in the relevant year, are not subject to corporation tax. However, under existing tax law, many entities are constrained from carrying on independent or original programs in response to the needs of their constituents.

To cope with the problems of governmentalization, effective countermeasures, including tax incentives, must be taken. One possible solution is to make Japanese charities compete for funds from ordinary citizens by creating tax incentives for contributions to unincorporated NPOs that are not subject to governmental authority.<sup>72</sup> That is, the existing individual

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<sup>70</sup> Unlike incorporated non-profit entities, unincorporated non-profit entities are taxed at the same rate on their for-profit activities as ordinary corporations, and face the same limits on deductibility of contributions. CTL Arts. 3, 7, 37, 66.

<sup>71</sup> CTL Art. 4(1).

<sup>72</sup> Independent type NPOs and NGOs have gradually had stringent financial problems. The government provides various grant programs particularly to NGOs that operate global activities. This is the case with Ministry of Foreign Affairs which offers "Subsidies to Charitable Organizations in Relation to International Development and Cooperation." See, KEIZAI KYÖRYOKU KYOKU SEISAKU KA, GAIMU SHŌ, KOKUSAI KAIHATSU KYÖRYOKU KANKEI MINKAN KŌEKI DANTAI (NGO) JIGYŌ HOJOKIN SEIDO NI TSUITE

contribution deduction structure should be changed so that individual donations to unincorporated NPOs become qualified deductible contributions. The composition of the charitable organization and limits on the size of the deduction, *inter alia*, will require thorough consideration. In addition, the definition of qualified contributions must be reviewed so that genuine public benefit corporations may raise funds from individual citizens, to conduct their philanthropic programs with no strings attached.

### 3. *State of Time Contributions*

Individuals often contribute their services to charitable entities. In Japan, volunteer labor has gradually come to represent an important resource for charitable entities.<sup>73</sup> Since time or service contributions are not tax deductible in Japan, the tax authority does not keep official statistics on the amount of time or service individuals provide to charitable entities.

As mentioned before, corporate programmed volunteering on a collective basis has risen sharply. Unlike in the United States and other jurisdictions, until recently, volunteering has not been popular among ordinary citizens. In fact citizens in Japan seem reluctant to take part in volunteer work. Some authorities attribute that reluctance to religious background, particularly the differences in principles between Buddhism and Christianity.<sup>74</sup> The accuracy of this analysis can not be ascertained. The reluctant attitude toward volunteerism may nonetheless be attributed to governmental policies undertaken to cope with labor shortages during World War II, as well as hand-to-mouth survival after the War.

During World War II, there was a severe labor shortage. Most Japanese private citizens, particularly housewives and students, were forced to participate in government-controlled uncompensated work under labor mobilization programs, or to contribute time or service to government-controlled self-help groups and neighborhood-based organizations. Many citizens, particularly in older generations, still have a negative image of volunteering because of these programs.

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[CONCERNING SUBSIDIES TO CHARITABLE ORGANIZATIONS IN RELATION TO INTERNATIONAL DEVELOPMENT AND COOPERATION] (1993). Note, however, that a deduction delivers more money to charitable entities at a lower cost to the government than would a program of direct grants.

<sup>73</sup> For a detailed analysis on volunteerism in Japan, see BORANTIA HAKUSHO 1992 [WHITEPAPER ON VOLUNTEERING] (Nihon Seinen Hōshi Kyōkai ed., 1992).

<sup>74</sup> See CORPORATE PHILANTHROPY, *supra* note 62, at 209.

Recently, the government and other organizations have actively encouraged participation in domestic and international volunteering, citing Japan's aging problems or the necessity for Japan to assert an international presence.<sup>75</sup> However, many citizens seem somewhat skeptical about the campaign to encourage volunteering. It projects too strongly an image of the "forced volunteering" or "labor mobilization" experienced during the War. If this negative image of volunteering does not improve, even through effective tax incentives to contributions of time, donations of time can not be expected to increase.

#### 4. *Growing Paid Welfare Service*

Continuing growth in the Japanese economy has been founded on the use of vast quantities of labor. Until recently, this practice has kept Japanese unemployment rates relatively low. Large numbers of housewives and students have entered the paid work force and prefer paid work over unpaid volunteering.

Recently, both the national and local governments have tried a variety of strategies to reduce spending on social welfare services. Governments have introduced or increased user charges and "paid-basis welfare service" programs. To implement these paid programs, many local governments have established governmentalized Civil Code Article 34 public interest corporations.<sup>76</sup> Depending on the program, citizens involved with a Civil Code Article 34 corporation may make "time deposits" which may be withdrawn for their own use at some time in the future instead of receiving compensation for the work performed.

The increasing number of such privatized social welfare service programs impedes furtherance of unpaid volunteering. Increasing numbers of "workers cooperatives," in which workers own and control equity in order to increase member welfare by internalizing the conflicts of interest between labor and management, also have an adverse effect on uncompensated volunteering. Many consumer cooperatives have expanded

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<sup>75</sup> See, e.g., *Borantia Katsudō*, ASAHI SHIMBUN, Feb. 28, 1993 (Morning ed.); *Najimu Ka Borantia Hyōka*, ASAHI SHIMBUN, Apr. 8, 1993 (Morning ed.); *Monument Completed for Slain Japanese U.N. Volunteer*, Japan Economic Newswire, Mar. 21, 1994, available in LEXIS, Asiapc Library, Jen File; *Businesses Urged to Take Lead in Social Contributions*, Japan Economic Newswire, Jan. 29, 1992, available in LEXIS, Asiapc Library, Jen File.

<sup>76</sup> For a detailed analysis of this major trend among local governments, see M. Aoyama et al., *Jūmin Sanka Gata Zaitaku Fukushi Saabisu No Suishin [Enhancement of Home Care Welfare Service with Citizens' Participation]*, 69 JICHI KENKYŪ, Feb. 1993, at 109.

their business to social welfare service fields, and have set up various paid-basis service programs or membership welfare service programs. Many housewives actively participate in these programs, rather than volunteering, because of the compensation elements.<sup>77</sup>

Public interest groups have criticized the recent expanded use of paid-basis social welfare programs and Civil Code Article 34 public interest corporations by the government, as well as the increasing growth of workers' cooperatives. However, these developments have received little public attention, particularly the idea of paid volunteering.<sup>78</sup>

### C. *An Agenda for the Reform of Tax treatment of Volunteer Activities*

The deductibility of qualified contributions of money and property is relatively well established in Japan. However, until recently, whether the value of volunteered personal services should be deductible as well has not been considered. Further, unlike in the United States, unreimbursed travel and other out-of-pocket expenditures incurred by a volunteer are not deductible in Japan.<sup>79</sup>

#### 1. *Contribution of Time and Out-of-Pocket Expenses*

It is unclear why Japanese policy does not support charitable contribution deductions for time or service contributions and unreimbursed expenses incurred while serving as a volunteer. However, the theoretical rationale seems to be that time or service contributions have not been taxed as income, and therefore do not need an offsetting deduction. In other words, monetary or property contributions are made with tax-paid money, whereas time or service contributions amount to giving pre-tax value to a charitable entity. This rationale cannot be applied for unreimbursed expenses or out-of-pocket expenses which are made with tax-paid money. Rather, the rationale disallowing the deductibility of unreimbursed expenses

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<sup>77</sup> *Id.* at 116-7. For a detailed analysis of the concept of workers cooperatives or producer cooperatives, see Avner Ben-Ner, *Producer Cooperative: Why Do They Exist in Capitalist Economies?*, in THE NONPROFIT SECTOR: A RESEARCH HANDBOOK 434-50 (Walter W. Powell ed., 1987).

<sup>78</sup> See WHITEPAPER ON VOLUNTEERING, *supra* note 73, at 32.

<sup>79</sup> Japan only allows individuals to deduct for "approved contributions" to: (1) the government or municipalities; (2) organizations designated by the Minister of Finance; or (3) contributions to the Japan Red Cross or to schools or corporations for scientific or educational purposes as defined in the Cabinet Order on Income Tax. I.T.L. Art. 78. See *supra* note 49. See also 26 C.F.R. § 1.170A-1(g), *supra* note 67 (U.S. rule on deductibility of out-of-pocket expenses incident to the performance of volunteer activities).

seems to rest on the administrative difficulties in determining whether these out-of-pocket expenses were spent for private household consumption or for qualified volunteer activities.<sup>80</sup>

As mentioned above, paid volunteering has gradually spread throughout local communities due to the recent development of privatized social welfare service programs. Critics argue that paid volunteering is irrational because it conflicts with fundamental principles of volunteerism. Rather than paid volunteering, a better policy choice is to allow the deductibility of qualified contributions of time and service.<sup>81</sup> This view seems notable, but its validity needs to be examined as a tax theory question.

On the other hand, legislative care must be taken concerning the deductibility of unreimbursed expenses incurred while volunteering without compensation. Theoretically it is rational that unreimbursed expenses, made from after-tax money, should be deductible as qualified contributions.

## 2. *Volunteer Activities by Dependents*

Another problem is volunteer work performed by a taxpayer's dependents. In general, a dependent spouse or child has more spare time in which to volunteer. When a dependent contributes service to a qualified charitable entity and incurs unreimbursed expenses, the taxpayer supporting the dependent should be allowed to deduct these expenses as a charitable contribution for the relevant tax year.

Under the existing law, if the taxpayer first contributes the amount of cash equivalent to these unreimbursed expenses to the charitable entity, and the dependent is reimbursed that amount from the charitable entity for his or her volunteer services, the taxpayer may claim a deduction for the amount of contribution equivalent to the unreimbursed expenses.<sup>82</sup>

## 3. *The Need for Carryovers*

Under the existing law, when the contributions are not fully deductible in the tax year they are made, the excess cannot be carried over

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<sup>80</sup> In fact, there has been no academic argument in Japan on this point until recently.

<sup>81</sup> See Koji Ishimura, *Borantia Katsudō To Zeisei (Ka): Amerika Zeisei To No Hikaku Ni Oite [Volunteering and Taxation (Part II): American-Japanese Comparison]*, 22 KŌEKI HŌJIN, No. 6, 1993, at 17.

<sup>82</sup> The unreimbursed expenses would be deemed a direct contribution to the charitable entity. ITL Art. 78.

to succeeding years.<sup>83</sup> This treatment is criticized for its adverse effect on volunteering, particularly for such people as new graduates and salaried workers who wish to stop working for a period to join a volunteer program. If carryover is permitted, it will provide a useful incentive to those volunteers because they will be able to deduct unreimbursed out-of-pocket expenses incurred while volunteering, even after returning to a paid position.

#### 4. *The Need for Systematic Reform*

As a general rule, employment income earners in Japan claim the standard employment income deduction.<sup>84</sup> Only those employment income earners whose expenditures exceeds the standard deduction amount are entitled to specified itemized deductions (SID) of employment expenses.<sup>85</sup>

Japan has a short history of allowing itemized deductions. Until 1988, Japanese employment income earners were not entitled to claim ordinary and necessary business expenses in computing their employment income. In the 1987 Tax Reform, the government, under pressure from the labor force, introduced the new scheme for itemized deductions, which theoretically incorporated the notion of "ordinary and necessary expenses."<sup>86</sup> However, the Ministry of Finance feared that tax offices would be inundated with taxpayers requiring assistance with filing their final tax returns.

<sup>83</sup> ITL Art. 78 has no provision for a carryover. Under Art. 78, the annual limit on the deduction is the amount of the contribution in excess of ¥10,000. In addition, the allowable amount for contributions may not exceed 25% of the taxpayer's total annual income.

<sup>84</sup> ITL Art. 28(2) and (3). Under the standard employment income deduction, the deductible amounts depend on gross employment income and are computed as follows:

Amounts of Gross Employment Income (Yen)	Formulae (GEI = Gross Employment Income)
¥1,650,000 or less	GEI x 0.4 (but at least ¥650,000)
over ¥1,650,000 to ¥3,300,000 or less	¥660,000 + (GEI - ¥1,650,000) x 0.3
over ¥3,300,000 to ¥6,000,000 or less	¥1,155,000 + (GEI - ¥3,300,000) x 0.2
over ¥6,000,000 to ¥10,000,000 or less	¥1,695,000 + (GEI - ¥6,000,000) x 0.1
over ¥10,000,000	¥2,095,000 + (GEI - ¥10,000,000) x 0.5

For a theoretical analysis of the standard employment income deduction, see Hirohisa Kitano, *Kyūyo Shotoku No Hitsuyō Hi* [Necessary Expenses Concerning Employment Income], in 3 NIHON ZEIHŌ TAIKEI 3 (Hirohisa Shimada ed., 1980).

<sup>85</sup> ITL Art. 57-2.

<sup>86</sup> For a historical analysis, see HIROHISA KITANO, SARARIIMAN ZEIKIN SOSHŌ [TAX LITIGATION BY SALARIED WORKERS] (rev. ed. 1990).

This concern about administrative overload reflects an unwillingness to change the status quo. In Japan the long-established practice for employment income earners has been to not require a final tax return if certain criteria are met, that is, if gross income falls under 15 million yen<sup>87</sup> and there are no complex personal deductions (e.g., medical expenses or charitable contributions).<sup>88</sup> Instead of a final tax return, the employer of such a taxpayer is required to carry out the year-end adjustment procedure, under which the employee's total annual tax liability is calculated and an appropriate adjustment is made to the amount of tax withheld in the final pay period for the year.<sup>89</sup> Typical investment income, including interest<sup>90</sup> and limited amounts of dividends,<sup>91</sup> are subject only to withholding tax, levied at lower rates. Similarly, normal personal deductions, including deductions for social insurance premiums,<sup>92</sup> life insurance premiums,<sup>93</sup> or casualty insurance premiums<sup>94</sup> are deductible through the year-end adjustment procedure.

As a result, the income tax liability of the vast majority of employment income earners is finalized by the year-end adjustment procedure. Those taxpayers who do file returns are generally those who have capital gains or rental income or who claim personal deductions which are not subject to the year-end adjustment procedure.<sup>95</sup>

Since the introduction of the SID scheme in 1988, the number of taxpayers who qualify for it was only sixteen in 1989, five in 1990, nine in 1991 and eight in 1992 among approximately forty million employment income taxpayers.<sup>96</sup> These figures demonstrate the strategy of the Ministry of Finance, which impracticably imposed severe requirements on itemized deductions, including limitation of deductions under the SID scheme to a few items and stipulation of severe ceilings for these limited items<sup>97</sup> in order to prevent a flood of final tax return filings. Critics claim that the

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<sup>87</sup> ITL Art. 121.

<sup>88</sup> ITL Arts. 73, 78.

<sup>89</sup> ITL Arts. 190-192.

<sup>90</sup> *Sozei Tokubetsu Sochi Hō* (Special Measure Taxation Law), Law No. 26 of 1957, Art. 3.

<sup>91</sup> *Id.* Art. 8-5.

<sup>92</sup> ITL Art. 74.

<sup>93</sup> ITL Art. 76.

<sup>94</sup> ITL Art. 77.

<sup>95</sup> *See* ITL Art. 120.

<sup>96</sup> *See* KOKU ZEI CHŌ TŌKEI NENPŌSHO: HEISEI 2 NENDO HAN [NATIONAL TAX ADMINISTRATION ANNUAL STATISTICS REPORT: 1990] (Koku Zei Chō ed., 1992).

<sup>97</sup> ITL Art. 57-2; ITL Enforcement Order Art. 167-3.



1988 reform to set up the SID scheme was mere lip service to the demand of academia and the work force.<sup>98</sup>

Despite the 1988 reform, most ordinary taxpayers are still not required to go to the tax office to file their returns. In fact, the government tends to discourage people from visiting the tax office. Consequently, even private citizens who make charitable donations are not willing to file a final tax return merely to claim charitable contribution deductions, except in certain cases when the taxpayer is required to report capital gains or other reportable income incurred anyway.

Taking all these circumstances into consideration, one important step to further individual philanthropic activity seems to be securing for employment income taxpayers the right to easily claim charitable contribution deductions by reforming the existing SID scheme. In addition to the present items in the SID scheme (e.g., commuting fees; travel expenses for removal; study and training fees; fees for acquiring qualifications; and travel expenses incurred in returning to the family home, when the taxpayer's job requires him or her to temporarily live away from home), other ordinary and necessary employment-related expenses should be generally allowed.<sup>99</sup> Presently, in addition to the "ordinary and necessary expense" requirement and "directly relatedness" requirement, there are several other restrictions in the application of the SID scheme.<sup>100</sup> The unreasonably burdensome or impractical restrictions should be lifted so that ordinary salaried workers may easily choose the SID scheme.<sup>101</sup>

As mentioned, presently some personal deductions are allowed in the year-end adjustment procedure. This is the case with various insurance premiums. For the convenience of taxpayers who are not entitled to the SID scheme, small charitable contribution deductions (i.e., less than 100 thousand yen), should be allowed through the year-end adjustment procedure.

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<sup>98</sup> See generally 3 NIHON ZEIHŌ TAIKEI 142 (H. Kitano ed., 1980).

<sup>99</sup> ITL Art. 57-2.

<sup>100</sup> ITL Art. 57-2; ITL Enforcement Order Arts. 167-3, 167-4 and 167-5; Shotoku Zei Hō Shikō Kisoku (Regulation Concerning Implementation of the Income Tax Law), Ōkura Shōrei No. 11 of 1965, Arts. 36-5, 36-6 [hereinafter ITL Regulation].

<sup>101</sup> Note that in its 1978 Income Tax Reform Proposal the Japan Social Democratic Party recommended insertion of the provision "unless stipulated otherwise, traveling, commuting, clothing, study and training, and other expenses that are directly attributable and necessary for acquiring gross employment income, except expenditures reimbursed or not incurred in the relevant taxable year." See generally NIPPON SHAKAI TŌ [JAPAN SOCIAL DEMOCRATIC PARTY], SHOTOKU ZEI HŌ NO ICHIBU O KAISEI SURU HŌRITSUAN YŌKŌ [PROPOSAL TO AMEND PART OF THE INCOME TAX LAW] (1978).

As previously suggested, "unreimbursed expenses" incurred while volunteering without compensation should be deductible as qualified charitable contributions. Even though this proposal has become a reality, since most Japanese individual taxpayers are employment income taxpayers who do not file a final tax return, the deduction is of no practical use. In this regard, drawing some analogy between "unreimbursed expenses" for volunteering and "ordinary and necessary expenses" for calculating employment income may be necessary.

## V. INTERNATIONAL TAX ASPECTS

In Japan, as in many other countries, the charitable tax scheme was originally designed to apply to domestic entities and donations. In recent years global operations of charitable entities and cross-border donations have greatly increased. However, unlike in the for-profit sector, the media of bi-lateral or multi-lateral treaties do not offer solutions to the problems this situation presents.<sup>102</sup> Japan's bilateral tax treaties do not deal specifically with the non-profit sector. At the present stage, only limited unilateral measures, far from comprehensive, may be found under Japanese tax law and practices.

### A. *Tax Treatment of Domestic Activities of Foreign Charitable Organizations.*

In recent years, many foreign charitable organizations, aside from being incorporated or unincorporated in the home country, have extended their operations to Japan. Some operate only fund-raising activities. Others operate their primary functions in the Japanese communities.<sup>103</sup> Japanese tax treatment of foreign charitable organizations depends on the form of the entity and its domestic (Japanese) operations.

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<sup>102</sup> For an accessible survey of some of the main issues, see Jonathan S. Schwarz, *International Tax Aspects of Charities: General Report*, 43 BULL. INT'L BUREAU FISCAL DOCUMENTATION 539.

<sup>103</sup> There is no official statistic on the operation of foreign charitable entities. However, Japan's recent economic rise in international society has attracted fund-raising operations of foreign charitable entities. They sometimes criticize Japan for imposing a non-tariff barrier, insofar as it requires foreign charitable entities to conform with Japan's philanthropic system, including treatment of taxes.

### 1. *Tax Treatment of a Subsidiary*

In general, a foreign charitable organization which proposes to operate in Japan must form an unincorporated subsidiary. Among these organizations are Amnesty International Japan,<sup>104</sup> Greenpeace Japan, and World Wildlife Fund, Inc. Since stringent approval procedures have to be followed in forming a Civil Code Article 34 Corporation and the primary function of an unincorporated organization is tax exempt per se, only limited numbers of foreign subsidiaries have sought to be incorporated.<sup>105</sup>

Under the Japanese rule, a wholly controlled Japanese subsidiary of a foreign charitable organization, although not incorporated, is treated the same as a domestic unincorporated organization for charitable taxation purposes.<sup>106</sup> These unincorporated subsidiaries may conduct many of their activities with wide discretion, and are not required to register at the National Registry.<sup>107</sup>

### 2. *Recognition of Tax-Exempt Status of Foreign Charitable Organizations*

Under the Japanese rule, foreign organizations, whether for-profit or not-for-profit, incorporated or unincorporated, are generally subject to the withholding tax on "domestic (Japanese) source income."<sup>108</sup> The scope and rates of taxes depend on the category of income, whether the organization has a Permanent Establishment — i.e., a branch office or fund-raising man-

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<sup>104</sup> Recently Amnesty International Japan, an unincorporated organization, has applied to the Ministry of Foreign Affairs for Civil Code Article 34 Corporation status.

<sup>105</sup> Until recently, relevant authorities have shown some hesitation in the approval of incorporation of a Japanese subsidiary of foreign charitable organizations. Presently, the government appears rather eager in the approval of incorporation of subsidiaries of prominent international entities such as the World Wildlife Fund (WWF) or Earth Watch.

<sup>106</sup> In both cases, the entities are treated as unincorporated organizations under CTL Art. 2(8). Like public interest corporations, both entities are taxed only on income derived from profit-making activities. CTL Art. 4(1). However, they are treated as corporations for tax calculation purposes, and thus face the same tax rate as ordinary corporations and the same limits on deductible contributions. See CTL Arts. 3, 7, 37, 66.

<sup>107</sup> Only for-profit corporations, public interest corporations, and other incorporated organizations are required to register. The National Registry lists corporate management, structure, and capital information on all incorporated entities, and can be searched at the Legal Affairs Bureau of the region where the head office of the corporation is located. See generally Malcolm Smith, *Commercial Law, in JAPAN BUSINESS LAW GUIDE (CCH)* ¶ 17-910.

<sup>108</sup> CTL Art. 138; ITL Art. 161; ITL Art. 5(2).

aging office.<sup>109</sup> For example, the "income derived from the donation of assets in Japan" is classified as "domestic source income" and is subject to the corporation tax irrelevant to whether it has a Permanent Establishment or not.<sup>110</sup> Under this rule, when a branch office of the foreign charitable organization that has a tax-exempt status in the home country carries out the fund-raising activity in Japan, the donated money is generally subject to the corporation tax because the non-profit status of the home country is not automatically recognized in Japan. This tax treatment seems considerably inconvenient. However, there has been no bilateral measure to recognize the tax-exempt status of each other among tax treaties concluded with foreign nations in Japan.

At present, only unilateral relief is available for this situation. A foreign charitable organization which is equivalent to Japan's public benefit corporation may ask for recognition (*shitei*) of tax-exempt status upon application to the Ministry of Finance under the CTL<sup>111</sup> and/or the ITL.<sup>112</sup> When the applicant entity obtains recognition under the CTL, the entity is treated as a public benefit corporation, and thus the Japanese source income (surplus) derived from its primary function is not subject to the corporation tax. On the other hand, an entity that obtains recognition under the ITL is not subject to the withholding tax on certain investment income (i.e., interest and dividends), which is attributed to its primary function.<sup>113</sup> Otherwise, Japanese source income derived from a taxable profit-making business and certain investment income attributable to a taxable profit-making business are subject to taxation respectively.

### B. Contributions to Foreign Charitable Organizations

Qualified contributions to domestic charitable organizations are generally tax deductible. Thus, direct contributions to foreign charitable organizations are not generally subject to a charitable contribution deduction, except certain corporate contributions as a business expense. This tax

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<sup>109</sup> CTL Art. 141; ITL Arts. 178-180. Also, notice the relevant tax treaty between Japan and the country of the parent organization. *Sozei Jōyaku No Jisshi Ni Tomonau Shotoku Zei Hō, Hōjin Zei Hō Oyobi Chihō Zei Hō No Tokurei Nado Ni Kansuru Hōritsu No Shikō Ni Kansuru Shōrei* (Special Case Order Concerning Income Tax Law, Corporation Tax Law and Local Tax Law in the Implementation of Tax Treaties), Ōkura-Jichi Shōrei No. 1 of 1969, Art. 2.

<sup>110</sup> CTL Art. 141; CTL Enforcement Order Art. 187(1)(iv).

<sup>111</sup> CTL Arts. 2(5), 4(2); CTL Enforcement Order Art. 3; CTL Regulation Art. 3.

<sup>112</sup> ITL Art. 11(2); ITL Enforcement Order Art. 51-5.

<sup>113</sup> ITL Art 11.

treatment also applies to contributions made to foreign charitable organizations which have acquired the aforementioned recognition of the Ministry of Finance. At present, the Japanese government has made no effort to expand the availability of the charitable contribution deduction for income tax and corporation purposes through the media of bilateral treaties.<sup>114</sup>

It is a well-established rule that qualified contributions made to Japanese charitable organizations carrying on their charitable activities abroad are tax-deductible.<sup>115</sup> In extension of this rule, as a unilateral measure and an administrative solution, the Japan Foundation has long been used to raise funds as a mere conduit or a nominal donee for foreign charitable recipient organizations<sup>116</sup> such as the Foundation for the Support of the United Nations, Inc., which is founded under New York state law and tax-exempted under the U.S. Internal Revenue Code.<sup>117</sup> In this scheme, a charitable deduction is allowed for a contribution to the Japan Foundation that raises funds for the U.N. Foundation. It should be noted, however, that the Japan Foundation holds a unique position as an implementing agency. Generally, Japanese corporations of a public charity nature which are originally incorporated to raise funds for foreign charitable recipients play the role of more than nominal donee. These corporations have reviewed and approved specific projects of foreign applicant organizations and have concluded that the applicant proposals further their own primary purposes.<sup>118</sup> This is the case with the Japan Center for International Communications, Inc. (JCIC, *Shadan-hōjin-kaigai-kōhō-kyōkai*)<sup>119</sup> or the Council for Better Corporate Citizenship, Inc. (CBCC, *Shadan-hōjin-kaigai-jigyō-kastsudō-kyōgikai*).<sup>120</sup>

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<sup>114</sup> For a more detailed analysis on cross-border donations, see Klaus Neuhoff, *Multilateral and Bilateral Solutions to Problems Concerning Charitable Contributions*, in INTERNATIONAL TAX PROBLEMS OF CHARITIES AND OTHER PRIVATE INSTITUTIONS WITH SIMILAR TAX TREATMENT 18 (1986).

<sup>115</sup> CTL Art. 37, governing deductibility of corporate donations, has no restrictions on donations to entities operating off-shore. Of course, the donation must still be made to a qualified entity in accordance with CTL Art. 37(3).

<sup>116</sup> See Kokusai Kōryū Kikin Tokutei Kifukin Toriatsukai Kitei (Japan Foundation Regulations for the Administration of Designated Donations), Kitei No. 4 of 1984.

<sup>117</sup> I.R.C. § 501(c)(3). See also FOUNDATION FOR THE SUPPORT OF THE UNITED NATIONS, A GUIDE TO THE FOUNDATION FOR THE SUPPORT OF THE UNITED NATIONS, INC. (Kokuren shien kōryū zaidan no an'nai).

<sup>118</sup> See *Kaigai Kōken Zeisei Staato [Start of Overseas Donation Tax System]*, 19 KŌEKI HŌJIN, No. 8, 1990, at 23.

<sup>119</sup> See JAPAN CENTER FOR INTERNATIONAL COMMUNICATIONS, A GUIDE TO THE JAPAN CENTER FOR INTERNATIONAL COMMUNICATIONS.

<sup>120</sup> See COUNCIL FOR BETTER CORPORATE CITIZENSHIP, A GUIDE TO THE COUNCIL FOR BETTER CORPORATE CITIZENSHIP. Critics argue that the real aim of these organizations is to buy "an international

## VI. CONCLUSION

The size and scope of Japan's philanthropic and non-profit activity has increased not only domestically but also internationally over the past few years. Government policy toward volunteerism has been influential and has changed the quantitative operation of charitable entities. For example, direct government subsidies tend to induce charities to follow government planned programs as well as partisan politics. Similarly, government policy toward the formation and regulation of charitable organizations induce these entities to become a de facto part of the government. In fact, the governmentalization of charitable entities in Japan is a questionable practice.

The effect of tax policy on charitable entities and charitable giving is not fully understood, but appears to be highly influential. Tax policy on charitable entities and charitable giving is of great importance in encouraging genuine charitable activities and thereby fostering Japan's independent sector. Particularly, it should be noted that charitable contribution deductions will result in greater independent funding of charitable entities at lower cost to the government than the current major program of direct subsidies.

Encouraging international philanthropy is imperative for any advanced nation. New initiatives can be expected to deal with increases in cross-border activity by charitable organizations and in cross-border contributions. Corresponding to its rise as a world economic leader, Japan must also assert its social presence by playing a leading part in these issues, proposing bilateral solutions as well as multilateral ones.

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reputation of the Japanese mega-corporations" disseminating nominal percentage of their profit in order to cope with pressure from various U.S. circles and thus most grants have been given to U.S. recipient organizations. It should be noted that, as a matter of fact, this contribution scheme was put in practice as a joint work with business circles (Keidanren) and the Ministry of International Trade and Industry (MITI, Tsūshō-sangyō-shō) to cope with the then "Japan bashing" by U.S. political circles.

