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Basic Idea for Fundamental Reform of Tax System

Tax Commission

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Preface

This recommendation report describes the basic idea about the overall picture of a desirable tax system from the medium- to long-term perspective that the Tax Commission has developed in accordance with the inquiry of the Prime Minister in November 2006. In preparation for drafting this report, the Commission has carried out research and analysis to determine what affect the tax system can and will have on the economy and public finance. Based on the findings of that research and analysis, since September this year the Commission has conducted a series of deliberations to comprehensively explore the desirable form of an overall tax system that should accommodate structural changes in Japan's economy and society in the 21st century. In the process, the Commission has identified and focused on the roles that should be assigned to each tax item.

This report summarizes in the form of a recommendation the outcome of the deliberations, including the arrangements that during fiscal 2008 expire or require action to respond to new systems. The Commission trusts that the government will consider and appropriately decide on a timeline to implement the specific recommendations contained in this report from fiscal 2008 onwards.

Whatever course is taken, there is certainly not much time left in view of the diverse socioeconomic structural changes and accompanying the challenges facing Japan, starting with the need to ensure a stable revenue source for social security that sustains the lives of its people. The longer reform is delayed, the bigger the challenges that are difficult to overcome will grow. Subject to public approval, a fundamental reform of the tax system needs to be implemented as immediately as possible. The Commission is eager to see that this report provides a roadmap to facilitate constructive discussions in all walks of life, leading to the establishment of a desirable tax system.

Part 1 General Observations

I. Pursuing Fundamental Reform of Tax System

With the curtain up on the new century, and an era of rapid change setting in, a pressing policy priority facing Japan is a fundamental reform of its tax system. A retrospective look at Japan's tax regime reveals a chronology of efforts to pursue a desirable tax system suited to then-prevailing socioeconomic realities by continuing with fundamental reforms, including the adoption of consumption tax in 1989 and the flattening of the progressive structure of individual income tax. Still, these fundamental reforms have been followed by rapid structural changes sweeping across Japan's economy and society.

An analysis of these structural changes pinpoints two major factors.

The first is the development of an aging society with fewer children at a speed unprecedented among the major developed countries and the beginning of Japan's transformation into a super-aged society with a shrinking population. The time is approaching when the baby-boomer generation will reach the eligible age to receive basic old-age pension, and with the birthrate continuing to decline, the population has begun shrinking after peaking in 2004.

The second is the accelerating globalization of the economy. The integration of world markets has prompted free movements of people and capital across national borders, greatly transformed the way enterprises operate, and increased the intensity of global competition. While the accumulation of wealth in the economy has increased the importance of its efficient use, fluctuations in asset prices now have a bigger effect on the economy and society.

The demographic aging and declining birthrate has led to increased social security benefit payments particularly under the old-age pension, medical-care, and nursing-care programs. Since the 1990s, an almost doubling of social security benefit costs during this period has put additional spending pressure on the nation's public finances, which have been weakened by stepped-up public works spending and tax reductions in the face of economic doldrums. In fiscal 2007, taxes accounted for no more than slightly over 60 percent of total national revenue, and the national and local governments' combined debt balance reached ¥773 trillion (148% of the nation's GDP). This fiscal situation calls into question the sustainability of the social security regime and gives rise to great insecurity and confusion among people of all stripes about their future. Procrastination in tackling this serious fiscal situation, allowing the debt balance to swell beyond its present level, would undermine global confidence in Japan's economy.

Meanwhile, in conjunction with the globalization of markets and the stagnation of the Japanese economy, one issue became the subject of much discussion and became referred to as *kakusa* or a gap. Such gaps widened in various aspects of society, particularly between the metropolis and the countryside, between large and smaller businesses, and between workers in different forms of employment. Especially as the phenomena coincided with the economic doldrums, people became increasingly concerned that the gaps might become fixed and permanent, and the government faces an important challenge in sincerely tackling this public concern.

Maintaining and enhancing the vitality and strength of the economy and society is a point of view essential to overcoming these two problems.

Looking at history reveals that after World War II Japan faced the problem of a two-tier industry in terms of corporate size, and a two-tier labor market in terms of employment and work patterns. However, that problem resolved itself considerably because the economy grew exponentially, and during the same period Japan established universal health insurance, universal pensions, and other social security infrastructures. Historically the economy's growth not only has increased individuals' income but also contributed to resolving issues related to the distribution of income and establishing and enhancing social security systems. Obviously the importance of cultivating the foundation of growth holds true now and will continue to do so in the future. Yet, Japan's economy today is not in a catch-up phase, as it was during its erstwhile high-growth period, relative to the industrialized world, but faces fierce global competition as it runs at the forefront of technological innovation. Continuous sincere efforts are needed to increase its growth potential.

Going hand in hand with socioeconomic structural changes, recent years have seen society embracing a more diverse set of values, exercising a wider choice about marriage, child bearing and rearing, and so forth. Changes in the way families function have meant an increased proportion of double-income households and single-person households, and the transformation of the labor market has visibly changed the traditionally Japanese practice of guaranteeing long-term employment. These changes in institutions and practices are blamed for lying behind the shrinking population and the gap phenomena, but at the same time, they provide opportunities for individuals to realize and put to full use their potential. A framework of conditions that encourage individuals to get further engaged in society should be developed in order to build a vibrant and strong society and shake off the mindset of being stuck in a dead end. It is important to step up these efforts to invigorate society in ways that invigorate the economy.

As clear from the above discussion, in the face of difficult fiscal realities the tax system now needs to tackle the major challenges facing the nation as a result of socioeconomic structural changes, particularly the demographic aging with a declining birthrate and the globalizing economy. These come down to ensuring a stable revenue source for social security, resolving the so-called *kakusa* phenomena, and enhancing the economy's growth potential. In the interest of overcoming these challenges, what is called for now is a fundamental overhaul of the way the overall tax system is structured from a medium- to long-term perspective.

II. Viewpoints and Specific Directions of Fundamental Tax System Reform

In view of the tax system's need to accommodate diverse socioeconomic structural changes, as discussed in I., designing the desired fundamental reform of the tax system that is based on the three-pillar taxation principle of "fairness, neutrality, and simplicity" calls for the following three viewpoints to be adopted:

1. A tax system that supports the safety and security of the people;

2. A tax system that enhances the vitality and strength of the economy, society, and communities; and

3. A fair tax system that gains the trust of the people and taxpayers.

1. A Tax System that Supports Safety and Security of People

People share the tax burden in the hope that they can lead safe and secure lives in the society in which they live. As the population ages and the birthrate declines, making provisions for illness and old age is increasingly a matter of public concern, and the need for mutual support among people has never been stronger. It is widely understood that social security programs, including medical care, old-age pension, and nursing care, provide the foundation of the society in which people live and support each other. A social safety net that is really needed should be guaranteed by social security, and actually, Japan today has social security play a major role in the redistribution of income among individuals.

Making this social security function sustainable and reliable and comfortable over a long future period is extremely important, and actually, that is high on the wish list of many Japanese. The social security regime is supported by public expenditures that are funded by taxes, in addition to social insurance premiums[1], and the amount of appropriations for this is

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[1] Currently social security benefits rely on taxes (pubic finance) for a substantial part of funding. In fiscal 2007, social security benefit expenditures amounted to ¥93.6 trillion (pensions ¥49.5 trillion, medical care ¥28.7 trillion, nursing care ¥6.8 trillion), of which ¥55.4

large, claims a high percentage of the budget, and is projected to continue to increase substantially. On the question of striking a balance between social insurance premiums and tax contributions, there has been legislation to increase the national treasury-funded share of the basic old-age pension from a third to a half, and some even propose that pensions should be covered totally by public funding. In any case, establishing a stable tax-revenue structure designed to use the tax system to support the social security regime is an urgent priority that must be tackled before people can lead secure and comfortable lives.

In particular, there is legislation stating that the above-noted expansion of the treasury-funded share of the basic pension to a half must be carried out by fiscal 2009 after ensuring a stable revenue source as a result of a fundamental reform of the tax system. Immediate action needs to be initiated.

Furthermore, the burden of medical-care, nursing-care, and other social security benefits on the public treasury is projected to continue to increase as the population ages further[2]. Yet, the public finances are already burdened with huge debts even before they can provide support for this public spending. Notwithstanding this, due consideration should be given to the fact that failure to take necessary action now would cause a further expansion of the increase in the burden that is required at a future time[3], which would run counter to intergenerational fairness.

Needless to say, thorough rationalization and streamlining of public expenditures, including social security appropriations, should be pursued for the sake of limiting the increase in the public burden as much as possible. It is equally necessary to make efforts to enhance the economy's growth potential simultaneously. Further, it is extremely important to regain public confidence in government administration services, starting with the resolution of the

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trillion was funded by social security premiums and ¥30.1 trillion was funded by public finance (¥21.9 trillion by national finance and ¥8.2 trillion by local finance).

[2] Ensuring funding to maintain medical-care and nursing-care benefits per recipient until fiscal 2025 without increasing the debt balance as a share of GDP will require a phased increase in taxes totaling between ¥14 trillion and ¥29 trillion by fiscal 2025, according to an estimate submitted by private-sector members to the Council on Economic and Fiscal Policy on October 17, 2007.

[3] An improvement required in the fiscal balance to reduce the debt balance to roughly 60% of GDP by fiscal 2050 will increase by 0.7% (approximately ¥3 trillion to ¥4 trillion) as a result of a delay of five years, according to an estimate submitted to the Fiscal System Council.

current pension records problem. Still, extreme scenarios must be avoided where cuts in essential public spending adversely affect people's quality of life. Considering the expansion in extra cost that could result from procrastination and the need for intergenerational fairness, a revenue source should be established as quickly as possible in order to realize social security benefit payments that are genuinely necessary to ensure people's security and comfort.

A social security infrastructure can be viable only if people come together in support of it. It has never been more essential that the burden is shared broadly and fairly among the people and that "everyone helps to support the system." A fundamental overhaul of the way the overall tax system is organized should be completed as soon as possible in pursuit of establishing a stable tax revenue structure.

Japan's population now is not only aging but also shrinking with its birthrate declining. It is commonly understood that the problem of a society with a shrinking population is an important challenge that should be tackled by unifying the efforts of national and local governments, the private public-interest sector, industry, and so forth. As a step in overcoming the declining birthrate, it is imperative to enable people to achieve an appropriate work-life balance by facilitating a diverse range of comprehensive initiatives, such as reforming consciousness throughout society, evolving people's work styles, and ensuring an enhanced variety of child-care services. It is important to provide for a revenue source for these efforts today without counting on the coming generations to shoulder the burden.

The public finances, which are expected to support people's peace of mind in this regard, are now in dire straits. The government sets itself a medium-term goal in its tax and fiscal reform agenda of first reliably achieving a surplus in the primary fiscal balance[4] by fiscal 2011, and thereafter by the mid-2010s reducing the debt-to-GDP ratio in a stable manner. In view of the status quo where a substantial portion of the fiscal outlays go to social security appropriations, securing a stable revenue source for the social security regime will also contribute to achieving this government goal.

In that process, a revenue source that is appropriate for supporting the sustainability of the social security regime must be identified and established while complying with the call for ensuring intergenerational fairness and examining the distinctive characteristic of each tax item. The Commission emphatically points out that, based on the attributes of consumption

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[4] Refers to the primary fiscal balance given by "tax and other revenues net of borrowing" minus "expenditures net of debt servicing on past borrowing."

tax, which are discussed below, consumption tax should play an important role in providing such a revenue source.

Further, on the issue of using the tax system to respond to the declining birthrate, it is necessary to implement genuinely effective programs, based on the overall discussion on measures to counter the declining birthrate, while also examining the interplay of relevant government policy instruments such as benefits.

Maintaining the safety and security of people's living requires tackling diverse phenomena known as *kakusa*, which are widening as the economy globalizes, to encourage people's hopes and expectations while dispelling people's insecurity about their future. The tax system is expected to play the best role it can in tackling these challenges by appropriately sharing the responsibility with fiscal spending. Certainly, as noted above, social security plays the primary role in this area of redistribution of income among individuals. In addition to supporting the funding aspects of the safety net that is provided by social security, however, the tax system, too, should put to appropriate use its own redistribution function on a standalone basis.

Specifically, it is appropriate to restore a wealth redistribution function of inheritance tax, in order to prevent the wealth gap from transcending generations and becoming hereditary, by adopting the notion of settling the cost burden borne by society to cover the benefits that deceased parties received over their lifetimes. The most appropriate form of the income redistribution function of individual income taxation should be considered, and the taxation on income earned on assets should be re-examined from the same point of view.

2. A Tax System that Enhances Vitality and Strength of Economy, Society, and Communities

Japan needs a vibrant and strong economy and society to provide the foundation that supports people's secure and comfortable living as the population ages with the birthrate declining. Accordingly, enhancing the vitality and strength of the economy and society should go in tandem with fiscal consolidation, in the government's steering of economic and fiscal policies.

In the interest of invigorating the economy and society, the tax regime has already been reformed from the viewpoint of accommodating globalizing markets and other structural changes, in ways including: repeated reductions in the effective corporate income tax rate; the institution of corporate reorganization taxation system and consolidated taxation system, the concentration and prioritization of policy-based tax-relief, including research and development tax credits; fundamental overhaul of depreciation system; the institution of gift and inheritance tax settlement system at time of inheritance; and expansion of Japan's network of tax treaties. While reviewing and building on these initiatives, the tax system should continue to be reformed in a manner that distorts economic activities as little as possible and allows individual economic entities to realize and put to maximum use their potential abilities by emphasizing neutrality in economic activities.

In these tax system reforms, it is necessary to be aware of the importance of accommodating the diversification of individuals' lifestyles, including work styles and family structures. It is particularly important to ensure that the tax system interferes with the lifestyle choices of individuals as little as possible. The taxation on individual income should be structured toward being a neutral system by giving full consideration to this point of view.

In the area of individuals' saving and investing activities, in the present environment of the declining saving rate along with the aging of population and lowering barrier for transferring capital across the national borders, simple and comprehensible infrastructures that enable risk-taking should be developed. By doing so, it is important to ensure that financial assets accumulated over the past years can be used efficiently within the framework of the national economy. Based on this point of view, the taxes levied on income earned on financial assets should be consolidated.

On the question of the vitality and strength of enterprises, the ideal form of corporate income taxation and the revitalization of small and midsize enterprises (SMEs) are identified as challenges. Many Commission members insist that it is necessary to consider reducing the corporate income tax rate, to accommodate the globalizing economy, according to global trends in corporate taxation. Under difficult fiscal conditions, this approach needs to be taken along with considering expanding the tax base, in the context of the future need to ask a broader spectrum of the public to share the burden of supporting social security. A system of policy tax incentives designed to invigorate the economy led by the corporate sector should be put to effective use by focusing instruments upon the fields that really need them, lending themselves to enhancing future productivity. It is important to support business startups in the fields of cutting-edge technological innovation in order to incubate and foster industries and technologies that should sustain the future of the economy. Investment channels to fund business ventures should be facilitated such as by improving the "angel taxation" system. It is also important to continuously improve international taxation in order to build a structure that does not hinder international capital flows or cross-border corporate activities.

Society gains vitality and strength as more members voluntarily participate in it. As society has diversified, it is now imperative to meet society's diversified needs in a flexible manner, and it is desirable that the private sector's public-interest activities share that role with the government sector. This should also serve the purpose of drawing out the potential vitality and strength of Japan’s society. Recognizing the importance of supporting “public-interest activities that are undertaken by the private sector,” it is necessary to develop tax programs to accommodate public-interest corporation system reforms and reform the donation tax framework.

It is necessary to tackle decentralization reform from the viewpoint of establishing local communities full of personality and vitality in which people feel and experience comfort and affluence. It is essential to promote the autonomy of regions and to attain decentralization in order to restore vitality and strength back to the countryside. It is enormously important that taxpayers pay their taxes close to home and check on the purposes for which they are used. From this decentralization point of view, the status of national and local public finances should be examined, and the most appropriate framework of national and local taxes should be explored. Based on these things, it is important to build a local tax system whose revenue base is distributed less unevenly and which provides stable tax revenue, in order to enhance and ensure local taxation.

Since disparities exist in the fiscal strength of local governments, an urgent challenge is to correct the uneven distribution of tax revenue sources among the regions and to reduce these gaps. A comprehensive examination should be initiated, and quick actions implemented.

3. A Fair Tax System that Gains Trust of People and Taxpayers

A tax system has a close bearing on the lives of all people, so it is important that a tax system has the trust of people and taxpayers. This translates into a call for a “fair tax system” in the sense that a tax system should be structured to gain the confidence and approval of people so that people share the burden required.

A “fair tax system,” in essence, is a simple and equitable tax system that takes the standpoint of people and taxpayers. This perspective should apply consistently in reforming specific taxes.

It is necessary to continuously explore framework improvements aimed at increasing the appropriateness of taxation for the sake of ensuring and maintaining taxpayer’s confidence. In conjunction with this, programs designed to enhance taxpayers’ convenience should be implemented consistently, especially by examining interfaces with taxpayers in the daily course of tax administration. Further, there should be further deliberation on a taxpayer identification number system and an appropriate system of penalties and punishments.

From the viewpoint of increasing confidence in the tax system, it is important that all relevant organizations, including the Commission, continue to enhance and expand their investigative and analytical capabilities. Desirably, the knowledge and understanding obtained from their investigations and analyses should be used in the general discussion on the tax system.

It is necessary to enhance public relations and education about taxes. It is essential to have a tax system in which people understand the purposes for which tax revenues are used and feel convinced with paying taxes. In particular, experiences of thinking and learning about the importance of paying taxes since childhood are the cornerstone of nurturing the members of society that carry on a democracy.

Part 2　Issues on Specific Taxes

1. Individual Income Taxation

(1) Recent Reforms and Current State of Individual Income Taxation

Individual income taxation (national income tax and local individual inhabitant tax) has seen repeated reductions in its progressivity as a result of past tax reforms, which, from the viewpoint of preventing taxation from interfering with work incentives and business interests, have raised the level of the minimum taxable income, lowered the tax rates, and widened the income bands (the widths of the brackets). Consequently, the overall burden of Japan's individual income taxation is extremely low in comparison with its counterparts in other countries, and its revenue-raising and income redistribution functions have declined.

The rate structure of income tax, as a result of repeated reductions in progressivity, is uniquely distinctive in the developed world in requiring the great majority of taxpayers to pay tax at extremely low rates. The tax base structure is made complex by the existence of a myriad of personal deductions, income deductions, special exemptions applicable only to certain income categories, and tax-free programs, which distorts the tax system.

In fiscal 2006, from the viewpoint of promoting decentralization, tax revenue sources worth ¥3 trillion were transferred from the national to local governments. The process involved the introduction of a 10% proportional rate to individual inhabitant tax from the viewpoint of emphasizing the benefit principle and reducing the unevenness of the distribution of revenues. Meanwhile, the progressive structure of income tax was reformed, clarifying the roles between income tax and individual inhabitant tax.

(2) Direction of Future Reforms of Income Tax

In view of the current situation, a future fundamental reform of the tax system needs to revise individual income taxation to make its burden appropriate, while tracking the discussion on the tax system overall and examining the broader benefit-burden relationship including social security. Following the conversion of individual inhabitant tax into a 10% proportional rate structure and anticipating the increasing role of consumption tax in the overall framework of a future tax system, an important challenge is to put income tax to appropriate use as it serves to redistribute income together with social security. In particular, the increasing awareness of the widening wealth gap brings income tax's income redistribution function into the spotlight.

At the same time, the income tax system needs to draw out the vitality and strength of individuals and society as a whole, responding to the impact of the aging population and the declining birthrate as well as diversifying people's lifestyles and work styles. From these perspectives, it is important to transform the individual income taxation into a neutral structure that interferes as little as possible with diverse choices made by individuals about their economic and social activities. Yet another challenge is to seek to consolidate and streamline the currently complex system in order to create a framework that is comprehensible and simple.

(3) Rate Structure of Income Tax

As noted above, as a result of the past tax reforms that have lowered the tax rates and widened the income brackets, the current rate structure of income tax applies the low marginal rates of 5% and 10% to the great majority of income taxpayers.

Because of this, a challenge is to examine the tax rates and bracket widths, while simultaneously examining reforms of other taxes and discussing the tax base in relation to personal deductions and other exemptions, in ways that put the income redistribution function to appropriate use.

As noted above, the top tax rate has been reduced, but recently views have been voiced in favor of reviewing it from the income-redistribution point of view, so further examination is needed.

(4) Household Structure and Tax Burden

As to the basic framework of taxing individual income, it is appropriate to maintain an individual-by-individual basis and take care of the particular circumstances of individual families by personal deductions. When it comes to specific personal deductions, the following viewpoints have come up for consideration.

1) Relationship with Spouse

Many share the view that deductions for spouses (standard and special deductions for spouses) should be examined from the following perspectives:

a) Society has moved toward gender-equal participation, and household work provided by the spouse adds economic value to the taxpayer.

b) The present framework limits tax neutrality toward the spouse’s participation in the workforce.

c) Situations may occur in which double deduction is enjoyed by the taxpayer eligible for a deduction for spouse with the taxpayer’s spouse eligible for basic exemption.

d) The deductions for spouses should be reviewed in favor of using the released revenue source to support childrearing.

Other people express the view that, because a husband and wife constitute a basic unit in which people lead their lives, the present framework should be continued.

The deductions for spouses may be revised based on the above-described various viewpoints. In that process, any sharp increase in the tax burden as a result of the revision should be avoided, and revisions in other deduction items also need to be monitored and reflected in the discussion.

2) Relationship with Dependent Family Members

The present deduction for dependents is designed to adjust the tax-bearing capacity of a taxpayer who has family members who share the same household with the taxpayer and whose income falls under a certain level ("dependent family members"). The amount of the adjustment varies according to the number of such members.

The present framework applies deductions for dependents to all who meet the eligibility criteria to be a dependent family member, irrespective of their age. However, as far as this treatment goes, it may be hardly necessary to deem an adult as someone who requires care for tax-bearing capacity and uniformly give him or her the coverage of deduction for dependent, unless disabilities or other special personal circumstances are involved.

The special deduction for dependents covers dependent family members who are 16 years of age or older and younger than 23 years of age. It is designed to provide an additional tax relief for the generation who in the prime of their working lives earn a relatively high income but nevertheless lead a life that is not so financially comfortable since they need to bear the heavy burden of education and other life costs. However, this rationale has recently weakened, especially in view of the reduced progressivity of income tax as a result of recent tax system reforms and the fact that individual households have different circumstances that determine when and how much they can spend on the education of children.

From the standpoint of providing policy assistance for childbearing and childrearing, one alternative to income deductions for dependents may be the use of a tax credit, which provides a certain amount of tax relief that is the same amount regardless of the size of the recipient's income, as discussed below. This thinking needs to be explored, from the viewpoint of income redistribution and in relation to other policy instruments such as allowances, while monitoring the general discussion on measures to tackle the declining birthrate and precedents implemented in other countries.

(5) Types of Income and Taxation

1) Wage Income

The deduction for wage income has been recognized as comprising two components: “estimated deductions for business expenses” bearing on the wage income earner and “special deduction to adjust the burden relative to other income” that applies to an amount in excess of the former.

In recent years, while employees have increased as a share of the workforce, the diversity of employment types has increased, particularly with increasing part-time, temporary, and other non-regular employments and contract-based work. Moreover, SOHO, satellite office, and other new working styles have appeared, and increasingly the dividing line between employee and employer has become relative.

These changes in the structure of the workforce and the diversification of employment forms now call for a redesigning of deductions for wage income to suit the socioeconomic realities today.

In that process, the estimated business expense component of the deduction for wage income needs a mechanism that more accurately reflects the actual work conditions of the wage income earner. More specifically, from the viewpoint of expanding the aspect of the deduction based on actual costs, it is appropriate to examine the range of the deduction for specified deductible expense items. It is also appropriate to reconsider the structure of the current deduction that places no cap on the amount deductible.

2) Business Income

It is important that self-employed business income earners keep appropriate records of sales and necessary business expenses, and engage in proper reporting.

When it comes to necessary expenses attributable to business income, it is not always easy to verify the eligibility of specific expenses, and no systematic safeguard exists that prevents the entry in necessary business expenses of household related overheads that in principle may not be included in necessary business expenses. It is pointed out that this has created a feeling of tax burden inequality among wage income earners.

Meanwhile, it is also pointed out that the lowering of the consumption tax exemption threshold has improved the level of recordkeeping among business income earners, leading to increasing transparency in the tracking of income. Also, recent advances in information technology have enabled business income earners to keep records without much difficulty.

In view of these circumstances, most likely the necessary conditions increasingly exist for seeking a more appropriate framework for recordkeeping practiced by business income earners. In that process, systematic arrangements may be necessary to ensure the appropriateness of necessary business expenses. One possible example is to establish a rule that limits necessary expenses deductible according to actual amounts to the situations where proper records of them are kept and otherwise permits only certain estimated expenses.

3) Retirement Income

In recent years, with the changes in the structure of the workforce and the forms of employment, the ways retirement allowances are paid have diversified, examples being the raising of salary during time in service as a substitute for paying retirement benefits and adoption of retirement pension annuities. In some instances, employees defer receiving salary to receive a higher amount of retirement allowance as a way of reducing their tax burden.

In view of these circumstances, the taxation of retirement allowances needs to be restructured into a framework that is generally neutral to diverse work choices. This should be done by reconsidering the present mechanism that permits a sharp increase in the amount deductible per year once an employee has served for over 20 years continuously and the mechanism that taxes only half of retirement-related income even for an employee who has served only for a short time.

Considering the nature of retirement allowance, as a consolidated payment at one time of what should be paid over a period of many years, it is necessary to continue to implement some forms of equalization mechanism. Further, because a reform could affect expectations incorporated in employees’ important life plans, appropriate measures including necessary transitional treatments are required.

4) Pension Income

In the area of public and other pensions, because a pension plan means a long-term life plan, it is necessary to examine a form of taxation that is appropriate across the distinct periods when funds are contributed, invested, and paid in old age.

As the population ages with the birthrate declining, an increasing number of people have opportunities to hold a job while drawing a pension, and in some cases, a pensioner earns a high amount in employment income in addition to pension. For such situations, steps should be examined to enhance the appropriateness of the existing deduction for public and other pensions from the viewpoint of tax burden equality between and within the generations.

Currently, public and other pensions are classified in miscellaneous income for tax reporting purposes. However, the increase in the number of public and other pension beneficiaries is likely to increase the importance of pension related income, and the method for computing pension income differs from the methods for computing other types of miscellaneous income in the first place. In view of these and other considerations, it may be appropriate to consider setting up an independent, separate income category for public and other pensions.

(6) Income Deductions and Tax Credits

When it comes to applying income tax, the basic approach taken historically is an income deduction that subtracts a certain amount from the taxable income, based on the notion of taking care of a decline in the tax-bearing capacity of a taxpayer because of the taxpayer's particular circumstances, including family structure. In comparison, a tax credit is another type of burden adjustment mechanism that subtracts a certain amount from the tax payable, and has a greater significance as fiscal assistance.

From a tax burden point of view, an income deduction gives higher-income earners a larger amount of tax relief, whereas a tax credit provides a flat amount of tax relief universally, basically regardless of income levels. Some countries have shifted away from income deductions in favor of tax credits.

In view of these features, amid difficult fiscal realities, from the viewpoint of consolidating fiscal assistance instruments and reinforcing the income redistribution function of income tax, recently some people have proposed remolding income deductions to adopt tax credits. This is worth considering.

In exploring the appropriate form of deduction in income taxation, it is necessary to deepen discussions on the issues of the way to adjust tax-bearing capacity, the necessity of introducing a tax credit, and the delineation of roles relative to relevant allowances.

(7) Discussion on "Refundable Tax Credits" (Benefit Instrument via Tax System)

In recent years, the United States, Canada, and other countries have adopted a system of refundable tax credits, and in Japan some argue for considering the adoption of such a system. This is a system designed to provide low-income people below the minimum taxable limit with a benefit to cover an expense that could not be deducted from their income. It is advocated from a variety of perspectives, including the provision of assistance to low-income people, particularly among the younger generations, childrearing assistance, employment assistance, and an approach to offset the regressivity of consumption tax. Some countries take the tax and social security regimes as a whole and use refundable tax credits to lessen the social insurance premium burden.

As Japan faces an important challenge of building a sustainable and reliable social security regime and establishing a stable revenue source for the regime that supports the safety and security of the people, continuing discussions from these perspectives makes sense.

At the same time, however, many issues remain that need examination and consideration. First, it is necessary to recognize the nature of refundable tax credits that function as the provision of benefits. Based on this, it is necessary to develop a consensus on the necessity of providing a public benefit to people earning under the minimum taxable income, from a social security policy point of view, in relation to existing benefits and various measures to assist low-income people. It is also necessary to examine the appropriateness of providing benefits only on the basis of an income level in a given year regardless of the balance of assets held. Yet another point of issue is how to secure a revenue source, and moreover, how to establish an appropriate manner of administering benefit payments and in particular how to ensure that payments are based on an accurate manner of tracking income. In view of the above, while consulting the experiences of other countries, it is necessary to continue the discussion on this instrument particularly to explore the advisability of instituting it and the problems involved.

(8) Individual Inhabitant Tax

1) Direction of Future Reforms

Individual inhabitant tax has the nature of being "dues of membership in the local community" whose burden must be shared by a broad spectrum of its residents according to their capacity. In view of clearer emphasis put on the benefit principle following the conversion of the income-based portion into a 10% proportional tax rate structure, it is necessary to consider the most appropriate form of this tax.

The level of the per capita tax rate still remains low, relative to the recent rate of growth in per capita national income, and it is necessary to explore an appropriate future form of this tax while giving full consideration to trends in the tax burden on individuals.

Now that income-based tax has clearer characteristics based on the benefit principle, it is necessary to review various deductions in the income-basis tax in order to expand the tax base, such as by re-examining those deductions that function as policy incentives.

2) Desirable Form of Donation Taxation

The promotion of the private sector's nonprofit activities that are closely embedded in the local community is an important priority from the viewpoint of the private sector's cooperation with the administration services of local government. In view of this, coupled with the establishment of the new public-interest corporation system, which is discussed below, it is necessary to consider a desirable form of donation taxation in the framework of individual inhabitant tax. In that process, considering the nature of individual inhabitant tax as being “community membership dues” and the decentralization point of view, it may be appropriate to conclude that the structure of donation taxation should be designed independently, and established basically by means of municipal regulations, at the level of individual local governments. On the question of the form of deductions for donations, it is necessary to consider switching from the present income deduction approach in favor of tax credits, from the viewpoint of making the effect clearer for taxpayers to see. It is appropriate to substantially reduce the present minimum donation amount of ¥100,000 to qualify for deduction.

Since there is a growing call to establish a tax-system vehicle to facilitate contributions and support the local government of a specific region that individual taxpayers consider and designate to be their spiritual hometown, it is necessary to consider a mechanism that takes advantage of donation taxation. In that process, on the question of the form of deductions for donation, some people propose that, in the interest of making the effect easier to recognize and the system comprehensible for taxpayers, it is appropriate to reform the present income deduction approach in favor of tax credits and the ratio of the tax credit should be established at as high a level as possible. Other people question, however, whether the full deduction of a donation amount up to a certain ceiling or a mechanism that minimizes a taxpayer’s own share of the burden is appropriate to a donation taxation system. Additionally, the present minimum donation amount to qualify for deduction should be lowered substantially.

Whatever course is taken, considering the various viewpoints noted above, while heeding the principle of building a comprehensible and simple structure, it is necessary to promote the discussion on the most appropriate form of donation taxation in the framework of individual inhabitant tax. This should cover donations also for the benefit of local governments.

2. Corporate Taxation

(1) Meeting Globalization

Appropriately accommodating socioeconomic structural changes, including the globalizing economy, and enhancing the economy’s global competitiveness to invigorate the economy is a priority challenge facing the tax system. From this point of view, as discussed above, a series of corporate taxation revisions have been carried out. In the fiscal 2007 tax reform, in particular, the deprecation system was revised with a view on a future fundamental reform of the tax system.

As the globalization of the economy continues to accelerate cross-border corporate activities, from a viewpoint that insists on ensuring an international equal footing in corporate tax burden, there are calls for a further reduction in the effective corporate tax rate. A look at trends in other countries shows that Germany, for instance, plans to reduce its corporate tax rate particularly from the viewpoint of countering moves among local enterprises to transfer earnings gained at home to foreign countries in order to reduce their taxable income at home. It should be noted, however, that the country plans at the same time to expand the tax base, in addition to having raised the VAT rate in advance.

(2) “Effective Corporate Tax Rate”

The “effective corporate tax rate” refers to the nominal tax rate that combines national and local corporate taxation. Some people argue that Japan’s effective corporate tax rate is high by international standards and should be reduced. In preparation for considering this question, the Commission conducted international comparisons of the real corporate tax burden that reflects the tax base and further of the corporate burden that includes social insurance contributions, based on its recommendation report on the fiscal 2007 tax reform. The Commission also conducted research and analysis to determine what effect a revitalization in the corporate sector as a result of a reduction in corporate tax can have on employment and individual income[5]. In comparisons of the corporate burden, with the tax base and social insurance premium costs factored in, the results of trial calculations using assumptive average-firm data indicate that Japan’s corporate burden currently is not necessarily high by international standards[6].

Based on these results, nevertheless, during the Commission’s deliberations many members insisted that it would be necessary to lower the effective corporate tax rate, according to international trends in corporate taxation. On this issue, it is necessary to take an approach that goes hand in hand with expanding the tax base, with public finance remaining in a serious

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[5] The expected macroeconomic effects of reducing the tax burden on the corporate sector are not definitely beneficial or adverse as facilitated capital investment benefits employment and income in the household sector while reduced tax revenue increases fiscal deficit and pushes up interest rates.

[6] In the fiscal 2004 pension reform, a decision was adopted to increase the employees pension insurance premium rate by 35.4 basis points each year, beginning with October 2004, until fiscal 2017 when and after which it will be set at 18.30%.

fiscal situation. It goes without saying also that it is necessary to make continuous efforts to invigorate the economy even before any step in that direction is taken.

(3) Invigorating of Economy and Policy-Based Tax Incentives

From the viewpoint of invigorating the economy, some people argue that initiatives should be stepped up to reduce the burden on the corporate sector by means of policy-based tax incentives. The research and development tax incentive has been largely expanded since fiscal 2003, and an increase of more than 10% in the amount of research and development investment during the period[7] indicates that it has had a certain degree of tangible impact. It is assumed that such policy-based tax incentives induce aggressive investments in technological innovations that should form the basis of the economy’s future development, with the improvement in productivity contributing to the economy’s continuous growth.

A theoretical consensus has been developed on the benefits and effects that effective corporate tax rates and tax incentives can have on corporate activities. The average effective tax rate (the “effective corporate tax rate”) that is a nominal tax rate can affect enterprises’ decisions regarding where they do business and their investments and transfers of earnings, whereas the marginal effective tax rate that takes account of policy-based tax incentives and other elements can affect their decisions on the amount of investment. In accordance with this thinking, in order to ensure continuous growth in the economy, it is necessary, for the time being, to put emphasis on effective use of policy-based tax incentives, including the research and development tax incentive, from the viewpoint of encouraging really effective investments to improve productivity and streamline business processes across the corporate sector, with SMEs included. In considering the future of the policy-based tax incentives whose term expires at the end of the current fiscal year, approaches should be taken based on these viewpoints.

(4) Local Corporate Taxation

The pro-forma approach was introduced into the corporate enterprise tax in the fiscal 2003 tax reform from the perspectives of ensuring tax burden equality, establishing clear tax characteristics based on the benefit principle, stabilizing the tax backbone that sustains local autonomies, and invigorating local economies.

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[7] Source: The Survey of Research and Development, Ministry of Internal Affairs and Communications

Pro-forma taxation is intended to correct the status quo in which a large number of corporations are excused from the burden of corporate enterprise tax as well as to reduce the corporate income tax burden. It is assessed on value added and other factors, and from the benefit principle point of view, future consideration should be advanced in the direction of expanding the ratio of the pro-forma taxation and the range of corporations subject to that tax.

The special measure in the enterprise tax framework that concerns the taxation on social insurance medical service fees should be abolished immediately from the viewpoint of ensuring tax burden equality.

3. International Taxation

With the economy globalizing and forms of business operations becoming complex and diverse, the taxation of cross-border economic activities needs to maintain a balance between, on the one hand, securing Japan’s appropriate taxation rights and, on the other, caring for economic activities and invigorating Japan’s economy. In this process, it is important to ensure that the taxation poses no impediment to the international flow of funds and corporate activities. At the same time, taking into account that certain non-tax factors might also affect them, a cautious attitude should be taken toward counting on the tax system to play a role beyond ensuring neutrality.

For instance, as for the foreign tax credit system, a well balanced system should be developed, in accordance with the principle that corporations should be allowed no deduction in excess of the tax burden they owe to Japan, while giving due consideration to the business realities of Japan’s corporate groups, such as increases in the proportion of overseas operations and in the retained earnings at overseas subsidiaries. In the United States and Britain, which have adopted a foreign tax credit system as a method of eliminating double taxation, in recent years, introductions of exemption systems with respect to foreign income or dividends from overseas subsidiaries have been proposed. These proposals are effectively attempting to amend, against the backdrop of the current state of international flow of funds, the method which eliminates double taxation based on the worldwide income taxation principle from the viewpoint of a capital-exporting country. It is necessary to watch closely these developments and trends in other countries.

Tax treaties constitute an important economic infrastructure that plays a role, with domestic laws and regulations, in international taxation by adjusting double taxation, countering tax avoidance, and encouraging bilateral investment. Efforts should be continued to expand Japan’s network of tax treaties, while at the same time developing domestic laws and regulations necessary to implement these tax treaties. In that process, care should be taken to ensure taxpayers' convenience such as by clarifying and simplifying the required procedures.

To firmly build confidence in international taxation, it is necessary to make continuous efforts to implement measures to prevent tax avoidance schemes that make use of discrepancies in the tax systems among different countries or in tax treatments between tax treaties and domestic laws.

4. Public-Interest Corporation Tax System

It is likely that the "public interest that is pursued by the private sector" along with the government sector will gain increasing importance, in the interest of enhancing the vitality and strength of Japan's society. A legislative reform relating to public-interest corporations that assume that role is now in progress, and the new framework (so-called public-interest corporation related tripartite legislation[8]) is scheduled to take effect in December next year. In connection, there is a growing call to establish a tax-system that "supports the private sector to share in the public interest."

In this area, the Commission in June 2005 drafted a report titled "Basic Thought on Taxation and Donation Tax System for New Nonprofit Corporations," through the Nonprofit Corporation Taxation Working Group under the Subcommittee on Fundamental Issues. Taxation measures should be developed in accordance with the principles described in this report, and the following viewpoints should be addressed afresh.

First, public-interest incorporated associations or public-interest incorporated foundations will, subject to the authorization of an independent commission, undertake operations for the purpose of the public interest, based on the new concept of assets belonging to operations for the purpose of the public interest. Accordingly, taxation on income earned from operations for the public interest should be in line with the aim to support the implementation of such operations.

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[8] Refers to the "Act on General Incorporated Associations and General Incorporated Foundations," the "Act on Authorization of Public Interest Incorporated Associations and Public Interest Incorporated Foundations," and the "Act on Establishment of Related Acts Following Enforcement of the Act on General Incorporated Associations and General Incorporated Foundations and the Act on Authorization of Public Interest Incorporated Associations and Public Interest Incorporated Foundations."

Second, general incorporated associations or general incorporated foundations can be set up as long as they register with the registry office in accordance with the related law, and it is likely that such corporations will appear in a variety of forms. Therefore, it is not appropriate to treat such corporations uniformly, and taxation measures should be developed in some ways, in consideration of balance with the taxation on income of other corporations.

Third, donations play an important role in funding public-interest activities undertaken by the private sector. For this reason, by according public-interest incorporated associations or public-interest incorporated foundations the status of specified corporations[9] for improving public interest, it should be made possible for individuals and corporations that donate to them to claim a deduction for that donation. In addition, consideration should be given to in-kind donations given by individuals, in order to develop an environment conducive to donations.

Additionally, the above-described direction should be given heed in the course of considering the most appropriate form of donation taxation in the individual inhabitant tax system.

Fourth, to ensure that newly instituted corporations are not used abusively for tax avoidance purposes, appropriate measures should be implemented in consideration of anti-tax avoidance measures governing the existing public-interest corporations.

Fifth, because existing incorporated associations or incorporated foundations may be required to ensure the continuation of operations for the purpose of the public interest when converting into general incorporated associations or general incorporated foundations, it is necessary to consider how to handle such cases.

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[9] The specified corporations for improving public interest mean the public corporations and public-interest corporations that promote education and science, enrich culture, contribute to social welfare, and otherwise contribute significantly to the advancement of the public interest, and are entitled to special tax treatment for donations intended for the operations that are the primary purposes of these corporations.

5. Consumption Taxation

(1) Consumption Tax

1) Characteristics

Ensuring that people have the safety and security of living under a reliable social safety net is building the foundation essential for individuals to realize and put to full use their potential abilities and lead enriched lives. For this purpose, a pressing challenge facing the tax system is to ensure a revenue source to support a sustainable social security system that allows children and grandchildren to entertain dreams and hopes about their future. In that process, the first requirements for candidate tax revenues to fund the system are that they must be capable of covering the financial needs of social security that amount to a certain size and that they must be fairly invulnerable to macroeconomic dynamics or changes in the nation’s demographic structure. At the same time, it is important that they are instrumental in correcting intergenerational inequalities as a result of sharing the burden equally across a broad spectrum of the present generations of the population.

Consumption tax meets these requirements and furthermore is distinguished for causing little distortion to economic activities, including savings and investments. Coupled with its simple mechanism, this reflects its nature of placing the burden broadly and evenly on consumptions of goods and services, rather than concentrating the burden on particular groups of people, such as the working generations. Also, it has a dimension of being able to cut off the effects on international competitiveness of a change in the rate via a mechanism of adjustment at national borders. As it is feared that the aging of the population with the declining birthrate might weaken the vitality and strength of the economy and society, these tax characteristics do matter, too. It may be concluded that a consumption tax that combines these diverse characteristics is suited to playing the pivotal role in the provision via the tax system of funding for social security.

2) Purpose for which Consumption Tax is Used

Every year since fiscal 1999, the general provisions of the national budget have stated that the national government’s share of all consumption tax revenues goes to the three expenditure items of basic old-age pension, medical care for the elderly, and nursing care for the elderly. Making it clear that consumption tax is appropriated for these areas closely linked to people’s lives and returned to the people is important for deepening people’s understanding. Considering the suitability of consumption tax as a revenue source for social security described in 1), it should be brought up as an alternative and considered broadly among the public to emphasize more clearly the use of consumption tax for social security purpose, in conjunction with pushing streamlining and rationalization efforts of social security costs, to make clear that social security costs are covered by implementing increases in the consumption tax rate instead of passing the burden on to future generations ("repurposing of consumption tax as funding for social security").

3) Consumption Tax and Income Redistribution

Consumption tax is blamed for being regressive to income. This viewpoint needs to be given due heed, but in considering the most appropriate form of income redistribution policy, merely focusing on the burden of a particular tax item alone will not suffice. Rather, the overall burden that includes other tax items and social insurance premiums and furthermore the overall picture that takes account also of benefits, including social security benefits, should be examined. While the widening of the wealth gap (as shown by an increase in the "Gini coefficient," for example) is highlighted in commentary, even in recent years a substantial change has not appeared in the state of income gaps adjusted for redistribution via tax and social security vehicles. This is because lower-income people receive greater benefits from social security, as social security plays an important role in redistributing income. Because of this, ensuring a stable revenue source for social security makes great sense also in terms of redistribution policy. In establishing a clearer status for consumption tax as being a revenue source for social security, emphasis should be placed on the role of consumption tax in contributing to the redistribution of income as viewed comprehensively by combining the benefit and burden aspects together.

Amid socioeconomic structural changes, including increased longevity, the development of a stock-based economy, and the diversification of work styles, increasingly it is not always appropriate to rely on a single measure called level of "income at one point in time" alone to assess an individual's tax-bearing capacity. For illustration, consider an individual who enjoys the benefits of an affluent life by drawing down the stock accumulated from the income he once earned and an individual who earns a certain level of income but leads an austere life in order to provide for future uncertainties and old age. In this situation, simply because the former has a higher consumption tax burden ratio relative to his current income level than does the latter, the adverse effect of "regressivity" of consumption tax that imposes a heavier burden on the economically weaker is not necessarily real. Moreover, according to the notion that income earned will be consumed at some time in the future, it is possible that consumption more accurately reflects an economic capacity built over a lifetime than "income at one point in time." It is possible to conclude that consumption tax which is imposed on this capacity proportionally contributes more effectively to distributing the burden equally.

When it comes to fundamentally reforming the tax system, including consumption tax, based on the above viewpoint, how income distribution could be affected should be given consideration. In pursuing income redistribution, in accordance with the principle that requires a broad spectrum of the people to share the burden equally, while avoiding ill-considered spending, social policy considerations should be provided in ways attentive to the particular requirements of people really in need of assistance.

Reduced consumption tax rate system is in use in countries in Europe where it applies mostly to food products. Because Japan’s tax rate is low in comparison with European countries and also because the benefits of a reduced rate reach high-income people also, it is not so effective in serving as a redistribution policy instrument. Moreover, considering the need to simplify the system, the need to ensure neutrality to the economy, the clerical burden on business operators, and the cost of tax administration, pursuing a flat tax rate structure as far as possible is desirable. Where it is necessary to ensure a certain size of tax revenues to provide a stable revenue source for social security, consideration should be given to the inevitable need to raise the standard rate by as much as necessary to cover the reduction in revenue because of the reduced rate. An appropriate rate structure of consumption tax should continue to be explored, while learning from the experiences of European countries where multiple rates are applied in a tax rate range that is high.

4) Initiatives to Enhance Reliability and Transparency of Consumption Tax

The consumption tax system has been revised, particularly in the fiscal 2003 tax reform when the tax exemption threshold applicable to smaller businesses and the upper limit to qualify for application of the simplified taxation system were lowered substantially. Most likely these revisions have improved the reliability and transparency of the consumption tax system to a considerable extent, but further efforts are needed when it comes to enhancing and expanding the consumption tax regime.

In that process, a question that needs considering is whether to adopt a so-called “invoice method” as is used in European countries for the purpose of an input tax credit. The adoption of an “invoice method” would be useful in increasing the appropriateness of an input tax credit, but at the same time it is feared that tax-exempt business operators might be kept out of the chain of transactions. Comprehensive consideration should be given in exploring how to strike a balance between the need to improve the reliability and transparency of the system and the need to care for the trading realities of SMEs and micro-SMEs. Additionally, if a reduced consumption tax rate is adopted, because the system of an input tax credit would become more complex, the adoption of an “invoice method” would be inevitable, from the viewpoint of ensuring an appropriate system of an input tax credit, considering the need to relieve the burden on business operators.

The tax exemption threshold for business operators and the simplified taxation system should continue to be reviewed and revised as necessary. It is also necessary to take care of situations where proper enforcement is difficult. These include a mechanism that entitles a corporation to be a tax-exempt business operator for two years following its foundation and tax avoidance conducts that make abusive use of the method for computing an input tax credit.

(2) Local Consumption Tax

Local consumption tax plays an important role in the local tax regime as the distribution of its revenue base is a little uneven and provides one stable pillar of the tax backbone. Meanwhile, the countryside has an important role to play in social security that needs the provision of services attentive to details, therefore establishing its revenue source is important with the population aging and the birthrate declining, as significant increases are expected in social security related costs that support local welfare in the countryside also, it is necessary to consider to enhance and ensure local consumption taxation.

(3) Revenue Sources Earmarked for Road Construction

On the issue of gasoline excise, motor vehicle tonnage tax, and other revenue sources specifically earmarked for road construction projects, a Cabinet meeting late last year adopted its resolution on "Specific Program to Review Revenue Sources Earmarked for Road Construction" (of December 8, 2006). It states that "the tax rate, which includes the portion added as the temporary tax rate, will be retained at its present level in fiscal 2008 and beyond, in the face of difficult fiscal conditions, while considering the effect on the environment." In accordance with this "Specific Program Resolution," reforms should be facilitated that obtain the understanding of the people in ways that give due consideration to the need for development of the roads, difficult fiscal realities, the effect on the environment, the taxpayers' understanding, and other perspectives.

(4) Responding to Global Warming

On the question of global warming, in accordance with the basic principle that seeks "compatibility between the environment and economics," it is necessary to appropriately deploy a variety of policy-based instruments that include promoting voluntary initiatives and education programs.

An environment tax is a question that needs comprehensive consideration, in ways that fully examine its specific bearing relative to the overall framework of anti-global warming programs at the level of national and local governments, efficacy, effect on the national economy and its international competitiveness, and its relationship to various energy related tax items already in place.

6. Asset Taxation

(1) Inheritance Tax

1) Present State and Future Direction of Inheritance Taxation

A review of inheritance tax shows that precipitous increases in land prices primarily during the economic-bubble period prompted tax reductions, including increases in the basic deduction, and a greater variety of special measures designed out of consideration for the continuity of residence and business. Later on, the fiscal 2003 tax reform revised the tax rate structure, including the reduction of the top rate.

Because of this, recent declines in land prices to pre-bubble period levels have substantially reduced the burden of inheritance tax. This has weakened the tax's wealth redistribution and revenue raising functions, as shown by a decline to approximately four percent in the ratio of deaths per year that result in the imposition of inheritance tax.

Reflecting the development of a stock-based economy in recent years, the value of financial assets as a share of household assets and of inheritance estates assessed for inheritance tax has increased markedly. The value of assets accumulated is particularly high among households of elderly people, as is the gap in household assets. The number of heirs has decreased over the years, and since these trends are likely to continue for the years to come, the value of assets inherited per heir is likely to increase further. Based on this perspective, it may be increasingly likely that the wealth gap within the elderly generation might be passed down to the next generations as their assets are inherited.

As the population ages, heirs themselves become advanced in age, and at the time when the inheritance takes place, it is possible that heirs themselves have already accumulated their own assets. This has diluted the importance of inherited assets forming the foundation on which the heirs make a living, and, coupled with the increase in financial assets as a share of inheritance assets, has made it likely that the group of people able to bear inheritance tax has expanded.

Further, today, public social security is enhanced and society takes care of providing for the needs of old age, and this contributes to the retention of assets in the hands of elderly people. In view of this, based on the thinking that the burden corresponding to the benefits the ancestor has received from society over his or her lifetime should be settled at death, it may be concluded that inheritance tax is instrumental in adjusting the benefits and the burden via returning to society a part of the estate as it is inherited.

Considering the above-described changes in conditions surrounding inheritance tax, it is not appropriate to leave the inheritance tax burden alone at the current level that reflects substantial relief as a result of the past tax system revisions. It is important to require inheritance assets to bear an appropriate burden and to restore the wealth redistribution function of inheritance tax.

2) Taxation Method

The present taxation method (taxation of the legal portion of inheritance) was designed, based on the wealth inheritance situation at the time it was adopted (in the fiscal 1958 tax reform), to prevent disguised division of assets and to care for succession circumstances of farm households and SMEs having difficulties dividing inheritance.

However, critics point out that it is not always the case that individual heirs are taxed commensurate with their share of the amount inherited, and identify a problem that occurs when one heir’s failure to declare causes a tax penalty to be levied on all the other coheirs.

The present variety of special measures designed out of consideration for continuity of residence have the effect, under the present taxation method, of easing the tax burden on the other coheirs also who are not involved in continuity of residence. This is considered a flaw in view of the purpose of the system and the principle of taxation equality. Heed should be paid because extension and enhancement of these special measures would amplify this problem.

Based on these viewpoints, an appropriate form of taxation method needs to be considered in a more specific and practical manner by taking into account changes in the inheritance situation since the initial years and the progress on development of special measures.

3) Basic Deduction and Tax Rate Structure

Historically, the basic deduction in the inheritance tax framework has been increased mostly in tandem with increases in land prices in order to prevent an erosion of the economic foundation of individuals’ lives in the middle-income class. However, as noted above, current land prices are down to pre-bubble period levels, and also, the group of taxpayers able to bear inheritance tax has expanded. Furthermore, on the legislative front, progress has been made in developing and enhancing various special measures to care for the interests of spouses and to accommodate continuity of residence.

In addition to these things, considering the perspectives, more relevant today, of preventing the wealth gap from becoming hereditary and returning wealth to compensate for society’s taking care of old age, it is considered appropriate to reduce the current basic deduction level that remains perched at a high level, having increased as land prices increased.

The fixed-amount portion of the present basic deduction was instituted to deduct a flat amount universally out of consideration for the succession circumstances of farm households and SMEs having difficulties in dividing inheritance. However, the subsequent progress in developing various special measures has reduced its importance as originally defined. Moreover, the existence of the fixed-amount portion creates a problem: because the larger the number of legal heirs, the smaller the share of amount of basic deduction becomes per heir, even if the inheritance amount is the same, inequality occurs in tax burden if the number of legal heirs differs. Because of this, it is appropriate to review the structure of the basic deduction as well as its level.

Further, it is necessary to consider an appropriate tax rate structure, particularly the top rate level, from the viewpoint of preventing the wealth gap from becoming hereditary.

4) Business Succession Tax System

When it comes to business succession, SMEs face uncertainty over the future prospects of the business and the shortage of successors to carry on the business. In connection with this, some people believe it is necessary to give increased consideration to the inheritance tax burden from the viewpoint of ensuring employment and maintaining economic vitality and strength. Other people insist on due examination from the viewpoint of the need to ensure taxation equity between haves and have-nots of business-purpose assets and the advisability of assisting business succession that takes the form of family succession (heredity). It is necessary to heed the fact that on average people who bequeath stock in a family concern to their heirs are among the wealthiest of the people subject to paying inheritance tax. Moreover, it is necessary to analyze facts and realities relating to the effects of inheritance tax burden involved in business succession events.

Considering these viewpoints, a business succession tax system needs to be one that is tolerable from the viewpoint of taxation equity and which is really effective for maintaining economic vitality and strength. While heeding the above-discussed issues relating to enhancement of the existing special measures, it is necessary to promote further consideration within the framework of reviewing the inheritance tax system overall.

(2) Taxation on Financial Income

1) Convergence of Financial Income Taxation

With international capital movements increasing and the savings rate falling reflecting the aging of the population, there are calls for putting individuals’ financial assets to efficient use in the interest of invigorating Japan’s economy. Accordingly, in recent years, with a view to ensuring the neutrality of taxation in relation to individuals’ choices of financial products and establishing a simple and comprehensible tax system that enables risk-taking, a variety of initiatives have been implemented to consolidate the taxation on income from financial assets. Based on the principle of separate taxation, they focus primarily on applying equal tax rates among different types of financial income and the expansion of the scope eligible for the aggregation of profit and loss.

2) Reduced Tax Rate on Dividends and Capital Gains on Listed Stocks

The reduced tax rate (10%) applying to dividend income and capital gains earned on listed stocks and others was adopted in the fiscal 2003 tax reform to provide a temporary market-stimulating vehicle in order to counter the slumping economy, the stagnation in the stock market, and the nonperforming loan problem plaguing financial institutions at the time.

Last fiscal year the Commission recommended abolishing the reduced tax rate as it expired, in favor of establishing a simple and comprehensible system along the lines of convergence of financial income taxation. This conclusion reflected substantial improvements in the economy and market conditions versus the time of the adoption of the reduced tax rate as well as the need to ensure the neutrality of taxation among different types of financial income as advances in financial technology now allowed cash flows from financial products to be easily processed into different income categories. Yet another perspective stressed equality based on the status quo of in whose hands stocks were held.

In the fiscal 2008 tax reform, approaches should be taken in the direction recommended by the report last fiscal year in order to prevent the tax system from distorting the market.

As far as dividend income goes, choosing to apply aggregate income taxation qualifies for the application of adjustment for corporate income tax, which emphasizes the nature of dividend income as accruing from participation in the business. Choosing to apply separate taxation (for which no reporting is required) does not have the benefit of adjustment for corporate tax. Most countries that have a separate taxation system do not institute a mechanism of adjustment of dividend income for corporate tax, and furthermore, in Japan even if the corporate tax burden is included, the tax burden on individuals is reduced significantly as a result of the 20% proportional tax rate. The present system is considered appropriate as a desirable form of adjustment of dividend taxation at the corporate and individual levels.

In the interest of making Japan’s financial services and securities markets stronger competitively and reliable and attractive for investors to use, it is important to promote efforts in fields not limited to the tax system but ranging diversely from the provision of various financial products and services to the enhancement of the regulatory environment to the development of human resources. In addition to invigorating and streamlining the markets, efforts are needed to ensure the transparency and fairness of the markets.

3) Expanding Scope Eligible for Profit and Loss Aggregation

As long as it is ensured that the expiration of the temporary special measure currently in effect that benefits dividend income and capital gains on listed stocks and others will prompt action to equalize taxation methods, efforts should be initiated to substantially expand the scope eligible for the aggregation of profits and losses among different types of financial income. This should reduce investment risks facing individual investors and encourage them to invest in risk assets. It is necessary to initiate consideration as early as possible to explore specific scopes and mechanisms. In that process, consideration should be deepened to explore the development of tax compliance infrastructures, including tax withholding, information reporting, and financial identification number arrangements, in order to ensure proper tax administration and to enhance taxpayers' convenience. It is also appropriate to consider an appropriate form of aggregation of profit and loss that takes advantage of the specified account mechanism that is already popular among large numbers of investors.

(3) Fixed Property Tax

Fixed property tax is appropriate for providing a pillar for the backbone of the municipal tax system as it is taxable on fixed property that exists broadly in every municipality and its tax revenue base is distributed quite evenly. It is important to secure this taxation in a stable manner now and into the future.

When it comes to land-related property taxation, following the enforcement of the so-called 70% assessment rule, in fiscal 1994, from the viewpoint of taxation equity, efforts have been continuing to equalize and optimize the burden levels. Today, a substantial degree of progress has been made in equalizing the burden levels on a region-by-region basis, but still some regions exist where the burden on land remains low, and so continuous efforts are needed to promote the equalization and correction of the burden levels.

7. Development of Tax Compliance Environment

(1) Basic Idea

Efforts are needed to simplify the tax system and enhance taxpayers' convenience and predictability in order to develop an environment in which people can pay taxes smoothly with a feeling of safety and security. Efforts are needed to institute effective programs to prevent tax avoidance and tax evasion. These efforts should lead to enhancing people's and taxpayers' confidence in the tax system, which is enormously important in establishing a fair tax system.

(2) Enhancing Taxpayers' Convenience and Appropriateness of Taxation

It is important to step up efforts further to popularize the use of electronic tax filing and electronic tax payment in order to develop a tax payment environment that allows people to feel and experience improved convenience and service, closer to home. Further, it is desirable to build a framework designed to allow tax authorities to receive personal identification information via the resident registration network (*Juki Net*), because it saves taxpayers trouble[10] and also contributes to the achievement of a simple and efficient government.

On the question of collecting individual inhabitant taxes from public pension accounts in special arrangements, a framework should be developed from the viewpoint of enhancing taxpayers' convenience as well as streamlining collection operations.

While efforts have been undertaken to develop and enhance a tax compliance environment in a variety of ways[11], there is no end to cases of large-scale and egregious tax evasion, and a call for appropriate and fair taxation is growing among the people. Efforts should be continued to step up both framework and enforcement approaches, one example being new requirements to submit payment records in the area of foreign exchange margin transactions (FX transactions), which is a matter of public concern recently.

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[10] For illustration, any mismatch between an address or name written in a return for refund and one written in a tax withholding slip would currently prompt a request for the taxpayer to submit a copy of his or her resident card for identity verification purposes.

[11] Tax compliance environment initiatives undertaken to facilitate smooth reporting and payment include: the retention of accounting books and records by means of electronic data; the commencement of electronic reporting and electronic payment; the overhaul of the inheritance tax in-kind payment system, including the articulation of permission criteria; and a program to promote the computerization of tax administration procedures. Tax compliance environment initiatives undertaken to encourage proper reporting include: the toughening of penalties and punishments for tax evasion; the extension of the statute of limitation on inspection and collection in the case of tax evasion; the institution of recordkeeping and bookkeeping requirements for white return taxpayers; and the raising of the rate of additional tax for noncompliance.

(3) Taxpayer Identification Number System

A taxpayer identification number system refers to an experiment to achieve appropriate and fair taxation by streamlining work by virtue of "taxpayer identification numbers," to process various documents, instead of the name-retrieval and name-matching that is currently performed by tax authorities using address and name data described in documents.

In designing a framework for that purpose, the most important issues that need considering are: 1) what kind of number system should be used for providing taxpayer identification numbers for use in tax enforcement and administration; and 2) what types of economic transactions should be described in the required submission of documents to tax authorities from the viewpoint of enhancing the income-tracking function. Further, when it comes to putting a framework into practice, it would be necessary to ensure security, assess the cost of using the number system between the government and private sectors, assess the implications for economic activities, and so forth.

First, on the question of what kind of number system is desirable[12], currently, "resident register code numbers" and the "basic pension numbers" are the most likely to be ready for specific deployment. Further, "social security numbers"[13] have been a subject of growing discussion recently. While monitoring the discussion on various number systems, efforts should be made to explore and determine their potential to be used for providing taxpayer identification numbers.

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[12] The basic requirements that a taxpayer identification number system must meet are: 1) it has a statutory basis; 2) it covers the great majority of the people by assigning each person a number that is serial and unique to that person nationally and lasts for a lifetime, without double-numbering; 3) it has the capability of managing subsequent changes in the addresses and names of people who are numbered; 4) it may be accessed by the private sector for use in situations in which the taxpayer proves, or the counterparty verifies, the taxpayer's identity; and 5) the computer system it uses adequately ensures security, including privacy protection. Additionally, many point out that a desirable system must allow people to feel and experience the benefits arising from its use, such as in the field of government administration where people receive service.

[13] A "social security number" refers to a number that many expect will be assigned to each person in order to integrate information about benefits and costs, individual by individual, across the entire social security regime.

Second, on the issue of an information reporting system, a question that needs asking is how far information collection should be expanded, while ensuring the understanding of the parties involved in particular transactions, in the interest of enhancing income-tracking functions. Take other countries for example, and, for the sake of keeping track of capital flow and stock, in the United States, people are obliged to report on certain domestic fund remittances, deposits and withdrawals in bank accounts, and offshore fund remittances; and in France, people must submit documents describing the establishment of deposit accounts. While looking at these examples, efforts should be made to expand the coverage of information collection as it relates to financial assets from the viewpoint of tracking income in a complementary manner.

Taxpayer identification numbers have been a subject of the Commission's past recommendation reports in which considerations and views have been discussed from a variety of perspectives. Now the time is ripe to move to the next stage of initiating specific action toward implementing a system. Efforts should be stepped up to develop a national understanding in order to pave the way for a smooth implementation.

(4) Penalties and Punishments

With economic and financial transactions becoming increasingly complex, global and computerized, tax inspections become complex and difficult. Also, the number of people filing tax returns increases, while the tax office is having difficulties increasing its staff. In these circumstances, a priority challenge that needs considering may be the development and enhancement of penalties and punishments overall in order to achieve a fair tax system.

The prison term for tax-evasion was increased to the present five years in 1981, but still cases of large-scale and egregious tax evasion are happening one after the other. It is necessary to take a more stringent stance toward non-rule abiding taxpayers. In particular, in the current situation in which many statutory penalties for economic crimes have been toughened, an increase to a level where an adequate degree of general deterrence can be achieved should be considered.

A trend in recent years is an increase in tax evasion cases in which non-declaration is the charge, as wider use of electronic commerce has increased highly anonymous transactions, and we urgently need to consider what action can be taken.

In the system of monetary penalties, the amount of penalties has not been raised since its establishment, and undeniably they carry less weight as a penal system than they used to, and so a revision should be considered to suit the current economic realities.

(5) Public Relations and Tax Education

Tax is a vehicle through which the members of society as a whole cover the costs of public services that sustain society. For this reason, each member of the nation is expected to pay tax, to show interest in the purpose for which it is used, and to take an attitude that voluntarily considers a desirable society. In a self-assessment tax payment system, it is important to nurture people who are conscious of being taxpayers and feel convinced with paying tax, including how that tax is being used.

From this point of view, it is necessary to perform comprehensible public relations positively about information not limited to knowledge of the tax system but ranging from the importance and role of tax to the purpose for which tax is used. Also, it is extremely important to understand from childhood the importance and role of tax and learn to be conscious of being a taxpayer, and it is necessary to enhance tax education in the school curriculum in cooperation with relevant private-sector organizations.