

1-1-2001

Japan's Income Tax System - Lessons for Australia

Justin Dabner

Follow this and additional works at: <http://epublications.bond.edu.au/rlj>

Recommended Citation

Dabner, Justin (2001) "Japan's Income Tax System - Lessons for Australia," *Revenue Law Journal*: Vol. 11 : Iss. 1 , Article 6.
Available at: <http://epublications.bond.edu.au/rlj/vol11/iss1/6>

This Journal Article is brought to you by the Faculty of Law at ePublications@bond. It has been accepted for inclusion in Revenue Law Journal by an authorized administrator of ePublications@bond. For more information, please contact [Bond University's Repository Coordinator](#).

Japan's Income Tax System - Lessons for Australia

Abstract

The Japanese income tax system was redesigned following World War II. As such it has features of the systems of both Europe and the United States, although in many respects it is quite unique. Whilst it arguably contributed to Japan's meteoric rise to the status of an economic superpower, little analysis of the Japanese income tax system from an Australian perspective has been attempted. This paper explores certain unique features of the Japanese income tax system with a view to identifying whether they are worthy of adoption in Australia.

Keywords

income tax, Japan

JAPAN'S INCOME TAX SYSTEM – LESSONS FOR AUSTRALIA

*By Dr Justin Dabner**

The Japanese income tax system was redesigned following World War II. As such it has features of the systems of both Europe and the United States, although in many respects it is quite unique. Whilst it arguably contributed to Japan's meteoric rise to the status of an economic superpower, little analysis of the Japanese income tax system from an Australian perspective has been attempted. This paper explores certain unique features of the Japanese income tax system with a view to identifying whether they are worthy of adoption in Australia.

Introduction

International comparisons of Australia's tax system typically focus upon Canada, the United States, New Zealand and the United Kingdom. Comparisons with our Asian neighbours are seldom valuable because of the different stages in development of the respective economies.

Often overlooked, however, are comparisons with the tax system of our largest trade partner, Japan.¹ This is even more remarkable given that Japan is the only non-Western nation to have achieved a standard of living comparable to Western economies.² Also, whilst Japan was one of the first countries to adopt an income tax³ the tax was overhauled following World War II and has been used as a key economic tool by the Government.

Whilst Japan has a civil law system and, indeed, a very different culture to that of Australia this can result in a different way of approaching issues that may provide some useful lessons. In fact, in a recent categorisation of the World's tax systems into eight categories Japan was placed in the

* School of Law, James Cook University, Cairns Campus.

1 For an international comparison of the Japanese tax system see T Aoki, 'Japan. A Comparison with Other Tax Systems' (July 1996) *Asia-Pacific Tax Bulletin* 199.

2 Noted in H Ishi, *The Japanese Tax System* (2nd ed, 1993) ('Ishi') ch 2. Singapore might also be categorized in this way.

3 1887. Discussed in Tax Bureau, Ministry of Finance, *An Outline of Japanese Taxes*.

miscellaneous group. It was the only industrialised nation to appear in this group.⁴

Certainly, the Japanese tax system can boast many unique features. For example:

- Contrary to popular belief Japan is not a highly taxed country.⁵ The tax burden has historically been very low⁶ although the portion of revenue raised from companies is one of the highest in the world.⁷
- There has been a very heavy reliance on direct taxes.⁸ For example, whilst a broad based consumption tax was introduced in 1989 its rate of 3%, subsequently increased to 5%, is the lowest in the world.
- Japan's rise to the status of an economic super power within thirty years is unprecedented. This has partly been attributed to the tax policy employed by the Government that has relied heavily upon the use of tax incentives and 'picking winners'.⁹
- Allied to this economic growth has been the phenomenal savings rate of the Japanese population. There remains disagreement among commentators on the influence of tax policy on the level of savings. However there is virtual unanimity that tax can influence the composition of savings and the amount of corporate debt finance.¹⁰

4 V Thuronyi (ed), 'Introduction' in *Tax Law Design and Drafting* at xxiv (1998).

5 See JM Ramseyer and M Nakazato, *Japanese Law: An Economic Approach* (1999) 222.

6 Ishi, above n 2, ch 1. The trend is, however, towards a higher tax burden as economic growth slows, the population ages with attendant increased welfare commitments and military spending is increased with Japan's renewed status in the world order. See Ishi, above n 2, ch 2.

7 Ishi, above n 2, chs 10 and 11. Whilst the corporate tax rate has been reduced to the international norm company tax revenues remain relatively high and the Japanese tax burden very low: H Ishi, *The Japanese Tax System* (3rd ed, 2000) 343.

8 T Dalsgaard and M Kawagoe, *The Tax System in Japan: A Need For Comprehensive Reform* (Working Paper No 231, February 2000) paras 9 to 13.

9 Discussed in Ishi, above 2, ch 8.

10 Tachibanaki refers to a number of studies that suggest that whilst tax incentives have not affected the quantum of the savings and investment they have affected the spread. He suggests that the main reasons for Japan's high savings rate include factors such as the conservative nature of the Japanese population, the high growth rate, the high proportion of working population and self employed, the existence of a bonus system, the high price of land and houses, a strong bequest motivation and rationing in the consumer credit market: T Tachibanaki, *Public Policies and the Japanese Economy: Savings, Investments, Unemployment, Inequality* (1996) 12 to 17 and 35 to 38. Also see M Homma, T Maeda and K Hashimoto, 'Chapter 9, Japan' in JA Pechman (ed) *Comparative Tax Systems: Europe, Canada and Japan* (1987) 406 to 407 where a tax incentive's

- The inheritance and gift taxes, whilst not relatively significant within the Japanese tax system, collected during 1992 the largest amount of revenue raised by major industrialised nations in terms of relative share.¹¹
- There are innumerable administrative concessions for small businesses and individuals built into both the income and consumption taxes. It has been suggested that these can be attributed to the fact that Japan is essentially a cash society.¹²

Notably Japan has been reluctant to join the last two waves of global tax reform. The first wave had been the move to adopting a VAT, not embraced in Japan until 1989.¹³

The most recent wave, which occurred during the early 1980s to the early 1990s, was the reduction in personal and corporate income tax rates accompanied by base broadening. These reforms witnessed the demise of vertical equity as a prime consideration and the rise in prominence of horizontal equity and tax neutrality. Most of these reforms were initiated by the US and then imitated by other countries. They included the removal of tax incentives and the more equal treatment of income sources. For Japan such reforms are particularly significant as tax incentives and differential treatment of income sources have been central features of the Japanese income tax.¹⁴

effect on the quantum of corporate investment, but not household savings, is acknowledged. Further see B Bosworth, *Tax Incentives and Economic Growth* (1984); and V Tanzi, 'The Tax Treatment of Interest, Income and Expenses in Industrialized Countries: a Discussion of Recent Crises', Proceedings of the 80th Annual Conference NTA-TIA, US, 1986, both discussed in K Messere, *Tax Policy in OECD Countries - Choices and Conflicts* (1993) 136 to 139; and see Dalsgaard and Kawagoe, above n 8. Shoup also acknowledges the divergence in views on the effect on savings of tax incentives: CS Shoup, 'The Tax Mission to Japan, 1949 - 50' in M Gillis (ed) *Tax Reform in Developing Countries* (1989) 199. Ishi also analyses the savings phenomenon and concludes that the results are ambiguous. However, he also concedes that tax policy may have influenced the type of investments entered into by the population: see Ishi, above n 2, 149. Ultimately whether tax breaks on interest is supported depends upon whether one supports a comprehensive consumption or income based theory of taxation.

11 Ishi, above n 2, ch 12.

12 CS Shoup, 'Tax Reform in Japan' (1990) 7 *Australian Tax Forum* 411.

13 Although this was the third attempt. See J Dabner, 'The Japanese Consumption Tax Experience: Lessons for Australia?', to be published, and the references referred to therein.

14 Messere, above n 10, ch 1.

It is proposed to briefly review the recent history and current features of the Japanese tax system and then focus on five aspects of the income tax system that may be of interest to Australian tax policy analysts.

Post World War II Development of the Japanese Tax System

Shoup Mission

Following World War II the Japanese tax system was rebuilt with American assistance. The most significant reforms occurred following the Shoup Report,¹⁵ a report premised on the leading tax policy of the time.¹⁶ Shoup's recommendations placed income tax at the centre of the taxation system. However the income tax was to be complimented by a net worth tax and an inheritance tax. Amongst the various tax criteria most importance was placed on 'tax equity' with the goal of making the Japanese tax system 'the best tax system in the world'.¹⁷

The income tax base was to be broad thereby permitting low marginal tax rates. The existing schedular system was to be replaced with an aggregation of income. Corporations were to be treated as an aggregate of individuals rather than as independent taxable entities. Thus corporations tax was to be treated as an advance payment of individual tax.

The Shoup Report has been described as 'epoch-making in the history of Japanese taxation'.¹⁸ Most commentators consider that the Report laid the foundations of a theoretically consistent tax system premised on cutting edge thinking.¹⁹ This is notwithstanding that, whilst most of its recommendations were enacted, there was a considerable departure from these reforms in the following years.²⁰

15 Report on Japanese Taxation by the Shoup Mission (1949), republished by Japan Federation of Certified Public Tax Accountants Association in 1979.

16 Discussed in ch 2 and the Japanese chapter in HJ Ault (ed), *Comparative Income Taxation* (1997).

17 Shoup Mission, Vol 1, p ii.

18 Ishi, above n 2, 29.

19 For further praise of the report see M Nakazato, 'The Impact of the Shoup Report on Japanese Economic Development' in CS Shoup (ed) *Retrospectives on Public Finance*; and M Nakazato and M Ramseyer 'General Description: Japan' in HJ Ault (ed) *Comparative Income Taxation: A Structural Analysis* (1997) 72 - 74 quoting from H Kaneko. For a comprehensive review of the commentary on the Report's success and extent of implementation see Shoup, above n 10, 177.

20 In fact, the extent of departure from the Shoup recommendations has led to debate as to whether these reforms were indeed the basic structure of the post-

Whilst the Shoup tax reform is generally viewed as very successful this can only partially be attributed to the quality of the report. Other factors contributing to its success were the unique circumstances under which the Mission laboured, namely unfettered and complete support from the MacArthur administration and Japanese Government and a desire for a complete break from the pre-war values thereby permitting the Mission to start completely afresh.²¹

Shoup and his colleagues would today be described as 'economic rationalists'. Thus, given this is the current dominant school of thought it is not surprising that recent reforms to the Japanese tax system have unwound many of the reform deviations of the intermediate decades and restored the Shoup principles.

Immediate post Shoup reforms - the pursuit of economic growth

Whilst the prime focus of the Shoup Mission was the creation of an equitable tax system subsequent Japanese governments were more concerned with economic development resulting in many deviations from the Shoup principles. Thus the insertion of numerous tax expenditure programs eroded the broad base but, arguably, contributed to the economic success of the country, an issue that is further explored below.²²

Ultimately the tax system that evolved from the Japanese refinement of the Shoup recommendations had at its core personal income tax. This contained certain exemptions such as for capital gains on the sale of shares and interest income from small savings accounts. Furthermore, to stimulate growth corporations were provided with significant tax incentives. These departures from the Shoup recommendations were justified on the basis of the need to encourage economic growth, changed economic and social circumstances, confusion caused by unfamiliarity with the new system and an improved application to Japanese life.²³

war Japanese tax system: V Beyer, 'The Legacy of the Shoup Mission: Taxation Inequities and Tax Reform in Japan' 10 (1992) *Pacific Basin Law Journal* 388.

21 Ishi, above n 2, ch 3.

22 The Japanese focus on economic growth at the expense of equity in their departures from the Shoup recommendations is surprising given the egalitarian nature of Japanese society.

23 Discussed in Beyer, above n 20, 399.

Income tax reduction policy

The economic expansion of the Japanese economy in the last half of the 1950s brought a new policy of income tax reduction. Thus the 1960s witnessed ongoing income tax rate falls, partly to compensate for the effects of inflation in creating fiscal drag.

Fiscal balance policy

With the advent of the 1970s and an economic downturn in 1973 Government policy shifted to reducing the fiscal deficit. Thus for the next 25 years tax measures were aimed at reducing the number of tax expenditure programs and raising revenue to improve the national welfare. The late 1980s, in particular, were characterised by controversial tax changes that included the introduction of a value added tax.

The period since the mid 1990s in Japan has been characterised by a slowing economy, falling Government revenues and fiscal deficits. The Government has undertaken no substantial structural tax reforms since 1993 and has been caught between the need to reduce taxes to stimulate demand and the need to rein in the deficit. The emphasis to date has been on reductions in the tax rate and the introduction of additional tax expenditure programs designed to stimulate the economy.²⁴

In contrast, most commentators have identified the need for increasing taxation on consumption and wealth together with further base broadening with the repeal of tax expenditures in both the individual and corporate tax systems. The adoption of a comprehensive income concept, with, in particular, capital gains and income from labour taxed at the same rate has also been recommended. However it is recognised that first a taxpayer identification number system is needed²⁵ and whilst further base broadening of the income tax may be needed it is likely that future reforms will focus on the consumption tax as it is simply too difficult to wind back income tax preferences and implement tougher enforcement strategies.²⁶

24 See Y Zhand, 'Japan Tax Reform 1998' (December 1998) *Asia Pacific Tax Bulletin* 463 and Y Zhang, 'Japan 1999 Tax Reform' (June 1999) *Asia Pacific Tax Bulletin* 228.

25 For example, see H Ishi, 'Chapter 6 Japan', in K Messere (ed), *The Tax System in Industrialised Countries* (1998).

26 Beyer, above n 20.

Some general observations on the Japanese income tax system²⁷

It was observed that the Japanese tax system has some unique or, at least, extreme characteristics. Pivotal is the income tax imposed on individuals and companies.²⁸

The Japanese tax system has traditionally featured low personal income tax. In fact, possibly 20% of employees do not pay income tax.²⁹ Whilst the rates applicable to individuals climb to as high as 65% this rate only commences at four times the average production worker's income, second only to the US.³⁰ Fringe benefits are largely untaxed.³¹ Individuals may adopt generous standard deductions or claim actual employment related expenses. Furthermore, there is a substantial housing loan tax credit. Not surprisingly, the redistributive effect of the income tax system is low.³²

Whilst the income base applicable to individuals is theoretically comprehensive, the rates applicable to different types of income vary thereby rendering the system a hybrid.³³ There has been considerable resistance to the introduction of a taxpayer identification number,³⁴ with lower tax rates on some types of income preferred as a means of encouraging compliance.³⁵ In particular, the income tax has traditionally imposed little tax on income from capital.³⁶ Share transactions are taxed

27 On the features of the Japanese tax system generally see: 'The Japanese Tax System' in GP Mcalinn (ed), *The Business Guide to Japan* (1996) ch 12; Y Gomi, *Guide to Japanese Taxes* (2000-2001); Deloitte Touche Tohmatsu, *Quick Guide to Taxation in Japan* (1998); KPMG, *Tax Facts Japan* (1998).

28 References to income tax in this paper include reference to both the income tax imposed on individuals and the corporations tax.

29 Dalsgaard and Kawagoe, above n 8, para 11.

30 Where this rate commences at a staggering 9.7 times average income.

31 On the taxation of fringe benefits in Japan generally see Y Ishizuka, 'Taxation of Fringe Benefits in Japan' (April 3 1995) *Tax Notes International* 1197.

32 Dalsgaard and Kawagoe, above n 8, paras 11 to 13.

33 Gomi identifies ten categories of income: see Gomi, above n 27, ch 5.

34 H Ishi, 'The Tax System of Japan' (17 April 1995) *Tax Notes International* 1407.

35 Shoup, above n 10, 177. The apparent Japanese reluctance to adopt a true comprehensive income tax might be attributable to enforcement concerns. In particular, the absence of record keeping and accounting requirements and the lack of a prohibition on anonymous bank accounts would likely render enforcement of a comprehensive income tax very difficult.

36 EM Zolt, 'Prospects for Fundamental Tax Reform: Comparisons between the United States and Japan' (10 May 1999) *Tax Notes International* 1969. An exemption for interest income and the relative absence of taxes on capital have

concessionally as is the disposal of real property other than speculative transactions.³⁷

In contrast to the low reliance on personal income tax relative company tax revenues are the second highest in the OECD.³⁸ To the corporate tax base are applied rates at the national, prefecture and municipal levels. At the prefecture level there is both an income tax and a special enterprise tax that is, in fact, deductible for the purposes of calculating the other taxes. This means that whilst the current headline corporate tax rates, for example, range between approximately 48 and 63%,³⁹ the effective maximum tax rate is closer to 41%.⁴⁰

To mitigate double taxation a credit is available for dividends received by both companies and individuals although with companies receiving a greater credit up to 100%.⁴¹ There is also liberal provision for tax free reserves and loss carry forwards and carry backs.⁴²

Whilst there are many features of the Japanese income tax system that are unusual and many others for which Australian counterparts exist, this commentator has identified five particular aspects that may be of interest to Australian tax reform analysts.

Five unique features

Firstly, in order to access many of the tax concessions taxpayers must register for and be approved to lodge a 'blue return'. Permission to lodge such a return is dependent on the taxpayer adopting certain accounting practices.

Secondly, the structure in which *tax policy formulation* occurs provides an interesting alternative to the Australian system. A pivotal feature of this

resulted in the income tax being described as more of a hybrid expenditure tax: Dalsgaard and Kawagoe, above n 8.

37 See Gomi, above n 27, ch 5, para 5-555, 5-560 and 5-565 in particular. Most individuals will elect to be taxed on any capital gains on share transactions pursuant to a 1.05% withholding tax: para 4-400.

38 Dalsgaard and Kawagoe, above n 8, para 13.

39 The tax rate faced by a company will vary with the size of its paid up capital and taxable income.

40 Dalsgaard and Kawagoe, above n 8, Table A1. This does not take into account other concessions and surtaxes that, depending on the circumstances, may increase or reduce this rate.

41 See Gomi, above n 27, para 5-580 and 6-150.

42 Ibid, para 6-350 to 6-435 and 6-570.

structure is the existence of the 'Tax Commission'. The tax controversy system also has some unique features.

Thirdly, Japan probably has the most developed *withholding tax system* in the World⁴³ and, furthermore, owing to the availability of standard deductions in lieu of deducting actual work expenses and a unique year-end adjustment system many employees are not required to file tax returns.

Fourthly, the prevailing policy in Australia, and indeed worldwide, is that tax systems should be comprehensive with low rates and the adoption of *tax expenditure programs* should be limited. However, the Japanese Government has tended to flout this principle, apparently with some successful results.

Finally, a significant feature of Japan's income tax system for Australia, given the Australian Government's policy of seeking to encourage the location of foreign businesses to the country, is the concept of '*non-permanent residence*' which carries with it tax concessions.

Each of these features will be discussed below followed by a consideration of their relevance, if any, for Australia.

Blue return system

The blue return system has its origins in the Shoup recommendations. It is intended as an encouragement to taxpayers to maintain proper accounting records and make honest self-assessment. Taxpayers who are permitted to lodge a blue return are entitled to certain privileges.

Shoup has written about the history behind the blue return recommendation.⁴⁴ It was seen as preferable to encourage record keeping rather than mandate it. The main advantage at that time from the filing of a blue return was that it would protect a taxpayer from reassessment in the absence of an audit and explanation. The Shoup Mission had discovered that many reassessments had been arbitrary and a failure to provide reasons was common.

Initially it was perceived that the blue return would be an intermediate return between the simplest form and the standard form for large enterprises with sophisticated accounting records. However it has become the standard return with the alternative, the white return, being only used by the smallest taxpayers.

43 Ishi, above n 2, 16.

44 Shoup, above n 10, 177.

To be registered for the blue return system a taxpayer must lodge an application for approval with the NTA describing their accounting system and records to be maintained.⁴⁵ Approval is conditional upon the taxpayer keeping a journal, general ledger and other necessary books, and recording all transactions affecting assets, liabilities and capital in the books according to double entry principles. The taxpayer must also settle accounts on the basis of the records, prepare balance sheets, profit and loss statements and keep the books and documents for seven years. Furthermore, the blue return must be lodged together with the balance sheet, income statement and other documents indicating the items necessary for calculating the taxpayer's income.

Privileges available to individuals and companies from filing a blue return include:

- A deduction for reasonable wages paid to relatives living with the taxpayer in the same household; (individuals only)
- Special standard deductions depending on the type of income derived; (individuals only)
- A deduction for certain reserves and provisions such as bad debts, loss on returned goods on-sold and employees' retirement allowances;
- Special depreciation for plant and equipment;
- Net losses may be carried forward or carried back for specified periods;
- The NTA may only adjust income when errors are found in the calculation of taxable income based on the taxpayer's books and records and is obliged to state reasons for adjustments; and
- A request for reconsideration by the National Tax Tribunal ('NTT') may be made without first asking the NTA for a further investigation.

As these privileges are considered valuable, particularly the ability to carry forward losses, this acts as a major incentive to make a timely application for the right to lodge a blue return. The attraction of these privileges is illustrated by the fact that since 1955 the percentage of individual business taxpayers filing a blue return has increased from 32% to 51% and the

45 This application must be lodged either before the commencement date of the accounting period for which the return is to be submitted or, in the case of the first accounting period, within three months of the establishment of the taxpaying entity or before the end of the first accounting period, whichever is earlier.

number of corporations filing a blue return in that period has increased from 68% to 92%.⁴⁶

It is generally accepted that the blue return system has contributed substantially to the improvement of the compliance standard and the modernisation of business management.⁴⁷ Indeed Shoup believes that the blue return system was the greatest tax administration legacy of the Mission.⁴⁸ He does concede, however, that the system may now be redundant as most taxpayers would have adopted sophisticated bookkeeping methods.⁴⁹ Also, the incidence of arbitrary reassessments has diminished with the imposition in 1984 of a mandatory system of record and bookkeeping for white return filers and so a chief advantage of filing a blue return is no longer as valuable.⁵⁰ Similarly now less valuable is the requirement that the NTA disclose reasons to blue return filers in the event of an adjustment as the consensus of opinion is that the Constitution may be relied upon to require the provision of reasons for the correction of a white return as well.⁵¹

Tax policy formulation

Probably as a result of the inherent consensual nature of Japanese society and the desire to avoid conflict an unusual regime for the settling and implementation of tax policy exists.⁵²

Central to this regime is the Tax Commission. The Commission consists of 30 regular members and some special and advisory members, all of whom are appointed by the Prime Minister. Typically tenure is for three years. Membership is from diverse sectors of the community such as journalism, academia, industry, women's groups, trade unions, tax accountants and local government. There is also considerable input from the Tax Bureau of

46 Dalsgaard and Kawagoe, above n 8.

47 For example, see H Kaneko, 'Problems of the Japanese Corporate Income Tax System' in H Oda (ed) *Japanese Commercial Law in an Era of Internationalisation* (1994) 214.

48 Beyer, above n 20, 388. A view probably shared by Ishi: see H Ishi, 'Overview of the Project' in O Oldman and H Kaneko, *A Final Draft Report from FAIR to the World Bank on Taxation and Economic Growth (Asian Miracle Project)*(1993) 513

49 Shoup, above n 10.

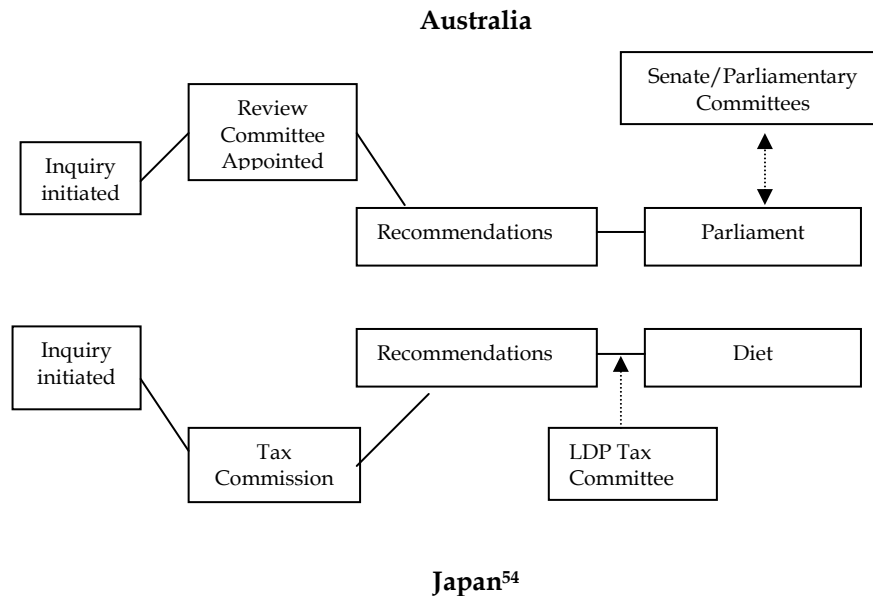
50 V Beyer, 'Tax Administration in Japan' (1994) 4 *Revenue Law Journal* 144.

51 K Ishimura, *The State of Taxpayers' Rights in Japan: A Survey of the Legal Situation* (1995) 35, fn 26.

52 This regime may also be reflective of the fact that the same party has been in power in Japan for much of the last 50 years.

the Ministry of Finance ('MOF').⁵³ It is essentially within this Commission that disputes over tax policy are resolved such that the ultimate recommendations to government tend to have universal support and are readily implemented.

The central position of this Commission in the formulation and implementation of tax policy can be demonstrated by the following diagram that also contrasts the Australian system:



The LDP Tax Committee is a more recent organ of the governing Liberal Democratic Party ('LDP'). It came into existence as the LDP politicians became more concerned with tax as the expenditure squeeze took hold during the 1970s.

53 Some would suggest too much and that the Commission merely states MOF policy: K Ishimura, 'The State of Taxpayers' Rights in Japan' in D Bentley (ed) *Taxpayers Rights: An International Perspective* (1998); M Shibuya, 'Tax Policy Making in Japan', in Oldman and Kaneko, above n 48, 27.

54 After the introduction of tax bills to the Diet they are referred to the respective finance committees of the two houses. Typically at this stage they are merely 'rubber stamped' in contrast to the rigorous treatment tax bills can receive at the hands of Australian Parliamentary Committees. See T Miyatake, 'Japanese Taxation' in H Oghigian (ed), *The Law of Commerce in Japan: A Collection of Introductory Essays* (1993).

Each November or December the LDP Tax Committee issues its report on tax reform for the following year. These reforms are typically enacted in the following March to take effect as of April. The Tax Commission also lodges its report at that time although in recent years the Tax Committee has been the more influential except perhaps during the period of the coalition governments in the early 1990s.⁵⁵ The Tax Committee would now appear to be responsible for short-term tax policy and the detail of specific changes and the Commission may be more of a think tank generating consensus about long-term tax objectives and broad principles⁵⁶ and arbitrating on conflicting issues amongst vested interests.⁵⁷ In this way the recommendations of the Tax Commission often lay the groundwork for the discussions of the Tax Committee.

Notably the deliberations of neither body are public but the outcomes from each are a result of consensus and compromise.

Whilst there may be much to recommend an instrument like the Tax Commission for arriving at a policy consensus the recent emergence of a second, apparently competing body, may have been a retrograde step. Whilst, as suggested above, there are signs that the two bodies are gradually working out a synergy it is possible that their co-existence may have contributed to the Government's tax policy paralysis during the last decade. Indeed it would appear that there is a precedent for politicians to play off the Tax Commission and Tax Committee in order to further their agenda.⁵⁸ It has even been suggested that the Tax Commission had become moribund by the mid 1980s and was only resurrected as part of the political process to implement the VAT.⁵⁹

Whilst the unique National Tax Review Committee is not a body for setting tax policy but rather for facilitating the settling of disputes, it is worthy of mention. Under Japan's tax controversy system a taxpayer whose objection has been dismissed by the NTA may appeal to the NTT. This body is a quasi-independent administrative arm of the NTA. Should the director of the NTT reject a taxpayer's claim, the matter may be referred to the National Tax Review Committee. This Committee is comprised of academics and tax practitioners appointed by the MOF. The Commissioner will give an

55 A Akamatsu and GM Thomas, 'Japan' (January 10, 1994) *Tax Notes International* 82.

56 Generally see Ishi, above n 2, 13-16, Shibuya, above n 53; and Dalsgaard and Kawagoe, above n 8.

57 See Ishi, above n 48.

58 JR Brown, *The Ministry of Finance: Bureaucratic Practices and the Transformation of the Japanese Economy* (1999) 210.

59 Ibid, 205.

instruction to the director based on the decision of this Committee.⁶⁰ The Committee's input may also be sought in relation to significant interpretations of the tax laws or contentious NTA circulars.

Withholding taxes and standard deductions

The Shoup Mission had intended that the average Japanese family be engaged in the process of tax determination.⁶¹ However, in fact, the bulk of personal income tax revenue comes from the comprehensive withholding tax system, said to be the most developed in the world. In excess of 80% of individual income tax is withheld at source.⁶² Japan's individual income tax thus stands alone in the degree to which it removes from taxpayers the need to lodge a return.⁶³

Income categories in relation to which withholding taxes are used include:

- wages and salary,
- interest,
- dividends,
- royalties,
- capital gains on the sale of shares,
- gains from selling discount bonds,
- retirement income,
- remuneration for professional services, and
- remuneration for entertainment services.

Some of these withholding taxes are final and others are creditable against general income tax. In some cases, for example dividends and capital gains on the sale of shares, the final withholding tax is optional.⁶⁴

Also, some taxes such as the securities transactions tax and the municipal inhabitants tax are collected using a special collection system. Under this system a recipient of a payment is nominated as a special tax collector and

60 K Mori, 'Japan's Tax Controversy System Reviewed' (8 January 2001) *Tax Notes International* 139.

61 Shoup, above n 10, 177.

62 Ishi, above n 2, 64. Its relative success has generated a reluctance to change tax collection methods and this partly explains a resistance to the introduction of a taxpayer identification number ('TIN') system: Ishi, above n 2, 380 - 381.

63 Shoup, above n 12, 411.

64 Generally see Gomi, above n 27, chs 4 and 5.

must collect a specified amount of tax and remit it to the relevant authority. Thus this is a form of withholding tax but it is broader in effect.⁶⁵

Year-end adjustment mechanism

The withholding tax applicable to wages and salary has a unique year-end adjustment system. This system requires the employer to gather information from employees about other income and deductions, to calculate the employee's annual tax liability and adjust the tax withheld in the final salary payment for the year.⁶⁶ Approximately 75% of Japanese taxpayers are eligible for this treatment and, therefore, spared the burden of filing a tax return.⁶⁷

Standard deductions

The application of this mechanism is simplified by the availability of standard employment income deductions.⁶⁸ Employee taxpayers do have an option to claim actual employment related expenses instead of the standard deductions. The availability of this option arose following a legal challenge to the effect that denying employees the ability to deduct expenses violated the equal protection clause in the Constitution. This hard won concession is, however, rarely used. It may be that this is because of the severe restrictions

65 K Ishimura, 'The State of Taxpayers's Rights in Japan - A Survey of the Legal Situation', 125 <<http://www.pij-web.net/com/e01.html>>.

66 Ishi, above n 2, 66.

67 Beyer, above n 50, 153. A resident taxpayer is not required to lodge a tax return where their salary has been subject to withholding tax and there was a year end adjustment and income other than salary was not more than a specified threshold.

68 As at April 1998 the standard deductions available to a resident taxpayer against employment income were as follows:

<i>Amount of receipts</i>		<i>Deduction</i>	
Up to	1,800,000	40% or	650,000
Excess over	1,800,000		
Up to	3,600,000	30% plus	180,000
Excess over	3,600,000		
Up to	6,600,000	20% plus	540,000
Excess over	6,600,000		
and up to	10,000,000	10% plus	1,200,000
Excess over	10,000,000	5% plus	1,700,000

on the type of expenses that may be deducted⁶⁹ and/or because the standard deductions are so generous.⁷⁰

The use of standard deductions in the Japanese tax system predates the Shoup Report. That Report had recommended their continuance although with a reduction in the amount of the deductions.

Issues with withholding tax

Although the wage and salary withholding tax and year-end adjustment system place an additional burden on employers, and raise privacy concerns, some argue that these concerns are outweighed by the administrative savings.⁷¹ In one of the numerous constitutional challenges to the withholding tax system it was argued that the obligation to collect taxes without remuneration contravenes the principle that private property may only be taken for public use upon the payment of just compensation. However the court held that the obligation on withholding agents is a mere trifle and does not impose such a burden as to warrant compensation. Others do not share this view.⁷²

Whilst the withholding tax system has been very successful in preventing tax delinquency, in a perverse way it has contributed to perceptions of tax inequity in the Japanese population. This is because the balance of taxpayers outside the system, mainly small businesses and farmers, historically appear to have been able to understate their income.⁷³ This has generated a belief in the 'Ku-ro-yon' (9:6:4) phenomenon, namely that whilst 90% of income of salaried workers is identified by the tax authorities only 60% of that of the self employed and 40% of that of farmers is assessed.⁷⁴

A rather peculiar response to this avoidance has been to introduce measures to ease the tax burden on salaried workers. That is, rather than attempt to tackle the avoidance further anomalies were introduced to placate the 'honest' taxpaying community.⁷⁵

69 Ishimura, above n 51, 159.

70 See Ramseyer and Nakazato, above n 5, 229.

71 Beyer, above n 50.

72 Ishimura, above n 51, 94.

73 Ishi reviews the statistical support for this perception: above n 2, 67 – 73.

74 It has been suggested that the success of the withholding tax imposed on wages and salaries relative to the other tax collection mechanisms means that effectively the income tax on salaried workers is a disguised payroll tax: Shoup, above n 10.

75 Ishi, above n 2, chs 5 and 6.

Furthermore, whilst the Japanese withholding tax system is lauded for its reduction in effort, tax evasion and costs of tax collection it is accepted that the failure to tax fringe benefits produces further inequities.⁷⁶ However tax avoidance and inequities have traditionally not been a major concern to the populace given the overall low incidence of taxation.

Of course the inequities 'caused' by the use of withholding taxes are not necessarily a feature of this tax collection mechanism. Equity could be enhanced through appropriate tax rates and enforcement procedures directed at taxpayers outside the withholding tax system.⁷⁷

Japan's reliance on withholding taxes, particularly in relation to interest income,⁷⁸ is probably necessitated by its failure to adopt a taxpayer identification number ('TIN').⁷⁹ The absence of a TIN and the extended use of withholding taxes, in turn, result in a departure from the orthodoxy of a comprehensive income tax to taxing different sources of income at different rates.

Whilst this raises equity concerns there are advantages in this approach.⁸⁰ Not only does the technique of taxing some income streams by virtue of a withholding tax at source have the advantage of minimising avoidance and the need to file returns but it also allows provision to be made for the mobility of capital and global competition. Thus a dual rate system can be

76 RK McCleery, 'What are Most Japanese Doing on Tax Day?' in J Mak et al (eds), *Japan - Why it Works, Why it Doesn't: Economics in Everyday Life* (1998).

77 Beyer, above n 50.

78 Kaneko and Masui identify lessons from the Japanese experience with the separate taxation of interest namely:

- the lessening of the administrative burden on government has a corresponding increase in compliance costs for taxpayers,
- where the tax rate applicable to interest is low then this can generate inequities unless the general income tax rates are also low, and
- it is difficult to unwind such a mechanism and move to a comprehensive income base.

H Kaneko and Y Masui, 'Taxation of Interest Income in Japan - History and Current Situation', in Oldman and Kaneko, above n 48, 85.

79 During the early 1980s the Government tried unsuccessfully to introduce a scaled back version of a TIN, known as the green card system. The matter has been on the agenda ever since.

80 Ishi acknowledges that the current system of reliance on withholding taxes and separate taxation is highly valued from an administrative and revenue raising perspective. However he prefers a move to a comprehensive income ideal in pursuit of enhanced equity: Ishi, above n 7, 388 - 389.

adopted with higher taxes imposed on income from labour and lower taxes on the many types of capital income.⁸¹

Possibly one reason why the withholding tax system has proved so effective is the relative homogeneity in the types of income flows. In particular, Japanese executives have traditionally not been rewarded with stock options and most investments have been in interest-bearing bank accounts rather than directly into companies or other more exotic financial instruments. Changes in reward structures and investment strategies together with the effect of globalisation on investment plans will pose new challenges for the integrity of the Japanese withholding tax system.

Finally, one interesting criticism of withholding taxes and the year-end adjustment mechanism is that they have contributed to the low level of tax rights consciousness of Japanese salaried workers.⁸² Whilst the mechanisms render the tax system very efficient, the absence of a taxpayer consciousness permits the NTA free rein which may jeopardise the fairness and transparency of Japanese tax administration. Accordingly it has been suggested that the current limited optional deductions arrangements should be extended to allow wage earners to claim deductions in the same way as businesses. This would encourage them to exercise their right to file returns in which case the year-end adjustment system might only be applicable by default.⁸³

Tax expenditure programs

With the adoption of most of the Shoup recommendations in 1950 Japan had a theoretically consistent and logical tax system premised on tax equity, efficiency and neutrality. Soon, however, other social and economic priorities of the Government led to reforms to the tax system that deviated

81 See Zolt, above n 36. In common with most other countries Japan utilises a withholding tax to tax interest income of non-resident investors. Deficiencies with this withholding tax have been identified. These include problems with defining interest, dealing with payments made and kept in a third jurisdiction, identifying a taxing point in complex international dealings, identifying appropriate rates and reconciling global competitive pressures to reduce withholding tax rates. See the discussion by Y Masui, 'Taxation of Cross Border Interest Flows: Japanese Responses' *Sonderdruck aus Staaten und Steuern*: in H von Paul et al (eds) *Festschrift für Klaus Vogel zum 70* CF Muller Verlag Heidelberg (2000) 863. Notwithstanding these difficulties, Masui nevertheless suggests that withholding taxes work smoothly when the borrower is located inside Japan even where the investor is a non-resident.

82 An issue that also concerned the Shoup above n 10, fn 57.

83 Ishimura, above n 51, 159-161.

from these criteria. In fact, Shoup suggests that tax expenditures had already replaced direct subsidies as the Government's preferred method of implementing industrial policy by as early as 1951.⁸⁴

Thus commenced a 20 year era dominated by special tax measures which had the effect of narrowing the income base and generating numerous inequities.⁸⁵ Whilst these special tax measures created considerable erosion of the tax base the high rate of economic growth ensured a natural increase in tax revenues. In fact the later part of this period was characterised by annual tax reductions in furtherance of a policy of supporting private enterprise and minimising government expenditure.

Although the consensus is that the use of tax incentives by the Japanese bureaucracy to nurture favoured industries was successful at the micro level, as each lobby group met with success this created a precedent for others and thus programs tended to proliferate and once in place became difficult to remove. Nevertheless the perceived success of this policy has led to its imitation by many of Japan's developing Asian neighbours.⁸⁶

Sometimes these tax incentives are detailed in special tax measures legislation but others are also incorporated in the general tax provisions. This has tended to make some of these incentives less transparent.

The most costly in terms of foregone revenue have been those directed at promoting individual savings and housing. The second largest relate to the promotion of business saving and investment.⁸⁷

84 Shoup, above n 10, fn 177.

85 The special tax measures, particularly promoting savings, have been identified as a major limit on the progressivity of the income tax system as these measures tend to be of greater benefit to high income earners; Ishi, above n 2, ch 6.

86 Ishi, above n 34. And also in Ireland. In fact, whilst the period to the mid 1970s witnessed the Japanese economic miracle the last decade has witnessed the Irish economic miracle. Again low tax rates together with targeted tax incentives featured. However it has been suggested that these policies did not prompt the economic recovery although they probably helped sustain it. Furthermore, these features have not been without their problems in that they necessitated that higher taxes be paid by others and Ireland has become a destination of inward transfer pricing; B Walsh, 'The Role of Tax Policy in Ireland's Economic Renaissance' (2000) 48 *Canadian Tax Journal* 658.

87 Ishi, above n 2, ch 11. Up until the late 1970s, when they began to be phased out, there were four distinct stages in the development of investment incentives, namely:

- the promotion of exports and encouragement of certain industries,
- the stimulation of savings and investment in targeted industries,
- incentives directed at developing technological innovation, and

Of these a particular focus of the Government were tax concessions to encourage the retention of investment funds by companies and equity financing.⁸⁸ Tax concessions available to companies were viewed to be of such significance that they spawned the phenomenon of 'quasi-corporations'. That is, many small firms incorporated solely to access tax concessions. This, in turn, resulted in reforms to provide similar tax concessions to unincorporated firms to stem the trend.⁸⁹

There is considerable debate as to the significance of the tax laws generally and tax expenditure programs in particular to Japan's spectacular economic growth. Allied to this economic success has been Japan's high savings rate, the highest in the world as at 1992.⁹⁰ As was observed earlier, whilst commentators are divided on whether tax policy has had a significant role in generating the high savings rate there is the general consensus that tax policy has influenced its make up.⁹¹

Similarly ambiguous is the effect of tax incentives on exports. It has been argued that other factors were probably more significant in relation to export growth and that the tax incentives simply generated non-neutralities.⁹² Another commentator has suggested that whilst these incentives were insignificant from an economic perspective they had a psychological impact in indicating the will of the nation. Nevertheless the provisions presented a number of difficulties. In particular they required an

-
- the extension of special measures to cover a wide variety of policy objectives such as pollution control and social welfare.

Three broad types of tax incentive mechanisms have been adopted namely special depreciation, tax credits/allowances and reserves. Of the latter there are two types, ordinary and special reserves. Ordinary reserves can be justified by the matching principle. Special reserves are, however, preferential treatments. They permit companies to deduct certain amounts as losses that are then returned as profit over the succeeding years.

88 Ishi, above n 2, ch 11. Measures designed to promote corporate non-debt financing included:

- The abolition of the interest surcharge on retained profits. (1951)
- Capital gains from share transactions made non-taxable. (1953)
- Exemption system for dividends introduced. (1954)
- Reduced tax rate on small companies. (1955)
- Reduced tax rate on dividends at the company level. (1961)
- Split rate system for companies. (1961)

89 Ishi, above n 2, chapter 10.

90 In fact, Japan was under pressure from other countries to reduce its savings rate as it was generating trade friction and worldwide economic distortions.

91 Above n 9.

92 H Ishi, *Making Fiscal Policy in Japan* (2000).

arbitrary decision as to how far in the chain of domestic transactions the tax benefits should extend, became inappropriate or ineffective when the nature of the relevant transactions changed, the scope of such special measures tended to expand and they have become very difficult to repeal once in place.⁹³

Other commentators have suggested that the rules pertaining to mergers that effectively made them tax free have made a significant contribution to economic growth.⁹⁴ Others still have suggested that Japan's international tax rules played a significant role in Japan's economic success.⁹⁵

Certainly the use of tax incentives has not been universally applauded within Japan. Fuke suggests that tax incentives have been accessed mainly by large companies with the result that they are exposed to a low effective rate of tax.⁹⁶ He doubts the effectiveness of these incentives and supports their abolition, coupled with a reduction in the headline tax rate.⁹⁷

93 T Murai, *The Export Promotion Tax System in Japan (1953-1973)* Japan International Cooperation Agency. Murai explores the rationale for these special tax measures concluding that they were directed not merely at the short-term goal of driving exports but also at a medium to long-term goal of strengthening the managerial and financial constitution of exporting corporations.

94 See Ramseyer and Nakazato, above n 5, 247.

95 Nakazato identifies three stages of development of these rules. In the first two stages they were used to further the policy of economic growth. In particular during the 1950s they were designed to encourage foreign investment into Japan. During the 1960s and 1970s the focus turned to favourable treatment for exports. Only more recently have the rules focused more on equity and compliance: M Nakazato, 'Internationalisation of Japan's International Tax Law' (1992) 35 *The Japanese Annual of International Law* 78. Ishi agrees that the international tax rules may have been significant in nurturing economic growth by making inward investment easier at the earlier stage of development and by expanding exports and outward investment at the later stage. However he concludes that generally tax policies and economic growth are not necessarily connected. Ishi, above n 48.

96 Whilst most commentators would support Fuke in his suggestion that companies have a low effective rate of tax due to the abundance of tax concessions, the official view is that the effective rate is higher than the statutory rate due to the non-deductibility of entertainment expenses: See Kaneko, above n 47, 203. Also see Ishi who argues that as at 1992 Japan had a relatively high effective tax rate on corporations; Ishi, above n 2, ch 11.

97 'The restructuring phase of tax law in Japan. An issue of Legitimacy over a more equitable and fairer system towards the 21st Century' in Y Zhang and T Fuke (eds), *Changing Tax Law in East and South East Asia: Towards the 21st Century* (1997). Also see H Ishi, 'Tax Incentives for Export Promotion in Japan, 1953-1964' in RA Musgrave, C Chang and J Riew (eds), *Taxation and Economic*

Notably the period since the mid 1970s has been characterised by fiscal deficits and the need to increase tax revenues.⁹⁸ This has been achieved through a gradual unwinding of the special tax measures and the adoption of a broad based consumption tax. With the aging of the population and the commitment to improving the welfare system, the need to fund Japan's increasing international responsibilities, the necessity to build further social infrastructure and the payment of interest on public debt, this trend of raising taxes and removing concessions may have to continue.⁹⁹

Taxation of expatriates

Japan adopts the standard residency/source principle. The test for residency is, however, relatively strict being based on domicile in Japan or actual presence in Japan continuously for more than one year.

Thus a foreigner who anticipates living in Japan for more than one year would be a resident. However where such person can prove that they have not been resident or domiciled in Japan for five years or more and have no intention to reside or domicile in Japan permanently then they will be classified as a 'non-permanent resident'.

'Non-permanent residents' are not taxable on income sourced outside Japan unless such income is remitted into or paid within Japan.

The NTA presumes that foreign nationals do not intend to reside permanently in Japan and so the length of the period of continuous residence tends to determine the issue of non-permanent residency. In contrast Japanese nationals are presumed to intend to remain in Japan permanently and are, therefore, treated as permanent residents. Thus this notion of a 'non-permanent resident' tends to be reserved for expatriates.¹⁰⁰

Development among Pacific Asian Countries (1994).

98 Tax rates did fall temporarily in the mid 1970s in response to the oil crises and during 1989 upon the introduction of the consumption tax.

99 Ishi, above n 2, ch 14, 284 - 288. On the other hand, Japan's importance to the world economy has been such that it has increasingly been under an expectation that it will adopt a fiscal policy that is not solely focused on domestic issues. Thus, during the Asian recession of the late 1990s Japan was under pressure to reduce taxation in order to promote consumption. This was notwithstanding that its long-term policy was one of increasing taxation. In response to United States support for the Yen, major tax cuts were implemented. Whilst there were some general tax rate reductions there was also a return to the use of special tax measures by the Government.

100 See J Huston et al, *Japanese International Taxation* (2000) para 5.01.

This provision was introduced in 1957 and continues a trend since World War II of liberally taxing non-resident expatriates.¹⁰¹ It also ameliorates the strict one-year residency test that was seen as a disincentive for expatriates to work in Japan. Whilst there have been some recent speculation as to whether the provision is to be repealed following reports of abuse by non-permanent residents having Japanese source income paid offshore the MOF apparently has no immediate plans to repeal it.¹⁰²

The non-permanent resident concept appears to be loosely based on the UK rule that if a taxpayer was not domiciled in the UK or was a non-resident then they were only taxed on income remitted to the UK.¹⁰³ However the rationale is probably quite different as the Japanese rule is designed as a concession for expatriates whereas the UK rule was in the nature of an anti-avoidance provision.¹⁰⁴

As an incentive to encourage expatriates the provision was a very early recognition of the mobility of skilled labour. Many countries are only now coming to the realisation that such tax concessions may be desirable. However the remittance feature harkens back to an earlier age absent electronic funds transfers and the Internet. Whilst the NTA has issued a Circular giving the word 'remittance' a broad meaning¹⁰⁵ the reality is that enforcement of this aspect of the provision is likely to become more problematic and probably requires reconsideration.

Relevance for Australia?

This review of novel features of the Japanese tax system has identified five features that may have relevance for Australia.

Blue return system

The blue return system operates as an incentive to taxpayers to maintain proper accounting records in return for certain tax privileges. There is a concern in Australia that small businesses often fail to report their true

101 Measures included an early rule that only income derived in Yen was taxable (US forces were paid in US dollars) and a later rule that only half the salary of non-residents was taxable.

102 'Japan to Preserve Tax Break for Foreigners' (16 April 2001) *Tax Notes International* 1914.

103 This rule last appeared as S.132 of the UK *Income Tax Act 1952*.

104 But see Huston et al, above n 100, para 5.01 where the provision is, surprisingly, described as an anti-avoidance rule.

105 Ibid.

taxable income due to inadequate accounting records. Furthermore, this lack of records is often attributed to the collapse of such businesses.¹⁰⁶ Thus a rule that restricted the availability of certain tax concessions to taxpayers that maintain proper accounts would appear valuable.

On the other hand, to the extent that these tax concessions may have socio-economic goals, the achievement of these may be frustrated by the inability of taxpayers to access the concessions due to inadequate record keeping. Thus the relevant incentives must be selectively chosen.

Ultimately possibly the most valuable lesson for Australia to be drawn from the blue return concept is the success of adopting a 'carrot' approach rather than a 'stick'. Indeed some Japanese commentators have suggested that this approach is one of the main reasons for the success of tax administration in Japan.¹⁰⁷

Tax policy formulation

Whilst there is much to be said for an open public consideration of tax policy the present system in Australia is both time consuming and costly. Typically tax reform is preceded by the establishment of a government sponsored review committee with a defined mandate. The committee usually prepares a preliminary proposal that it subjects to public consultation and further analysis. Ultimately a final report is tabled. However, the nature of the Australian process is that the report of the review committee is viewed as independent from the Government. The Government then comments but as it has to deal with the political ramifications arising from the recommendations historically few recommendations are enshrined in a bill.

Even then the Government must secure a passage for its legislation through Parliament. However because in more recent times the Government has tended not to control the Senate these reforms are usually subject to considerable debate in the Senate and are often referred to committee. After deliberation and compromise a revised reform is typically promulgated. The political process thus tends to stifle any major structural reforms.

Whilst an advantage of this system is the ample opportunity for interest groups to air publicly their concerns, the process creates considerable

106 Indeed it is thought that one of the incidental benefits of the Australian consumption tax is to force small businesses to improve their accounting.

107 H Sato and M Shibuya, 'The Role of Tax Administration and Collection', in Oldman, and Kaneko, above n 48, 175. Withholding taxes and the year-end adjustment mechanism have also been instrumental in this success in their view.

uncertainty. This is typically because the Government's announcements will often specify a date for the commencement of the reforms that is unrealistic. The result is that as the reform package proceeds through the political system taxpayers are left in considerable doubt as to what may soon be or even is the law.

Furthermore, because the legislation is subject often to late compromise the policy behind it tends to become obscured and the legislation poorly drafted and riddled with avoidance opportunities. The spectre of politicians debating the minutiae of complex legislation is also common.

A recognition that this system is inefficient was inherent in the Ralph Review recommendation that the Government create a Board of Taxation with an advisory function.¹⁰⁸ Subsequently the Government has created such a body,¹⁰⁹ however, there is concern as to its limited mandate and status.¹¹⁰ In particular there is a debate over the extent to which the Board should be involved in tax policy formulation.¹¹¹ There is cause for the Government to reconsider the nature of this Board and valuable lessons may be obtained from the operation of the Japanese Tax Commission.¹¹² The Tax Commission has a more permanent and representative existence and presents its recommendations to the Government not to the general public. Whilst political compromises are still a feature of the Japanese system the advantage is that all inquiry recommendations can be relatively easily and swiftly implemented.

At a time when the Australian judicial system is increasingly under attack for the quality of its decisions, its timeliness and the cost of proceedings, consideration might also be given to adopting a body such as the National Tax Review Committee. A particular feature of current tax law jurisprudence in Australia is the number of decisions that are reversed on

108 J Ralph, *Review of Business Taxation*, Commonwealth of Australia July 1999, <<http://www.rbt.treasury.gov.au/publications/paper4/index.htm>>.

109 See the Treasurer's Press Releases No 74 (11 November 1999) and No 83 (10 August 2000).

110 A Fabo, 'Toothless tax board feels bite' (21 August 2001) *The Australian Financial Review*, 5.

111 F Buffini and A Fabro, 'Warburton calls for unity on tax board' and R Warburton, 'Tax board is vehicle for community input' (24 September 2001) *The Australian Financial Review*, 7 and 59.

112 The Board is itself investigating aspects of the process by which tax policy is expressed. On 15 May 2001 it announced a review into the arrangements for Government consultation with the community on the development of taxation legislation: Board of Taxation press release number 2. <<http://www.taxboard.gov.au/pressreleases/002.htm>>.

appeal. Furthermore, it is no secret that certain judges are more highly qualified to decide tax matters than others, yet the determination as to who is to sit on a case is premised on logistics rather than qualifications.

Whilst the number of tax cases that proceed to judicial consideration might not justify the existence of a specialist Tax Court, as distinct from the current specialist Tax Tribunals that hear the plethora of smaller matters, there may be value in allowing disputes involving doubt as to the law to be referred to an independent body of tax experts prior to immersion in the court system. This may result in these matters either being settled or, at least, will provide the judges ultimately hearing the cases with some expert guidance on the law and tax policy considerations. In this way the quality of tax precedents may be improved and the likelihood of reversal on appeal lessened.

Withholding taxes and standard deductions

The reliance on withholding taxes in the Japanese tax system would appear to present many advantages for government such as the combating of tax evasion and avoidance, administrative savings, improved cash flow and reduced visibility of taxes. The freeing up of NTA resources for more productive audit activities has also been acknowledged.¹¹³

However, as the Japanese experience illustrates, in order for an income tax system to be based on withholding taxes, either final withholding taxes with their equity concerns, or mechanisms to calculate the cumulative amount of tax payable, are necessary. The tax system may also need to feature broad tax brackets, different rates for different income types, possibly an exemption for fringe benefits and few non-standard deductions. Thus administrative simplicity is achieved at the expense of equity.

The concern in Australia with the complexity of the tax system is evident by the tax simplification program embraced during the 1990s. Unfortunately this program has stalled leaving a worse case scenario of two Income Tax Assessment Acts that now must be read together.¹¹⁴

Furthermore, the growth in complexity of tax legislation and policy would appear to be inevitable as successive governments add layers of regulation onto an overloaded framework.

113 Sato and Shibuya, above n 107.

114 The *Income Tax Assessment Act 1936* was gradually being rewritten as the *Income Tax Assessment Act 1997*.

Very few individual taxpayers can now successfully complete their own tax returns and the use of tax agents is the norm. The high cost of this regulatory burden to society must be questioned given the resultant redirection of these resources away from other more socially or economically advantageous pursuits.

One area in which taxpayer error, inadvertent or otherwise, has been a source of concern to the Australian Tax Office ('ATO') is in the claiming of employment deductions. Substantial resources have been devoted by the ATO to ensuring the accuracy of such deductions and there is detailed legislation and case law dealing with the topic.

Under Australia's resident withholding tax system employment and associated income is subject to withholding. Also if a taxpayer does not disclose their tax file or Australian business number other payments such as dividends, interest and business income are subject to withholding.¹¹⁵ However these are not final withholding taxes and limitations in identifying the appropriate rate of withholding, the absence of any year-end adjustment mechanism and the availability of deductions, in particular employment deductions, necessitate that taxpayers lodge a return. If the average taxpayer can be completely removed from the tax system¹¹⁶ through the use of either final withholding taxes or a year-end adjustment mechanism together with standard deductions then this would be a major step forward in simplifying the system. Whilst there may be equity issues it has been demonstrated that reliance on withholding taxes has contributed to tax collection in Japan being much less costly than in Australia.¹¹⁷ The administrative savings could be returned in the form of low final withholding tax rates or generous standard deductions as in Japan.¹¹⁸

There have been other calls to extend Australia's reliance on withholding taxes. For example, the Ralph Review proposed a comprehensive withholding tax regime in respect of Australian source income and gains on the disposal of assets subject to Australian tax by non-residents. The tax would be final in relation to salary and wages only. It would be at the

115 Generally see CCH Australia, *Australian Master Tax Guide 2002* (2002) ch 26.

116 There are indications that the Government is considering ways to minimize the need to lodge tax returns: S Marris and L Milligan, 'Plan for Easier Tax Refunds', (8 January 2001) *The Australian*.

117 Beyer, above n 50.

118 On standard tax reliefs generally see Messere, above n 10, 224 to 225 and 244. He notes that they can vary greatly in size and kind as between countries and over time. For example, they can be in the form of tax credits, fixed allowances and zero rated tax brackets.

company rate except for disposals of assets where the rate would be 10% on the gross proceeds.¹¹⁹

Also in 1991 the Taxation Institute proposed an interest withholding tax system for Australia at the rate of 20% similar to that existing in Japan. It was suggested that such a system would encourage savings, dampen inflationary pressures, reduce demand for imported capital, cut reliance on social welfare resources, involve less compliance costs, combat tax avoidance and bring in more tax revenue. It was argued that this was a superior approach to an extension of the tax file number system then being undertaken.¹²⁰ History has indeed borne out that the tax file number has its limitations.¹²¹

The major drawback with a move away from a comprehensive income tax to taxing different streams of income at source at different rates are the inequities that final withholding taxes will necessarily generate from ignoring the inherent features of the taxpayer. Equity could be maintained by using withholding taxes as merely interim collecting devices rather than as final taxes and requiring assessment by reference to progressive rates. Of course this would defeat the goal of seeking to minimise the need to file returns in the absence of a year-end adjustment mechanism. This mechanism, in turn, raises privacy issues and involves a transfer of the tax assessment burden.

Avoidance opportunities also feature in a system that provides different rates of tax for different income sources. The tax avoidance industry in Australia has been founded on the income, capital distinction. Therefore, a system that provided different withholding tax rates for different income types would need to contain anti-avoidance rules to address recharacterisation techniques.

Furthermore, the uncertainty for the future of income taxation presented by technological advances in telecommunications and, in particular, the

119 J Ralph, *Review of Business Taxation* (1999) <<http://www.rbt.treasury.gov.au/publications/paper4/index.htm>>, Rec 21.6.

120 Discussed in a series of articles in (1991) 26 *Taxation in Australia* 4 to 8.

121 See the report by the House of Representatives Standing Committee on Economics, Finance and Public Administration, *Numbers on the Run* (2000) and Australian National Audit Office, *Performance Audit, Management of Tax File Numbers*, Report Number 37 (1998/99).

Internet is generally acknowledged. It is also possible that these developments could reduce the effectiveness of withholding taxes.¹²²

Nevertheless there is merit in further assessing the effectiveness of the Japanese withholding tax system with its optional final taxes, year-end adjustment mechanism and standard deductions. In particular it would be useful to monitor how the Japanese Government responds to the pressure on the integrity of the withholding taxes given technological advances, globalisation and less homogeneous work and investment patterns.

Tax expenditure programs

A recognition of the concept of 'tax expenditures' essentially dates from the early 1970s.¹²³ Only since that period have they been brought under budgetary control in most jurisdictions.

Much of the period since has witnessed a debate over the appropriateness of such measures. Opponents refer to the lack of transparency, the difficulties in estimating the amount of expenditure and in ensuring appropriate targeting, the increased complexity, the potential for tax avoidance, the regressivity of these measures, their non-availability to non-profitable or tax exempt enterprises and that they discriminate in favour of larger companies. On the other hand, the flexibility, high and rapid take up, ease of administration and the opportunity for governments to stay within spending limits are referred to by proponents. These proponents also suggest that most of the criticisms of tax expenditure are, in fact, criticisms of poorly designed measures.

However even these proponents recognize the danger in these measures where a government is overly influenced by the short-term demands of its constituency. Also they are often politically very difficult to repeal and most effective when used sparingly. These observations are attested to by the Japanese experience.¹²⁴

Academic and expert opinion on tax expenditures differs markedly from actual government policy. With the advent of globalisation these measures are likely to become more common as countries compete. This is especially

122 For example, the employment income withholding tax may need reconsideration should employees increasingly become self employed working on the Internet.

123 In particular see SS Surrey, *Pathways to Tax Reform: the Concept of Tax Expenditure* (1973).

124 Generally see Messere, above n 10, 126 to 132.

true of South East Asia as countries in that region emerge from the economic crisis of the late 1990s.¹²⁵

Certainly the Japanese Government's love affair with tax expenditure programs continued in 2001 notwithstanding that official Government policy is to phase out such programs. The debate over, and subsequent, measures to support, the depressed stock market are indicative.¹²⁶

Japan thus provides a useful study of the use of tax incentives to further economic priorities. Unfortunately the evidence is ambiguous as to whether such measures have been effective. Possibly Japan's economic success would have been all that much more spectacular had other policy measures been used in lieu of tax incentives. The leakage of tax revenue together with the perception of inequity may have had a significant, although unquantifiable, cost.

The current orthodoxy is echoed in the Australian Ralph Review recommendation that tax incentives should only be utilised where they were assessed to be superior to other forms of government intervention. Accordingly, an ongoing review of Australia's tax expenditure programs was suggested. This suggestion is consistent with the Australian Government's general reluctance to adopt tax expenditure programs¹²⁷ notwithstanding pressure from various interest groups.¹²⁸

Possibly the most interesting lesson from the Japanese experience is the nominal division of tax laws between ordinary laws and special measures.¹²⁹ By identifying tax incentives and separating them from the revenue raising provisions this may assist in the community focusing on these tax expenditure programs for what they are and thereby limit the tendency for

125 See M Asher and G Heij, 'South East Asia's Economic Crisis: Implications for Tax Systems and Reform Strategies' (January 1999) *International Bureau of Fiscal Documentation Bulletin* 25.

126 See K Mori, 'Japan's Ruling Party Moves to Shore up Stock Prices with Tax Provisions' (19 February 2001) *Tax Notes International* 851 and G Beaumont 'Japan's Coalition Government Struggles with Consensus on Tax Measures to Revitalise Stock Market' (19 February 2001) *Tax Notes International* 852.

127 Rec 6.24.

128 Such as the Queensland Government which recently called for tax incentives to encourage investment: A Fabro, 'Beattie calls for tax incentives' (25 June 2001) *The Australian Financial Review*, 7. A recent report to the Prime Minister also endorsed an 'industry-specific promotion' approach for sectors with strong potential. See S Lewis, 'Australia Inc: the new blueprint' (14 August 2001) *The Australian Financial Review* 1.

129 The special tax measures legislation was first enacted in 1957. This demarcation has not always been strictly adhered to. See Ishi, above n 2, ch 6.

these to be used to attack the integrity of the tax system generally as being complex and containing inequities and non-neutralities.

Taxation of expatriates

The resumption to Chinese control of Hong Kong in 1996 and the potential for the relocation of Hong Kong based business enterprises highlighted to the Australian Government the opportunity to attract foreign businesses. Successive reports identified the Australian tax system as detracting from Australia's attractiveness as a location.¹³⁰ In particular, one important consideration identified in the choice of corporate location was the tax regime applicable to foreign executives who were to be temporarily located in the foreign destination.

Since 1998 the Australian residency rules have been applied by the ATO such that, as a rule of thumb, if a foreigner intends to reside in Australia for a period of six months or more, they will be treated as an Australian resident and therefore taxed on their worldwide income.¹³¹

This is clearly a disincentive for expatriates to locate to Australia and to the extent that their tax liability is typically met by their corporate sponsor this could be viewed as a disincentive to establish an operation in Australia. It was recognised by the Ralph Review in its recommendation that non-resident expatriates be taxed by way of a final withholding tax at the corporate rate on their wages and salary rather than at the high marginal rates. Furthermore, it was recommended that resident expatriates in Australia for four or fewer years be exempt from taxation in relation to foreign source income derived from assets acquired pre-residence and from interest withholding tax on interest payments in respect of liabilities incurred pre-residence.¹³²

Subsequently the Government announced that it would implement this recommendation with an extension that it would be available regardless of when the assets were acquired or liabilities incurred. Also, as a further concession, no capital gains tax was to be imposed on the disposal of assets not having the necessary connection with Australia, other than portfolio interests in Australian publicly listed companies. Where the period of the

130 For example, see J Dabner, *Should Taxation Incentives be Introduced to Encourage the Location of South East Asian/Southwest Pacific Regional Corporate Headquarters to Australia?* (1994).

131 TR 98/17. Previously the ATO had applied a 2 year test.

132 Ralph, above n 119, Rec 22.17 and 22.18.

temporary visa exceeded four years, the exemption would still be available for four years.¹³³ Legislation is yet to be tabled.

These measures should thus go close to adopting the Japanese concept of a non-permanent resident, with its five year window and exemption for all foreign source income, not merely income arising from pre-residence investments. Fortunately the problematic Japanese remittance exception will, apparently, not be embraced.

Conclusion

Whilst the Japanese tax system contains some unique features and, arguably, has contributed to that country's economic success there has been little analysis of it from an Australian perspective.

This paper has identified five features of the Japanese income tax that may be of interest to Australian tax policy analysts:

Blue return system - a system that operates to encourage desirable taxpayer behaviour, in this case the maintenance of proper accounting records, in return for the availability of tax incentives, is to be contrasted with the typical Australian approach of threatening punishment or the denial of tax deductions. The apparent success of this alternative approach warrants that it be given consideration.

Tax policy formulation - a permanent body (like the Japanese Tax Commission) to deliberate on and advise the Government in relation to tax policy might be a more effective mechanism by which to resolve the compromise inherent in tax policy formulation than the creation of ad hoc advisory committees and the reliance on Treasury and the Australian Tax Office.

Withholding taxes and standard deductions - greater reliance on domestic withholding taxes promotes administrative simplicity and enhanced integrity at the expense of equity. Whilst the Japanese template illustrates how the average taxpayer may be removed from the burden of filing a tax return the equity compromise needs to be appreciated. Possibly availing taxpayers of an option to adopt standard deductions and be subject to final withholding taxes might be an appropriate response.

Tax expenditure programs - although the current orthodoxy is that such measures should be limited, the Japanese experience is, whether rightly or

133 Prime Minister and Treasurer, Press Releases Nos 81 and 82 (15 October 2001).

wrongly, typically referred to, to illustrate their value. This experience does illustrate that there may be value in separately identifying such measures from the revenue raising provisions.

Taxation of expatriates - the Japanese rules have long provided a tax concession for short-term expatriates working within the country. The Australian Government has only recently announced its intention to adopt such measures and the Japanese approach illustrates one option.

Whilst these features of the Japanese income tax system may or may not ultimately be an improvement on the Australian rules, it is nevertheless valuable to reflect on alternative approaches as a test of the robustness of one's own system. The real value of the exercise may not be in whether the alternative is embraced but in the better understanding of the limitations and strengths of one's own tax system that is thereby gained.