Note: Informal summary of the report. For nuance and complete information, please refer to the Japanese original (1)*.*

Basic Policy in Formulating FY2003 Tax Reform (Summary)
Report submitted by the Tax Commission to Prime Minister Junichiro Koizumi
19 November 2002

- According to the instruction by Prime Minister Junichiro Koizumi in January, the Tax Commission studied comprehensive tax reform from the medium to long-term viewpoint and published 'Policy Guidance on the Establishment of a Desirable Tax System' (Policy Guidance) in June (2). From March to October, the Commission held 'town tax meetings' at twelve venues throughout Japan in order to solicit the views of the general public.

- The Prime Minister instructed the Commission to study some specific items to be incorporated in the fiscal 2003 (Heisei 15) tax reform. Among the items in the 'Policy Guidance', the Commission conducted its deliberation on items to make up the fiscal 2003 tax reform, with a focus on the items instructed by the Prime Minister, and released this report.

(Reference)
- In the course of deliberations, the commission published the Interim Report in September, taking into account the results of the exchanges of views at the town tax meetings.
- In October, remarks by chairman Ishi on the framework of tax incentives for R&D and investments in plants and equipment were released.

I. Basic Thinking

(1) Steps toward establishment of a desirable tax system

- Five viewpoints for establishment of a desirable tax system outlined in the 'Policy Guidance' in June 2002
  - Taxation should not distort free economic activities
  - Tax treatments that cause distortion and a sense of inequity in the tax system should be rationalized
  - Tax system should be simple and easily understandable for taxpayers
  - Tax system should provide stable revenue structure
  - Local taxation should meet needs of enhanced local autonomy

- Main items for each tax in FY2003 Tax Reform.
  - Individual income tax: As a first step towards streamlining of exemptions, special exemption for spouse and special exemption for dependants should be drastically simplified (including possible abolishment).
  - Corporation tax: Tax incentives for R&D and focused investment incentives should be enhanced.
  - Consumption tax: As prerequisites to strengthening its role in the future tax system, the tax-exempt threshold (Y30 million) should be drastically reduced and the simplified regime (Y200 million) should be abolished in order to reduce the sense of unfairness.
  - Gift tax and inheritance tax: In addition to existing gift taxation on an annual basis, gift taxation on a cumulative gift/inheritance basis at the time of paying inheritance tax (i.e. integration of gift and inheritance taxes) should be introduced from the viewpoint of facilitating the transfer of assets from the older generation (i.e. parents) to the younger generation (i.e. children). The top rate of inheritance tax should be cut and the tax base should be broadened. Current annual basis gift tax should be reviewed accordingly.
  - Taxation of corporations by the size of their businesses (local tax) should be introduced.
  - Property tax (local tax): The level of tax burden on each type of property should be adjusted in a homogeneous and appropriate way.
  - Land taxation: Registration and licence tax as well as land acquisition tax should be reduced in order to promote efficient use of land, such as urban renewal.
  - Taxation of financial assets and stocks: The tax system should be changed to be more simple and neutral in its treatment of different financial products.

(2) Basic thinking in FY2003 tax reform

The Prime Minister stated as follows in his policy speech at the beginning of the 155th Session of the Diet (Oct. 2002): "With regard to taxation, we will conduct sweeping tax reform with a view to establishing a desirable tax system that will bring about a sustainable revitalization of the economy and society. Taking into account the current economic environment, we will initiate a tax reduction, exceeding one trillion yen by as much as possible. Under the framework of a multiple-year, revenue-neutral tax reform, we will further conduct examination to formulate and submit a package of tax reform bill(s) to the next general session of the Diet with a view to establishing a tax system that is fair, simple and easy to understand."

(1)http://www.mof.go.jp/singikai/zeicho/tosin/141119a.htm
(2) http://www.mof.go.jp/english/tax/e020614a.htm
http://www.mof.go.jp/singikai/zeicho/top_zei2.htm

The Tax Commission considers that the above-mentioned items of the proposed tax reform should be carried out, in principle, in fiscal 2003.

However, given the current economic situation, the timing of implementation of each item may be adjusted to frontload tax reduction measures.

It is important to present to the general public a clear picture of the sustainability of public finance so that the tax reduction can achieve the desirable effects of stimulating consumption and investment. Therefore, the tax reform should be revenue-neutral over a certain period of time and all the reforms should be made into one bill. This policy does not bind further tax reform after FY2004.

II. Discussion on the Elements in FY2003 Tax Reform

(1) Individual income tax:

- Special exemption for spouse should be in principle abolished. Special exemption for dependents (Age 16-22) should be reduced or abolished. A further cut in tax rates would be inappropriate.

(2) Corporation tax

- Given the effectiveness of the current incremental R&D tax credit, proportional R&D tax credit should be introduced on a permanent basis. Focused investment tax incentive should be introduced on a temporary basis. Taxation for SMEs should be reviewed to improve their vitality. The criteria for eligible non profit-making corporations should be reviewed. Taxation of corporations in the public interest should be comprehensively reviewed together with taxation of donations, taking account of the ongoing regulatory reforms for those corporations. Taxation of corporations by the size of their businesses (local tax) should be introduced at an early stage. Existing special taxation measures should be reviewed and integrated drastically. Taxation to promote reduction of non-performing loans should be examined as a part of overall policy, taking into account various elements.

(3) Consumption tax (VAT)

- The level of tax-exempt threshold (Y30 million) should be drastically reduced. Corporations should basically be excluded from having tax-exempt vendor status. The simplified regime (Y200 million) should in principle be abolished.

(4) Taxation of property

- Gift tax and inheritance tax: As the society is aging, transfers of assets from parents to the next generations take place at the later stage of people's lives. Efficient use of the assets of elder people could contribute to the vitalization of the economy and society. Against such backgrounds, measures to integrate inheritance and gift taxes should be introduced in the fiscal 2003 tax reform.

  The tax base of inheritance tax should be broadened through measures such as reduction of basic exemption. The highest tax rate (currently 70%)—which is significantly higher than the top rate for individual income tax (50% including local tax) and those in other countries—should be cut while keeping the overall redistribution function of the inheritance tax. The tax rate structure of the current annual basis gift tax shall be reviewed in accordance with the changes made in inheritance tax rates.
- Property tax (local tax): The level of tax burden on each type of property should be adjusted in a more homogeneous and appropriate manner.

(5) Taxation of land

- Given the current trend in which market prices of land are increasingly dependent on the use and profitability of the individual land, the tax burden of registration and licence tax as well as land acquisition tax should be reduced in order to promote efficient use of land, such as urban renewal.

(6) Taxation of financial assets/stocks

- Simple and stable tax treatment of financial assets and stocks is desired under the current 'from deposits to investments' policy needs. Taxation of financial assets and stocks should be changed to ensure a neutral effect on different types of assets and so that unified tax treatment is applied as much as possible.

(7) Other taxes

- Liquor tax: The tax categories for liquor should be simplified and the inequity of burdens between the tax categories for liquor should be reduced.
- Tobacco tax: The appropriateness of a tax rate increase should be examined.
- Earmarked tax and energy taxes: Earmarking of energy taxes should be reviewed. Temporary surtax on gasoline should be maintained.
- Taxation and the environment: Examination of introducing environmental tax should be continued based on the Polluters Pay Principle.
- International taxation: Access by the tax authorities to information on cross-border transactions should be enhanced.

(8) Tax compliance

- e-Filing: A new system for filing tax returns and paying tax over the Internet should be introduced.
- Publication of large taxpayers should be reviewed from the viewpoint of privacy including its possible abolishment.