CHAPTER I
INTRODUCTION TO THE JAPANESE TAX SYSTEM

1/1 Historical Background

1. Tax System Before the End of World War II

(1) Prior to the Beginning of World War II

A modern tax system was established in Japan approximately 20 years after the Meiji Restoration (1868), when Japan emerged from feudalism. Until that time the Japanese tax system had relied mainly upon land taxes, which represented more than 80% of all tax collected. Rapid development of a capitalism economy in the Meiji period brought about broad changes in the tax system. An income tax system was introduced in 1887, making Japan one of the first countries to adopt an income tax system with modern features. However, since economic development was still at an early stage, income tax played only a minor role in total tax revenue (1.5% in 1888); the number of people paying income tax was only 118,600 out of a total population of 39 million, while land tax still accounted for more than half of the aggregate tax revenue (53.8% in 1888). As the modern tax system developed in Japan, the importance of land tax for revenue decreased steadily. This trend continued until 1940, when the income tax system was expanded and the indirect tax system was modernized.

Supported by an increase in national income and improved administration, the income tax system gradually evolved: provisions of the tax law were more precisely defined, the number of taxpayers increased, tax revenue grew gradually, and the importance of income tax in national finance increased. Until 1908, land tax was the main source of national tax revenue. Indirect taxes, of which the liquor tax was the most important, expanded gradually. Since 1935, income tax has been the most important single item in tax revenue. Major changes up to World War II included:

<table>
<thead>
<tr>
<th>Year</th>
<th>Major Tax Reforms</th>
<th>Descriptions</th>
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<tr>
<td>1868 Meiji Restoration</td>
<td>Reform of land Tax (land tax revenues accounted for more than 80% of total tax revenue)</td>
<td>The tax base changed from crops to the value of the land. A fixed tax rate was applied. Payment in cash was adopted in place of payment in kind.</td>
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<td>1872</td>
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<td>Year</td>
<td>Major Tax Reforms</td>
<td>Descriptions</td>
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<tr>
<td>1887</td>
<td>Introduction of an income tax system</td>
<td>A general income tax as levied on the aggregate income of each individual, the level of basic exemption being 300 yen and progressive rates ranging from 1% to 3%. Individuals paying income tax in 1887 numbered about 120,000.</td>
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<td>1889</td>
<td>Promulgation of the Meiji Constitution</td>
<td>Business tax as imposed on the capital amount, and the number of employees, etc. 504 district tax offices ere established.</td>
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<td>1894</td>
<td>Sino–Japanese War</td>
<td>Income tax as divided into three schedules; I (e.g., corporate income, tax rate 2.5%), II (e.g., interest, tax rate 2%), and III (e.g., personal income, tax rates 1%~5.5%). Income tax was not imposed on dividends received by individuals, thus avoiding double taxation of income from dividends.</td>
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<tr>
<td>1896</td>
<td>Introduction of a registration tax and business tax and the reorganization of tax collection organs</td>
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<td>1899</td>
<td>Introduction of scheduler income taxation, including corporate income taxation and with holding tax on interest</td>
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<td>1904</td>
<td>Russo–Japanese War</td>
<td>10% of employment income as deductible Tax rates ranging from 2.5% to 22%.</td>
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<td>1913</td>
<td>Introduction of an employment income deduction</td>
<td>Interest on term deposits and dividends and bonus payable to nonresidents became subject to withholding tax. Exemption for dependents as 50 or 100yen for each dependent according to the taxpayer ’s income. Dividends received by individuals, less a 40% deduction, ere included in taxable income. Tax rates ranged from 0.5% to 36%.</td>
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<td>1914</td>
<td>World War I</td>
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<td>1920</td>
<td>Establishment of the League of Nations</td>
<td>Introduction of exemption for dependents and withholding tax system for some income categories</td>
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<td>1921</td>
<td>Limitation of Armaments Conference</td>
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<td>1926</td>
<td>Tax reform for both national and local tax systems</td>
<td>A business profits tax was introduced as a supplement to income tax, replacing business tax. The land tax base as changed from the price to the rental value of the land. The indirect tax system as reorganized.</td>
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<tr>
<td>1932</td>
<td>Shanghai Incident</td>
<td>A series of tax increases to meet increased fiscal needs and the introduction of commodity tax</td>
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<td>1939</td>
<td>World War II</td>
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(2) Tax System during World War II

A. Direct Tax System

In 1940, overall reform of the tax system was carried out to meet the requirements of the wartime economy and to refine the tax system as a whole. The main characteristics of this reform were as follows:

a. The direct national tax system was rearranged. The former income tax was levied not only on individuals but also on corporations. The new income tax, as a rule, applied only to individuals, and consisted of two parts; namely, a scheduler income tax and a comprehensive income tax.

b. With the scheduler income tax, income was divided into six schedules according to the nature of income; i.e., (i) real property income, (ii) dividends and interest income, (iii) business income, (iv) employment income, (v) timber income, and (vi) retirement income. Different rates were used with each schedule in calculating income tax liability. The idea of a basic exemption was introduced for business income and employment income.

c. Comprehensive income tax on aggregate income was imposed at progressive rates (10%~65%).

d. With respect to corporate income, the Corporation Tax Law was introduced. Corporate income was taxed at the rate of 18%.

e. With respect to employment income, withholding tax at a rate of 6% was introduced.

B. Indirect Tax System

Main reforms of the indirect tax system during this period involved:

a. After 1938, the number of commodities that were subject to the commodity tax increased and rates were differentiated according to commodity.

b. The liquor tax, which had been the leading item of indirect taxes, was simplified in 1940.

C. Increased Role of Direct Taxation

As a result of the tax reform of 1940, Japan’s tax system came to rely mainly on direct taxes. The share of direct taxes, 67% of which was income tax and corporation tax, reached 64% of total tax revenue in 1941.

2. Tax System After World War II

The history of the Japanese tax system was characterized by the influence of
the United States for more than 30 years after World War II, and especially the philosophy of Professor Carl S. Shoup’s recommendations; later modification of the tax system was made in an effort to adapt it to Japanese society. Since by its nature taxation is closely connected with economic and social conditions, the modification and development of the Japanese tax system mentioned also reflected changing circumstances in Japan prior to its present economic status. From this point of view, the postwar history of the Japanese taxation system can be divided into four periods: the first period when the economy was in chaos (1945—49), the second period featuring economic reconstruction (1950—59), the third period marked by the achievement of economic growth (1960—69), and the fourth period devoted to the improvement of national welfare (1970 to the present).

(1) **First Period - Economic Chaos after the War (1945 - 49)**

The war left the Japanese economy in shambles, ravaged by rampant inflation. The goal of fiscal policy at the time was simply to cope with this crisis in the nation’s economy. Many reforms were undertaken so as to coordinate tax policy with other economic policies. For example, a special tax on war indemnity was introduced for the purpose of canceling various claims for compensation.

**A. Introduction of Anti-inflationary Tax Measures**

One of the anti-inflationary measures introduced in 1946 was the property tax, which was also designed to redistribute national income. Since the Japanese people were forced to deplete their contingency reserves after the end of the war, the new tax did not prove fully effective in curbing hyper-inflation. However, this new tax substantially redistributed income through its extraordinarily progressive tax rates ranging from 25% to 90%.

Another special tax for wartime compensation newly introduced was to be levied on wartime compensation of munitions companies, etc. at 100%. This tax was contrived to put an end to the obligation claimed against the government for wartime compensation by munitions companies, etc.

**B. Introduction of the Self-assessment System on a Current Basis**

The dual income tax system, in effect since 1940, was abolished in 1947, which made it impossible to secure adequate revenue through conventional means. A new method was adopted to permit a taxpayer to assess his or her own income tax on the basis of income for the current year. Previously, income tax on such categories of income as earnings from business and agriculture had been generally assessed by tax officials on the basis of a taxpayer’s income in
the preceding year. However, the implementation of this new system met with a storm of opposition from taxpayers because it was considered a radical change in the method of taxation. In order to collect the amount of taxes due, the government had to embark on sweeping countermeasures immediately after the final reporting period.

C. Trial Introduction of the Turnover Tax

One of the remarkable events in taxation during this period was the introduction of the turnover tax and its abrogation. This tax was levied on the basis of the sales amount at every stage of a transaction at the rate of 1%. Its aim was to flexibly meet revenue needs according to economic changes. Collection was first made by the sale of stamps to vendors, but this method produced numerous complaints from taxpayers. It was later changed to collection on the basis of a return submitted monthly by the taxpayer. The enforcement of the tax required close examination of taxpayers’ accounting books, which made the tax very unpopular. It was also argued that this tax dealt a hard blow to small businesses, which could hardly afford to shift the tax burden to consumers. The ill-fated tax was abolished in 1950, following suggestions made by the Shoup Mission.

D. Local Tax System

In 1947 and 1948, the local tax system was reviewed. In order to establish a sound local financial system, administration of several national taxes such as the land tax, house tax, business tax, mineral product tax, and amusement tax were transferred to local governments.

E. Establishment of National Tax Agency

One of the notable changes in the field of tax administration was the establishment of the National Tax Agency in 1949. The reorganization of tax administration was intended to allow the government to enforce tax laws more efficiently and to clarify the authority and responsibilities of the tax administration by reallocating these functions of the Tax Bureau of the Ministry of Finance.

(2) Second Period - Economic Stabilization and Restoration (1950 - 59)

Since the late 1940s, stringent economic policy was pursued in accordance with the plan worked out by Dr. Joseph M. Dodge, then advisor to the General Headquarters, who pointed out that the maintenance of a balanced budget was necessary to halt inflation. In the same year, a mission headed by Professor Carl S. Shoup was invited to review the structure and administration of the Japanese
A. Main Features of the Reform of 1950 based on the Shoup Recommendations

Professor Shoup’s approach placed direct taxes, and especially income tax and corporation tax, at the centre of the entire taxation structure. In theory, income tax was to be complemented by a net wealth tax and on inheritance tax. For corporation tax purposes, a corporation was deemed to be a mere aggregate of shareholders not constituting an independent taxable entity.

It is to be noted that a system called the “blue return system” originated from Professor Shoup’s recommendations. This system involved a basic over-haul of the administration of the income tax system.

a. National Taxes

(a) Introduction of a new concept for the corporation tax

The most important issue in the income tax field was the introduction of a concept that the corporation tax was an advance payment of individual income tax by shareholders. In order to avoid double taxation, dividends received by a corporation were exempt from corporation tax and a 25% credit with respect to income tax was granted for dividends received by individuals.

At the same time, a corporation tax of 2% was levied on undistributed profits on the grounds that the holding in reserve of profits by a corporation amounted to the deferral of shareholders’ personal income taxes.

(b) Overall aggregation of income

The principle of aggregation of income was applied to all categories of income, including temporary income. Income derived from securities transactions and all other income derived from the transfer of assets (capital gains) was now subject to the income tax.

(c) Revaluation of assets

On the other hand, the fall in the value of currency due to rapid inflation caused a substantial difference between the current value and the book value of fixed assets. To make the capital structure more realistic, a revaluation of assets was undertaken. Revaluation of assets for business use was optional, while revaluation of other individual assets was obligatory at the time of transfer for such assets. A surplus arising from revaluation was treated as if it had accrued from the transfer of proper-ties, but such income was taxed at a reduced flat rate of 6%.
(d) Introduction of a net wealth tax

Coupled with the lowering of the maximum income tax rate from 85% to 55%, a net worth tax was supplementarily levied on persons with large incomes from property.

Individuals whose net assets exceeded ¥5 million were taxed at progressive rates, ranging from 0.5% to 3%, according to their net wealth.

(e) Others

Widespread special taxation, though given on the pretext of economic and industrial needs, had undermined basic tax principles. In the reform of 1950, special measure was reduced to the practical minimum.

b. Local Taxes

(a) Granting of an independent right of taxation to each local entity prefectures previously levied such taxes as the land tax, house tax, enterprise tax, and consumption tax on hotels and restaurants, while the financial resources of municipalities were provided by a surtax on these taxes. This system was abolished in 1947, and all local entities were given an independent right to tax.

(b) Enactment of a value-added tax

A new law was enacted in 1950 to introduce a value-added tax on production or marketing under the local tax system. The tax base of the value-added tax was the gross receipts of an enterprise less its purchases from other enterprises; consequently wages payable to its employees as well as interest and rent payable to other firms were included in the base. This proposal was immediately criticized because enterprises employing large labor forces would be penalized. There was also a strong sentiment among businessmen opposing a tax that must be paid by an enterprise even when its operations resulted in a loss. For these and other reasons, opposition to the new tax was vehement. The controversial law was later revised to a slight degree. Enforcement of the law was postponed several times, but it was finally repealed in 1954 without having been put into operation.

B. Modifying Shoup’s Taxation System

a. In general, the tax reforms based on the recommendations of the Shoup Mission of 1950 sought an optimal long-term tax system. The mission’s intentions, however, were somewhat idealistic and did not consider the reality of the Japanese economy and the standard of living for the Japanese people. Yearly tax reforms since 1951 represented an effort to re-adjust the tax system to meet actual conditions prevailing in the country.

b. The following brief review of a series of tax reforms since 1951 shows the
process of modification through which the tax system based on the Shoup recommendations was adjusted.

(a) Abolition of taxation on the retained profits of corporations

For the purpose of the corporation tax, retained profits at the end of each accounting period had been taxed at the rate of 2%, in line with the suggestion by the Shoup Mission that such tax be deemed an interest surcharge on retained profits. However, in light of the important role of profit retention in business financing, the retained profit taxation of corporations other than “family corporations” was abandoned in 1952.

(b) Abolition of taxation on capital gains derived from the transfer of securities

The philosophy of the Shoup recommendations was to make all categories of income, including capital gains, subject to individual income tax. However, in 1953, capital gains from the transfer of securities were made non-taxable, not only because the taxation of capital gains allegedly hampered the development of the securities market, but also because taxes on such gains were technically difficult to assess and to collect.

(c) Abolition of the net wealth tax

The net wealth tax proved inequitable because real property owners whose net wealth is easily identified bore the full brunt of taxation while others avoided the burden to an extent. Consequently, this tax was abolished in 1953.

(d) Measures for the development of the Japanese economy

The Shoup recommendations were founded on the general principle of equitable sharing of the burdens to meet government expenditures, avoiding arbitrary reduction of the tax burden even at the cost of economic policy goals. A number of concerned persons in the government, however, felt that in light of the prevailing condition of the Japanese economy, vital economic policies might override certain general principles of taxation. As a result, several measures were initiated in 1953 to this end, including the extension of special depreciation allowances, wider application of reserves for bad debts and price fluctuations, exemption of certain income from exports, and other provisions.

(e) Transformation of the death tax

On the basis of the Shoup recommendations, the death tax was transformed from the former estate tax system into an inheritance tax system. The results were unsatisfactory because the tax amount due varied depending on the method of dividing the estate. Taxpayers often made false reports of the amount received. In 1958, revision was made to calculate the tax on the basis of the statutory shares of estates provided under the Civil
C. Natural Increase in Revenue and the Adjustment of the Tax Burden

a. Reduction of direct tax commensurate with economic development

The latter half of the 1950s saw remarkable development of the Japanese economy, and the increase in tax revenues resulting from economic expansion was so great that the idea of reducing direct taxes was felt to merit study. Annual tax revisions since 1951 were designed to raise the basic exemption and the exemption for dependents and employment income exemption, while also making income tax less progressive as revenues increased due to rapid economic development.

b. Establishment of the Tax Commission

Since the end of the war, the principle of budgeting had been to draft the budget solely in relation to tax revenues. However, increasing tax revenues due to high economic growth in the period necessitated that the government fundamentally review the tax system in order to maintain the equitable sharing of the tax burden and to adapt the current tax system to new economic conditions.

To meet these requirements, a Tax Commission composed of economists and other experts in various fields of society was established in 1959 as one of the advisory organs to the Cabinet. Since that time, yearly tax amendments have largely been based on reports submitted by the Tax Commission.

(3) Third Period - Economic Progress (1960 - 69)

A. Pursuit of Tax Reduction Policies and Refinement of the Taxation System

a. In 1959 the Tax Commission was directed to find ways to improve the tax system and divide tax revenue between national and local governments on a reasonable basis. Major tax questions at the time concerned the taxation system in general, taxation of business enterprises, and sharing of government revenues.

After examining the present tax burden in comparison to that of the prewar period and those in foreign countries, and in relation to budgetary expenditures and similar items, the Tax Commission submitted the first report in 1960 estimating that the tax burden should be limited to approximately 20% of national income. Expectations were that the ensuing national and local tax burden would be around 20% and that a part of any unexpected increase in revenues resulting from economic growth would be used as a resource to reduce taxes each year.
b. Thus, throughout this period, one major tax policy was a series of tax reduction programs, in accordance with the recommendations of successive Tax Commissions, which all insisted on a lessening of the income tax burden.

At the same time, as a result of yearly reductions in the burden of direct taxes, indirect taxes came to be increasingly levied even on the taxpayers who are exempted from paying income taxes. Thus, the Tax Commission recommended in 1961 that the rate of indirect tax should be, in principle, approximately 10% of consumer prices or 20% of producer prices.

c. Accompanying this tax reduction policy was the refinement of tax laws. In the second report issued in 1961, the Tax Commission recommended the enactment of a general law for national taxation establishing general and fundamental principles of taxation such as the principle of substantial taxation, limit to the period of tax claims, method of taxation procedures for the self-assessment and imposition, obligation of bookkeeping, authority to inquire and inspect, additions to taxes, notification procedure tax disputes, penalties and rule-infringement control. As a result of the report, the General National Tax Law was enacted in 1962. Another significant improvement was the introduction of the self assessment system for indirect taxes, following the recommendations of the Tax Commission.

B. Long-range Plan for Taxation

The Tax Commission was requested by the Prime Minister in 1962 to study the ideal way that the fundamental system of taxation should be adjusted to match the future progress of the national economy and society. In 1964, the Tax Commission presented its final report after three years of intensive study, intent on examining the present taxation system and providing perspectives for future tax reform so that further economic growth might be achieved under the government’s trade liberalization policy. The main points cited by the Tax Commission were:

a. New criterion for tax reduction

The Tax Commission introduced a new criterion for tax reduction; namely, the amount of tax reduction in the next several years should be around 20% of the expected annual increase in tax revenue under the existing taxation system. Since the increase in tax revenue would be substantial with rapid and sustained economic growth, determining an appropriate division of this added revenue into tax reduction and increased public expenditures became of vital importance.

b. Importance of income tax in the overall taxation system

Income tax: (a) is a suitable means to distribute resources for public purposes since it can bring sufficient revenue without impacting the market price
mechanism; (b) can perform its function best to redistribute incomes through progressive structure combined with deductions and tax rates and; (c) retains a good function to stabilize business conditions with its highly elastic tax revenue and its action as built-in-stabilizer. Consequently, income tax is the most modernized tax and the tax system is ideal in which, income tax plays the central role. However, in consideration of the present situation of the tax burden etc, future tax reduction should concentrate on income taxes as before since it will be necessary to reduce and rationalize the tax burden in correspondence with increase in incomes and living standards throughout the nation.

c. Abolition of special taxation measures

Special taxation measures are significant as a part of economic policies to utilize tax incentive effects as a means to attain their certain purposes. However, in consideration of their demerits such as hindrance to the principle of the equity of tax burden and the neutrality of taxation which may harmfully impact the morality of taxpayers, streamlining them should also be facilitated from now on.

In particular, special taxation measures on asset income such as those on interests and dividends should be abolished since they may give much evil influences through exceedingly favorable treatment of some high as-set income owners and it is difficult to demonstrate any political effects as a compensation for the demerit.

d. Tax withheld at corporation level on dividends

With regard to the tax reduction for dividends adopted in 1961, since no effect was noted on promotion of capital increase which the system was aimed at, and the system became increasingly complicated through joint use of the tax reduction for dividends and the dividend tax deduction, it will be appropriate to adopt a tax withheld at corporation level on dividends.

C. Tax System Pursuant to Deficit Financing Policies and the Issue of Government Bonds

a. Japan’s economy made an unprecedented rapid growth during the 1950s. With the rapid growth and the progressive taxation structure, tax revenues were extended to renew the record of economic growth rate by a considerably high rate almost every year. With the above as a back-ground, it was possible for Japan’s financial situation to appropriate most of the natural growth of tax revenues to the increase in expenditures, tax reductions with a part of the natural growth of tax revenue, and it was still possible to appropriate not a little amount to a surplus fund. In the meantime, the preconditions for the tax policy were maintenance of these economic trends and the
principle of balanced financial conditions.

However, tax revenue marked little increase during the period of stagnation from 1964 to 1965, and this led to a new situation of issuing governmental bonds to cover the loss of revenue for the supplementary budget of FY 1965. Then in FY 1966, the government decided on the full scale issuance of governmental construction bonds. From the aspect of taxation, the financial policy was positively converted including enforcement of tax reduction largely in excess of the estimated natural growth of tax revenue, thus, giving a remarkably overcoming depression in some way or other. Thus, the importance of financial affairs to ensure a stable economic growth came to be recognized more than before. It became also necessary to review from a new angle the way a tax policy should be.

b. With respect to this matter, Tax Commission released the interim report and the final report in 1966 and 1968 respectively. The basic idea of the final report was that the existing fundamental structure should be retained. The main points noted in the report were:

(a) Direct taxes

With respect to the income tax, the tax threshold should be raised to approximately one million yen for an employment income earner with a spouse and three children and, at the same time, necessary improvements should be made for employment income deductions and tax rate structure.

As for the corporation tax, while the fundamental review of the basic scheme should be continued for the time being, effective and appropriate measures should be taken to cope with the urgent request for intensified international competitiveness of corporations.

(b) Indirect taxes

Taking their relationships with prices into consideration, targets of taxation and tax rate structures should be reviewed from time to time so that they may be adaptable to changes in economy and society, especially to changes in the style of consumption. At the same time, efforts should be made to maintain the appropriate level of indirect tax burdens for both individual articles and overall consumption expenditures within the limit of possibility.

(c) Other items

It is necessary to improve the present appeal system for the settlement of tax disputes and to reform the taxation rules related to land.
(4) Fourth Period - Improvement in National Welfare (1970 to the present)

A. Growing Role of the Public Sector

For 25 years after World War II, the Japanese economy grew steadily, giving Japan the second largest gross national product (GNP) in the free world and a comfortable balance-of-payments position. At the same time, however, the rapid economic growth of the past brought to the fore the relative lack of infrastructure. In order to fulfill the urgent task of correcting various distortions in the Japanese economy such as environmental pollution and the need to improve the quality of life, the economy had to shift from one spearheaded by investment in the private sector to one led by public finance.

B. Restoration of the Fiscal Balance

Reflecting the severe recession after the oil crisis, however, tax revenue stagnated markedly in FY 1975 and a large issue of “deficit-financing bonds” was needed to cover the revenue shortfall. Tax revenue did not recover from this stagnation and the ratio of bond issues to total expenditures in the national budget continued to be extraordinarily high from 1975 on, reaching 34.7% (with bond issues amounting to ¥13.47 trillion) in FY 1979. Of the ¥13.47 trillion worth of national bonds issued in FY 1979, ¥7.13 trillion were construction bonds appropriated for capital expenditures and the remaining ¥6.34 trillion were deficit-financing bonds appropriated for current expenditures.

Fears were that a continuation of these irregular conditions, in which budget financing depends on a large issue of national bonds and especially deficit-financing bonds, might disturb the healthy development of the national economy. Thus, reducing the budgetary deficit became an important national goal. Drastic efforts have been made to economize and rationalize expenses, and the scale of expenditures as a whole has been strictly curtailed, by limiting general expenditures other than those for national bonds as much as possible and by the distribution of local allocation taxes. Consequently, the annual growth rate of expenditures with respect to the initial budget for the previous fiscal year has been severely limited.

Secondly, in terms of the tax system, a growing number of special taxation measures have been curtailed or repealed since FY 1976. At the same time, taxable objects, tax bases, and tax rates of existing taxes have been re-examined. As a result, tax increases in FY 1981 covered a broad range, including corporation tax rates, liquor tax rates, stamp tax rates, and other items.
(5) Recent Tax Reforms

A. Drastic Tax Reform of 1987 to 1988

The high economic growth and two oil crises led to drastic changes in Japan’s economic society. Out of structural changes such as increase in standardized income levels, diversified consumption and greater consumption of services, aging of population structure and globalized economic transactions, various issues on the conventional tax system based on Shoup’s Advice were presented and a drastic tax reform took place from 1987 to 1988.

a. Looking over the tax systems before the drastic tax reform, around 1975 when the high economic growth and frequent tax reductions were over no review was made on the personal income tax system and taxation came to largely depend on income taxes. Since taxpayers felt they were being burdened with higher tax payments due to considerably strong progressiveness in personal income taxes and an imbalance of collection among different types of incomes interest in guaranteeing the equity of tax burden is greater than ever.

Unlike other leading countries, Japan’s consumption tax had long de-pended only on indirect taxes centering on commodity taxes levied on individual commodities for their luxury and convenience, and this caused an unbalanced taxation of individual commodities. In addition, since services had not been targets of taxation, it was impossible to cope with the changes revealed in the issues of diversified consumption and greater consumption of services, resulting in serious problems from the viewpoint of maintaining equity, neutrality and simplicity of tax systems.

Moreover, since the full-scale aged society with a smaller number of children is coming in the near future, the conventional taxation system was considered as unsuitable for creating of a richer economic society. This might cause an increased burden for the working generation whose numbers would be relatively smaller compared with that of the aged generation, resulting in less willingness to work and create business activities. Therefore, it was necessary to construct a tax system to enable more people to support their society and ensure a stable revenue system to fill the increasing financial needs such as social security.

b. Based on these circumstances, with personal income tax continuously ranked as the core of the tax system, a large-scale tax reduction should be done, so that they will be more willing to work and create business activities. Therefore, mitigation and simplification of progressive tax rate and a review on various deductions were made. As for income from assets, rationalization of taxation was realized through reviews of taxation of interests and capital
gains from stock transfer to ensure equity of taxation. As for taxation of
corporations, tax base was broadened and the effective tax rate was reduced
by differing emphasis on equity of tax burden, economy activation and sim-
plicity of taxation.

With respect to the consumption tax, equity of the real tax burden should
be realized throughout the entire tax system. Moreover, to help stabilize the
revenue structure required for providing public services which has been in-
creased as society ages it was considered as necessary to seek for wide–ranged and equal tax burden based on general consumption. The con-
ventional, indirect tax system where taxes were imposed only on limited
commodities and services should be drastically revised, and a possibility
should be examined for foundation of sales tax imposed on the general con-
sumption. The bill of this new tax was abolished although it was introduced in
the Diet in 1987. Afterwards, streamlining individual indirect taxes and the
foundation for a consumption tax were examined based on the insistence and
discussion made concerning sales taxes, and the Law on Tax Reform in-
cluding reform of the indirect tax system was enacted in December 1988.
Consumption tax was also realized in April 1989.

As for inheritance tax and donation tax, no review had been made on them
since 1975. Therefore, measures were taken to raise the tax threshold and
mitigate tax progressiveness to ensure reduction in the tax burden and ra-
tionalization of the tax system.

B. Tax reform from 1989

a. Tax reform of 1994

This reform was enforced from the standpoint that the leveling of tax
burden throughout generations would be important for all members of society
in accordance with the basic principles of equity, neutrality and simplicity so
that the working generation supporting the aged society with smaller number
of children may not suffer from excessive and imbalanced tax burden, and the
society of fair and active welfare may be realized. With the enactment of the
related law in November 1994, the tax reform was realized from the viewpoint
of creating a tax system where taxpayers are willing to pay their fair share.
To be specific, the personal income tax was largely reduced through mitiga-
tion of the entire progressive tax rate structure so that the sense of being
under increased tax burden might be mitigated centering on the middle in-
come earners. As for consumption tax, necessary reviews were made on
special measures for medium–and small sized enterprises so that tax burden
might be widely shared by the members of society. The tax rate was raised to
substantiate the consumption tax system and local consumption tax was es–
tablished.

The tax reform of 1994 was to cope with the structural changes in economy and society. At the same time, this reform had another aspect of stimulative measures. In other words, in consideration of the economic situation, increase in the rate of consumption tax rate was to be implemented in April 1997 in parallel with the institutional reduction in personal income taxes for FY 1995 and onward combined with the special tax reduction for FYs 1994 to 1996. Thus, a precedent tax reduction was realized.

As for inheritance tax, to contrive to simplify the system and to mitigate the increase in the average tax rate, the tax threshold was raised and the range of brackets was enlarged.

b. Land taxation system

With what is called the “land mythology” as a background, the Basic Land Act was enacted with the basic idea of maintaining ownership of land for the common good aimed at promotion of the general land policy involving review of the land tax system. From 1991 to 1992, the land tax system was reformed to rationalize taxation of capital gains from land transfer and establish the land value tax. This reform was based on the viewpoints of appropriate and fair sharing of the tax burden and land policy to create effective use of land while decreasing the profitability of land as a property and controlling land speculation. Afterwards, reduction in tax burden was realized in response to the land value decline and stagnation. In 1998 the land value tax was suspended and through revision of the taxation on capital gains from land transfer from 1995 FY to 1999 FY, the tax burden was lowered than that during the “bubble economy (in latter half of 1980s and early in 1990s).” Because of the soaring land price in the bubble period, inheritance tax has been cut continuously since 1988. With the slump of land price after the bubble period, the tax burden of inheritance tax have been lowered greatly.

c. Financial taxation system

With the progress of financial liberalization and internationalization, it was inevitable for Japan’s financial system to enforce a remarkable reform in order to create competitive market. In response to such reform of the financial system, necessary tax measures were timely taken. For example, to correspond with the liberalization of the foreign exchange system in April 1998, the system to submit reports on remittance abroad was established, and tax measures were taken on SPC and stock options. In the tax reform of 1999, accompanying rationalization of capital gains from stock transfers, Securities Transaction Tax and Bourse Tax were abolished. Moreover, from the standpoint of helping the internationalization of the yen, measures were taken to exempt nonresidents from withholding at the source of the interest
concerning national bonds for lump sum registration and TB/FB issuance in addition to the collateral measures alternative to tax rationalization.

d. Corporation taxation system

No general review of tax base was made since 1965 when the Corporation Tax Law was entirely revised. However, the corporation tax system was reformed in 1998 both on the tax base and tax rate. Through this reform, the tax rate of reserves and depreciation were rationalized and effective tax rates were lowered for corporation taxes from the viewpoint of ensuring the vitality and international competitiveness of companies through promotion of tax neutrality for economic activities.

C. Recent counter-cyclical policies and permanent tax reduction

Because of the impact of the currency crisis in Asia and the successive failures of financial institutions, Japan’s economy has been in an extremely serious situation since autumn of 1997. The serious situation lasted with minus 0.1% as the real growth rate of GDP for FY 1997, which was the first minus growth since 1974 and also minus 1.9% for FY 1998, the following year. From the standpoint of ensuring business recovery, countermeasures were required through use of every possible financial and monetary measure. Since utmost consideration was required also for the tax system, special tax reduction was effected twice in FY 1998 on the personal income tax. In the tax reform of FY 1999, based on the opinion that tax reduction only for a year would be insufficient, tax reduction was effected in the largest scale on personal income tax and corporation taxes to cover the amount considerably in excess of ¥6 trillion. This tax reduction has been continued up to now. As a part of this permanent tax reduction, reductions were realized in the highest bracket of personal income tax and in the effective tax rate of corporation tax to be similar to the international level. As stated above, the permanent tax reduction includes partial tax reduction anticipating the direction of a drastic reform to be enforced in the future. However, based on the business conditions of the time, only the measures to realize tax reduction were enforced. Review of tax base, etc. of personal income tax and corporation tax still remains as an issue to be examined in the future.

D. Tax reform toward the construction of a desirable tax system

Now that the 21st century has begun, the structure of the Japanese socio-economy is changing greatly because of the rapidly aging society and married couples having a smaller number of children, diversified life styles and globalization of the country. To sufficiently respond to these various structural changes and to realize sustainable activation of the socio-economy, it is considered necessary to execute reform toward the construction of a desirable tax
system based on medium to long-term viewpoints.

In the tax reform in 2003, the first step of the reform toward the construction of “a desirable tax system” on corporation tax should be taken so that a sustainable socio-economy may be activated. Inheritance and gift taxes should be unified to achieve integration. Thus, measures such as the increased tax reductions for R&D and investment in plant and equipment to support growth of strategies to innovate in the 21st century and unification of the inheritance and gift taxes to help smooth transfer of assets to the next generation are taken. Further more, taxation of financial assets and securities should be comprehensively reviewed to help the reform “from saving to investment,” distorted tax burdens should be corrected and tax burdens should be fairly shared by all the people. From these viewpoints, a wide-ranging reform was made as a package including abolition of the special tax deduction for spouses (additional part) on personal incomes and reduction of special measures for small and medium-sized corporations aimed at promoting the solidity and transparency of consumption tax.

In the FY2006 tax reform, in a continuous effort to implement a “desirable tax system,” a major transfer of sources of tax revenue in personal income taxes from the individual income tax to inhabitants taxes, amounting to 3 trillion yen, was conducted as part of the trinity reform. Also the proportional tax credit, which had been in place since 1999 as a temporary and exceptional measure to boost the economy, was abolished in light of the economic recovery. In corporation taxes, R&D-related taxation was revised to promote private research and development activities, and a new tax system was established to strengthen the information infrastructure and to increase competitiveness. Additionally, other wide-ranging revisions were made, including the simplification of liquor classification, narrowing of the differences in tax rates among liquors and the abolition of public announcement of taxpayers who have paid large amount of taxes.

1/2 Present Tax System

Current taxes levied by national and local governments in Japan can be classified into three groups: taxes on income; property, etc.; and consumption.

1. Taxes on Income:

National Taxes ........ Income Tax (Individual Income Tax) and Corporation Tax (Corporate Income Tax).

Local Taxes ........ Prefectural Inhabitants Tax, Municipal Inhabitants Tax, and Enterprise Tax.
2. **Taxes on Property, etc.:**

   National Taxes ........ Inheritance Tax, Gift Tax, Land Value Tax, Registration and License Tax, and Stamp Tax.

3. **Taxes on Consumption:**

   Local Taxes ............ Local Consumption Tax, Prefectural Tobacco Tax, Golf Course Utilization Tax, Automobile Tax, Municipal Tobacco Tax, Light Vehicle Tax, Bathing Tax, Hunter’s Tax, Automobile Acquisition Tax, Light Oil Delivery Tax, and Mineral Products Tax, etc.
### Revenue Estimates by Tax Items (FY 2005)

(In 100 million yen)

<table>
<thead>
<tr>
<th>National Taxes (Budget)</th>
<th>Local Taxes (Estimated)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Tax item</td>
<td>Amount</td>
</tr>
<tr>
<td>Direct Taxes (Total)</td>
<td>302,354</td>
</tr>
<tr>
<td>Income Tax</td>
<td>127,880</td>
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<tr>
<td>Corporation Tax</td>
<td>130,580</td>
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<tr>
<td>Inheritance Tax</td>
<td>13,800</td>
</tr>
<tr>
<td>Income Tax*(s)</td>
<td>30,094</td>
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<tr>
<td>Indirect Taxes, etc.</td>
<td>206,889</td>
</tr>
<tr>
<td>Consumption Tax</td>
<td>105,380</td>
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<tr>
<td>Liquor Tax</td>
<td>15,720</td>
</tr>
<tr>
<td>Tobacco Tax</td>
<td>9,400</td>
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<tr>
<td>Gasoline Tax</td>
<td>21,560</td>
</tr>
<tr>
<td>Liquefied Petroleum Gas Tax</td>
<td>140</td>
</tr>
<tr>
<td>Aviation Fuel Tax</td>
<td>870</td>
</tr>
<tr>
<td>Petroleum and Coal Tax</td>
<td>4,760</td>
</tr>
<tr>
<td>Motor Vehicle Tonnage Tax</td>
<td>7,370</td>
</tr>
<tr>
<td>Customs Duty</td>
<td>9,060</td>
</tr>
<tr>
<td>Tonnage Due</td>
<td>90</td>
</tr>
<tr>
<td>Consumption Tax*(s)</td>
<td>12,170</td>
</tr>
<tr>
<td>Local Road Tax* (s)</td>
<td>3,098</td>
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<tr>
<td>Liquefied Petroleum Gas Tax* (s)</td>
<td>140</td>
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<tr>
<td>Aviation Fuel Tax* (s)</td>
<td>158</td>
</tr>
<tr>
<td>Motor Vehicle Tonnage Tax* (s)</td>
<td>3,685</td>
</tr>
<tr>
<td>Special Tonnage Due* (s)</td>
<td>113</td>
</tr>
<tr>
<td>Customs Duty on Oil (s)</td>
<td>5</td>
</tr>
<tr>
<td>Promotion of Power</td>
<td></td>
</tr>
<tr>
<td>Resources Development Tax (s)</td>
<td>3,540</td>
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<tr>
<td>Gasoline Tax (s)</td>
<td>7,393</td>
</tr>
<tr>
<td>Special Tobacco Tax (s)</td>
<td>2,237</td>
</tr>
<tr>
<td>Total</td>
<td>509,243</td>
</tr>
</tbody>
</table>

Note: Taxes marked with (s) are distributed to Special Accounts.
* Distributed to local governments.
** Municipal property tax includes Charges on National Assets and Public Corporations’ Assets.
*** Automobile acquisition tax, Light–oil Delivery Tax, etc.
**** Bathing Tax, Business Office Tax, Urban Planning Tax, etc. (see Appendix VII)
1. National Taxes

a. Article 30 of the Japanese Constitution states that “The people shall be liable to taxation as provided by law,” declaring the duty of the people to pay tax. In addition, Article 84 states “No new taxes shall be levied or existing taxes modified except by law or under such conditions as law may prescribe,” laying down the principle that no taxes can be imposed on the people except by law. The principal existing laws are shown in the following table.

b. In order to implement the provisions of the law, the Cabinet can enact cabinet orders (Paragraph 6, Article 73 of the Japanese Constitution). In addition, each minister can enact ministerial ordinances in order to implement laws and cabinet orders.

c. The Commissioner of the National Tax Agency issues directives to officials of the National Tax Agency and its local subordinate bureaus, providing a uniform interpretation and application of laws and ordinances. In general, these directives are made public. They are merely the interpretation of the tax authorities, and do not bind judicial courts as a source of law. The final interpretation of laws and ordinances lies with the courts.

d. Treaties with foreign countries are concluded by the Cabinet but require the approval of the Diet (Paragraph 3, Article 73 of the Japanese Constitution). Treaties are faithfully observed and are given the full force and effect of law. Japan has concluded 45 tax treaties which are applied to 56 countries for the avoidance of double taxation and the prevention of tax evasion concerning taxes on income (see 24/3).
## National Tax Laws and Regulations

<table>
<thead>
<tr>
<th>Classification</th>
<th>Law</th>
<th>Cabinet Order</th>
<th>Ministerial Ordinance</th>
</tr>
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<tbody>
<tr>
<td>Special Corporation Surtax</td>
<td>Special Corporation Surtax Law 31 March 1992 Law No.15</td>
<td>Cabinet Order Implementing the Special Corporation Surtax 31 March 1992 Cabinet Order No.89</td>
<td>Ministerial Ordinance Implementing the Special Corporation Surtax 31 March 1992 Ministry of Finance Ordinance No.15</td>
</tr>
<tr>
<td>Registration and License Tax</td>
<td>Registration and License Tax Law 12 June 1967 Law No.35</td>
<td>Cabinet Order Implementing the Registration and License Tax Law 26 June 1967 Cabinet Order No.146</td>
<td>Ministerial Ordinance Implementing the Registration and License Tax Law 30 June 1967 Ministry of Finance Ordinance No.37</td>
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(continued)
<table>
<thead>
<tr>
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<th>Ministerial Ordinance</th>
</tr>
</thead>
<tbody>
<tr>
<td>Local Road Tax</td>
<td>Local Road Tax Law 30 July 1955 Law No.104</td>
<td>Cabinet Order Implementing the Local Road Tax Law 30 July 1955 Cabinet Order No.151</td>
<td>Ministerial Ordinance Implementing the Local Road Tax Law 30 July 1955 Ministry of Finance Ordinance No.151</td>
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<tr>
<td>Tonnage Due</td>
<td>Tonnage Due Law 31 Mar. 1957 Law No.37</td>
<td>Cabinet Order Implementing the Tonnage Due Law 31 Mar. 1957 Cabinet Order No.48</td>
<td>Ministerial Ordinance Implementing the Tonnage Due Law 31 Mar. 1957 Ministry of Finance Ordinance No.48</td>
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<tr>
<td>Special Tonnage Due</td>
<td>Special Tonnage Due Law 31 Mar. 1957 Law No.38</td>
<td>Cabinet Order Implementing the Special Tonnage Due Law 31 Mar. 1957 Cabinet Order No.49</td>
<td>Ministerial Ordinance Implementing the Special Tonnage Due Law 31 Mar. 1957 Ministry of Finance Ordinance No.49</td>
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</tbody>
</table>
### National Tax Laws and Regulations (Continued)

<table>
<thead>
<tr>
<th>Classification</th>
<th>Law</th>
<th>Cabinet Order</th>
<th>Ministerial Ordinance</th>
</tr>
</thead>
</table>

In addition to these laws, the following laws are common to all tax laws:

### National Tax Laws and Regulations (Continued)

<table>
<thead>
<tr>
<th>Classification</th>
<th>Law</th>
<th>Cabinet Order</th>
<th>Ministerial Ordinance</th>
</tr>
</thead>
<tbody>
<tr>
<td>National Tax Violation Control</td>
<td>National Tax Violation Control Law 17 Mar.1900 Law No.67</td>
<td>Cabinet Order Implementing the National Tax Violation Control Law 23 Mar.1900 Cabinet Order No.52</td>
<td></td>
</tr>
<tr>
<td>Tax Collection</td>
<td>National Tax Collection Law 20 Apr.1959 Law No.147</td>
<td>Cabinet Order Implementing the National Tax Collection Law 31 Oct.1959 Cabinet Order No.329</td>
<td>Ministerial Ordinance Implementing the National Tax Collection Law 2 Apr.1962 Ministry of Finance Ordinance No.31</td>
</tr>
</tbody>
</table>

Note: The promulgation date and law number are shown immediately following the name of the law in the “Law” column.
The General National Tax Law contains provisions for matters that are common and fundamental to all aspects of taxation, primarily intended to simplify the system for tax laws as well as to clarify the legal basis of taxation. Articles dealing with procedural matters, such as the determination of the tax amount, payment of taxes (see Chapter XIX), postponement of tax payment, pledges for taxes, refunds (see Chapter XXI), and tax disputes (see Chapter XXII) make up the bulk of the Law, but general provisions on additional taxes (see 20/2), on limitation of the period of assessment and collection (see 21/5), and on other areas are also included.

Enactment of the General Law of National Taxes in 1962 laid the ground-work for the simplification and clarification of Japan’s tax laws. This Law is designed to make each tax law more understandable.

The Special Taxation Measures Law provides special tax measures directed toward economic policy goals. For example, it provides for special tax rates on interest and for special depreciation. Most of the forms of special tax treatment provided by this Law are temporary.

The Law of Exemption, Reduction, or Deferment of Collection of Taxes for Those Who Suffered from Disasters grants an exemption, reductions or de-ferment of collection of taxes for victims of a disaster.

The National Tax Violation Control Law stipulates the procedures for investigation and punishment of tax evasion (see 20/3).

The National Tax Collection Law generally stipulates the procedures for the collection of national taxes (see 21/1).

f. Japan has concluded 45 tax treaties which are applied to 56 countries: Ireland, Azerbaijan the United States, Armenia, the United Kingdom, Israel, Italy, India, Indonesia, Viet Nam, Ukraine, Uzbekistan, Egypt, Australia, Austria, the Netherlands, Canada, Kyrgyz, Georgia, Zambia, Singapore, Switzerland, Sweden, Spain, Sri Lanka, Slovak, Thailand, Czech, Den-mark, Tajikistan, Germany, Turkmenistan, Turkey, New Zealand, Norway, Pakistan, Hungary, Bangladesh, Fiji, the Philippines, Finland, Brazil, France, Bulgaria, Belarus, Belgium, Poland, Malaysia, Mexico, Moldova, Romania, Luxembourg, Russia, the Republic of Korea, China, and South Africa.

These conventions include provisions on the method of levying taxes on industrial or commercial profits, exemption from taxes on income de-rived from the operation of aircraft or ships, reduction of taxes on interest, dividends, and royalties, and tax exemption for temporary visitors.

By international custom, moreover, diplomats are exempted from taxes.
2. **Local Taxes**

Article 92 of the Japanese Constitution states that “Regulations concerning the organization and operation of local public entities shall be fixed by law in accordance with the principle of local autonomy.” The Local Autonomy Law was enacted on the basis of this provision in the Constitution, and local public entities have been organized and placed in operation. Local public entities consist of To, Do, Fu, Ken (prefectures), cities, towns, and villages.

There are 47 prefectures (1 To, 1 Do, 2 Fus and 43 Kens) and about 1,800 municipalities (cities, towns, and villages) in Japan (see 23/1).

Article 94 of the Japanese Constitution states that “Local public entities shall have the right to manage their property, affairs, and administration and to enact their own regulations within the law” and Article 223 of the Local Autonomy Law provides that “Local public entities can assess and collect local taxes as provided by law.” Under these provisions, local public entities are given the right to assess and collect local taxes; thus “Local Tax Law” (31 July 1950, Law No. 226) was enacted.

Broadly, the Local Tax Law consists of 4 chapters; (1) General Rules, (2) Ordinary Taxes for To, Do, Fu, and Ken (prefectures), (3) Ordinary Taxes for Cities, Towns, and Villages, and (4) Earmarked Taxes (see Chapter XXIII).

Unlike national tax laws, the Local Tax Law does not directly mandate that residents pay taxes. It only confirms the right of local public entities to assess and collect taxes within a framework prescribed by law. The regulations enacted by each local public entity mandate that residents pay local taxes.