New Developments in Small and Medium-sized Enterprise Income Tax Policy

—How to Address Income Shifting from Labor to Capital Income Tax Base—*

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Abstract

Labor and capital incomes are usually taxed at different rates. These rate differentials are widening world over as countries cut corporate income taxes and effectively raise personal income taxes by levying higher social insurance premiums on their aging population. Therefore, owners of small and medium-sized enterprises (SMEs) can reduce their tax liability by restructuring their sole proprietorships as corporations. By doing so, they convert income from labor into lesser-taxed capital income and owe less tax burden. This tax-minimization strategy, so-called "income shifting from labor to capital", has become notable and been reported by many researches and government reports world over.

The first half of this paper studies the recent problem in the US and UK. Thereafter, it takes up the case in Japan. The often-noted problem in Japan is rather unique. Point is that tax burden on salary income is alleviated because its tax code grants a special deduction for it. As its corporate tax rate was high until 2000s, Japanese small-business owners have incorporated and received all of their corporation's earnings as salary and retained none. Because of this tax avoidance activities ("income shifting to salary"), many small corporations have seemingly gotten into red (Tajika and Yashio, 2005).

This situation is changing. Like many countries, Japan has raised taxes on wage income by hiking social insurance premiums while reducing corporate tax rates. These reforms favor retaining corporate earnings over paying them as salaries. As a result, tax-minimizing efforts to convert wage income into capital income (retained earnings) by SME owners, that is, "income shifting from labor to capital" can become a serious problem in Japan in the near future. This paper studies such recent situations and offers suggestions for future tax and social security reforms.

Keywords: SME owners, income shifting, tax system reform, comparison of institutions
JEL Classification: H24, H25, H26

* Yashio was supported for this work by JSPS KAKENHI Grant Number 16K03721.

I. Introduction

Tax codes customarily distinguish among types of income and tax them at different rates. For example, corporate income is subject to corporate tax and personal income to personal tax, with further distinctions between income from labor (wages) and capital (dividends or capital gains). Such tax systems have problems characterizing the income of owners of small and medium-sized enterprises (SMEs). As their income represents a return on investment and labor, determining whether to tax it as wages or capital income becomes difficult. Complicating matters, owners of SMEs can choose their organizational form (sole proprietors or corporations) and recharacterize their income from a higher-rate to lower-rate tax base to reduce their tax liabilities (Mackie-Mason and Gordon, 1997; Goolsbee, 2004). Such tax avoidance activities (so called “income shifting” (Slemrod, 1995)) plague tax authorities globally[1].

This problem appeared following 1986 tax reform in the US (Wilkie et al., 1996; CBO, 2012a). Before the reform, the wealthy established personally owned corporations and retained their profits, paying low corporate income tax instead of higher progressive personal income tax. When the 1986 reforms reduced top personal rates below the corporate tax rate, they dissolved their corporations and took earnings as personal income. As a result, personal income reported by the wealthiest Americans soared (Feldstein, 1995).

After that, researchers have documented numerous types of income shifting by owners of SMEs worldwide (Alstadsæter, 2007; de Mooij and Nicodème, 2008; Thoresen and Alstadsæter, 2008; Romanov, 2006; Edmark and Gordon, 2013). Two recent policy trends are important. First, amid globalization, capital income tax rate has fallen through cuts in corporate income tax or tax rates on capital gains and dividends to mitigate double taxation. Second, tax rates on wages effectively have risen via escalating social insurance premiums as the population ages. That has prompted owners of SMEs to shift income from higher-taxed labor to lesser-taxed capital by retaining profits in self-owned corporations or paying themselves dividends rather than salaries. In addition, legislation to prevent such income shifting often becomes too complicated, eroding public trust in tax policy.

The recently published Mirrlees Review addressed this problem as an important issue in tax policy. To deter income shifting by owners of SMEs, it insisted that tax structures for corporate and personal income (including social insurance premiums) be set integrally and that the preferential tax treatment of SMEs be kept to the minimum (Crawford and Freedman, 2008).

The first half of this paper surveys recent problems in the US and UK[2]. Although income

[1] Distortionary effect of tax system on business organizational form choice attracted much attention from Gravalle and Kotlikoff (1989).

[2] Other famous examples are the Nordic countries, in which the introduction of the dual income tax systems caused sizable income shifting by owners of SMEs (Sørensen,1998; Lindhe, Södersten and Öberg, 2004).

shifting takes distinctive forms in each country, owners of SMEs in both countries have used corporate entities to convert high-taxed wage income into lesser-taxed capital income to reduce their tax and social insurance liabilities. The latter half of the study discusses recent institutional changes in Japan. Our aim is to consider the implications recent changes present for future tax and social insurance reforms in Japan.

The situation in Japan is somewhat singular compared to the US and UK. Japan grants a generous special deduction for salary income but not for business income from sole proprietorships or capital income. Accordingly, if sole proprietors incorporate and recharacterize business income as salary on their services, they can reduce tax liabilities via the salary deduction. Because Japan's corporate tax rate was high until 2000s, owners of incorporated SMEs retained no income and paid all earnings to themselves as salaries. It has been said that as a result of such income shifting, many small Japanese corporations seemingly operated at a loss (Tajika and Yashio, 2005; Ministry of Finance, 2014).

In addition, owners of SMEs in Japan have no incentive to draw dividends from their corporations even when they produce surplus income. Japan taxes dividends from unlisted corporations under the classical system—i.e., they are taxed at both the corporate and the personal level. Consequently, the marginal tax rate can be extreme, and the tax disadvantages of dividend income increasingly encouraged owners of small corporations to pay themselves salaries.

However, we show that recent changes in tax laws and social insurance have altered this long-standing situation in conformity to above-mentioned worldwide trends. First, Japan has reduced its national corporate tax rate, in particular a reduced rate applicable to small corporations from 22% to as low as 15%. Second, social insurance premiums keep rising as Japan's populace ages, and their combined rate on employers and employees have exceeded 30% in 2017. Therefore, retaining corporate earnings has become preferable to paying salaries, and shifting income from salary to retained earnings—a problem documented in many foreign countries—may soon become serious in Japan. However, dividends remain double taxed in Japan, making it likely that corporate profits will be retained rather than distributed as dividends.

Though recent situation has not been clarified yet because of poor availability of data,[3] the problem in Japan seems to be that recent changes in tax and social insurance policy have greatly reduced the tax rate for small corporations compared to the effective tax rates on salary and dividends. To correct the situation, we propose three reforms based on the ideas of the Mirrlees Review. Giving the brief outline here, the first is to abolish the reduced tax rate for small corporations, as the UK has recently done. The second is to alleviate double taxation of dividends to prompt distribution of earnings as dividends to some extent. The third is drastic reform of wage taxation and social insurance premiums, such as broadening the tax base (including reform of the above-noted salary deduction) and a unified review of tax rates

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[3] Using repeated cross-section data, Yashio (2018) shows that it is likely that some owners of SMEs actually have shifted income from their salary to retained corporate earnings in recent years.

and social insurance premiums in order to reduce the effective marginal tax rate on wages.

This paper proceeds as follows. Sections 2 and 3 discuss recent situations in the US and UK. Section 4 presents the situation in Japan and describes recent policy changes, considering how to accommodate expected problems. Section 5 concludes.

II. The Situation in the US

It has been said that owners of SMEs in the US escape substantial liability for social security and Medicare taxes by incorporating their businesses as pass-through entities, such as Chapter S corporations.

II-1. S corporations and Income Shifting

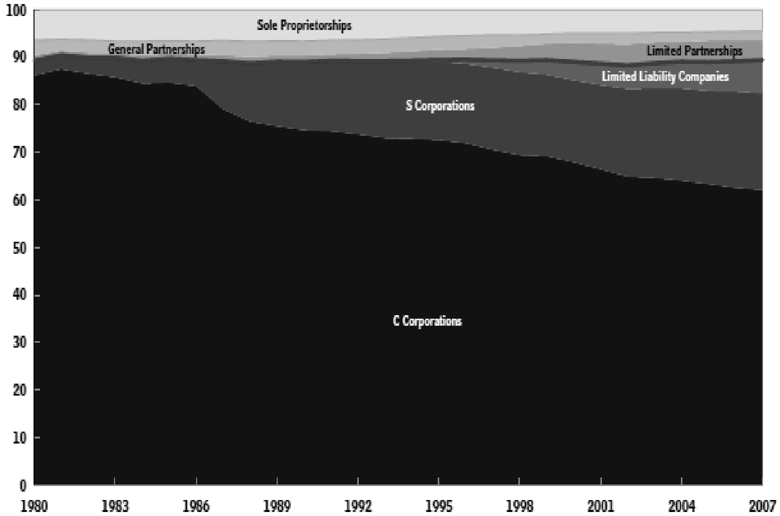
US tax law allows businesses to organize in several forms. Sole proprietorships and partnerships are basic forms of unincorporated business, and Chapter C corporations are the fundamental form of incorporated businesses. Hybrid organizations such as Chapter S corporations and limited liability companies (LLC) offer selective advantages. S corporations enjoy advantages of incorporation such as limited liability and corporate status,[4] but pay no corporate income tax. Profits are passed through to shareholders and taxed as personal income.

As was noted in the introduciton, S corporations attracted much attention right after the 1986 tax reform. Before the reform, the wealthy established self-owned C corporations and retained their earnings to shelter them from highly progressive personal income tax. However, the reform reduced the top personal tax rate below the corporate tax rate, so the wealthy dissolved their C corporations to establish S corporations that paid lower personal income tax. As a result, the share of business profits from S corporations jumped, as shown in Figure 1.

After that, the US again raised top personal income tax rates in 1993 and has set them equal to the corporate tax rate since 2004. Nonetheless, S corporations' share of business profits keeps rising (Figure 1), and this has again attracted attention. CBO (2012a) cited the US economy's tilt toward services as the cause, but we focus on another reason: the use of S corporations by owners of SMEs to minimize social security and Medicare taxes (US treasury, 2005). The point is that, as will be explained later, after they reorganize their sole proprietorships as S corporations, distributions (dividends) they pay themselves escape social security and Medicare tax (employment tax), whereas income from sole proprietorships does not. When people are single-owners of S corporations (in fact, 70% of S corporations are owned by one person), they characterize as much business profits as they can as distributions, thereby reducing their tax liabilities. The US Treasury (2005) emphasized the seriousness of

[4] There are some regulations which are imposed on S corporations but not on C corporations, such as limitations on the number and type of shareholders. See the Joint Committee on Taxation (2015) in detail.

Figure 1. Distribution of business profits in the US



Source: CBO (2012a)

the problem by describing S corporations as a "multibillion dollar employment tax shelter for single-owner businesses."

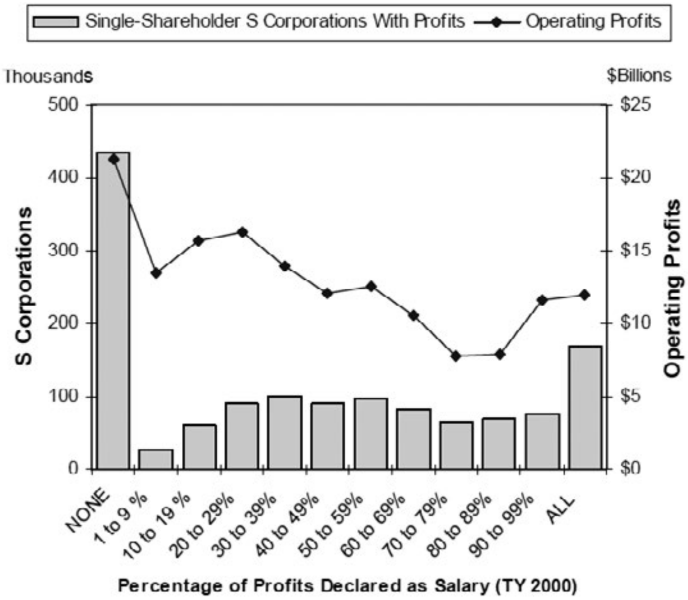
II-2. Actual Situation of Social Security and Medicare Tax Abuse

To describe the problem, we briefly explain the social security and Medicare tax system in the US (CBO, 2012b). Social security and Medicare Part A are financed by taxes on earnings of employers, employees, and the self-employed. The self-employed are subject to the Self-Employment Contributions Act (SECA), whereas employees and employers fall under the Federal Insurance Contributions Act (FICA). The self-employed pay 12.4% Old Age Survivors and Disability Insurance tax (OASDI) and 2.9% Hospital Insurance (HI) tax on annual business earnings under SECA (self-employment tax). If the self-employed do business as a corporation (Chapter S or C), they owe 12.4% tax for OASDI and 2.9% for HI on salaries received under FICA (employment tax)[5]. Both acts limit maximum earning for the OASDI portion ($118,500 for 2016).

As such, income from self-employment and employment are taxed identically, but the important point is that if sole proprietors do their businesses as one-person owners of S corporations, they can characterize business profits as their salary or distributions. As distributions escape the employment tax (and also the corporate tax, because S corporations are pass-through entities), they minimize tax liability by paying themselves minuscule

[5] 12.4% and 2.9% are the sums of employer and employee contributions, and owner-workers effectively pay the sums.

Figure 2. Valuations in salaries selected by owners of single-shareholder S corporations (TY2000)



Source: U.S. Treasury (2005)

salaries and larger distributions. It is said that this tax loophole prompted higher-earning sole proprietors to establish S corporations.

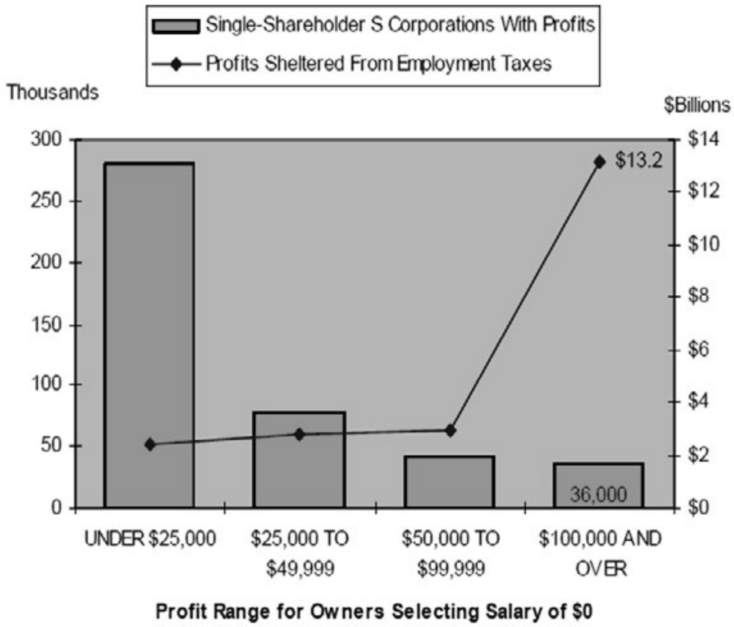
Figures 2 and 3 show actual situations of tax minimization by one-person owners of S corporations in 2000 (US Treasury, 2005). First, in Figure 2, more than 400,000 one-person owners of S corporations received no salaries, instead taking all business earnings as distributions. In Figure 3, 36,000 one-person S corporations that paid no salaries earned profits exceeding $100,000. That meant $13.2 billion in earnings were passed through to the wealthy owners of S corporations without employment taxes. US Treasury (2005) estimated the revenue lost at $5.7 billion in the whole country in TY 2000.

FICA originally requires corporations to pay “reasonable salaries,” and the IRS is escalating enforcement by auditing tens of thousands of S corporations yearly. Given the growing popularity of the entity, however, examination rates for S corporation returns are well below 1%. In addition, determining whether the wages paid are “reasonable” or not is highly subjective and dependent on numerous factors, so the IRS could not promulgate specific guidelines (GAO, 2009). As a result, many lawsuits have been filed by tax payers contesting the IRS’s determination that salaries were unreasonably low.

GAO (2009) insisted the IRS cannot rectify the problem through enforcement and that reforming the tax system itself is needed. Although reforms such as subjecting distributions received by active shareholders to employment tax have been suggested (Hennig et al., 2013; GAO, 2009), concrete action is not in sight.

The US experience of social security and Medicare tax abuse by owners of SMEs warns

Figure 3. Operating profits of S corporations that paid no salaries their sole owners (TY 2000)



Source: U.S. Treasury(2005)

Japan about potential future problems. As was noted in the introduction, social insurance premiums are increasing every year in Japan. Such an increase of social insurance premiums may cause income shifting by owners of SMEs to occur in the near future.

III. The Situation in the UK

In the 2000s, the introduction (at 10%) and subsequent reduction (to 0%) of a starting rate in corporate tax prompted sole proprietors in the UK to incorporate in massive numbers. Unskilled workers also began to incorporate to escape tax and social insurance burdens by establishing Managed Service Companies (MSCs). In response to a series of problems, the UK government abolished not only the starting rate but also a small corporation's rate in succession during several years.

III-1. Introduction of a starting rate in corporate tax

The UK has witnessed an increasing trend of workers providing labor as independent, self-employed contractors or through intermediary companies established by workers. Although some employers have required workers to do so in order to avoid costly obligations associated with employment (pay-as-you-earn or ensuring job security etc.), workers also have an incentive to do so because they can reduce their tax and National Insurance (NI)

Table 1. Corporate income tax rates in the UK

	main rate (companies with profits over £ 300,000)	small campany's rate (companies with profits under £ 300,000)	starting rate (companies with profits under £ 10,000)		main rate (companies with profits over £ 300,000)	small campany's rate (companies with profits under £ 300,000)	starting rate (companies with profits under £ 10,000)
1996-97	0.33	0.24	−	2006-07	0.3	0.2	−
1997-98	0.31	0.21	−	2007-08	0.28	0.21	−
1998-99	0.3	0.21	−	2008-09	0.28	0.21	−
1999-00	0.3	0.2	−	2009-10	0.28	0.21	−
2000-01	0.3	0.2	0.1	2010-11	0.28	0.21	−
2001-02	0.3	0.19	0.1	2011-12	0.26	0.2	−
2002-03	0.3	0.19	0	2012-13	0.24	0.2	−
2003-04	0.3	0.19	0	2013-14	0.23	0.2	−
2004-05	0.3	0.19	0[a]	2014-15	0.21	0.2	−
2005-06	0.3	0.19	0[a]	2015-16	0.2	−	−

a 19% is applied to dividend instead of 0%.

Source: Crawford (2008) and the website of HM Treasury

burdens. Especially, as doing business as a corporate entity has conspicuous tax advantages, many employees and sole proprietors has become incorporated. The corporations which workers establish for providing labor are referred to as Personal Service Companies (PSC) in the UK.

Incorporation became particularly advantageous in the early 2000s when UK corporate taxes featured a starting rate (initially 10% and thereafter 0%, see Table 1). Although a pre-existing small corporation's rate applied to corporate profits below £300,000, a starting rate pertained to the first £10,000 of corporate profits[6]. Though the aim of the government in introducing this rate was to encourage entrepreneurship, owners of SMEs responded by merely establishing corporations, not by undertaking new entrepreneurship (Crawford, 2008).

Table 2 illustrates the magnitude of the tax advantage of incorporating in 2002, when the UK reduced the starting rate to 0%. It compares the tax and NI contributions of an employed worker, a self-employed person, and an incorporated owner-manager whose business earns £25,000 gross earnings or profits a year. It shows that the self-employed enjoyed clear advantages over employees; this is because NI premiums applied to self-employment were below those of employee and employer's NI contributions are also imposed on salary of employees.

However, the tax advantages of incorporating far exceeded those of self-employment. An owner who establishes a PSC first takes as salary a personal allowance (£5,411), which incurs neither income tax nor NI contributions. The tax burden on remaining PSC profits (£19,589) is also alleviated because the 0% starting rate pertains to the first £10,000, and the small corporation's rate of 19% applies to the remaining £9,589. In addition, dividends received by the owner-shareholder of the PSC effectively escape personal income tax via the

6 See Pope and Roantree (2014) about the UK tax system.

Table 2. Tax and NI contributions due on £25,000 gross income or profits in 2002–03, by legal form

(unit; £)

		Employed	Self-employed	Imcorporated
Gross income/profits	A	25000	25000	25000
Salary		23870	0	5411
Income tax		3791	4039	0
NIC(Class1 employee's NICs)		1930	0	0
NIC(Class1 employer's NICs)		1130	0	0
NIC(Class2 and Class 4 NICs)		0	1493	0
Corporate tax		0	0	2277
Total tax and NI	B	6851	5532	2277
Net income/profits	C=A−B	18149	19468	22723
Total tax and NI as a % of gross income/profits D=B/A×100		27.4	22.1	9.1

Source: Author's calculation based on Crawford (2008)

credit to eliminate double taxation[7]. As a result, the tax and NI contributions owed on £25,000 is £2,277, far below the £6,851 owed by the employee or the £5,532 owed by the self-employed.

Figure 4 shows how the percentage of gross income or profits paid in tax and NI contributions for business earning £25,000 yearly changed after 1996–97 for an employee, the self-employed, and an incorporated owner-manager. The tax advantage of incorporation stands out in 2000–2003 when a starting rate was applied, although it was evident throughout the period.

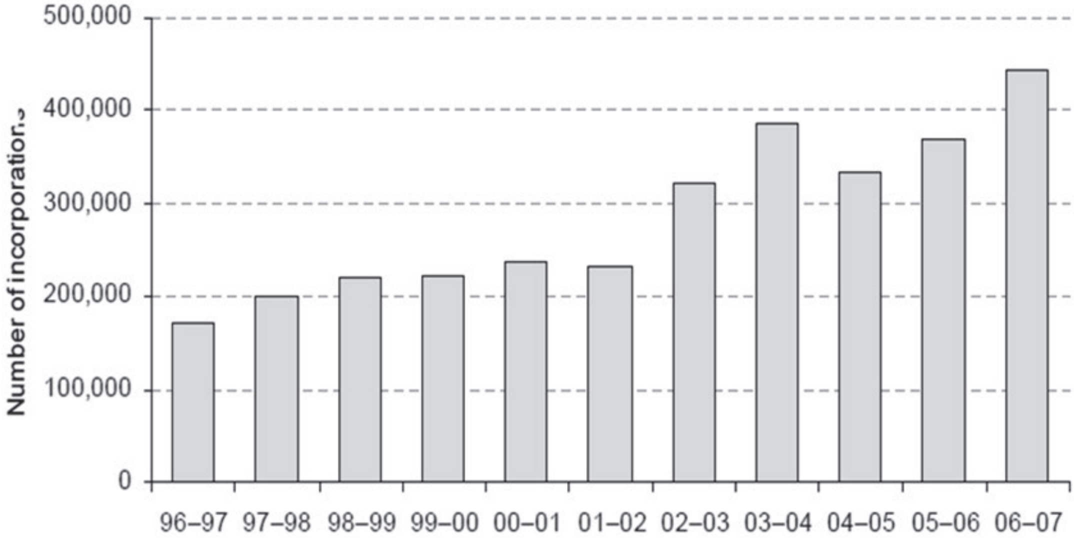
Specifically, reduction of a starting rate to 0% in 2002 caused large-scale incorporation by sole proprietors. In Figure 5, the number of newly-established corporations rose from 230,000 in 2001–02 to 320,000 in 2002–03 to nearly 390,000 in 2003–04. This number later rose again in 2006–07 following the introduction of MSC legislation, discussed later. However, it has been said that most of these incorporations were attributable solely to tax motives and not business expansion, which was the government's original intent (Crawford, 2008).

[7] When taxable income was up to the basic rate limit, personal tax was actually not imposed on dividends because the tax was offset by the dividend tax credit (Pope and Roantree, 2014). This system has been changed since 2016.

Figure 4. Percentage of ￡25,000 gross income or profits paid in tax and NI contributions over time, by legal form

Source: Author's calculation based on Crawford (2008)

Figure 5. Gross number of incorporations in the UK



Source: Crawford (2008)

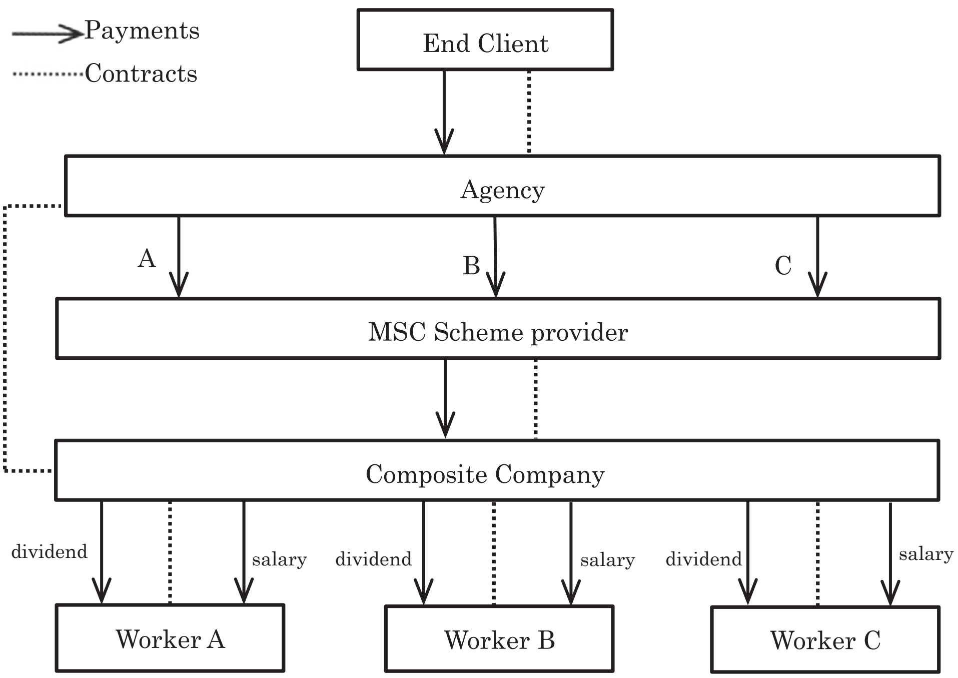
III-2. Tax Abuse and Managed Service Company

Furthermore, right after the reduction of the starting rate to 0%, increasing numbers of unskilled workers began to unite and incorporate as Managed Service Companies (MSCs) to reduce taxes and NI contributions. The number of workers who participated in MSCs rose from 60,000 in 2002 to 230,000 in 2006 (HMT and HMRC, 2006). As a result, the dilemma of the starting rate became clear.

Figure 6 illustrates how MSCs work (HM Treasury and HM Revenue & Customs, 2006). First, an employment agency introduces its workers (commonly 10 to 20) to an administrator (MSC scheme provider) who establishes MSCs, which are funded by pooling capital from the workers. Then, workers provide their labor to an end client through the agency. The client pays the workers through the agency, the scheme provider, and the MSC, but compensation the workers receive from the MSC are dividends, not wages. As Table 2 shows, these worker-shareholders greatly reduce their tax and NI contributions by receiving dividends rather than receiving salary as agency workers. The MSC provider takes a part of the savings in taxes and NI contributions as a fee.

The UK government had expected the introduction of a starting rate to exacerbate distortions, and in 2000, the year in which a starting rate was introduced, the UK enacted

Figure 6. Structures of a Managed Service Company



Source: HMT and HMRC (2006)

legislation—the Intermediary Registration (IR35)—to prevent tax abuse through use of corporate entities. This legislation prohibited establishing corporate entities solely for tax reasons, and most MSCs were considered illegal. But it was difficult for the government to collect the evidence of illegality, and the prohibition did not deter their rapid increase in number. Therefore, the government enacted new legislation (MSC legislation) to prohibit MSCs outright in 2007[8]. In response to this, many unskilled workers disbanded their MSCs and established their own PSCs, because if a worker controlled the business, the PSC did not contravene IR35. As a result, the number of new corporations again rapidly increased in 2006–07 (Figure 5).

The government recognized the flaw of a starting rate through a series of events, effectively ending it in 2004 and formally abolishing it in 2006. However, as Figure 4 shows, the tax advantages of incorporation remain today, and tax avoidance through use of PSCs by famous BBC newscasters became a scandal (Louzenhiser, 2013). Thus, the problem remains a notable point in the UK, and through this series of events the thought has spread that creating tax incentives to favor one legal form over another may not encourage entrepreneurship. As a result, the small corporation's rate was also abolished in 2015 by unifying it into the reduced basic rate[9].

IV. The Situation and the Direction of Reform in Japan

The problem of income shifting by Japanese owners of SMEs appears singular in comparison with the US and UK. In Japan, it has been said that the income deduction applied to salary (k*yuyo-shotoku kojo* in Japanese) under the personal income tax (PIT) system prompted sole proprietors to incorporate. Due to recent tax and social insurance changes, however, the long-standing situation is changing. We discuss Japan's current situation and policy implications, taking situations in the US and UK into account; however, the actual situation is clouded by lack of micro-data for SMEs[10].

IV-1. Japanese tax and social insurance systems and "income shifting to salary"

We begin by explaining the Japanese tax system and the mechanism of income shifting. First, sole proprietors living in the average household (a married couple with one child) calculate taxable income under PIT as follows:

$$\begin{aligned}&\text{business income} = \text{sales} - \text{business expenses}\\&\text{taxable income (PIT)} = \text{business income} - \text{basic allowance} - \text{allowance for spouse}\\&\qquad - \text{allowances for dependents} - \text{allowance for social insurance premiums.}\end{aligned} \tag{1}$$

[8] Seely (2015) explains the process of the legislation in detail.
[9] Office of Tax Simplification, which was launched by the government in 2010, recently published a report about how to reform small business taxation in the UK. (OTS, 2016).
[10] Ishi (2000) explains Japan's tax system in detail.

Table 3. Salary income deduction (2017)

the amount of salary	the amount of the deduction
1,800,000 yen or less	the amount of salary × 40% (minimum 650,000yen)
3,600,000 yen or less	the amount of salary × 30% + 180,000yen
6,600,000 yen or less	the amount of salary × 20% + 540,000yen
10,000,000 yen or less	the amount of salary × 10% + 1,200,000yen
10,000,000 yen or over	2,200,000yen

After subtraction of business expenses, several personal allowances (¥380,000 per person in 2017) and social insurance premiums are deducted from taxable income.

On the other hand, taxable income of salaried workers in the same household is calculated as follows:

salary income = salary − salary income deduction
taxable income (PIT) = salary income − basic allowance − allowance for spouse − allowances for dependents − allowance for social insurance premiums. (2)

A salaried worker may deduct a salary income deduction as approximate expenses necessary to earn his salary instead of being entitled to deduct actual expenses. The deduction is set by law (Table 3). For example, a salary of ¥2 million enjoys a deduction of ¥780,000 and salary of ¥8 million a deduction of ¥2 million. The deduction covers about 30% of the overall salary nationwide and is very generous. Other allowances are the same as those granted to sole proprietors. The common progressive tax rate structure applies to taxable incomes of sole proprietors and salaried workers.

This generous salary income deduction encouraged owners of SMEs to incorporate because owners of incorporated businesses can deduct the expenses ‘twice’ by receiving salary for his services from corporations. To illustrate, we first describe the taxable income in corporate income tax (CIT), which is calculated by subtracting expenses from sales, in (3).

taxable income (CIT) = sales − business expenses–owner’s salary (3)

An owner’s salary is deductible from the CIT tax base as a business expense (described separately from other expenses in (3)). The salary is subject to PIT, and salary income deduction is applied to it to calculate the PIT tax base, as shown in (2). Because of the double deduction of expenses (business expenses and salary income deduction), his PIT tax base shrinks compared to that of sole proprietors and he reduces his PIT liability significantly.

The owner may retain earnings in the corporation and pay CIT on that amount instead of receiving salary and paying PIT on it. Under Japan's CIT system (which includes local tax), a corporation with capital stock of ¥100 million or less enjoys a reduced rate on taxable income up to ¥8 million instead of a basic rate. However, as shown later, since the effective CIT rate (including local tax) was high in the past even when a reduced rate was applied, many owners of SMEs incorporated with no incentive to retain earnings and paid everything to themselves as salaries. These corporations raised funds by borrowing part of their owners' salaries. Given this shifting of income to salary, many small corporations seemingly operated at a loss (Tajika and Yashio, 2005; Ministry of Finance, 2014).

There are two more related points about the Japanese system. The first concerns taxation of dividends. In Japan, dividends from unlisted corporations are taxed under the classical system, in which CIT is levied on corporations and PIT on personal income (although a dividend tax credit for personal income partly ameliorates double taxation). In addition, since PIT is progressive and is levied after dividends are added to salary or business income, total marginal tax rates on dividends can be extreme. Consequently, Japanese owners of incorporated businesses generally do not receive dividends from their corporations and instead take salaries for their services to the greatest extent possible.

The second point concerns Japan's social insurance. All registered residents of Japan are covered by public health, long-term care (aged 40 and older) and pension insurance, but the types of systems covered and the contribution systems differ with location of employment. We call the insurance system for employees IE and that for non-employees INE here[11]. Contributions for INE are primarily fixed, whereas contributions for IE are proportional to salary up to a maximum limit (a yearly salary of ¥7,440,000 for pension and ¥14,520,000JPY for health in 2016[12]). Employer contributions are levied on top of those of employees.

Therefore, the burden of social insurance contributions originally is heavier if the businessperson incorporates and draws the same salary he earned from business income as a sole proprietor. In practice, however, many owners of incorporated businesses illegally failed to register their corporate status with the government's pension offices[13] and remained covered under INE, thereby evading the social insurance burden. Japan's government has controlled this problem loosely, and it is likely that differences in social insurance contributions have not affected the business organizational form choice by owners of SMEs. Therefore, the above-mentioned tax loophole presented by the salary income deduction has become the main tax advantage of incorporating in Japan.

[11] Strictly speaking, sole proprietors who employ at least 5 full-time employees are covered under IE. The words IE and INE are used just for simplicity. Expressing more accurately, sole proprietors are covered under National Health Insurance System and categorized as Category I insured persons in the public pension system. Incorporated owners are covered under the Employee's Health Insurance System as Category Ⅱ insured persons.

[12] We suppose that owners don't receive bonuses here.

[13] The official name is the Japan Pension Service Branch Office.

IV-2. Japan's historical situation and recent tax and insurance changes

The generous deduction for salary income has caused owners of SMEs to shift income. However, following recent changes in tax and social insurance, that long-standing situation is changing. After touching on a preceding study that analyzes how the deduction for salary influences income shifting by owners of SMEs, we explain recent tax and social insurance changes.

IV-2-1. The deduction for salary income and income shifting

First, we show that expansion of the salary income deduction in the past might have prompted owners of SMEs to incorporate. The deduction remained largely ignored during 1960s, but it was expanded significantly in 1974. The deduction that applied to a salary of ¥3 million was expanded from ¥450,000 to ¥1,050,000, and the deduction applied to a salary of ¥8 million was raised from ¥750,000 to ¥1,850,000. Tajika and Yashio (2005) showed that the number of corporations increased nationwide immediately after this reform, as Figure 7 also confirms. The figure illustrates changes in the ratio of corporations to all business entities (individual and corporate)[14]. The 45-year peak of incorporations occurred in 1974 and 1975, the years immediately after expansion of the deduction[15]. Based on this observation, Tajika and Yashio (2005) analyzed how tax reform affected owners of SMEs' choice of organization with a model modified from MacKie-Mason and Gordon (1997) and Goolsbee (1998).

A noteworthy point is that the effective CIT rate historically was so high that most owners of incorporated businesses had no incentive to retain earnings. Figure 8 compares marginal effective PIT rates (including national and local tax, and employee and employer social insurance premiums) by salary ranking[16] with the effective CIT rates (including national and local tax[17]) under the 1997 tax system. One of two effective CIT rates in the figure is calculated with a reduced rate for small corporations and the other with a basic rate. As noted, owners of incorporated businesses were relatively free to choose IE or INE, so the figure depicts two sets of effective PIT rates: IE on the left and INE on the right.

With regard to IE (left figure), first, marginal PIT rates (tax only) are rather low partly because of the generous deduction for salary income. Second, the general shape of marginal PIT rates, including tax and social insurance contributions, is far from a simple monotonic

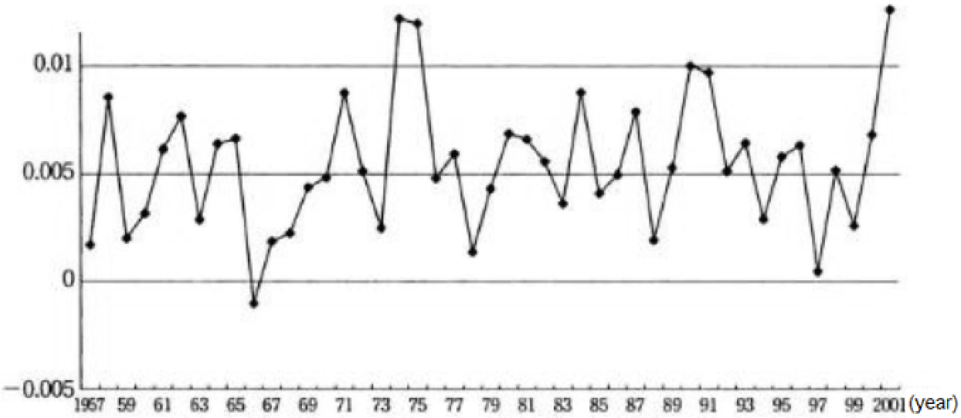
[14] Figure 7 shows the values of $\frac{corporations_t}{corporations_t + sole\ proprietorships_t} - \frac{corporations_{t-1}}{corporations_{t-1} + sole\ proprietorships_{t-1}}$.

[15] There was a special tax treatment for sole proprietors in which they could choose to be taxed as if they were corporations during 1970s. Such 'deemed corporations' are included in corporations in Figure 7. See Ishi (2000) about this tax system.

[16] The effective marginal PIT rates are calculated by $\frac{\Delta(tax + social\ insurnce\ premiums)}{\Delta(salary)}$. An average household (a married couple with a child) is used in this calculation.

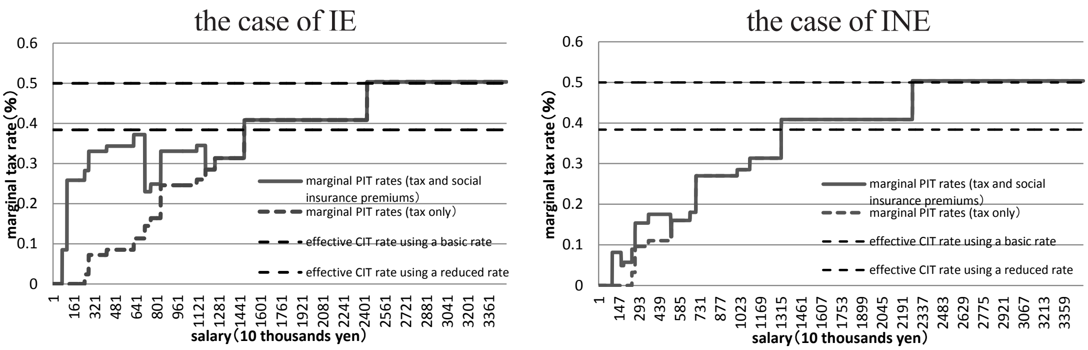
[17] Local tax includes corporate inhabitant tax and enterprise tax.

Figure 7. Change in ratio of corporations to all business entities (sole proprietorship and corporation) in number



Source: Tajika and Yashio (2005)

Figure 8. Comparison of the effective PIT rates according to salary rank and CIT rates in 1997

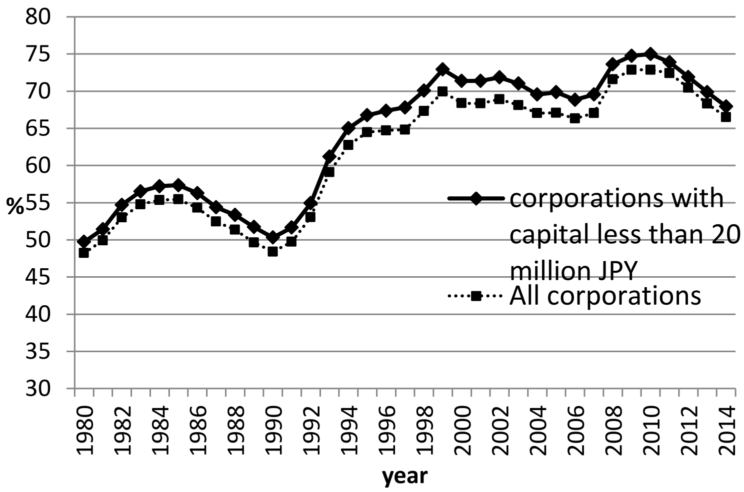


Source: Author's calculation

progression because of earning limits for social insurance contributions (Iwamoto and Hamaaki, 2008)[18]. The most important point in Figure 8 is that the effective CIT rate was so high (nearly 40% when the reduced rate pertained) that the salary at which the marginal effective PIT rate surpasses was ¥15 million. Therefore, most owners of incorporated businesses could reduce tax and social insurance liabilities by taking all earnings as salary and retaining none[19]. In the case of INE, the effective PIT rate was even lower, and the

[18] There are two earnings limits: one for pensions and another for health and long-term care.
[19] According to tax statistics, the average yearly salary for owners of small corporations is about ¥5 million.

Figure 9. Ratio of corporations operating at deficits to all corporations



Source: Tax Statistics (National Tax Agency)

incentive to receive a salary was stronger.

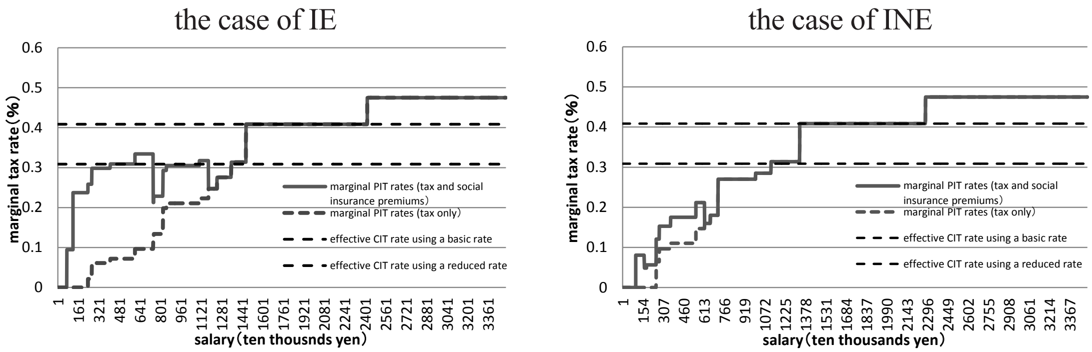
This rate structure plausibly explains why many small Japanese corporations apparently operate at a loss. Figure 9 shows the ratio of companies operating with deficits among all small corporations. Since the burst of the Bubble Economy in the early 1990s, the ratios have remained constant at around 70%. As corporations operating with deficits cannot collect enough funds to remain in business, it should be impossible for that situation to persist for 20 years. Therefore, it seems likely that tax avoidance by owners of SMEs (shifting income to salary) explains this phenomenon. It is also clear that owner-shareholders had no incentive to receive dividends from their corporations because the progressive PIT pertains to that income on top of the high-rate CIT.

IV-2-2. Recent tax and social insurance changes in Japan

This situation persisted for a while. Figure 10 shows the marginal effective PIT rates and the CIT rates in 2005. According to the left figure (PIT rates for IE), the effective CIT rate using a reduced rate fell to around 30% in 2005 from nearly 40% in 1997, but the PIT rates also decreased and were approximately equivalent to the CIT rate up to a salary of ¥15 million. In addition, the PIT rates for INE remained low, as described in the right figure.

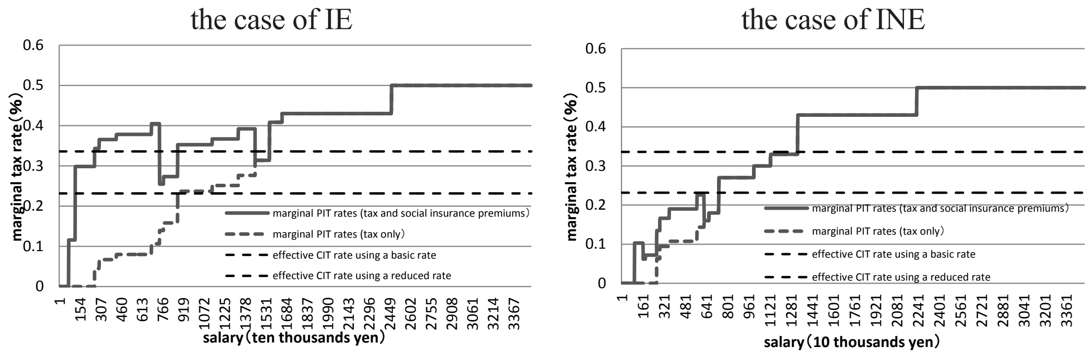
However, that situation drastically changed after that. Figure 11 depicts the situation in 2017. The effective PIT rates for IE (left figure) far exceed the two CIT rates. Two policy changes are important for explaining this trend. First, Japan has reduced the national CIT rate, particularly for small corporations, from 22% to as low as 15% over several times after 2009 (Figure 12). As a result, the effective CIT rate (including local tax) for small corporations has fallen below 25%. Second, social insurance premiums rise yearly, and the combined rate

Figure 10. Comparison of the effective PIT rates according to salary rank and CIT rates in 2005



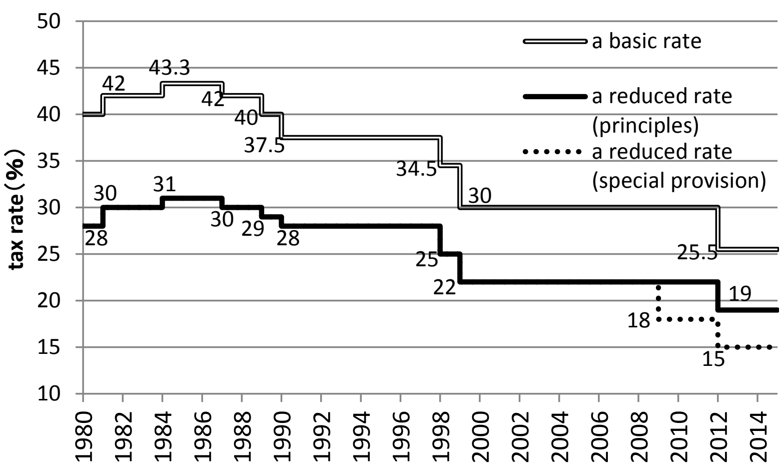
Source: Author’s calculation

Figure 11. Comparison of effective PIT rates according to salary rank and CIT rates in 2017



Source: Author’s calculation

Figure 12. Corporate income tax rates in Japan



Source: Website of the Ministry of Finance for employers and employees has exceeded 30% in 2017. Consequently, the effective PIT rates have risen 35% or more among middle class salary workers, and the PIT rate now exceeds the CIT rate for small corporations by more than 10 percentage points. PIT rates for INE (right figure) also have risen, and the salary at which the effective PIT rate surpasses the CIT rate has fallen to ¥7 million in 2017 from ¥15 million in 2005.

Another noteworthy point is the government's announcement to strengthen control over the public insurance coverage for owners of SMEs. As described, many owners of incorporated businesses have illegally been covered under INE, but the government has declared its intent to tighten control over this problem in a few years. If it is successful, many incorporated owners will have to move from INE to IE, and the tax advantages of retained earnings over salary will become clear.

We cannot say here what impact these changes have had on income shifting of owners of SMEs. Unlike the US and UK, dividends still remain double taxed and it is unclear whether the government's tightening control over the coverage of social insurance will be successful. Since availability of micro-data of SMEs for economic research is limited in Japan, little attention has been given to the point in previous researches. However, as depicted in Figure 12, retaining profits surely has great tax advantages over receiving a salary, and we actually find several websites by tax accountants which strongly recommend shifting income from salary to retained earnings. Therefore, the problem may become serious in the near future.

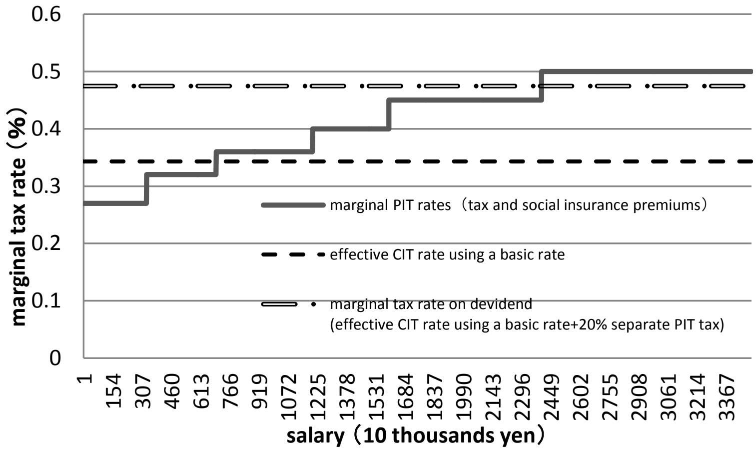
IV-3. Direction of future tax and social insurance reform in Japan

The Mirrlees Review insisted that to prevent income shifting by SMEs, the rate structures of CIT and PIT, including social insurance contributions, must be aligned, and special tax incentives for small businesses should be subject to limits. Drawing upon its ideas, we propose three points for future tax and social insurance reform in Japan. Our reform plan, which is illustrated in Figure 13, aims to curtail the tax advantages of retained corporate earnings over salary and dividends.

First of all, we call on abolishing or cutting back a reduced rate for small corporations in CIT. As discussed, the UK recently abolished it in recognition that it only gave owners of SMEs a strong incentive for income shifting and failed to encourage real economic activities. With the basic rate of CIT being lowered, Japan should also essentially abolish it and limit the special tax treatment to SMEs to the minimum.

Second, double taxation of dividends from unlisted corporations should be alleviated. Possible alternatives to the current PIT on dividends is the flat separate taxation by 20%, which is now being used as the taxation on dividends from listed corporations. By introducing it coupled with abolishing a reduced rate in CIT, total marginal tax rate on dividends (CIT

Figure 13. Illustration of the tax and social insurance reform plan



and PIT) would fall to 48%, a little lower than the top PIT rate on salary[20]. The reform would partially mitigate double taxation and prompt some profits to be distributed to owners as dividends, thereby preventing too much earnings from being retained.

Third, drastic reforms of labor income taxation, including social insurance premiums, are needed. Due to the increase of social insurance premiums, PIT rates have risen nearly 40%, even for salaries of around ¥5 million (left figure of Figure 12), and that may induce income shifting by middle-income owners of incorporated businesses. As the general shape of the marginal PIT rates is far from a simple progressive structure, reforming it into the simple one illustrated in Figure 13 should be desirable from the viewpoint of not only preventing income shifting of middle-income earners, but also restoring the income redistribution function of PIT. The rate structures of tax and social insurance should be reviewed integrally[21].

Another noteworthy point for PIT reform is to broaden the tax base of PIT by reducing various kinds of allowances and deductions[22]. Such reform would enable the government to cut marginal effective PIT rates without losing much revenue. In particular, reform of the salary income deduction is important. Its generosity has caused income shifting by owners of SMEs, and its structure weakens the income redistribution function of PIT because in the current system, the higher salary people earn, the larger the deduction granted. Reforming it would alter the current tax system into a more efficient and equitable one[23].

[20] Today's top marginal PIT rate (including local tax rate of 10%) is 55%, which is applicable to taxable income of ¥40 million and over, but the number of people to whom the rate is applicable is very small. 50% is applied to taxable income from ¥18 million to ¥40 million.

[21] The Netherlands has the unified rate structures of tax and social insurance premiums.

[22] Many countries have recently carried out tax reform that replaces deductions with (refundable) tax credits. It is well known that such tax reform strengthens income redistribution of the tax system.

[23] Accumulated earnings tax is levied on retained profits of crossly-held corporations in Japan, but small corporations are exempt from it. To prevent the wealthy owners of small businesses from retaining too much profits to avoid the progressive PIT, this tax should be utilized in a restrictive way.

V. Conclusion

This paper discussed how to address income shifting by owners of SMEs. Amid globalization and aging, capital income tax rate has fallen, whereas tax rates on wages have risen worldwide, prompting owners of SMEs to transfer income from higher-taxed labor to lesser-taxed capital. In the first half of this paper, we described the recent problems regarding this in the US and UK.

In the latter half, the situation in Japan was discussed. It has been said that generous salary income deduction has prompted many owners of SMEs to convert the business income into salary. But the situation is changing following recent tax and social insurance changes. Therefore, income shifting from salary to retained earnings may become a serious problem in Japan in the near future.

One important tasks left behind is to clarify the actual situations of income shifting in Japan through use of micro-data of SMEs. Partly because of poor availability of data, there have been very few studies which analyzed the problem we have discussed. However, clarifying its actual situation would be not only interesting but also indispensable to making our reform plan more concrete.

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