Tax Policy I (2005.10.12) ASATSUMA Akiyuki (Rikkyo University)
http://www.rikkyo.ne.jp/~asatsuma/05taxpolicy.html asatsuma@rikkyo.ne.jp

Asatsuma: direct taxation (income tax, corporate tax and inheritance tax) 01-11
Yoneda: indirect taxation (value added tax / consumption tax) 12-15

self-introduction
major (law? economics? or others?)

1. Introduction of Tax Law

1.1. The objective of this coursework

from the viewpoint of bureaucrats (tax officers)
from the viewpoint of taxpayers (citizens)

(The structure of tax avoidance is important for taxpayers and also for tax officers.)

3 points of tax systems:
equity / neutrality (efficiency) / **simplicity**

from the viewpoint of economists and lawyers
(This coursework focuses on legal aspects of tax system.)

1.2. Textbooks

金子宏『**租税法**』(弘文堂、第十版、2005)
KANEKO Hiroshi "Sozei-hou (Tax Law)" (Koubundou, 10th ed. 2005, no translation)

金子宏、佐藤英明、増井良啓、渋谷雅弘『**ケースブック租税法**』(弘文堂、2004)
KANEKO Hiroshi, et al. "Casebook: Tax Law" (Koubundou, 2004, no translation)
(This coursework doesn't use textbooks.)

1.3. The overview of Japanese tax system

http://www.mof.go.jp/english/budget/pamphlet/cjfc2005.pdf (See Appendix, page 2)

(Japanese budget relies heavily on government bond.) (゜Д゜;)
National tax revenue is constituted mainly by
income tax / consumption tax (VAT) / corporation tax.
VAT=value added tax
The volume of corporation tax will be small and the volume of consumption tax will be large.
(The main revenue of European countries is consumption tax (VAT).)

See the volume of **inheritance tax**. (very small)

This table shows only national tax revenues,
but local governments also impose taxes.

Tax revenue of municipals is constituted by **property tax** (imposed on fixed property), income tax (on individuals and corporations), consumption tax and etc.

◇◆◇

Tax systems do not have global standard and are different from country by country reflecting the histories and cultures respectively.

Executing of income tax (on individuals and corporations) and consumption tax need much of

information of taxpayers, so most countries had started to impose land tax and excise tax (liquor tax, tobacco tax, etc. including tariff or customs).

This coursework naturally treats Japanese tax law, but participants should customize the tax system reflecting the situations of your own countries.

However I think that "**rule of law**" is important for all countries. Tax has strong effects to people's interests. Executing tax is faced with strong resistance. Therefore, we should study not only economic aspects of tax but also legal aspects of tax.

◇◆◇

words (technical terms)

tax requisition (Steurtatbestand): condition of tax liabilities

tax payer: the person who owes tax liability in the legal relation of tax

[caution] The persons who owe tax liabilities in legal sentence do not necessarily owe tax burden in economic means.

[example] Corporation tax is imposed on corporations but corporations feel no pain and the tax burden will be shifted to individuals (shareholders, debtors, labors or etc.).

Withholding tax

[example] corporation (withholding) —— labors (earning income)

progressive taxation (⇔ regressive taxation)

Income Tax Act (ITA), Art. 89 (adjusted by special act)

under ¥3.3 million	10%
¥3.3 million — ¥9 million	20%
¥9 million — ¥18 million	30%
over ¥18 million	37%

[caution] Local governments also impose tax on income and the top rate is 13%, so the total tax rate for high earners is 50% (= 37%+13%).

[caution] High tax rate is applied only to the amount over the income bracket.

[example] Mr. X earns ¥3.4 million and Mr. Y earns ¥3.3 million.

X's tax: ¥3.4 million×20%=¥0.68 million? after tax: ¥2.72 million?

X's tax: ¥3.3m×10% + ¥0.1m×20%=¥0.35m after tax: ¥3.05 million

Y's tax: ¥3.3 million×10%=¥0.33 million after tax: ¥2.97 million

[example] Mr. Z earns ¥4 million. His tax is ¥0.47m. (= 3.3*10%+0.7*20%)

Marginal rate is 20% (if he earns ¥1 additionally, his tax increases by ¥0.2).

Average rate (or effective rate) is 11.75% (=0.47/4).

Effective rate is not same as average rate. If Mr. Z earns ¥5m but gets a special deduction of ¥1m for some special act, then effective rate is 9.4% (=0.47/5).

Classification of income (or income categories)

Your earnings will be categorized to the one of classification of income according to the source of earnings. Japanese ITA has 10 categories. (It is said that …) Different category of income needs different tax treatment reflecting the nature of that income.

interest / dividend / real estate / business / salary / retirement / foresty / capital gain / temporary / other

[cf] Germany has 7 categories but USA has only 2 categories: ordinary income and capital

gain.

Aggregation of profit and loss

There are two types of aggregation.
[type 1: among categories] Mr. X makes profits of ¥5m of category-A, but also makes losses of ¥2m of category-B. X's taxable income is ¥3m because of aggregation.
[caution] Aggregation among categories is subject to some limitation.

[type 2: among taxable years] Mr. Y makes losses of ¥6m in year 2001 (tax amount is ¥0), but makes profits of ¥9m in year 2002. Y's taxable income in year 2002 is ¥3m. (= −¥6m + ¥9m)

Global taxation / Separate taxation

As a general rule, taxable income is calculated globally. Some types of income are separated from other income and are withheld by payor, and then the taxation procedure is end.

[example] X Bank pays interest to a depositor-Y. That interest income would be aggregated with Y's other income as a general rule (global taxation), but in practice, special rule treats that interest income in separate taxation system. X withholds the amount of tax from that interest payment, and pays that amount of tax to the tax office. Y gets the remainder of that interest, and Y does not need to fulfill the tax-payment procedure for that interest.

◇◆◇

[sample] A last year's examination (in Rikkyo)
Mr. K is a young man who intends to be a politician, but now he has no job. A kind person, Mr. F, feels sympathy for Mr. K. Mr. F is operating a store (F-Store), and makes an appearance that F employs K, and makes a payment that is named as a wage, saying "Mr. K, your job is to be elected in the next vote." However, K's activity is limited to the political activity, and as a matter of fact, K does not act as an employee of F-Store. What problems are there in tax affairs?

Point at issue: Is the payment from F to K really considered as a wage by tax officers?

(1) If Mr. F really pays a wage to Mr. K, then that payment is deducted from F's income. In this case, however, that payment is not considered as a wage from the legal viewpoint, and that payment is considered as a **donation**. That payment cannot be deducted from F's income. What Mr. F does is **tax evasion**.

(2) Suppose that F's income (before the wage-payment) is ¥5m, and the wage-payment to K is ¥2m. (In a tax return, F says that his income is ¥3m.) (In this example, personal deduction is ignored.)

If F's income is ¥3m	tax amount: ¥**0.3**m	after tax income: ¥**2.7**m
If K's income is ¥2m	tax amount: ¥**0.2**m	after tax income: ¥**1.8**m
(total	tax amount: ¥**0.5**m	after tax income: ¥**4.5**m)

However, the wage-payment-deduction is not permissed, because that payment is not a wage.

F's income is ¥5m tax amount: ¥**0.67**m after tax income: ¥**4.33**m
(¥3.3m×10% +¥1.7×20% = ¥0.33m + ¥0.34 = ¥0.67m)
((3) Mr. K is subject not to income tax but to gift tax.)
[lesson] When we make some transactions, we need to pay attention to the tax effect.

1.4. Significance and function of tax

(1) financing for supplying public goods

public goods……**National defence** is a typical example.

nonrivalrous……no marginal cost for additional users (Two or more persons can use the goods without additional cost.)

nonexcludable……no way of excluding users who pay no fee

↓

free rider……Selfish (rational) users enjoy the utility of goods without paying fee.
[example] easily downloadable musics or novels on the internet

↓

shortage of supply……Selfish (rational) users pay no fee, therefore supplier can not cover the supplying cost. [example] Musicians or writers cannot get money.

↓

failure of market……Market does not work for supplying public goods, some of which we need. A typical example is national defence. Therefore, government must supply public goods. Government needs money.

(2) Redistribution (of income or wealth)

Not all people can get money for there survival. There are the weak.
Relief for the social vulnerable need revenue, unless we leave them dying.
Many people think that the government should supply public welfare.

(3) one policy measure

Sometimes tax is used for accomplishing a policy object.
[example] carbon tax: decreasing CO_2

1.5. Definition and nature of tax

(1) public interest

financing for supplying public goods
⇔ fine, penalty

(2) compalsion, authority

Tax officers have legal power to collect tax without the agreement of taxpayers.
⇔ revenue from national business
[example] If the government has oil mine, the government gets revenue from selling oil, but the buyers is not compelled to make contracts of oil.

(3) not a consideration

The government makes supply of public goods to resident people, however, collecting tax is not correspond to a specific government service to a certain taxpayer.
⇔ charge, registry fee

(4) generality

Tax law is applied to all persons who satisfy the requirements of law.

(5) money payment

As a general, tax is a money payment.
Exception: payment in kind in the context of inheritance tax

Discussion: Compalsory military draft (Japan doesn't have this system.) can be seen as a kind of tax which is paid with body. I think that tax paid with money is efficient. Some persons are aptitude for military, but others are not. When military service is supplied by non-suitable persons, it is not efficient. If people do their job with their own aptness and then

pay tax with money to the government, it will be efficient for national economy.

2. Tax law and Constitution

2.1. Principle of no taxation without law

http://www.kantei.go.jp/foreign/constitution_and_government/frame_01.html

Constitution, **Article 84** No new taxes shall be imposed or existing ones modified except by law or under such conditions as law may prescribe.

2.1.1. Meaning of this principle

Historically, the **congress** was born in order to preclude the King's arbitrary taxation.
(Magna Carta, England | States General, France)

Two bases for the principle of no taxation without law

democracy / liberalism

2.1.2. Tax requisition shall be designated by law.

democracy → no taxation without representation

People elect politicians, and politicians make law in the Congress. (indirect democracy)
Tax law should be a reflection of public opinion.

Assumption: Suppose that Japanese tax law is made by foreigners (for example, Americans). That tax law may be reasonable from the viewpoint of economics and that tax law will give people legal predictability. However, Japanese people may be reluctant to be subject that tax law because that tax law does not reflect the opinion of Japanese people. Japanese people wish to determinate how to allocate the tax burden among people with their own thought.

Question: Corporation has no vote. Is the taxation on corporation unconstitutional?
Question: Foreigners have no vote. Is the taxation on foreigners unconstitutional?

◇◆◇

Tax law is law made in the Congress. However the Congress does not have enough capacity to make tax rule in detail. (The Congress is faced to other works and tax matter requires expartness heavily.)

↓

delegation to cabinet orders

General or unconditional (blank) delegation is prohibited (unconstitutional).
Delegation must be concrete or specific.

If tax law delegates the authority to cabinet orders widely, then it means that tax provisions are made not by parliamentary representatives (indirectly by Japanese nation) but by bureaucrats. It is unconstitutional.

Tokyo high court, 1995 November 28, 行集(Gyoushû), vol. 46, no. 10=11, p. 1046.

Fact: Special Taxation Measures Act provides that some types of cooperative union are well-treated in the context of registration tax. Special Taxation Measures Act Enforecement

Regulations (which is a type of cabinet orders) provides that taxpayers shall present the certificate of a prefectual governor in order to reduce the tax as a procedural requisition.

A taxpayer (named X, petitioner) carelessly paid a usual amount of registration tax without presenting the certificate of the prefectual governor. After that X discovered that X had paid the tax amount excessively, and X asked Y (the director of taxation office, respondent) the refund of the difference between the amount paid and the correct tax amount. Y rejected the claim of X, and made the action of notice.

X filed a suit claiming (1) the cancellation of Y's action and (2) the restitution of unjust enrichment.

Judgement: For the principle of no taxation without law, the delegation to cabinet orders shall be concrete or specific. In this case, tax law has no express provision about whether a certain procedure [*i.e.* presenting the certificate of a profectual governor] is added as a tax requisition (a tax-reducing requisition) or not, therefore that procedure should not be interpreted as a tax (-reducing) requisition. That procedural matter has only a procedural effect, and it is not a tax (-reducing) requisition.

(1) Y's action of notice rejecting the X's claim has legality. <procedural aspect>
(2) X's claim of the restitution of unjust enrichment is accepted. <substantial aspect >

Point at issue: If the procedure of presenting the certificate of a prefectual governor is a tax (-reducing) requisition and the procedure has substantial effect, that provision is unconstitutional. Therefore, the procedural provision shall have only a procedural effect.

Example:
Usual tax amount is ¥100.
Well-treated tax amount is ¥60.
Unjust enrichment is ¥40.

2.1.3. Tax requisition shall be clear.

liberalism → predictability

In transactions, tax has significant effect.
If people can not predict the tax effect before concluding contracts, there will be chilling effect to transactions.

small transactions → small **welfare** (or utility)

Two persons make a transaction because the utility for both persons will increase after the transaction. When X buys a book from Y and pays ¥1000, the book is more valuable than ¥1000 for X, and ¥1000 is more valuable than the book for Y.

◇◆◇

However, tax law sometimes uses **indeterminate concepts**.

Tax law should give people predictability, but at the same time, should be equitable among taxpayers. If tax law uses only determinate words, the latter requirements may not be satisfied.

Income Tax Act, §157 [**Denial of action or calculation of family-controlled companies**]

People can easily make tax avoiding transactions using family-controlled companies. ITA § 157 gives directors of taxation office authority to deny the family-controlled companies' action or calculation which "result to reduce the tax burden unfairly".

Although tax law sometimes uses seemingly indeterminate concepts, the concepts should

be clear in light of the law's purpose and object. That kind of concept is not unconstitutional.

However, if the concepts do not became clear as a result of the interpretation of law, then, that kind of concept is unconstitutional.

2.1.4. Principle of legality

Tax officers have little **discretion** about taxation.
Execution of tax shall be in line with the law.
Tax officers cannot make the tax amount heavy without law.
Tax officers cannot make the tax amount light without law.

Tax officers cannot make **compromises** with taxpayers.

2.1.5. Prohibition of retroactive legislation

The law of 2005 cannot have effects on taxation in 2004.

2.1.6. Guarantee of due process

When a taxpayer has complaint against certain taxation, law shall give him an opportunity to contend against the taxation in legal procedure.

Supplementation:

In Japanese tax suit, tax officers owe **burden of proof** as a general rule.
(In the US, taxpayers owe burden of proof as a general rule.)

2.2. Principle of tax equity

2.2.1. Constition, §14 : Principle of equality

Constitution, Article 14. All of the people are equal under the law and there shall be no discrimination in political, economic or social relations because of race, creed, sex, social status or family origin.

Unreasonable (irrational) discrimination is prohibited.
However reasonable (rational) discrimination is allowed.

Until today, there have been many many tax law suits about whether certain tax law breached the principle of equality of Constition, § 14.
However the discretion of legislation (discretion of the Diet) is widely admited.

●Tax law is related with very wide range of finance, economy, and social policies. Legislation of tax law needs synthetic and comprehensive policy judgements.
●Legislation of tax law also needs highly technical judgement and expartness.
↓
As a general rule, **court should respect the discretion of the legislative body**, unless there are heavily irrational discriminations and the irrationality is clear.

Leading case: **Supreme court, 1985 March 27**, 民集(Minshû), vol. 39, no. 2, p. 247.

◇◆◇

In the discussion of law interpretation, the principle of equality in tax law suit has little meaning.

However, in the field of law making (policy making), the discussion of tax equity is important from the viewpoint of economics.

2.2.2. ability to pay

the criterion of the ability to pay

income / consumption / property (asset)

However, the concept of ability to pay is not clear. Therefore I don't recommend the use of the word "ability to pay".

2.2.3. horizontal equity / vertical equity

horizontal equity : Treat the two samely as the two is on the same situation.
X and Y have same income. → X and Y should bear same tax.

vertical equity : Treat the two differently as the two is on the different situation.
X gets more income than Y. → X should bear more tax than Y.

However, what is "same"? What is "different"?
In the example above, people pay attention to income. The criterion for "same" or "different" is income. However, people do not necessarily pay attention to income.

Example 1: Japanese budget reaches ¥80 trillion. The population of Japan is 120 million.
¥80 trillion / 120 million ¥0.67 million.
Is the taxation of ¥0.67 million per head equitable?

Example 2: Mr. V gets income of ¥100, and consumes ¥100. Mr. W gets income of ¥1000, and consumes ¥100. Are V and W on the same situation?
Mr. X gets income of ¥1000, and consumes ¥100. Mr. Y gets income of ¥1000, and consumes ¥1000. Are X and Y on the same situation?
The answer depends on whether we look at income or consumption.

When we discuss the equity, we need to clarify the criterion of the equity.

2.2.4. equity and neutrality (efficiency)

(1) Nonneutral (discriminative) treatment does not necessarily lead inequity.

Suppose X is subject to tax and Y is not. Is it necessarily unequity?
Suppose that bond-X and bond-Y yield returns of 10% in no-taxation world. Now, the government imposes tax only on the interest of X at 50% rate and imposes no tax on the interest of Y. After tax return of X is 5%, and that of Y is 10%.
Some of investors who have invested in X, watching this situation, will transfer capital from X to Y. Presupposing the law of **diminishing returns***, the rate of return of X will rise, and that of Y will diminish.

*diminishing returns: Textbooks of economics use an example of guns and butter. There are resources which are suited for making guns, and other resources are suited for making butter. At the first time, guns are made with resources suited for guns. The more guns, the less suitable resources are used. Therefore, the more amounts of production of guns, the less productivity of guns. In a similar way, the more amount of production of butter, the less

productivity of butter. The reason of why the supply curve is rising is the law of diminishing returns. (diminishing returns of additional resources → rising costs for additional products) (This explanation ignores the counter-effect of the "economy of scale" and the "learning".)

Finally, the capital will be transferred from X to Y **until the after tax return of X becomes equal to the after (= before) tax return of Y**. For example, the adjustment of capital between X and Y finishes at the time when the after tax return of X rises to, for example, 7% (the before tax return of X is 14%) and the after (=before) tax return of Y diminishes to 7%.

The situation after adjustment is called as "**equilibrium**".

Although, namely Y is not taxed, the rate of return of Y goes down from 10% to 7%. Y is subject to "**implicit tax**".

What does this example means?
Nonneutral (discriminative) taxation does not necessarily lead inequality.

Does it mean that no matter how nonneutrally the law treats the two, there will be no inequality?
……This argument is extreme.
Of course, the example above is based on several (sometimes unrealistic) assumptions.

●non-friction

The example above makes an assumption that the transfer the capital from X to Y occurs fluently (without friction).

However, in real world, there are many frictions when transferring from one to another.

Example: Suppose that income of employees are perfectly captured by tax officers (100% captured), but, on the other hand, income of farmers are captured by tax officers at only half (50% captured). If the nominal tax rate is 40%, then it means that, the actual tax rate on income of employees is 40%, but, on the other hand, the actual tax rate on income of farmers is **20**%.

How to work is also one type of investments (the investment of one's body or one's time). Maybe, some of those who seek jobs give up becoming employees, because the actual tax rate of employees is higher than that of farmers. However, much of those who seek jobs have little opportunity to choose employees or farmers. There is a friction in the choice of jobs.

Moreover, some people might say that nonneutral and discriminative taxation among jobs is suspected to be unconstitutional in the light of the freedom of profession. Japanese Constitution, Article 22 (1) provides:

> "Every person shall have freedom to choose and change his residence and to choose his occupation to the extent that it does not interfere with the public welfare."

●transition

Remind the equilibrium case of bond-X and bond-Y. If, after the equilibrium, the government makes relieves for those who have invested in X and cuts the taxing rate of X from 50% to 20%, then, immediately after the change of tax rate, the after tax returns of X will rise from 7% to **11.2**% (= **14%**×**0.8**). Those who have invested in X will get "**windfall**". When the system is changed, some people get windfall (saying in the other words, other people are at the disadvantage) until the adjustment to the next equilibrium is accomplished.

An applied question: Does a certain change to system always give some people windfall (or minus windfall)? How about if the change to system has already been predicted?

◇◆◇

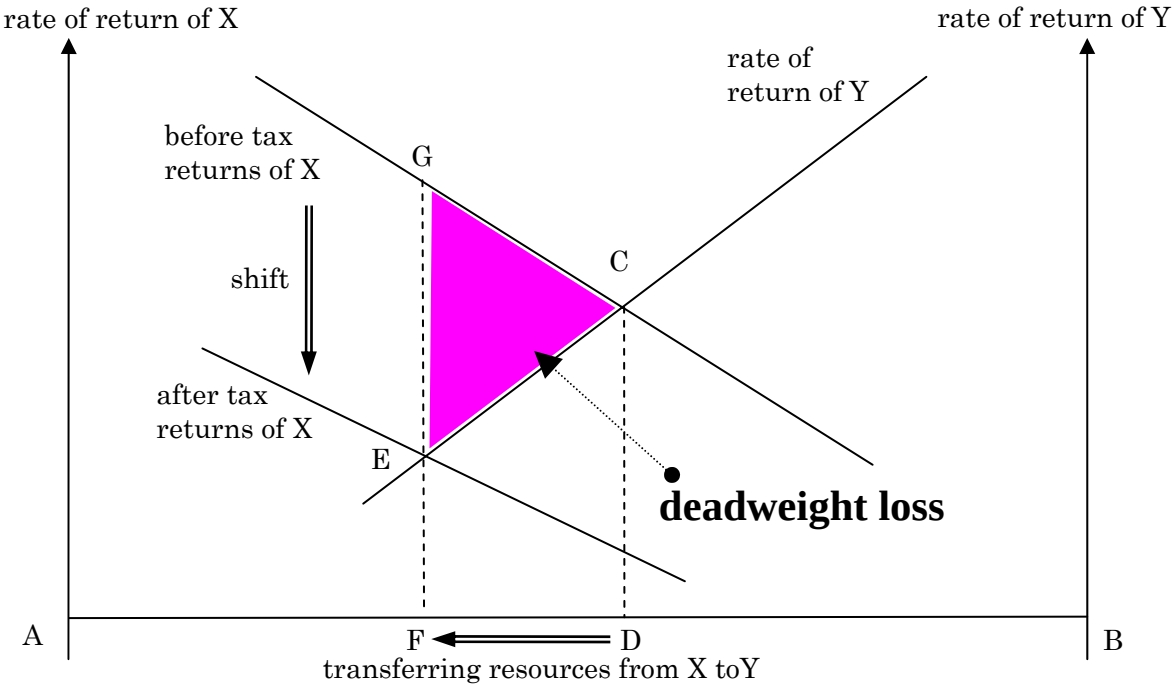
We learned that nonneutral or discriminative taxation does not lead inequity when there is not the problem of friction and the problem of transition. However, tax scholars usually criticize the nonneutral taxation. Why? What is the evil of nonneutral taxation?

↓

(2) Evil of nonneutrality …… inefficiency

Nonneutral taxation (taxation on X and nontaxation on Y) leads inefficiency.

Suppose that the volume of resources is fixed and is discripted by the horizontal axis in the figure. This world has the volume of resources discripted as A – B. Resources are invested in X from the left to right (from A to somewhere), and the rest of resources are invested in Y from the right to left (from B to somewhere). The right down curve means the rate of return of X and the left down curve meas the rate of return of Y. Because of the law of diminishing returns, the curve of the rate of return of X is right down. The more resources invested in X, the less marginal return of X. Y is also subject to the law of diminishing returns, the curve of Y is left down.



In the non-tax world, C is the equilibrium, at the point of which the curves of returns of X and Y are crossing. In this world, the volume of resources invested in X is discripted as $\mathbf{A-D}$, and the volume of resources invested in Y is discripted as $\mathbf{B-D}$. If the volume of resources invested in X goes beyond D, the return of X is less than that of Y. It is inefficient. If the volume of resources invested in Y goes beyond D, the return of Y is less than that of X. It is also inefficient. Therefore, the equilibrium is C.

Then next, suppose that the taxation only on X occurs (Y is not taxed). Naturally, the after tax return of X shifts downward. Some of resources that have been invested in X will be transferred to Y, because the return of Y is more the after tax return of X. The after tax equilibrium is E. The volume of resources invested in X decreases from $\mathbf{A-D}$ to $\mathbf{A-F}$.

Look at the horizontal axis of F – D. This part of resources would make more returns (= before tax returns) if invested not in Y but in X. The triangle of CEG is missed because of nonneutral taxation between X and Y. This loss is called as "deadweight loss".

Although nonneutral taxation usually leads inefficiency as above, there are some cases that nonneutral taxation does not have effect on efficiency.

Example: The government imposes tax on men but not on women. This nonneutral taxation does not have effect on the allocation of resources, therefore does not have effect on efficiency.

However, taxation that leads no inefficiency sometimes is not admissible and is inequal and unfair. Sex-discriminative taxation such above is a case of it.

Generally nonneutral taxation leads inefficiency, therefore, the words, "**nonneutrality**" and "**inefficiency**" are used interchangeably.

Unless we explain what kind of choice at which we look, "neutrality" has little meaning. Almost all of taxation is nonneutral from the viewpoint of something. We should remind limitation of the concept of neutrality.

Example: The government imposes tax on men's labor income, but imposes no tax on women. What kind of inefficiency will occur, and what is the cause of the inefficiency?

Men are more reluctant to do work in this world than in a non-tax world. The pleasures needing money (buying foods, books, services, and etc.) are less attractive than the pleasures needing no money (*i.e.* leisure), because the former is subject to tax, but, on the other hand, the latter is not subject to tax. Therefore, men will reduce their working time and reduce their labor income in this taxation world.
(This explanation relies on some, perhaps unrealistic, assumptions, discussed later.)
Inefficiency is reducing men's labor.

What is the cause?

— Not taxation on men but taxation on "**income**"

What is a neutral and effective taxation? – The answer is "**lump-sum tax**".

Lump-sum tax is tax **without** considering taxpayers' income, consumption, nor property.

"**Head tax**" (also called as "a poll tax" or "capitation") is one example of lump-sum tax. Because of non-consideration on taxpayers' situation, lump-sum tax has no effect on taxpayers' behaviors (except for taxpayers' **suicide**), therefore lump-sum tax is mostly neutral and efficient.

2.3. Source of law in taxation

Law (**Act**) (e.g. Income Tax Act, Corporate Tax Act)
Cabinet orders (e.g. Enforcement Ordinance of Income Tax Act, Enforcement Regulation of Income Tax Act)
Treaty (**Convention**) (e.g. Convention between the Government of Japan and the Government of the United States of America for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income)

↓

These listed items have "**binding authority**" (or binding force). It means that all persons (taxpayers, tax officers and courts) are bound by them when interpreting and applicating of law.

"**Case law**" has, namely, no binding authority when courts interpret and applicate law in Japan. In actual, however, courts rarely overrule the precedential case law.
(U.K. and U.S.A are the countries of common law (case law). Germany, France, and other European countries are the countries of continental method (statutory law). Japan is on the latter.)

"**Official notices**" are intra-governmental orders from upper level to lower level, how to interpret and applicate the law. Naturally tax officers are bound by them because they are orders; however, they have effects only in the government (only in tax offices). Therefore taxpayers can conflict with tax officers whether the official notice is correct or not. Courts also are not bound them. Official notices do not have binding authority.

Supreme court, 1958 March 28, 民集(Minshû), vol. 12, no. 4, p. 624: "**Pinball machine**" case.

Fact: Commodity Tax Act made a list of objects of taxation. The list used a word of "遊戯具" (*yûgigu*, toy). Until 1950, "パチンコ"(*pachinko*, pinball machine) had not been subject to tax. In

1951, the government revised the official notice and the revised version of the official notice stated that a “pinball machine” was included in a “toy”. Taxation on pinball machines started without revising Commodity Tax Act. Was this taxation lawfull?
Judgement: This taxation was lawfull.

There were two **points at issue**.
① Was so-called “**official notice taxation**” (taxation only based on the official order but not on tax law) lawfull?

Obviously this kind of taxation was never lawfull, by definition.

Then, why the court authorized the taxation above?

In this case, the revised version of the official notice was not the basis of taxation. The official notice only made it clear whether pinball machines were included in the item of “toy”. Nontaxation on pinball machines before 1951 had been mistake in interpreting and applicating tax law.

② Was nontaxation on pinball machines before 1951 “**customary law**” (*lex non scripta*)?

Even if nontaxation on pinball machines did not have explicit legal basis, some people thought that such nontaxation had already been established and was given the status of law (customary law) by such treatment. (In the context of private law, customary law is very important, because not all of possible situations are provided by explicit law. In the context of public law like tax law, the role of customary law is smaller than in the context of private law; however, the role of customary law is not zero even in public law.)

However the court did not think so. In general terms, there is a possibility that long nontaxation on something become customary law if it has been established. In this case, however, the court thought that nontaxing treatment before 1951 had not been established and had not become customary law.

An applicated question: If a treatment of nontaxation on something is already been established and becomes customary law, then what the government should do?
…… The government needs to revise the **law**, not only the official notice.
(Of course, making law is not the authority of the administrative body (nor tax offices), but the authority of the **congress**.)

3. Income Tax

3.1. History of taxation

Until the early 20th century, Japanese tax revenue mainly relied on land tax and liquor tax.
Income tax and corporate income tax became the main source of tax revenue after that.
After the World War II, the **Shoup Report** was the ground of Japanese tax sytem. Carl Shoup was a famous American scholar of public finance, and he recommended the global income taxation.
Consumption Tax (VAT) was introduced in 1989.

Seeing worldwidely, income taxation was hated because executing income tax needs much of information of taxpayers and income tax was felt as an invasion of privacy.

3.2. Concept of inocme

3.2.1. Introduction: three type concept of income

The significance of income tax: The government imposes tax burden on those who are rich or who have ability to pay tax. (In the context VAT, we cannot look at the situations of each individuals.)

Problem: What is “rich” or “ability to pay”?
When and in what situation people think as “taxable”?

●real or economic meaning of income …… "**utility**"

Those who have utility (who feel happy) are "rich".
However, utility cannot be quantified among people and utility itself cannot be transferred.
In executing tax, income needs to be expressed as **monetary value**.

●(1) consumption (expenditure) type concept of income
└—→expenditure tax

If we try to explain the utility of someone in monetary value, people will naturally call to mind the consumed monetary value.

Caution: The monetary value that is now saved is not eternally exempt from taxation. Under this concept, when the earner spends money taking out from his savings, he is taxed.

Application: Under this concept, **inheritance tax** is difficult to be justified, if without additional considerations. Bequested asset will, some day in the future, be spent by successors (or others), and at that time taxation will happen.

However, this thought is sometimes opposed as follows:
A young working person, X, earns ¥10 million but spends only ¥6 million. Is X only "rich" as ¥6 million, not as ¥10 million?
An old retired person, Y, earns nothing but spends ¥4 million taking out from Y's savings. Is Y "rich" as ¥4 million although he has no source of earnings?

↓

Some people feel oddness when treating consumption as (taxable) income.

↓

●(2) acquisition (accrual) type concept of income

Under this concept, when a person acquisite something, the acquisition itself is income, even if he spends less than earnings this year and makes savings.
This type has two versions.

(2)①limited income (or source income)
└—→scheduler system

Under this concept, only repeating and continuous gains (such as interest, dividend, rent, wage, etc.) are (taxable) income. Gains only from some **sources** (such as land or labor) are taxable.
In the other words, temporary, accidental or beneficial gains (such as capital gain, lottery, gift, etc.) are not (taxable) income.

(2)②comprehensive (or global) income
└—→global system

Under this concept, from whatever source gains are derived, gains, including capital gains or other temporary gains, are (taxable) income. This concept is also called as "**(Schanz-) Haig-Simons income**", as Georg von Schanz, Robert M. Haig and Henry C. Simons were advocators of it.
Comprehensive income is difined as follows:

income = consumption + net increase of wealth ($I = C + \Delta W$)

X 1000 at January 1, 700 at December 31, consumption 500 => income 200

Differences between comprehensive income and limited income:
Capital gains and gifts are taxed under the former, but not taxed under the latter.

Differences between comprehensive income and consumption type concept of income:
Investment income is taxed under the former, but not taxed under the latter.

Differences between acquisition and consumption type concept of income:
Timing of taxation: at the time of earning under the former and at the time of consuming under the latter.

Germany has a tradition of ①type. In income taxation on individuals in Germany, capital gains of taxpayers' private assets (such as living houses) are exempted from tax.

USA and Japan adopts ②type. Capital gains are subject to tax.
Moreover, also in Germany, income taxation on corporations are based on ②type.

Unless otherwise noted, we use the word "income" in the meaning of "comprehensive income".

3.2.2. Legal application of comprehensive income

Income Tax Act, Article 9 makes the list of exempting.
Although the term "income" is not defined in a positive manner in ITA, "income" is interpreted as "comprehensive income".
If a person has a certain receipt, it is taxable income unless it falls under the negative list of Article 9.

---

illegal income

Supreme court, 1971 November 9, 民集(Minshû), vol. 25, no. 8, p. 1120; "**Interest violating Interest Rate Restriction Law**" case.

Fact: X (a petitioner) had made a loan to someone, charging high interest which violated the limitation of Interest Rate Restriction Law (roughly saying, interest rate over 20% is illegal).
The issue in this case was whether the part of interest violating the limitation that had not been earned by X was taxable income or not.

Judgement (decision): Unearned interest was not taxable income.

Precedential meaning of this case: The part of interest that has already been earned by X, including the part violating the limitation of law, is all subject to taxation as income of the lender.
Even when the lender has once earned the interest violating the limitation of law, sometimes the lender cannot hold it lawfully, however, courts shall not interpret that this unlawfulness is the reason that the actuall earned part over the limitation is not taxable. (This case also has a relation with problems of timing of taxation, which are discussed later.)

How to read judgements: Please note that the latter part of statement by the court has no influence upon the decision. The statements having no influence upon the decision are called as "*obita dicta*" (傍論 *bouron*: side discussions).

The statement leading the decision are called as "*ratio decidendi*" (判決理由 *hanketsu riyû*: grounds for the decision).

Discussion:
In the field of private law, because of Interest Rate Restriction Law, the lender cannot lawfully hold the part of interest violating the limitation of law. That part of interest is illegal

income. The borrower has a right to recapture that part of interest. However, illegal income also is taxable.

Suppose that, in 2001, a lender, X, lends ¥10 million to a borrower, Y. This loan contract charges the interest rate of 30%, although the limitation of interest rate by law is 20%.

In 2002, according to the contract, Y pays to X ¥13 million, which is the amount with interest added. X has legal income of ¥2 million, and illegal income of ¥1 million. According to the case law above, X's taxable income in 2002 is ¥3 million, not ¥2 million.

Suppose additionally that, in 2003, Y recaptures the illegal part of interest, ¥1 million, from X. X can ask the reclamation of the income of 2002 to the tax office, after this recapture by Y.

If, although Y has a right to recapture, Y does not actually ask the recapture to X in 2003, then, what should X do?

X can do nothing. Although X has a potential liability to repay ¥1 million to Y, it cannot be the cause of asking the reclamation, because X's liability is only a potential one.

3.2.3. imputed income

Difinition: income that is derived from taxpayers' own property (such as house) or from taxpayers' own labor (such as housekeeping) and that is imputed to taxpayers without market

In section 3.2.1, I wrote that income needs to be expressed as monetary value.
However, nonmonetary gains should also be subject to tax.

- Suppose that Mr. X and Mr. Y eat apples. The utility or happiness derived from apples is not measurable. Therefore, utility is not taxable.
- Suppose that Mr. P gets ¥100, and Mr. Q gets an apple, the value of which is ¥100. P and Q should be taxed similarly. Therefore, nonmonetary gains should also be subject to tax. (However, as discussed bellow, this is applied in not all situations.)

---

imputed rent

- P buys a house, and lends to Q (a tenant) at cost of ¥1.2 million per year.
  → The rent of ¥1.2 million is taxable income of P.

- Q rents a house and pays rent of ¥1.2 million per year to P (a landlord).
  → The rent is consumption expenditure, therefore, the payment is not deducted from Q's income. (Please remind the definition of income: $I = C + \Delta W$)

- R buys a house, and lives in it.
  → We can consider that R pays rent as consumption expenditure as a tenant, and gets rent as a landlord. This gain is imputed rent.

If we treat P and R (or Q and R) neutrally and equally, R should also be considered as earning income and be taxed on the imputed rent.

In Japan, however, imputed rent is not taxable. (I hear that some countries impose tax on imputed rent. Also in Japan, some economists argue that imputed rent should be included in taxable income.)

An applied question: Is there another way to treat Q and R neutrally other than taxing on R?
…Treating Q's rent as nontaxable (or deductible)

An applied question: Another way above has other nonneutrality. What is it?
…Treating houses too well

---

self-labor……supplying labor by oneself

●S (a barber) cuts hair of T (a customer).
→ S earns service fee, ¥3000, which is taxable income (supposing that the cost is 0).

●T's hair is cutted by S.
→ Service fee, ¥3000, is consumption expenditure, and is not deducted from T's income.

●U (a barber) cuts his own hair.
→ If we remind imputed income, U earns ¥3000, and this ¥3000 is not deducted from U's income because it is consumption expenditure.
In actual, however, U's self-labor income, ¥3000, is not taxable.

An applied question: Mr.V (a talented lawyer) can earn ¥20,000 per hour, consulting with customers. In a holiday, V does gardening in his home two hours, which would cost ¥1000 per hour if V employs a part-timer. How much should we consider V earns from the viewpoint of imputed income?

¥40,000? or ¥2000? **(looking at the value of service)**

Caution: From the viewpoint of efficiency, we need to look at, how much V could earn if he does his job.

Supplying services within a family is also considered as same as above.
Mr. W makes a supper for his wife, Mrs. X who is working outside.
↓
This example is related with problems of **unit of taxation** (discussed later).

The example of U (a barber) above is nontaxable.
However, **self-consumption** (personal consumption) is taxable.
Example: Mr. Y, who carries on a food shop, eats some articles for sale. Y shall calculate his income as if he sells those inventories.

Although the examples of U (a barber) and Y (a food seller) are equal from the economic viewpoint, U is nontaxable and Y is taxable, because only the latter situation is provided by law. (Income Tax Act, Article 39 treats only "inventory", not "services".)

3.2.4. gift / donation (transfer)

The definition of comprehensive income ($I=C+\Delta W$) may be considered as rational and natural. Sometimes, however, there are strange situations if we do taxation completely according to the concept of comprehensive income. We look at three situations: gift, capital gain, and saving.

Suppose tax rate is flat and 40%.
Example 1: Mr. A earns ¥100 and donates ¥40 to Mr. B.
Example 2: Mr. C earns ¥60 and Mr. D earns ¥40. There is no donation.

Example 1: A: income ¥**100** tax ¥**40** B: income ¥**40** tax ¥**16**
Example 2: C: income ¥**60** tax ¥**24** D: income ¥**40** tax ¥**16**

From the taxpayers' viewpoint, example **1** is more disadvantageous than example **2**.
There is **double taxation** on gift/donation, although examples 1 & 2 have same GDP.

Caution: In actual, donation is sometimes deductible, however this deduction is permitted

only by special provision, not by general rule.
In actual, a donee is taxed not by Income Tax Act because Article 9, paragraph 1, number 15 exempts donation from an individual, but by gift tax (provided in Inheritance Tax Act). Examples above ignore differences between income tax and gift tax. (By the way, donation from a corporation is taxed as temporary income under Income Tax Act, Article 34.)

What does it mean that the donated amount is not deductible as a general rule?

……Donation is considered as one type of **consumption**.
Some participants might feel oddness with this explanation, and consider donation, not as consumption, but as mere transfer from A to B. There may be a space that donation is considered as transfer. However, one advocator of comprehensive income, Henry C. Simons, framed the concept of income, looking at the possibility of controle. In example 1, Mr. A has some choices: not only donation but also eating, playing, and etc.

In actual taxation, **progressive** tax rate is significant. Suppose that, in progressive tax rate world, a high earner, Mr. E, eanrs a lot, and donates a half of earnings to his daughter, Miss F, who is a student and has no job. If **income splitting** is admitted easily, progressive tax rate will not work well.

Even if tax system treats donation as mere transfer, some payments may be difficult to be differentiated between mere transfer and consumption. Mr. E makes a payment to his daughter, Miss F. Is this payment **donation** without doubt? Isn't there a space that it is a **renumeration** of F's services to E? If E makes a payment to Miss G who works as a hostess at a bar, then many people will consider that the latter payment is consumption. What is dirrent between payments E – F and E – G?

donation to the government or charitable institutions
special treatment

3.2.5. capital gain

Suppose that Mr. H has a land. The price of the land was ¥1000, but now, the price is ¥1500. When he sells the land and gets ¥1500, then ¥500 is taxable income of H. What is evil?

present discounted value: Suppose that interest rate is 10%. ¥100 in this year (2001) and ¥110 in next year (2002) has same value. The present discounted value of ¥110 in next year is ¥100 ($=110\div1.1$). ¥121 in two years after is equal to ¥110 in next year, and is equal to ¥100 in this year ($100\times1.1^2=110\times1.1=121$). Adversely, the present discounted value of ¥100 in next year is ¥91 ($=100\div1.1$). The present discounted value of ¥100 in two years after is ¥83 ($=100\div1.1^2$).

How the price is decided? According to finance theory, the price of a certain object is the present discounted value of future cash flow which will be derived from the object.

If a certain land makes ¥100 rent in this year, in next year …… eternally (supposing the interest rate (or discount rate) as 10%), then the price of this land is calculated as follows:

$$100+100/1.1+100/1.1^2+\cdots=1000$$

150+150/1.1+…..=1500

If there is no change in the interest rate but the price of the land rises from ¥1000 to ¥1500, the appreciation of the land price reflects that the future cash flow per year (*i.e.* rent) will rise from ¥100 to ¥150. (Of course, the price theory above is overly simplified.)

Naturally, the future rent, ¥150, will be subject to tax.
There is **double taxation**: first taxation on the price appreciation in this year and second taxation on the high rent in the future.

Advocates of consumption type of income and of limited income criticize comprehensive income as above.

Another criticism: When there is **inflation**, the appreciated price of a certain object is not reflection of owner's richness.
Therefore, there tends to be many cuttings of taxation on capital gains.

3.2.6. saving/investment

(1) Double taxation on savings

Example: Interest rate is 10%, and tax rate is 40%. Mr. J earns ¥1000 in year 2001 and consumes all earnings. Mr. K also earns ¥1000 in year 2001, saves all earnings, and will consume all in year 2002. (In this sense, saving is considered as "deferred consumption".)

J: 2001 income ¥1000 tax ¥400 consumption ¥600
K: 2001 income ¥1000 tax ¥400 savings ¥600
interest ¥60 tax ¥24 consumption ¥636
¥636 in 2002 → present discounted value in year 2001 = ¥578 (= 636÷1.1)

K is more disfavored than J.
In this sense, comprehensive income taxation is criticized as causing **nonneutality to the choice between consumption and saving** (or between present consumption and deferred consumption).

From the viewpoint of advocates of consumption type concept of income, interest ¥60 above should not be taxed, because ¥660 in 2002 is equal to ¥600 in 2001. Interest ¥60 is only an adjusting item between 2001 and 2002, and it is called as "**time value of money**". Interest amount of ¥60 is also considered as "**opportunity cost**" for saving (or investing) ¥600.

> **Caution:** If the return of K's saving (or investment) exceeds the time value of money (say, not ¥60 but ¥100), this excess amount (¥40) should be subject to tax even under consumption type concept of income, because this excess amount let K consume more than J.

(2) Elimination of double taxation on savings

There are two ways.
① Exemption at entrance and taxation at exit

2001 exemption ¥1000
2002 taxable income ¥1100 tax ¥440 consumption ¥660
¥660 in 2002 = ¥600 in 2001

② Taxation at entrance and exemption at exit

2001 taxable income ¥1000 tax ¥400 saving ¥600
2002 exempted income = consumption ¥660

These two ways of taxation are neutral to the choice between consumption and saving.

(3) Discussions in theory and in practice

Some advisors argue that saving or investment should not be taxed. There are two moments.

① In theory: Taxation on investment income is **an obstruction to saving or investment**.
Nontaxation on investment income (roughly equal to taxation only on consumption or to taxation only on labor income) is neutral to how to consume in one's lifetime.

> When economic scholars discuss theoretically whether tax is imposed on "income" or "consumption", they discuss whether tax is imposed on saving (or investment) or not. In this context, "income" means "comprehensive income", and "consumption" means "consumption type concept of income".

② In practice: Investment income (or capital income) is "**quick**" of foot, therefore, the government should refrain from taxing investment income. If not, then "capital flight" will occur and taxing countries will become poor. (Wages per head will be decreased because labors are fixed and capital is decreased.)

> Some North European countries adopt "Dual Income Taxation". It taxes lightly on investment income with flat rate and taxes on labor income with progressive rate.

3.2.7. Is comprehensive income wrong?

Certainly, comprehensive income taxation leads double taxation in many contexts.
However, it is not the problem whether right or wrong.

"second best"

Counting the number of nonneutrality has little meaning.

If a certain tax system causes zero of nonneutrality, it is "first best" (completely efficient). However, this kind of taxation is impossible. Almost all type of taxation causes some nonneutrality/ineffiency. Taxation only on consumption also causes nonnetrality between labor and leisure.

Even if a certain tax system, named L-system, leads only one of nonneutrality, but, on the other hand, another tax system, named M-system, leads two of nonneutrality, we cannot consider that L-system is nearer by "first best" than M-system.

Because we cannot accomplish "first best", we should do "second best".

The problem of what is taxable inevitably includes "**value judgement**".

> **Question:** Suppose that Bill Gates, a millionaire, consumed as same as you. Should he owe same tax burdern as you?
> The answer will be different among persons reflecting their own value judgement.

An advocator of comprehensive income, Henry C. Simons, made concept of income according to his value judgement and his political judgement. His interest was in **rejecting concentration of wealth** and in **redistribution**, although he had already recognized double taxation caused by comprehensive income taxation.

3.3. Timing of Taxation: Realization of Recognition of Income

3.3.1. Cash method & Accrual method

ITA § 36, CTA § 22 (2): receipt, revenue
ITA § 37, CTA § 22 (3): expense

cash method——People add up receipts or expenses at the time when cash is actually received or paid.

Shortcomings:

(1) Among merchants, they usually make transactions with credit. Cash method is not matched with the actual condition.

(2) There should not be possibility that taxpayers **manipulate the timing** of adding up receipts or expenses in order to avoid taxation.

Under existing law, cash method is allowed only for small businesses by ITA § 67 exceptionally.

accrual method——People add up receipts or expenses according to the fact of accrual of receipts or expenses.

When receipts or expenses "accrue"?

↓

3.3.2. Criterion of establishment of rights

ITA § 36 (1): Receipts is the amount which the taxpayer has right to receive in that year.

Criterion of establishment of rights……It is one of criteria for deciding when receipts or expenses "accrue". For example, in 2001 the ownership of a certain asset is transferred and the monetary claim is established, but the money is actually paid in 2002. In this case, the income "accrues" in **2001** in tax affairs. On the other hand, if in 2001 the claim is not established, then the income does not accrue (is not realized) in 2001.

There are some exceptions.

(1) ITA § 36 (3): Interest accrues when the actual interest payment occurred.

In 2001, Mr X. make loan of ¥1000 to Mr. Y. Interest rate is 10%. Y pays interest ¥100 in 2002. The right certainly established in 2001, but taxation on interest payment occurs in 2002.

(2) **Installment**: For example, a building contractor, Mr. X, builds a house for Mr. Y in 2001. The price is ¥30 million. However the payment is divided in ten times and Y pays only ¥3 million in 2001 (interest rate is ignored in this case). Although certainly X's right for ¥30 million is established in 2001, X's income in 2001 is ¥3 million.

(3) Criterion of control (discussed later)

CTA § 22 (4): Caluculation of the amount of receipts and the amount of expenses is generally based on "**generally-accepted accounting standards** (**GAAS**)" (or **generally-accepted accounting principle** [**GAAP**]).

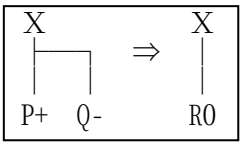
GAAS is the baseline for calculating income. However, accounting and tax law have different purpose. Tax law sometimes provides different calculation than GAAS.
GAAS is not comprehensive. Sometimes a certain situation is not regulated by GAAS nor by tax law, and then, we need other criterion in law suit. Therefore most general criterion is establishment of rights.

Valuation gain and loss of asset

It is not reflected in income calculation.

Tokyo district court, 1989 September 25, 行集(Gyôshû), vol. 40, no. 9, p. 1205

Fact: X-corporation (petitioner) had stocks of P-corporation (X's subsidiary). These stocks were unlisted and had no market rate. P made profit (i.e. black). Q-corporation was also X's subsidiary and made loss (i.e. red). Q was merged into P because this merger let P's profit be offset*. After the merger, P's name was changed to R. Now, X had stocks of R. The value of R's stocks was ¥0 and X made valuation loss of ¥4.6 billion in X's accounting. Was this valuation loss reflected in X's tax return?



*Supplementation: If P and Q are separated and P's profit is ¥100 and Q's loss is ¥80, then P's tax is ¥40 (suppose tax rate is 40%) and Q's tax is ¥0. When Q is merged into P, P's tax is ¥8 [= (¥100-¥80)*0.4].

Judgement: X's claim was rejected. The inclusion of the valuation loss into expenses is not allowed by CTA § 33. As a general rule, CTA § 33 (1) prohibits including valuation losses in accounting book into expenses in tax affairs. CTA § 33 (2) exceptionally allows inclusion in expenses when asset other than monetary claim is deeply injured by "disaster".

Why tax law restricts the possibility of including valuation losses into expenses? There are two reasons.

(1) If valuation losses can be included into expenses, there is a fear that taxpayers manipulate their income.

(2) In this case, when the value of R's stocks arise because of betterment of R's business in the future, this increase will not be reflected in X's income. There will be possibility of tax avoidance. Therefore, only when the stock value remarkably decreases **and** that remarkable decrease is fixed and there is no possibility of recovery of the stock value, the valuation losses is allowed to be included into expenses in tax affairs by special rules in Enforcement Ordinance of Corporate Tax Act.

Although this was a case of corporate tax, its reasoning also applied in a case of income tax.

Losses from bad debt

Oosaka district court, 1958 July 31, 行集(Gyôshû), vol. 9, no. 7, p. 1403.

Fact: X-corporation (petitioner) had a credit to A-corporation. X made cancellation of the credit because A was in excessive debt. X included the amount of the cancellation into expenses. However, Y (the director of the tax office) rejected the inclusion into expenses, because he considered X's cancellation as gift.

Judgement: X's claim was rejected. The cancellation of credit is not automatically allowed to be included into expenses. Only when the credit is nonrecoverable (*i.e.* the credit become completely worthless), the amount of the cancellation can be included into expenses. Even when a debtor (in this case, A-corporation) is in excessive debt now, the cancellation is not necessarily included into expenses; because we need to examine the debtor's ability to make repayment in the future.
In this case, X's cancellation was not owed to nonrecoverable, and it was considered as gift.

Discussion

●Why the court restrict the inclusion into expenses only when nonrecoverability?
(1) Substantial reason: If inclusion into expenses is allowed, taxpayers can arbitrarily dispose their profit **with sacrifice of national fisc**.
(2) Formal reason: Valuation losses can not be included into expenses (CTA § 33) without special rule.

●In this case, X's cancellation was considered as gift. What happened?
Inclusion of gift into expenses is subject to limitation provided by CTA § 37. (Discussed later)

●How about taxation on A-corporation?

Gain from cancellation of debt is included into A's income as a general rule. However, the debtor usually has loss in other contexts; therefore the gain is usually offset by the loss.

●If X-corporation sells the credit whose value is less than the face value, **the difference between the face value and the sales price is loss**. This loss is not valuation loss. This is loss with legal establishment. Therefore this loss is included into expenses.

●Some scholars criticize that courts are extremely restrictive when recognizing loss from bad debt. They argue that even if not all amount of a certain credit is nonrecoverable, when the value of credit is clearly decreased than the face value, the **partial bad debt** should be included into expenses. However, courts do not accord this argument. (*e.g.* **Supreme court, 2004 December 24**, 民集(Minshû), vol. 58, no. 9, p. 2637; **Industrial Bank of Japan** case. In this case, although inclusion into expenses was allowed, the argument of partial bad debt was not applied.)

◇◆◇

If we thoroughly apply year-by-year calculation, there will be taxation on no-income in economic substance.

2001 income:**＋100** → tax:**40**

2002 income:**－100** → tax:**0**

If the term of calculation is 2 years, then, income is **0**, and tax is **0**.

The shorter the term of calculation is divided into, the **more** tax amount.

ITA § 70: **Carry-over of losses**

The amount of net loss in near 3 years past can be carry-overed to this year.

ITA § 140: **Refund carryback of losses**

The amount of net loss in this year can be carrybacked to last year and the tax is refunded.

year	income	carry-over/back of losses	tax/refund
2001	+100	--------	**+40** (tax rate: 40%)
2002	-500	carry**back -100**	**-40** (**refund**)
2003	+250	carry**over -250**	**0**
2004	+350	carry**over -150**	**+80**

Supreme court, 1968 May 2, 民集(Minshû), vol. 22, no. 5, p. 1067.

Fact: X-corporation was in black (surplas) and W-corporation was in red (deficit). W was merged into X. According to Commercial Code (Corporate Law), W's rights and liabilities are succeeded to the transferee corporation, *i.e.* X. Could X use W's ability to carry-over losses?

Judgement: X's claim was rejected.

The amount of gain or loss is only ideological figure in accounting books and therefore W's amount of loss is not included in "rights and liabilities" that are naturally succeeded to the transferee corporation, X.

Carry-over of losses exists **in order to break down the boundaries of the business terms**, not in order to break down the boundaries of the legal personality.

Discussion

Case law is established to disallow succession of the red corporation's figure to the transferee corporation.

↓

How about "**reverse** merger" in which the black corporation (X-corporation) is merged into the red corporation (W-corporation), which becomes the transferee corporation? In the latter case, W-corporation is able to carry-over losses, because this loss is its own. (It might be strange between the former case and the latter case, but it is a certain application of law.)

↓

Recently CTA is amended.

In the case of "**qualified merger**", succession of carry-over of losses is allowed. Qualified merger is one type of mergers which satisfies the special requisitions. However, in the case of "**nonqualified merger**", the reasoning of case law is applied and succession of carry-over of losses is not allowed.

3.3.3. Criterion of control

Supreme court, 1978 February 24, 民集(Minshû), vol. 32, no. 1, p. 43; **Claim of increasing rent** case.

Fact: Mr. X (petitioner) leased his real property to Mr. W. X had claimed the increasment of rent and filed a lawsuit. In a district court, X won, and in accordance to the provisional execution, X got increased rent from W. However, W appealed to the upper court; therefore, **the increased rent was not finalized in legal matter**, because the increased rent was based upon only the provisional execution. **If W would win in the upper court, the increased part of the rent would be repaid from X to W**. Was the increased rent really X's income at that time before the finalization of the judgment? Could Y (the director of the tax office) impose tax on X's increased rent?

Judgment: As a general rule, the increased amount is taxable when the judgment is finalized. However, even before the finalization of the judgment, if X had already received the money of increased rent, it was taxable income at the year.

If W would win in the upper court, X could get remedy with "reclamation" at that time.

This case is cited as a case of "criterion of control". (**Supreme court, 1971 November 9**, 民集(Minshû), vol. 25, no. 8, p. 1120; "**Interest violating Interest Rate Restriction Law**" case [in page 14th] was also a case of criterion of control.)

However, criterion of control is vague; therefore its application should not be expansive.

Criterion of control is different from cash method. In 2001, Mr. X and Mr. Y make contract, in which X supplies services two years and Y pays fee. Y pays ¥1000 in 2001. ¥500 is fee for services in 2001 and another ¥500 is advance fee for services in 2002. Under cash method, X's income in 2001 is ¥1000. In usual, however, income should be correspondent to services in each year; therefore criterion of control is not applied in this case although X certainly controls ¥1000. Under accrual method, X's income in 2001 is ¥500 and X's income in 2002 is ¥500.

3.3.4. Principle of matching costs with revenues

In business accounting, in order to grasp periodical gain and loss accurately, **revenues and matched costs** should be booked in a same year.

Example: Suppose that tax rate is 10% for ¥0 - ¥2 million bracket, 20% for ¥2 million - ¥5 million bracket, and 30% for ¥5 million - ¥10 million bracket. Mr. X operates a store, and he purchases a certain commodity, P, at cost of ¥50,000 and sells P at ¥100,000. Mr. Y also does same type of business.

In 2001 January 1, X purchased 150 P and sold all items till 2001 December 30. In 2002 January 1, X purchased 50 P and sold all items till 2002 December 30.
In 2001 January 1, Y purchased 150 P and sold all items till 2001 December 30. In 2001 December 31, Y purchased 50 P and sold all items till 2002 December 30.

X	(revenue) - (cost) = (income)	(0~2m) (2m~5m) (5m~)
2001	income: ¥15m - ¥7.5m = ¥7.5m	tax: ¥1.55m (0.2+0.6+0.75)
2002	income: ¥5m - ¥2.5m = ¥2.5m	tax: ¥0.3m (0.2+0.1)

Y: If cash method is applied;

2001	income: ¥15m - ¥10m = ¥5m	tax: ¥0.8m (0.2+0.6)
2002	income: ¥5m - ¥0m = ¥5m	tax: ¥0.8m (0.2+0.6)

Y: If principle of matching costs with revenues is applied, Y's calculation is same as X's.

However, not all cost can be considered as corresponding to certain revenues. ITA § 37 treats costs in two ways.
●cost of sales and other type of cost that is **directly needed** in getting a certain revenue
→Principle of matching costs with revenues is applied. Costs that are correspondent to next year's revenue are not deductible in this year and they are deductible in next year.
●selling and general administrative expenses (SGA) and other type of cost that accrues in business operating (i.e. that is not matched to a certain revenue)
→Costs are deductible in cash method.

3.3.5. Mark-to-market method & Realization method

Diffences between mark-to-market method and realization method
Example: Interest rate is 10%. Tax rate is 40%. In 2001, a certain taxpayer purchased land at cost of ¥1000. In 2002, the value of land appreciated to ¥1100, although he did not sell the land and hold it. In 2003, he sold the land at ¥1210.

year	the land value	mark-to-market method income / tax	realization method income / tax
2001	1000		
2002	1100	100 / 40	0 / 0
2003	1210	110 / 44	210 / 84
present value in 2003		~~210 / 84~~ (220) / 88	210 / 84

According to the concept of comprehensive income ($I = C + \Delta W$), the appreciation of asset should be included in taxable income although the taxpayer has not sold the asset and he has not got money, because the appreciation is also one type of net increase of wealth. Taxation under mar-to-market method is adequate in the light of the concept of comprehensive income.
Under realization method, the taxpayer did not pay ¥40 tax, which would be paid according to the concept of comprehensive income. However we should not consider that he does not pay ¥40 tax eternally. ¥40 tax is considered to be deferred till the realization event in 2003. It is called as "**tax deferral**".

Tax deferral is preferable for taxpayers in general. In the example above, the taxpayer is treated under realization method better than under mark-to-market method. The benefit of tax deferral in this example is ¥4.

In general, recognition of revenues later and recognition of costs earlier are preferable for taxpayers. (From the viewpoint of tax officers, the situation is reverse.)
The benefit of tax deferral
= (amount of deferred tax)×(interest rate)×(term of deferral)
In the example above: (¥40)×(10%)×(1 year) = ¥4.

In this explanation, we ignore other factors. In tax planning, taxpayers also consider the tax rate, ability to offset gain and loss, classification of income, and etc.

3.3.6. The reason not taxing unrealized gain

As a general rule, taxation does not occur until the realization.
Why tax law neglect unrealized gain although gain, whether realized or unrealized, should be subject to taxation according to the concept of comprehensive income?

(1) Difficulty in valuation and capture
(2) Financing for tax payment
(3) Feeling of uncomfortableness with mark-to-market method and the concept of comprehensive income

(1) & (2) are on the traditional textbooks.
(3) is difficult to understand now, and is discussed later in section 3.3.11.

(1) Valuation
Certainly, valuation of all assets is troublesome. Especially, closed corporations' stocks are hard to valuate. As discussed above, tax deferral is not same as non-taxation, and the benefit of tax deferral is only the amount equivalent to interest; therefore the administration cost of valuation might not pay for tax equity.

However, valuation of land is not impossible, because all land is subject to rough valuation in the context of fixed property tax. Although the benefit of tax deferral is only the amount equivalent to interest, tax deferral of land's appreciation is not negligible, because land is usually expensive. Moreover, some of land is long long inherited and is not subject to taxation because there has long long been no sale.

(2) Financing for tax payment
Even if the land is appreciated, sometimes the taxpayer has no money to pay tax before selling it.

However can't he really get money before sale?
If finance market is perfect, the taxpayer can borrow the money equivalent to the appreciation from a bank. See the matrix of section 3.3.5. There is a possibility that the taxpayer borrowed ¥40 in 2002 from a bank and paid tax and that in 2003 he paid back ¥44 to the bank.

Of course, the ability to borrow relies on the (unrealistic) assumption: finance market is perfect.
The bank has capacity to valuate the appreciation of the land. The taxpayer can borrow the money with interest rate of market (*i.e.* in the example above, 10%); however he is usually subject to somewhat higher interest rate (*e.g.* 12%).

Certainly many taxpayers have little access to fluent finance market. However rich persons or corporations have the access. The ability to borrow offers serious issue into the discussion of taxable timing.

Traditionally (1) & (2) have been considered to be the reason of adopting realization method.
However, in my view, (1) & (2) and adopting realization method are not necessarily linked in strictly theoretical disucussions such above. I guess that, from the beginning, people feel somewhat uncomfortableness with mark-to-market method, as discussed in section 3.3.11.

◆Partial adoption of mark-to-market method
If there is little problem about valuation and financing, is mark-to-market method superior to

realization method?

↓

CTA § 61-3 (1)(1): Securities which the corporate taxpayer has for the purpose of trade (buying and selling), are subject to mark-to-market method.

3.3.7. Depreciation

Question: Suppose that in 2000 a business person expends ¥1735 to buy a machine for business, whose fair market value is naturally ¥1735. How much loss is realized in 2000?

Answer: ¥0 (money -1735, asset +1735, sum 0)

According to the **principle of matching costs with revenues**, not all cash expenditure should be included into expenses in 2000. The acquisition fee of a depreciable asset should be gradually included into expenses according to the timing that the value of the asset decreases.

There are two typical and convenient manners of depreciation.
(Real economic depreciation is showed in section 3.3.8.)

Fixed amount method: including same amout of cost into expenses

Fixed rate method: including same rate of cost into expenses

Suppose that the acquisition fee is ¥10000. The useful life of the machine is 5 years. The residual value is ¥1681.
(0.7^5=0.1681 (10000 - 1681)/5=1664)

year	2000	2001	2002	2003	2004	2005	
fixed amount method	10000	8336	6672	5009	3345	1681	depreciation amount = 1664
fixed rate method	10000	7000	4900	3430	2401	1681	depreciation rate = 30%

Example 1: On 2000 December 31, X purchased a machine, whose cost was ¥1000, whose useful life is 2 years, and whose residual value is ¥200. On 2001 December 31, the machine was sold at ¥1200. How much was the capital gain? (Fixed amount method was applied.)

[false] $1200 - 1000 = 200.$ <1>

[true] $1200 - (1000 - 400) = 600$ <2>

(revenue from transfer) – (acquisition fee and etc.*) = (capital gain).

*(acquisition fee and etc.) = (purchase price) – (depreciation cost)

How much was the taxable income in 2001?

In this example, the depreciation cost was included into expenses in 2001.

(capital gain) – (expenses) = (taxable income)

$600 - 400 = 200$ <3>

(Of course, if there was other income from other sources, for example, business income, the other income was also included into taxable income. In this example, the other income is ignored.)

<1> = <3>?

The calculation procedure of <2> & <3> is redundant? No.

Example 2: On 2002 December 31, the machine was sold at ¥1200. How much was the capital gain?

Capital gain was ¥1000 (= $1200 - (1000 - 800)$).

Taxable income was ¥600 (= $1000 - 400$).

3.3.8. Accelerated depreciation

Example of real economic depreciation and accelerated depreciation: Suppose that interest rate was 10%. A machine yielded ¥1000 cash flow annually and the useful life was 2 years. The residual value was ¥0. However, in accelerated depreciation, the all amount of acquisition fee was depreciated 1 year after. A taxpayer purchased the machine on 2000 December 31.

	cash flow	present value of the machine	real economic depreciation	taxable income	accelerated depreciation	taxable income
2000	-1735	1735		0		0
2001	1000	909	826	174	1735	-735
2002	1000	0	909	91	0	1000

¥1000 in 2001 = ¥909 in 2000 ¥1000 in 2002 = ¥826 in 2000

How do we see the taxable income in 2001 and 2002 calculated in each depreciation method?
If we simply add the taxable income in 2001 and 2002, the sum of income in each depreciation method seems same. (171+91=265) (-735+1000=265)
However, **the sum of forth column and sixth column is not same**.

Please remember that ¥100 in 2001 is equal to ¥110 in 2002.
Therefore, ¥174 in 2001 is equal to ¥191 in 2002 and ¥-735 in 2001 is equal to ¥-808 in 2002.

The sum of forth column: $191 + 91 = 282$

The sum of sixth column: $-808 + 1000 = 192$

If the taxpayer used accelerated depreciation, the total taxable income was ¥192, therefore it was preferable by ¥91 than under real economic depreciation.

Please remember that **recognition of revenues later and recognition of costs earlier are preferable for taxpayers** in general (section 3.3.5, page 24th). In the example above, under the accelerated depreciation, more cost (by ¥909 [=1735 – 826] than under real economic depreciation) was included into expenses in 2001. This earlier recognition of costs was preferable for the taxpayer.

Please remember the benefit of tax deferral:
= (amount of deferred tax)×(interest rate)×(term of deferral)

In the example above, the earlier recognition of costs was beneficial.
¥282 (real economic depreciation) – ¥192 (accelerated depreciation) = ¥91.
What this amount (¥91) means?
(amount of earlier cost) [×(tax rate)]×(interest rate)×(term of earlyness)
= ¥909[×(tax rate)]×10%×1 year
= ¥91[×(tax rate)] ……the benefit of earlier recognition of costs.

Earlier recognition of costs is considered as another type of tax deferral.

In practice, the asset (such as a film, airplane, and etc.), whose useful life is short, is often used in tax avoidance structures, because the **large depreciation cost** of such asset is included into expenses earlier.

3.3.9. Expensing / Cash flow tax

Depreciating all amount of the acquisition fee at the time of purchase is called as "**expensing**". "Expensing" is also called as "**cash flow tax**".

	investment cost	return	profit	profit rate
Before tax	100	400	300	300%
Tax	−40	160		
after tax	60	240	180	300%

Suppose that a taxpayer purchases a machine at cost of ¥100. In this case, **before tax investment cost** is ¥100. Using this machine in his business, the return is ¥400. This return is before tax return. In this case, the profit is ¥300, and profit rate is 300%.

Next, 40% tax is introduced. Moreover, suppose that all investment amounts can be depreciated, i.e., can be included into expenses, at the time of investment. In this case, ¥100 is deducted from the taxpayer's income. If the taxpayer has other income enough, ¥100 deduction means ¥40 decrease of tax amount. Therefore, **after tax investment cost** is ¥60. The return of ¥400 is subject to taxation (Note that ¥100 has already been deducted), and tax amount is ¥160. After tax return is ¥240, after tax profit is ¥180, and after tax profit rate is 300%. If "expensing" is introduced, **before tax profit rate and after tax profit rate are 300%**. Taxation has no influence on the profit rate; therefore, we can say that effective tax rate is 0%, although nominal tax rate is 40%. **"Expensing" means no taxation on investment income.**

From the economic viewpoint, this taxation is not income taxation, but consumption taxation (taxation based on the consumption type concept of income).

Please look at national fisc. When the taxpayer makes investment, national fisc loses ¥40 tax. When the taxpayer gets return, national fisc also gets ¥160 tax. From the viewpoint of national fisc, profit rate is also 300% (= (160 − 40)/40).

We can say that the taxpayer and national fisc participate, at the rate of 60:40, in the project whose investment cost is ¥100 and whose return is ¥400. The taxpayer gets 60% of the return and national fisc gets 40% of the return.

We can say, in another way, that national fisc loans the taxpayer ¥40, and makes the 300% profit.

3.3.10. Lock-in effect / Freezing effect

As a general rule, at the time when the right on a certain asset is transferred, there is a realization of income.

If an asset which has "**built-in gain**" (nonrealized price appreciation) is now sold, then taxation on capital gain occurs now. If it is not sold now, then taxation is deferred. As we learned, tax deferral is preferable for taxpayers.

↓

A rational taxpayer refrains from selling the asset now.

↓

"**Lock-in effect**" / "**Freezing effect**"

Example: Tax rate is 40%. An asset was purchased in 2000. The acquisition fee was ¥0. In year 2001, fair market value of the asset rised to ¥1000. (In the examples below, all transactions occurred on the date of December 31.) In 2002, the taxpayer sold the asset.

	holding rate of return 10%	reinvestment rate of return 10%	holding rate of return 9%	mark to market borrowing money
2001	asset 1000 tax 0	tax 400 reinvestment 600	asset 1000 tax 0	asset 1000 tax/borrowing 400
2002	asset 1100 tax 440 residual 660	asset 660 tax 24 residual 636	asset 1090 tax 436 residual 654	asset 1100 tax 24 residual 636

First column: The taxpayer continued to hold the asset. In year 2002, fair market value of the asset was ¥1100. (It can be said that the rate of return is 10% because ¥1000 in 2001 had become ¥1100 in 2002.) In 2002, he sold the asset.
Second column: The taxpayer sold the asset in 2001. After tax amount was invested in another asset, whose rate of return was 10%. In 2002, he sold the second asset.
Third column: The taxpayer continued to hold the asset. However, the rate of return from 2001 to 2002 is 9%. Therefore, fair market value of the asset in 2002 was ¥1090. In 2002, he sold the asset.
Fourth column: Taxation based on mark-to-market occurred in 2001. Because the taxpayer continued to hold the asset, he has no money for paying tax. He borrowed ¥400 in order to pay tax. In 2002, he sold the asset at ¥1100 and paid ¥440 to the money lender.

(1) Comparing first and second column:
Under the taxation based on realization, the choices of "holding" and "reinvestment" are not treated neutrally. **First column is preferable for the taxpayer. Therefore, there is "lock-in effect"** or "freezing effect".
What is evil in "lock-in effect"?

(2) Comparing second and third column:
Second column is superior to third column in the light of social welfare. However, if the taxpayer is rational, he will choose third column. Therefore, **there is welfare loss**. It is inefficient.

(3) Comparing second and forth column:
If taxation is based on mark-to-market method, the choices of "holding" and "reinvestment" are treated neutrally.

(4) Comparing first and forth column:
The taxpayer of first column is treated more preferably than of forth column although he continued to hold the asset in both column. In usual, "lock-in effect" is considered as disfavoring the choice of "reinvestment" in second column. However, if we go back to the root of this problem, the taxation based on realization treats first column "too" preferably, as compared with forth column. **The ultimate root of "lock-in effect" is not taxation in second column, but nontaxation in first column.**

3.3.11. Relationship between concepts of income and timing of taxation

Example: On 2000 December 31, a taxpayer gets, without cost, a security which will produce ¥100 cash on the date of each year's end in future three years.

	intuition	Value of property	depreciation	correct income
2000	0	249	---------	249
2001	100	174(91+83)	75	25
2002	100	91	83	17
2003	100	0	91	9

He gets cash of ¥100 on 2001 December 31, 2002 December 31, and 2003 December 31. According to the intuition, his income is ¥0 in 2000, ¥100 in 2001, ¥100 in 2002, and ¥100 in 2003.
However it is wrong in the light of the concept of comprehensive income.
¥100 in 2001 = ¥91 in 2000.
¥100 in 2002 = ¥83 in 2000.
¥100 in 2003 = ¥75 in 2000.
The present value of the security in 2000 is ¥249 (=91+83+75). If financial market is perfect, he can sell the security at ¥249. Althogh he gets no cash in 2000, he is certainly rich than on the date of the year's beginning. Therefore his income in 2000 is ¥249.

Is [0, 100, 100, 100] translated into [249, 0, 0, 0]? No.

In 2001, the value of the security is ¥174. There is depreciation of ¥75 (=249 – 174). This is included into expenses. He gets cash of ¥100 and it is his revenue. Therefore, his income in 2001 is ¥25 (=100 – 75).

In 2002, the value of the security is ¥91. Depreciation is ¥83. Income is ¥17 (=100 – 83).
In 2003, the value of the security is ¥0. Depreciation is ¥91. Income is ¥9 (=100 – 91).

However, correct income [249, 25, 17, 9] is **odd!!** There is double counting. (Comprehensive income includes double counting of income.)
Cash flow type of income [0,100, 100, 100] is natural.
↓
Can't we change the concept of income and make tax system along with cash flow type of income?
↓
Yes, we can!!
The concept of income is not absolute, and is not defined, a priori. If many people feel oddness in the column of "correct income", then people can change tax law through the democracy in the congress.
When we change tax law, we should note that cash flow type of income [0, 100, 100, 100] is not compatible with comprehensive income, but with consumption type concept of income. Although the definition of comprehensive income (I = C + ΔW) might be seen as natural, many people might also consider the consumption type concept of income as natural in other contexts.

People will naturally think that the concept of income (the width of income) and timing of taxation are different problems. However, as discussed above, **both problems are deeply and complexly related.** Realization principle is not compatible with comprehensive income; it compromises two concepts of income.

3.4. Personal attribution of income

3.4.1. Legal substance or attribution / ~~Economic substance or attribution~~

ITA § 12 provides that income is not attributed to a mere nominee.

問屋 (*toiya*; in French, commissionaire; in English, commission agent) does business of selling or buying of commodities in his own name on befalf of somebody else (Commercial Code, § 551). Legal rights or obligations derived from the transactions are attributed to commission agent (Commercial Code § 552).

Example 1: Mr. X wants to sell his asset to someone. X consigns the transaction to Mr. Y, who is a commission agent. Y finds a purchaser, Mr. Z, and makes the transaction with Z. The asset has contained built-in gain, and the capital gain occurs from the transaction. Whose capital gain is this?

Y does this intermediate transaction "**in his own name**", therefore, legal rights and/or obligations derived from the transaction with Z are attributed to Y, not X. However, Y does this transaction "**on behalf of**" X. The substantial result of this transaction belongs to X. In this example, Y is only a mere nominee. The capital gain derived from the asset is attributed to X.

Next question: How to judge the substance of transactions?

Example 2 (Sale and lease back transaction): Mr. P has a machine. P sells the machine to Mr. Q, and Q leases the machine back to P. P actually uses the machine in his business. As learned in section 3.3.7, the owner of the machine can deduct the depreciation cost from his income. Who can utilize this depreciation cost?

P sell ➔ Q

← lease back

In economic sense, people might consider P as the true owner of the machine because P actually uses the machine and makes business profit. However, P is not the owner, but mere the borrower of the machine in legal sense. The substance of transactions should be judged in the light of legal sense because economic substance or economic attribution is vague concept. In this case, the depreciation cost of the machine is attributed to Q.

Why are there such redundant transactions as sale and lease back?

In a typical case, the machine is an airplane, P is an air transport company, and Q is a financial institution. If P continues to hold the airplane, P does not have enough income to offset the depreciation cost; in other words, P can not fully utilize the tax attribute of this minus income (i.e. the depreciation cost). There is a space of tax planning. Q is rich, and if Q is the owner of the airplane, Q has enough income to offset the depreciation cost; in other words, Q can fully utilize the tax attribute of this minus income. However, of course, Q has no capacity to operate airplanes. Therefore, only the legal ownership of the airplane is transferred from P to Q, i.e., the tax attribute of this minus income (depreciation cost) is transferred from P to Q; although the actual operation of the airplane remains in P.

Somebody might think that the example 2 is inconsistent with the example 1.

In example 1, Y is a mere nominee. X has legal substance because Y does transactions "on behalf of" X, although Y does "in his own name".

In example 2, Q is not a mere nominee. Q has legally substantial ownership of the machine, although the actual user of the machine is P. (Suppose that Mr. S is an owner of a house and Mr. T is a tenant of the house. Who has legally substantial ownership of the house?)

However, legal substance or legal attribution is not the perfect criterion for problems of personal attribution of income. Sometimes, the courts can not decide the personal attribution of income mere according to legal substance or attribution.

3.4.2. Taxation on eaners

Example 3: Mr. F lives with his daughter, D. Only F works and D is a student. F & D make a contract that F's wage will be divided equally. In a certain year, F's wage is ¥5 million. Tax rate is 10% for 0 – 3.3 million bracket and 20% for 3.3 – 9 million bracket. How to calculate the tax amount?

(If F makes this contract after his earning, there is gift. However, in this case, the contract is concluded before F's earning; therefore we can consider that there is no gift. Although the latter statement is questionable, we ignore the problem of gift in this case.)

(1) If income splitting is not admitted, the total tax amount is:

¥3.3m×10%+¥1.7m×20%=¥0.67 million

(2) If income splitting is admitted, the total tax amount is:

(¥2.5m×10%)×2=¥0.5 million

Even if we follow the criterion of legal substance or attribution, we can not answer the question. Both (1) and (2) have legal foundations. If we look at the point of earning, (1) is correct. If we look at the final incidence of income, (2) is correct.

In real, tax is imposed on eaners, i.e. Mr. F in this case.
Case law adopts the principle of **taxation on earners**.
Some scholars say that taxation on eaners is one indication of legal substance or attribution. However I don't think so, because (2) is also based on legal substance. I guess that the principle of taxation on eaners is based on case law in order to prevent tax avoidance.

By the way, the principle on earners does not have strongly persuasive reasons.

Example 4: Mrs. M lives with her son, S. S is a student and has no income source. M is a writer and has the copyright on a certain novel. M transfers the copyright to S.

In this case, the royalty income derived from the copyright is attributed to S, although he does not work, because he is really a legal owner of the copyright. (Caution: In this case, there is clearly **gift** from M to S; therefore this contract is not suited for tax avoidance.)

Income from labors can be hardly transferred; however income from property can be easily transferred. It is strange. In example 4, the property (i.e. the copyright) is derived from labor, i.e. M's writing. There is dichotomy between labor income and capital income, although the dichotomy is hardly justified.

3.4.3. Family business

ITA § 56 provides that in calculation of one's business income, consideration paid to his family is not included into expenses.

Example: X does business and makes profit 900. If tax rate is 10% for 0 – 500 bracket and 20% for 500 – 1000, then X's tax is 130 (= 50+80).

Suppose that X hires his wife, Y and his son, and pays wages 300 per head. If these wages are included into expenses in calculation of X's business income, then this family's total tax amount is 90 (= 30+30+30). If this kind of income splitting is admitted, tax amount is reduced.

However, tax officers can hardly confirm intra family contracts and the properness of the considerations. Therefore tax law ignores intra family contracts and intra family payments. (ITA § 57 allows intra family wages to be included into expenses only under special requirements.)

Tokyo high court, 1991 May 22, 税資(Zeishi) no. 183, p. 799
Fact: X (husband) borrowed a building of W (X's wife) for his business and paid rent to W. Was this rent included into expenses in calculation of his business income? Or ITA § 56 was applied?

Decision: ITA § 56 was applied.

Discussion: In *de lege ferenda* (legislative arguments), ITA § 56 is strictly criticized. If the price of X's payment to W is proper, the legislative basis of ITA § 56 collapse.

However, in *de lege lata* (interpretation of law), courts have tendency to apply ITA § 56.

In other cases (Supreme court, 2004 November 2, and 2005 July 5), a husband who is a lawyer pays renumeration to his wife who is a lawyer or a tax attorney, however those payment is not included into expenses in calculation of the husband's income.

Some scholars, criticizing case law, state that courts apply ITA § 56 too broadly.

Incorporation movement

X's business ——→ W
↑ salary
ITA § 56 considers the saraly as nothing.

——→ X
X-co. ——→ W
↑ salary or dividend
There is no restriction to income splitting.

Suppose that Mr. X (husband) forms a corporation and X's business is transferred to the corporation, named X-co. Now business income is attributed, not to Mr. X, but to X-co. Mr. X is not an entrepreneur but an employee (in this case, maybe a manager) or a shareholder of X-co., therefore, X's income is salary income or dividend income.

X-co. can lawfully employ persons. Also Mrs. W (X's wife) can be an employee of X-co. and can lawfully gets salary income from X-co. In this case, X-co. can lawfully include W's salary income into expenses in calculation of X-co.'s income.

When X's business is under private management, income splitting among family is denied by ITA § 56. However, after incorporation, income splitting is admitted.

Although there is no incorporation, if X and W (husband and wife) do their business (such as farming, shop, etc.) cooperatively, then they seem to be co-entrepreneurs; therefore income seems to be naturally splitted among co-entrepreneurs.

However, in actual cases in courts, co-enterpreneur among family are rarely recognized.

Tokyo high court, 1991 June 6, 訟月(Shougetsu) vol. 38, no. 5, p. 878.
Fact: X (father) operated a dental clinic, named T-clinic. S (X's son) had passed the national examination of dentist, therefore S started to be engaged in dental care in T-clinic with X. In tax

filing, T-clinic's total revenue and total cost are halfly divided between X and S.
However, Y (the director of the tax office) denied the tax filing of X and S. Y considered that X was a solo-entrepreneur of T-clinic and S was a full-time employee of X. (Salary income attributed to S is lawfully included into expenses in calculation of X's business under the special condition of ITA § 57.) Therefore, Y considered that T-clinic's revenue and cost were attributed X. If Y's argument was right, the tax amount would rise.

Judgement: X's claim was rejected.

In general, revenue attribution is not judged according to whether the revenue is derived from one's labor. Revenue of a certain business is considered to be attributed to the management person of that business.

In this case, X had operated T-clinic over 20 years. As the actual condition of T-clinic, X had credit capacity because of his long experiences as a dentist and T-clinic was operated with X's credit. Therefore X had dominant influences on T-clinic's management.

Discussion

Business income and salary income are treated differently under ITA. Even if a certain revenue is derived from S's services, the revenue is not attributed to (or does not belong to) S when S acts as only an employee, not as an entrepreneur. S's income is salary income and not business income. In this case, the court considered that S owed little business risk of T-clinic.

When S makes enough experiences as a dentist and T-clinic's business is under the credit of X and S, then X and S will be recognized as co-entrepreneurs.

If X and W (husband and wife) form a **partnership** for their business and both X and W owe the risk of the partnership's business with legal substance, then tax officers must recognize X and W as being co-entrepreneurs. However there are little cases of family partnerships and case law is not established.

3.4.4. Unit of taxation

This section is an applied question of **imputed income** and **personal attribution of income**.

How to measure the **ability to pay** of a certain household?

Oldman & Temple's principle

(1) B is a married couple: B1 works and B2 does household duties. C is also a married couple: C1 and C2 works. If B1's income and the sum of income of C1 and C2 are same, then B's tax burden should be heavier, because B2's household services produce **imputed income**.

(2) C is a married couple. D1 and D2 are singles. If the sum of income of C1 and C2 and the sum of income of D1 and D2 are same, then C's tax burden should be heavier, because a married couple has **economy of size**.

(3) A is a single. If A's income and B1's income are same, then A's tax burden should be heavier, because the former has less cost for living.

↓

A（single:500）、B（B1:500 B2:0）、C（C1:250 C2:250）、D（singles:250＋250）

↓

Inequation of their tax burden should be **A>B>C>D**.

Japanese ITA imposes tax person by person. The unit of taxation is **individuals**.

Under the individual-unit taxation, Oldman & Temple's principle is not applied, because it will be A = B.

There are other possibilities. Some countries' unit of taxation is **couples** or **families**.
If married couples' income is simply added up, then taxable income of couples is too larger than that of singles; therefore tax burden of couples will be too larger than that of singles under

progressive tax rate system. It is called as "**marriage penalty**", which means that married couples face disadvantages although married couples have "economy of size".

There are two ways.
[1] Income bracket for couples are broadened.

	10%	20%	30%	37%
For singles:	0	3.3	9	18
For couples:	0	6.6	18	36

If income bracket is simply doubled, Oldman & Temple's principle is not applied, because it will be C = D. If tax law legislators respect the principle, the income bracket for couples should be slightly narrowed.

[2] Couples' income is divided, progressive tax rate is applied and then the tax amount is doubled.
If a certain couple's income is 5, then progressive tax rate is applied to 2.5, therefore, applied tax rate is 10%. Tax amount, 0.25, is doubled; therefore, total tax amount of the couple is 0.5.
If progressive tax rate is simply applied, the couple's tax amount would be 0.67.
Also in this way, Oldman & Temple principle is not applied, because it will be B = C.

As discussed above, all systems have some defects under progressive tax rate system.
There is no logical answer; therefore each country does its own value judgment.

3.4.5. Allowance for spouse

As seen above, Japanese ITA's taxable unit is individual as a general rule.
However, as seen above, individual-unit taxation has some defects.

ITA § 83: **Allowance for spouse**

When income of X's spouse, W, is less than ¥380,000, then X can deduct ¥380,000 from X's income. This deduction is called as allowance for spouse.

If there is no allowance, Oldman & Temple's principle is not applied, because it will be A = B, as discussed above. Due to the allowance for spouse, it will be A > B.

Caution: If W gets only salary, then there is deduction for salary earners provided by ITA § 28. The minimum amount of this deduction is ¥650,000. Therefore, till W's salary is less than ¥1,030,000 (= 380,000+650,000), X is benefited by allowance for spouse.

(Please take care that what amount is deducted from whose income.)

ITA § 84: Allowance for **dependents**

When X has a dependent, say a son, named S, and S's income is less than ¥380,000, then X can deduct ¥380,000 from X's income.

In my view, a spouse and a dependent are different; however ITA treats both samely.

Supreme court, 1998 September 9, 訟月(Shougetsu), vol. 44, no. 6, p. 1009.
Fact & Issue: X and W were not legally married; however X and W actually lived together as a married couple (it is called as "concubinary"). W had little income. Was allowance for spouse applied to X?

Judgment: X's claim was rejected.
The word, "Spouse", in ITA § 83 is limited to the person who is legally married.

Supplement: "Dependent" in ITA § 84 is also limited to the person who is legally a family.

Discussion: In legislation, ITA § 83 makes focus on the actual cost for living. Actual condition of cohabitation of a certain couple is more significant than the legal status of the couple: whether ther

are legally married.

However, in interpretation and application of tax law, tax officers might be hard to confirm the actual conditions of numbered taxpayers. Therefore, the court attached greater importance to legal status than actual condition, although that kind of interpretation and application is inconsistent with the legislative intent.

As a general rule, "**borrowed concepts**" should be interpreted as original.

Borrowed concept: Tax law borrows many concepts from other law, such as civil law, commercial law, etc. The examples of borrowed concepts are "spouse", "inheritance", "dividend", etc.

3.5. Classification of income

ITA § 23: Interest income
ITA § 24: Dividend income
ITA § 26: Real estate income
ITA § 27: Business income
ITA § 28: Saraly income
ITA § 30: Retirement income
ITA § 32: Forest income
ITA § 33: Capital gain
ITA § 34: Temporary income
ITA § 35: Miscellaneous income

3.5.1. Capital gain（ITA § 33）

Long-term capital gain: holding the property longer than 5 years
Short-term capital gain: capital gain other than long-term capital gain

Only half of long-term capital gain is subject to tax.
Capital gain has long been accumulated and is realized at once; therefore **high progressive tax rate** would be applied without special relief provisions.

Moreover, when a taxpayer has long held the property, nominal gain derived from **inflation** will realize. However this type of nominal gain will not be considered as token of the taxpayer's richness.

==========

Difference between revenue (selling price) and cost (purchasing price) is naturally considered as taxable capital gain. However this intuitive understanding is incorrect. Taxation on capital gain is not taxation on difference.
According to the comprehensive income concept, **net increase of wealth** should be subject to tax even if there is no revenue. Taxation on net increase is only restrained until the realization event. At the time of realization (*i.e.* transfer of the property), taxation on net increase of wealth, which means difference between **the fair market value** and **the acquisition cost** (not between revenue and cost), should happen as a basic rule, even though there is no or little revenue.

ITA § 59: Considered transfer

When an individual transfers a property to a **corporation** (1) at no price or at remarkably low price (2), the individual is considered (deemed) as getting fair market value.
→The capital gain taxation will occur.

The provision of considered transfer exists in order **to prevent the eternal tax deferral**.

(1) Now this provision is only applied to the transfer to a corporation. Formerly, the transfer to an individual without no price also triggered the capital gain taxation in order to prevent the tax deferral (**Supreme court, 1968 October 31**, 訟月 Shougetsu, vol. 14, no. 12, p. 1442). The width of capital gain taxation on considered transfer has become narrowed, because an individual does not exist eternally.

(2) "Remarkably low price" means the price less than half of the fair market value.

Example 1: Mr. X has an asset, whose acquisition fee was ¥1000 and whose fair market value is ¥3000. When X transfers the asset to a corporation, named Y-co, at price of ¥1900, ITA § 59 is not applied. X's taxable capital gain is ¥**900**.
After that, when Y-co transfers the asset to a third party, named Z, at price of ¥3000,

Y-co's taxable capital gain is ¥1100.

Example 2: Mr. X has an asset, whose acquisition fee was ¥1000 and whose fair market value is ¥3000. When X transfers the asset to a corporation, named Y-co, at price of ¥1200, there is considered transfer. X is considered as getting ¥3000, and taxable capital gain is ¥2000. Y-co is considered as being gifted with ¥1800. This gift is also considered as Y-co's taxable income.

After that, when Y-co transfers the asset to a third party, named Z, at price of ¥3000, there is no taxable capital gain, because Y-co's acquisition fee of the asset is considered not as ¥1200 but ¥3000.

If X-co is corporation
X-co → Y-co 1900 capital gain is 900
X-co → Y-co 1200 capital gain is 1800

X-co is considered to make donation to Y-co of 1800. X-co can deduct some of the donation from X-co's income. Some part means 0.25% of X-co's capital.

If X-co is corporation and W is an individual
X-co → W 1200 capital gain is 1800

X-co is considered to make donation to W of 1800. X-co can deduct some of the donation from X-co's income. Some part means 0.25% of X-co's capital.

Example 3: Mr. X has an asset, whose acquisition fee was ¥1000 and whose fair market value is ¥3000. When X transfers the asset to an individual, W, at price of ¥1200, ITA § 59 is not applied. X's taxable capital gain is ¥200.

After that, when W transfers the asset to a third party, V, at price of ¥3000, W's taxable capital gain is ¥1800.

Please look at the **acquisition fee**.

In example 2, **X's acquisition fee is succeeded to the transferee** (ITA § 60). If Mr. X has held the asset more than 5 years, the tax attribute of long-holding is also succeeded to the transferee. Therefore, Y-co's gain is long-term capital gain. (In general rule of corporate income taxation, there is no distinction between long- and short-term capital gain; however there are some special rules which distinct them.)

In examples 1 & 3, X's acquisition fee is not succeeded to the transferees. Even if Mr. X has held the asset more than 5 years, Y-co's gain or W's gain is not long-term capital gain.

(3) Ordinary inheritance does not trigger capital gain taxation. However, **inheritance with limited recognition** is also listed as considered transfer; therefore it triggers capital gain taxation.

X is a father and S is his son.
X has plus asset and minus asset (=borrowing)

If S makes limited recognition

Example 4: Mr. X has an asset, whose acquisition fee was ¥1000 and whose fair market value is ¥3000. When X dies and his son, U, ordinarily inherits X's asset, ITA § 59 is not applied. There is no capital gain taxation. U is only subject to inheritance tax.

After that, when U transfers the asset to a third party, T, at price of ¥3000, U's taxable capital gain is ¥2000.

Example 5: Mr. X has an asset, whose acquisition fee was ¥1000 and whose fair market value is ¥3000. When X dies and his son, S, inherits X's asset **with limited recognition**, ITA § 59 is applied.

There is capital gain taxation. S is also subject to inheritance tax. (If capital gain tax amount was ¥800 (=¥2000×40%), the amount of all inheritance assets is ¥2200.)

After that, when S transfers the asset to a third party, R, at price of ¥3000, S's taxable capital gain is ¥0.

There is a **double taxation in Example 5**; income taxation on X's capital gain and inheritance taxation on S's inheritance assets. However this type of double taxation is not unfair. If Mr. X gets saraly income and he dies, there is also double taxation; income taxation on X's saraly income and inheritance taxation on S's inherited cash. If people deny this type of double taxation, it means that people deny inheritance taxation itself.

However, there is a possibility of **unfair double taxation in Example 4**. This example is changed as follows;

Example 6: Mr. X has an asset, whose acquisition fee was ¥100 and whose fair market value is ¥1000. When X dies and his son, U, oridinally inherits X's asset, ITA § 59 is not applied. There is no capital gain taxation. U is only subject to inheritance tax. If inheritance tax rate is 70%, tax amount is ¥700.

After that, when U transfers the asset to a third party, T, at price of ¥1000, U's taxable capital gain is ¥900. If income tax rate is 40%, tax amount is ¥360.

Although U gets the asset of ¥1000, his total tax amount is ¥1060. This double taxation is unfair and strange.

In existing law, Special Taxation Measures Act § 39 provides a special relief. In this example, the amount of inheritance tax (=¥700) is added to the acquisition fee of the asset; therefore U's taxable capital gain becomes ¥200, and capital gain tax amount becomes ¥80. However this special relief is available only under special conditions.

If ITA § 59 is applied in all cases of inheritance, this unfair double taxation will not happen. When X dies, capital gain tax is ¥360. The amount of U's total inherited asset is ¥640, therefore, tax amount is ¥448. Total tax amount is ¥808, and it is naturally below ¥1000.

ITA § 59 in inheritance with limited recognition is blamed by civil law scholars. Adversely, however, nontaxation on capital gain at the time of ordinary inheritance is blamed from the viewpoint of comprehensive concept of income.

==========

In examples 1 – 3, we learned **succession of tax attributes**: in those examples, acquisition fee and long-holding.
There is another type of succession of tax attributes.

ITA § 58: Like-kind exchange

Example 7: Mr. X has an asset, named P-asset, whose acquisition fee was ¥1200 and whose fair market value is ¥3000. Mr. Y has an asset, named Q-asset, which is similar with P-asset, whose acquisition fee was ¥2500, and whose fair market value is ¥3000. If X exchanges P-asset with Q-asset, and X uses Q-asset in the same way of using P-asset, **the exchange is considered not to be happened**. It means that X's taxable capital gain is ¥0.

After that, when X transfers Q-asset to a third person, Z, at price of ¥3000, X's taxable capital gain is ¥1800. Tax attributes of Q-asset is not succeeded to X. X succeedes P-asset's tax attribute, because the exhange is considered not to be happened.

Even if ITA § 58 is applied to X, it does not necessarily means that ITA § 58 is also applied to Y. If Y uses P-asset in a different way than of using Q-asset, ITA § 58 is not applied to Y. Therefore Y's taxable capital gain is ¥500. After that, when Y transfers P-asset to Z at price of ¥3000, the Y's taxable capital gain is ¥0.

==========

The meaning of "**transfer**"

Supreme court, 1985 May 27, 民集(Minshû) vol. 29, no. 5, p. 641.
Fact and Issues: Mr. X and W divorced. As part of the divorce settlement, X transferred his asset to W. Did capital gain taxation on X occur?

X's argument: X did not get anything from transferring the asset to W; therefore there is no capital gain.

Decision: X's claim was rejected.
X had owed a liability to settlement. By transferring the asset, X got the economic gain of being discharged from the liability.

Criticism by Prof. Kaneko: Divorce settlement has three moments: ①Settlement (clearing) the couple's community property (which is a core meaning of divorce settlement), ②payment of damages for unfaithfulness, and ③supporting.
The settlement of the asset in the meaning of ① is same as splitting shared assets; therefore it is not interpreted as "transfer" and it should not trigger capital gain taxation.

This criticism became prevailing notion among tax law scholars; however courts do not follow it.

3.5.2. Salary income（ITA § 28）

Fringe benefit is benefit that an employer gives to an employee other than monetary salary. Taxable income should be comprehensive; therefore fringe benefit should also be taxable. However there are some discussions.

●Commuting allowance

Supreme court, 1962 August 10, 民集(Minshû), vol. 16, no. 8, p. 1749.
When an employer gives commuting allowance to an employee, this also constitute the employee's taxable income.

Somebody might feel strangeness; the employee is rich because of commuting allowance? (Is there net increase of wealth or consumption?)
However, the answer is yes.
Comparing with another employee who is not given commuting allowance, taxation on the employee above is equitable.
Employees have liberty to live anywhere. When a certain employee lives far from the place of job, he lives there of his own free will; therefore, the commuting fee is considered as **consumption**.

However it might be hard to understand that commuting fee is consumption. Employees might have difficulties to live near by the place of job.
Now tax law is amended.
ITA § 9 (1) (5): Ordinary commuting allowance is excluded from an employee's taxable income.

●Company housing
Some employers provide company housings for their employees at low price. Difference between fair market value of the rent and actual payment of the rent is generally considered as taxable income.
There are some difficulties in calculating income.
In some situations, an employee has no choice other than live in a company housing. He doesn't live there of his own free will. He might feel less utility (less happiness) than fair market value of the rent. If he has cash and has choices, he might live somewhere else. In the case of **compulsory consumption** like this, there tends to be difficult problem in calculating taxable

income.

●Comfort in office

In usual, an employer's office provides comfortable circumstances for employees, such as air conditioner. If we strictly think about tax equity, these employees' benefit should also be included into their taxable income, comparing with other taxpayers who live in their own houses and pay fuel and lighting costs.

In reality, however, it is difficult and bothering to measure the benefit of these employees. Therefore comfort in office is not taxed under existing law.

However, there is a convenient way to impose tax on the comfort in office, if we can ignore the progressive tax rate. The way is taxation on an employer: it means denial of including the office's fuel and lighting cost into expenses in calculation of the employer's taxable income. The employer is an individual or a corporation. In the former case, income taxation on the employer substitutes for the taxation on employees' fringe benefit. In the latter case, corporate taxation on the employer substitutes for the taxation on employees' fringe benefit. (Existing law does not adopt this way of taxation.)

==========

Income taxation has an effect of favoring lazy persons than diligent persons.

People work and get salary. Money makes people happier.

People don't always work. People have leisure time. Leisure also makes people happier.

Money (which is result of work) and leisure give people utility.

Mr. A likes money. Mr. B likes leisure. Both A and B have chances of jobs which makes ¥10,000 per one day.
A works 6 days per week; B works 2 days per week.
Both Mr. A and Mr. B feel happiness with their own money and leisure. However income tax is not imposed on the utility of leisure. Clearly A's tax burden is heavier than B's tax burden.

Mr. C works 6 days per week and gets ¥100,000 per week.
Mr. D works 2 days per week and gets ¥100,000 per week.

Cleary Mr. D is richer than Mr. C because D has more leisure and more utility; however it is not reflected on actual taxation.

If we try to treat A and B equally or C and D equally **from the viewpoint of efficiency**, taxation should be based, not on the actual salary, but **on the possibility of salary**. In the example of Mr. A and Mr. B, tax base of both persons should be ¥70,000 per week. (Naturally if we expand tax base like this, tax rate will be lowered.)

Measurements of the possibility of salary are hard to execute.
Moreover, taxation on the possibility might have some issues **from the viewpoint of liberty**.

Suppose that Mr. E has had a chance to be employed by a famous company and, if so, his annual salary would be ¥20 million. However, he has a dream to become a musician. He refused the employment above, and actually he does part-time jobs and he spends his main time for the lesson of music. His actual salary is ¥2 million. Should tax base be ¥20 million?

==========

Human capital is attributes, such as knowledge and technique that make person be more productive.
One typical way of raise the value of one's human capital is **education**. Education is one type of investments.

Other factors also have effects on one's human capital; **talent**.

Athletes and beautiful models are endowed with talent; although they have also made investments (such as training and makeup). Talent (such as sports ability and beauty) produces **excess profit**: it is called as **rent**.

Example: A certain beautiful model gets ¥100 million per year. He has another choice of job: a waiter in a restaurant. He would get only ¥5 million per year. In this case, unless this model's tax exceeds ¥95 million, he will continue to be a model. For example, if tax amount is ¥90 million, his after tax income is ¥10 million; it is better than when he becomes a waiter.

Being a model, he gets "rent" (=excess profit). Taxation on "rent" does not change the choices of rent-eaners as above; therefore it is very **efficient** (although non-neutral) way of taxation. This kind of taxation is called as **rent tax**.

Existing tax law does not explicitly take into account the concept of human capital. It produces non-neutrality in some cases.

If we take into account human capital, education cost is not consumption but investment in human capital; therefore it should be deducted from income. Medical cost is cost of repairing human capital, and it should be deducted. Food cost has two parts: the essential part for life is investment and food for amusement is consumption.

However existing tax law generally treats all them as consumption, and does not allow deduction without special rules.

Human capital might be important concept in discussing tax equity. However it is hard to be included in the tax system.

Although people do not know the word "human capital", human capital might have effect on tax equity. Some people might think that, even if cash revenue is same, salary income earners have less "ability to pay" than investment income earners; *i.e.* the formers are less rich than the latters. I guess people implicitly take into account of human capital concept; salary income earners can be considered as having **depreciation cost** of their own human bodies.

3.5.3. Business income (ITA § 27)

Business expense is deductible from business income. This deduction precludes taxation on original capital. If deduction is not allowed, taxation disturbs reproduction on an expanded scale of business.
However deductible expense is limited to the cost which has relation with business income.

Tokyo district court, 1970 May 25, 行集(Gyôshû), vol. 21, no. 5, p. 827.
Fact and Issue: X had made a loan to A-corporation. However the loan became bad debt. There was a loss. X argued that the loss was his business expense, because he offered consultancy services to A-corporation and the loss is related with his consultancy business.

Decision: X's claim was rejected.
Bad debt loss included into expenses is limited to the loss of the loan which is ordinary necessary for earning business income. In this case, the loan had no relation with X's consultancy business.

Business expense is distinguished from **housekeeping cost**; the latter is **consumption**. However distinguishing the character of actual cost might be difficult. Moreover, in some cases, a certain cost might have both characters: business expense and housekeeping cost.

Deductible business expense is not limited to lawful expenditure.

Takamatsu district court, 1973 June 28, 行集(Gyôshû) vol. 24, no. 6=7, p. 511.
Real-Estate and Building Business Act restricted the amount of agency fee. In several real estate transactions, X paid agency fee more than the restriction of law. The director of the tax office, Y, argued that expenditure included into expenses was limited to ordinary and necessary expenditure for the taxpayer's business and unlawful part of the agency fee could not be included into expenses. However, the court judged that, in the context income tax, the unlawful expenditure was also included into expenses when it was necessary.

However tax law does not always ignore the legality of certain expenditure.
ITA § 45 (1) (6): **Fines and penalties** are not included into expenses.

Suppose that tax rate is 40%. Mr. X had ¥300 income. X did a crime in relation with his business (for example, he violated the speed limitation when driving a truck) and paid ¥100 as a fine. If ¥100 was not included into expenses, his taxable income was ¥300 and tax amount was ¥120. If ¥100 was included into expenses, his taxable income would be ¥200, and tax amount would be ¥80. Inclusion into expenses means that a fine of ¥100 has only pain-effect of ¥60 for X. In these cases, income tax law restrains the logic of income tax, and respects the purpose of fines and penalties.

3.5.4. Real estate income（ITA § 26）

Tokyo district court, 1998 February 24, 判タ(Hanrei Times), no. 1004, p. 142.

Fact and Issue: Mr. X is a salary-earner. He purchased one room of a resourt hotel (hereafter, it is called as "the premise") from a tourist enterprise, named I-co. X leased the premise back to I-co and got real estate revenue (=rent payment of the premise). Sometimes X or X's friends used the premise because X was an owner.
In calculating real estate income, there was a loss: it means that costs related with real estate were larger than real estate revenue. X offset this real estate loss against his salary income. X applied ITA § 69 (1). However, the director of the tax office, named Y, argued that offsetting the loss against other income was prohibited in this case because of ITA § 69 (2).

Purpose of the transaction: It was a typical example of **sale & lease back** transaction. The premise yielded a little real estate revenue. However, the premise brought much larger **depreciation cost** to X. The purpose of sale & lease back was **the transfer of the depreciation cost** from a seller and a borrower (in this case, I-co) to a buyer and a lessor (in this case, X). The buyer (X) intended to offset the depreciation costs and other costs against his other classification of income (in this case, salary income).

Why the seller (I-co) by himself utilized the depreciation costs in offsetting his other income? …… I guess that I-co had little other income to offset the costs.

Provision
ITA § 69 (1): If there is loss in calculating real estate income, business income, forest income and capital gain, a taxpayer offsets the loss against other classification of income.

Japan has ten classification of income.

In calculating interest income, salary income and retirement income, there are no costs.

In calculating dividend income, temporary income and miscellaneous income, there are costs; therefore costs can be larger than revenue and there can be loss. However a taxpayer cannot offset the loss against other classification of income. In other actual cases, the denial of offsetting these loss against other income is important.

In the case above, X's loss is real estate loss. If only ITA § 69 (1) is applied, X can offset the loss against other income. However, there is another provision.

ITA § 69 (2): The loss related with the asset which is **ordinary unnecessary to living** cannot be offset against other income.

The vacation house (or cottage) is typical.

Decision: X's claim was rejected.

The decrease of value of the asset mentioned in ITA § 69 (2) was considered as **consumption**; therefore the decrease was not the minus item of income (because $I = C + \Delta W$).

In this case, X was considered as having the premise for the main purpose of recreation. Certainly he had got real estate revenue (rent), and X argued that his main purpose of having the premise was real estate business and speculation (it means that X expected the rise of the premise's price). However, those purposes were construed as secondary or ancillary.

Discussion:

Whether the offset is available or not depends on the **main purpose** of having the asset. If X did not use the premise in this case, the court could hardly recognize the main purpose as recreation; therefore X's claim would be accepted. Why X did not stop using the premise? I guess that the tax benefit was not much larger than the merit of using the premise.

In this case, we can say that there were **two factors**: the first was the purpose of recreation (*i.e.* consumption), and the other was the purpose of getting real estate income (*i.e.* investment). Should the costs (depreciation costs, management costs and other) be allocated between the two factors: consumption and investment? This thought is attractive and is logically consequent with the concept of income. However, the administration of distinguishing between consumption and investment will be difficult.

4. Corporate Tax

4.1. The foundation of corporate tax

4.1.1. The relationship between corporate tax and income tax.

Discussions of corporate tax start from the point that *corporate tax should not exist*.

Financing of corporations: debt / equity

Debt: When A-co pays interest to B-bank or a bond holder, Mr. C, interest payments are deductible from A-co's taxable income. There is only one tier taxation: non-corporate tax on A-co, and corporate tax on B-bank or income tax on C.

Equity: When D-co pays dividend to a shareholder, Mr. E, dividend payments are not deductible from D-co's taxable income. There is double taxation: corporate tax on D-co and income tax on E.

Debt financing is more preferable than equity financing.
It might lead to the situation in which corporations tend to become bankrupt.

When F is a partnership and Mr. G is one of partners, a partnership is not subject to corporate tax in Japan; therefore there is only tier taxation: non-corporate tax on F and individual income tax on G.
When there is corporate taxation, business activities through partnership-forms might be more advantageous than business activities through corporate-forms.

If corporate tax is simply abolished, what will happen?
Mr. E will not demand D-co to pay dividends. D-co will retain profits internally. Taxation on the retained profit will be deferred until it flows out as dividend. As we learned in section 3.3.5, generally, tax deferral is preferable to taxpayers. If the retained profit is not subject to corporate tax, business activities through corporate-forms are more advantageous than business activities through partnership-forms.

A corporation is a mere aggregation of individuals, not a real-being. A corporation is not a man and feels no pain of tax burden. Corporate taxation is **advance taxation on individuals' income**.

Integration of corporate tax and income tax

(1) **Classical system**: Double taxation on corporations and shareholders are not resolved. Traditionally USA has adopted this system(, but Bush Administration might change the system).
[Example] A certain corporation, A-co, yields ¥100 profit and pays all of after-tax income to shareholders as dividend. Corporate tax rate is 30%, income tax rate on a rich man, Mr. B, is 50%, and tax rate on a poor man, Mr. C, is 20%. Corporate tax amount in this example is ¥30, and dividend amount is ¥70. If B receives the dividend, individual income tax amount is ¥35. If C receives the dividend, individual income tax amount is ¥14. Total tax amount on B is ¥65 and that on C is ¥44. There are double taxations. If B or C did business not through a corporation, tax amount would be ¥50 or ¥20.

(2) **Partnership** method: Corporations are treated as partnerships. There is no taxation on entity level. In order not to treat corporate-forms more preferably, not only dividends but also retained profits should be allocated to shareholders, and shareholders are subject to income taxation.
[Defects] Execution of this method is almost **impossible**. Please imagine the situation that a shareholder holds stocks of a corporation, which also holds stocks of another corporation, which also holds stocks of another corporation … Allocation of retained profit is difficult.

(3) **Unrealized capital gain taxation** method: Dividends are not taxed at the level of corporations, and taxed at the level of shareholders. Retained profit will be reflected upon price appreciation of stocks; therefore income taxation on unrealized capital gain of the stocks will be substitute for corporate taxation on retained profit.
[Defects] Valuation of stocks is difficult. Moreover, price of stocks reflects not only retained profit but also other factors.

(4) **Dividend-paid deduction** method: Dividend payments are deductible from corporations' taxable income, like interest payments. Corporate tax is imposed only on retained profit.
[Defects] The part of retained profit is not integrated with income tax.
[Example] A-co's tax amount is zero if A-co pays all profits to shareholders. Individual tax amount of B or C is ¥50 or ¥20. However, if A-co internally retains all profit, corporate tax amount is ¥30, and B or C is not taxed at that time. It is a destruction of progressive tax system.

(5) **Dividend-received deduction** method: When a shareholder receives dividend, it is not included into his taxable income. There is only one tier taxation on corporations.
[Defects] Progressive tax rate is not applied to dividend.

(6) **Dividend-received credit** method: When a shareholder receives dividend, a certain percentage of the dividend amount is deducted from his tax amount. (Deduction from tax amount is called as "credit".) Japan adopts this method.
[Defects] Integration tends to be too rough.
[Example] Dividend-credit rate is 10%. A-co's tax amount is ¥30 and dividend amount is ¥70. B's income tax amount is not ¥35 but ¥28 (= $35 - 70 \times 0.1$). C's tax amount is ¥7 (= $14 - 7$). Total tax burden on B or C is ¥58 or ¥37; these figures are less than examples of (1).

(7) **Imputation** method: Dividend-received amount is grossed-up by the correspondent corporate tax amout, and that corporate tax amount is deducted from a shareholder's individual tax amount.
[Example] A-co's tax amount is ¥30, and dividend is ¥70. When B receives dividend, the correspondent corporate tax amount, ¥30, is grossed-up; therefore B's taxable income is deemed as ¥100 (=70 + 30). Suppositive income tax amount of B is ¥50, and corporate tax amount, ¥30, is deducted from the suppositive tax amount; therefore finally B's income tax amount is ¥20 (=$50 - 30$). C's final tax amount is ¥-10 (=$20 - 30$) (it means refund). Total tax burden on B or C is ¥50 or ¥20. If imputation method is completely applied, there is no double taxation on dividend (although double taxation on retained profit is not resolved).
[Defects] Imputation method is **incompatible with international investments**. Suppose that A-co is a German corporation and Mr. C is a foreigner. If imputation method is applied also to foreign investors, German government shall pay 10 to C: that result is not acceptable for Germany: even though Germany is the source of the business profit, why Germany refrain from taxing the profit? However, if imputation method is not applied to foreign investors, it is a breach of EU treaty which provides **non-discrimination between domestic and foreign investors**.

In the field of international investments, "corporate taxation is advance taxation on individuals' income" means "corporate taxation is advance taxation on foreigners' income". However, if a source country adopts tax system which integrates corporate and income tax, advance taxation on foreigners' income might not work well.

Do we need to integrate corporate tax and income tax?
If partnership-forms are more preferable than corporate-forms, partnership-forms will increase.

If debt-financing is more preferable than equity-financing, debt-financing will increase. We learned the law of **diminishing returns** (in section 2.2.4, page 8). At the **equilibrium**, partnership-forms / corporate-forms and debt-financing / equity-financing will produce same after-tax revenue. Therefore, double taxation does not necessarily produce inequity. However, non-inequity is not necessarily justified. There might be **inefficiency**.
The number of partnership-forms might be too large than proper level. Financing of corporations might too heavily rely on debt more than proper level.

Then, should we abolish corporate taxation?
It will also produce other problems that we saw above.
How to treat the relationship between corporate tax and income tax has no solid solution.

==========

The reasons of existence of corporate tax have commonness with the reasons of **realization** method.
●Difficulties of valuation is one of reasons of realization method. It refuses the adoption of mark-to-market method. It is also one of reasons of non-abolishment of corporate taxation. If we abolish corporate tax, the tax office needs to allocate internal reservation of the corporation's profit to it's shareholders. One of the ways of allocation is (3)-type method: valuation of unrealized capital gain. However, valuation of stocks is difficult, especially when the stocks are unlisted in stock-market.
●Even if the allocation or valuation faces no problems, there is another problem: how can the shareholder finance cash for paying tax when the corporation pay no dividend? It is the problem of financing for tax-payments, which is also the reason of realization method.

4.1.2. Taxpayers of corporate tax (omitted)

4.2. Income of corporations: the meaning and calculation

4.2.1. The meaning of income of corporations

Income of corporation = (gross revenue) – (expenses)

Corporate Tax Act distinguishes two types of transactions.

Capital transactions etc.:
[transactions which increase or decrease the corporation's capital] &
[distributions of earnings and surplus of the corporation]
↓
This transaction has no effect on the corporation's income, revenue or expense.
For example, when a certain shareholder, Mr. X, makes **capital contribution** to a certain corporation, Y-co, Y-co's asset certainly increase. However, the increase is reflected only upon capital account of Y-co, because contribution can be considered as transaction-with-himself: X and Y-co can be seen as the same person. Therefore, contribution is not reflected upon Y-co's revenue or taxable income.
For another example, when Y-co pays **dividend** to X, it is also one type of capital transactions. It does not reflect upon Y-co's expense.

Profit-and-loss transactions:
[transactions other than capital transactions etc.]
↓
Only this transaction has effect on the corporation's income, revenue or expense.
Not all transaction between a corporation and a shareholder, say, Y-co and X, are capital transactions. Sometimes X does transactions with Y-co as like a third party. For example, when

X makes a loan and Y-co pays interest back to X, **interest payment** is not a capital transaction but profit-and-loss transaction; therefore the interest payment is included into Y-co's expense.

In calculation of corporations' income, distinction between capital transactions etc. and profit-and-loss transactions is important.

4.2.2. The meaning of "revenue"

CTA § 23: All of or part of **dividend-received is not included into revenue**.
Suppose that Mr. X holds Y-co's stocks and Y-co also holds Z-co's stocks. When Z-co makes business profit and pays all amount of after-tax income, what happens?
There is triple taxation. If all persons are subject to 40% tax rate and Z-co's before-tax income is ¥1000, Z-co's tax amount is ¥400. From the view point of Z-co, the dividend payment is capital transaction and the dividend is not deducted from Z-co's income. From the view point of Y-co, the dividend-received is not capital transaction. If there is no relieving provision, Y-co's taxable income is ¥600 and Y-co's tax amount is ¥240. X's dividend-received is ¥360 and X's tax amount is ¥144, (in this example, we ignore dividend-received credit method in Japanese tax system). Total tax amount is ¥784.
If the business profit was Y-co's, then Y-co's tax amount is ¥400 and X's tax amount is ¥240. Total tax amount is ¥640. Doing business through subsidiaries is much less preferable if triple taxation is not resolved. Therefore CTA § 23 provides some relieves.

If Y-co holds 25% or more of stocks of Z-co, all amount of dividend from Z-co to Y-co is not included into Y-co's revenue. Therefore there is only taxation on Z-co's level.
If not, Y-co is considered not as a parent company of Z-co but as a mere investor, and only 50% of dividend is not included into Y-co's revenue.

Supreme court, 1966 June 24, 民集(Minshû), vol. 20, no. 5, p. 1146.

Provision: CTA § 22 (2) provides that when a corporation transfers property or supplies service regardless **whether with or without consideration**, revenue is recognized.

Caution: there are four patterns.

transfer property	with consideration
	without consideration (discussed now)
supply service	with consideration
	without consideration (discussed later)

Suppose that A-co has a property, whose fair market value is ¥1000, and transfers it to B-co without consideration. A-co is considered as getting ¥1000 from B-co; therefore ¥1000 revenue is recognized in this transaction.

Why CTA recognize revenue even when there is no consideration?

The transaction without consideration is actually one transaction, however we can consider the transaction as two transactions: A-co is deemed to receive ¥1000 and to gift B-co ¥1000.

Even when there is no consideration, A-co must include ¥1000 into his revenue. However, A-co's asset is decreased by ¥1000. If this decrease is included into his expense, there are ¥1000 revenue and ¥1000 expense; therefore there is ¥0 taxable income. Whether the decrease is included into his expense is discussed later.

We have already learned similar provision: ITA § 59 (considered transfer) in section 3.5.1, page 37. If Mr. C has a property, whose fair market value is ¥1000 and whose acquisition fee is ¥100, and transfers it to D-co without consideration, C is also considered to get ¥1000 from D-co. Therefore C's taxable capital gain is ¥900.

If A-co's acquisition fee for the property is also ¥100 in the example above, A-co shall also recognize ¥900 capital gain (= [revenue] – [acquisition fee] = ¥1000 - ¥100).

Fact X-co was a business corporation, and had stocks of K-co. K-co had had a plan of new issuance of stocks. However, X-co could not get the new issued stock because of antitrust law at that time. (Now this prohibition has been relaxed.) X-co changed the holder's name in the list of K-co's shareholders, and the new nominal holder became Mr. A, who was an executive director of X-co. K-co issued new stocks to Mr. A. After getting new-issued stocks, Mr. A returned the old stock to X-co.

X-co ----old ¥350-------- K-co
X-co <----new ×-------- K-co
↓
Mr. A -----old ¥200----- K-co
Mr. A <-----new ¥200 (gain ¥150) ○----- K-co
↓
X-co ----old ¥200-------- K-co

What happened?

We should learn **new-stock premium**.

Suppose that the price of K-co's old stock was ¥350. K-co would issue one new stock for one old stock. Getting new stock demanded ¥50 contribution to K-co. After the issuance of new stocks, the stock price would be ¥**200**. Although Mr. A contributed only ¥50 to K-co, A got a stock whose price was ¥200. The difference between the price of new stock and the contributed amount, that is to say ¥**150** (=200 – 50), became A's gain. This gain is called as "new-stock premium".

The argument of Y, the director of the tax office: The difference between new stock's price and contributed amount was included into X-co's revenue. X-co transferred the **subscription right** (the right to get new-issued stock) to Mr. A without consideration, and the value of subscription right

was the difference amount; therefore it was included into X-co's revenue. The transfer made decrease of X-co's asset, however, it was characterized as **bonus**; therefore it was not included into X-co's expense.

Provision: CTA § 35: **Bonus** payments for directors are not included into the corporation's expense.

In usual, salary and bonus for normal employees are included into the corporation's expense, because they are cost for doing business.

Normal salary for directors is also included into the corporation's expense.

However, bonus for directors is considered as **distribution of profit** in accounting. Moreover, bonus can be used as a tool of tax avoidance. If a shareholder gets dividend from a corporation, there is double taxation. However, when the shareholder is also a direcotor of the corporation, he can choose the legal form of distribution of the corporation's profit: dividend for a shareholder or bonus for a director.

The argument of X-co: X-co could not get new stocks because of antitrust law. At the day of new issuance of stocks, the shareholders who were granted the new stocks were the nominal holders on the K-co's list of shareholders: in this case, not X-co but Mr. A. There was no transfer of the subscription right from X-co to Mr. A.

Decision: X-co's claim was rejected.

Even though X-co could not get new stocks because of antitrust law, X-co could make a third party to get new stocks, and that kind of status of X-co was **the advantage with economic value**. When X-co made a third party (in this case, Mr. A) to get new stocks, X-co could collect the adequate consideration from Mr. A. X-co did not do so, and it means that X-co's advantage with economic value was transferred to Mr. A without consideration.

The advantage was constituted by the new-stock premium of K-co. The transfer of the advantage was the outflow, from X-co to Mr. A, of **the appreciated part of K-co's stocks** which X-co had held. If fair market value of K-co's stock were higher than X-co's acquisition fee, the appreciated part was X-co's unrecorded asset. When unrecorded asset outflows, the corporation needs to recognize the value of the asset and needs to include the outflowing part of asset into revenue. In this case, unrecorded value of asset outflowed from X-co; therefore X-co had to recognize the revenue.

On the other hand, next question is whether the decrease of X's asset was included into expenses. In this case, the decrease was the distributing of profit to directors, and it was considered as bonus. Therefore it was not included into expenses.

Discussion:

(1) Difference of the reason between Y and the court:

Y only argued that there was a transfer from X-co to Mr. A of the subscription right without consideration and that it was not included into X-co's expense. However, according to the Y's logic, what was the source of X-co's taxable income was not explained.

The court's logic has two steps: the first is that there was X-co's unrecorded asset, which was unrealized capital gain of K-co's stocks. The second is that when it outflowed from X-co, X-co needed to include the outflowing part of asset into revenue, even when X-co did not any cash.

If X-co has no unrealized capital gain in K-co's stocks (for example, X-co's acquisition fee of K-co's stocks was ¥350 and the fair market value was also ¥350), there was no unrecorded asset, according to the court's logic. Therefore, X-co would not need to recognize revenue. However, according to Y's logic, even when X-co has no unrealized capital gain, X-co's taxable income would increase, even though there was no source of taxable income.

(2) How Mr. A was taxed?

Y and the court characterized the transfer from X-co to Mr. A as bonus; therefore A was considered as getting salary income.

If the transfer was characterized as gift, then A was considered as getting temporary

income.

(3) How much was the A's acquisition fee of K-co's new stocks?

If Mr. A only contributed ¥50 to K-co, the acquisition fee was ¥50. After the issuance of new stocks, K-co's stock price would be ¥200. When Mr. A sold the stock, A's taxable capital gain would be ¥150.

By the way, there had been corporate tax on X-co, and income tax on Mr. A when Mr. A got bonus. There would be triple taxation on the ¥150 value. It is strange. However existing law provides no relief.

(4) In the case above, there was no consideration. How about when there was consideration but it was too low?

According to the case law (**Supreme court, 1995 December 19**, 民集 vol. 49, no. 10, p. 3121), the transfer with too low consideration is samely treated as the transfer without consideration. The diferrence between the fair market value and the actual consideration is included into the transferor's revenue.

What is "too low"? It means the price less than half of the fair market value.

Oosaka high court, 1988 March 30, 高裁民集(Kôsai Minshû), vol. 31, no. 1, p. 63.

Fact: X-co was a parent company of T-co. T-co's business became red. In order to relief T-co, X-co loaned ¥20 million without interest. Y, the director of the tax office, recognized that the amount equivalent to interest, 10% of the principal amount, was the donation from X-co to T-co. (The figures in this rejume is simplified for convenience.)

Provision:

CTA § 37: When a corporation makes donations, deductible amount is limited to the half of the sum of follows;

- ●0.25% of the capital
- ●2.5% of the income of the year

For example, if X-co's capital was ¥100 million and X-co's income of the year was ¥10 million, deductible amount was ¥250,000 (=(¥100m×0.25%+¥10m×2.5%)÷2).

The part of the donation over the deductible amount was not included into expense.

Therefore, Y argued that the amount equivalent to interest, ¥2 million, was included into X-co's revenue because X-co supplied service without consideration (see, CTA § 22 (2)), and that the part of the donation over the deductible amount, ¥1.75 million, was not included into expense; therefore X-co's taxable income was increased by ¥1.75 million.

Judgement: Y's argument was partially sustained.

Y argued that the amount equivalent to interest was 10% of the principal amount. The court judged that it was 6% of the principal. However other part of Y's argument was approved by the court.

Why X-co needed to include some amount into revenue? When X-co supplied service without consideration, it was also equivalent to the situation that X-co got the proper consideration and next X-co provided the consideration in exchange for nothing.

Money provides fruits when a firm utilizes money, for example, doing business. Even if a corporation has no way of utilizing money, at least the corporation has a way of utilizing money and getting fruits: it is to deposit money in a bank and to get interest. The corporation exists for profit; therefore, in usual, there is no possibility that the corporation loans money without interest. When the corporation loans money without interest, the amount **equivalent to ordinary interest** is considered as becoming apparent and being transferred; unless there is another reason with **legitimate economic purpose**. Therefore the amount equivalent to ordinary interest will be recognized as revenue.

In this case, the court could not recognize the rational economic purpose which justified the transfer from X-co to T-co. The amount equivalent to ordinary interest was considered as donation; therefore the part over deductible amount was not included into expense.

Discussion:

(1) How to determinate the amount "equivalent to ordinary interest"?

We learn the word "**arm's length price**" and "**transfer pricing**".

Transfer pricing problems usually occurs in international transactions as follows.

R ----------car----------S ➔customer
¥200 ???? ¥200 ¥1000
¥400 wholesale price
↓¥720
Q-co

Suppose that R-co in R-country and S-co in S-country are affiliated companies. R-co produces cars and S-co sells cars in S-country's market. R-co's purchase fee of material is ¥200, R-co's other production fee is ¥400, S-co's sales fee is ¥200 and S-co's retail sales price is ¥1000. In this example, total income of R-co and S-co is ¥**200**. How much the respective income of R-co and S-co? The answer relies on the wholesale price between R-co and S-co.

If R-co also trades cars to a third party, named Q-co, which is not an affiliate company with R-co and S-co, and the wholesale price is ¥720, then, R-co's income would be ¥**120**. This price is determined between independent companies and it is called as "arm's length price". If so, the wholesale price between R-co and S-co is also ¥720?

Next, suppose that R-country's tax rate is 40% and S-country's tax rate is 20%. If the price between R-co and S-co is ¥720, R-co's income is ¥120, S-co's income is ¥80, R-co's tax amount is ¥48 and S-co's tax amount is ¥16. Total tax amount is ¥64. In this case, R-co and S-co plan to decrease the tax burden. If the price between R-co and S-co is ¥600, what happens? R-co's income is ¥**0**, S-co's income is ¥**200**, R-co's tax amount is ¥**0**, S-co's tax amount is ¥**40**, and total tax amount is ¥**40**. In the latter case, they transfer the income from R-co to S-co, and they decrease the tax burden. This problem is called as "transfer pricing", which means the price setting which causes the transfer of income.

Existing law does not allow such tax avoidance in international transactions. Special Tax Measures Act § 66-4 authorizes the dirctor of the tax office to redetermine the price for the tax purpose. Suppose that R-country is Japan. From Japanese fisc's viewpoint, the price of ¥600 is arbitrary; therefore, the price is redetermined and deemed to be "arm's length price", in this case, ¥720, and R-co's income is deemed to be ¥120.

When R-co trades with a third party, it is easy to determine the arm's length price. However, in actual, R-co rarely trades with third parties; therefore, in usual, it tends to be difficult to determine the arm's length price.

Let's go back to the case above: "equivalent to ordinary interest" between X-co and T-co.

The court mentioned the possibility of depositing money in a bank. However, "equivalent to ordinary interest" is not the interest rate of bank deposits. The court mentioned it as **minimum line**. "Equivalent to ordinary interest" is the "arm's length price" of interest.

Tax law does not looks at the possibility of R-co's income gaining, but looks at the **hypothetical situation** if X-co and T-co are not affiliated companies, i.e. their relationship is independent.

(2) Comparison of domestic and international transactions

Transfer pricing problems often occur in international transactions, because tax rates are different among countries. On the other hand, corporations in a same country usually face same tax rate (, although there are some exceptions). Does transferring income between the same country corporations have effects on their tax burden?

The answer is yes.

Suppose that X-co and T-co face same tax rate. If T-co has deficits, they can reduce their tax burden by transferring X-co's gain to T-co.

In Japan, Special Tax Measures Act § 66-4 is applied only to international transactions. (Cf. In America, similar provision in IRC § 482 is applied to both domestic and international transactions.)

However, even when there is a domestic transaction in Japan and the transaction occurs in order to transfer income arbitrary, the domestic corporation compelled to include arm's length profit into its revenue, according to CTA § 22 (2). Therefore, CTA § 22 (2) can also work as anti-transfer pricing provision in domestic transactions.

However there are some differences.

In the domestic transaction case like above, X-co is deemed to transfer its income (say, 100) to T-co; however, X-co can include some amount (say, 20) into its expense until the limit of deductible amount provided by CTA § 37. Some part of transferring income (say, 20) is successful in domestic transactions.

On the other hand, in international transactions, Special Tax Measures Act § 66-4 denies all amount of transferring of income (say, 100).

In domestice transactions, if CTA §§ 22 (2) and 37 are applied, there can be double taxation on the transferring of income over the limitation of deductible amount (say, 100 – 20 = 80). If the tax office recognizes the donation (100) from X-co to T-co, T-co is compelled to include the amount (100) into its revenue because of CTA § 22 (2), which also provides that getting a property without consideration is included into the transferee's revenue. Even if X-co's deductible amount is 20, there is double taxation on 80. In the court case above, T-co got **gain from forgiveness of debt**.

On the other hand, in international transactions, usually, when income and income tax of R-co is increased, income and income tax of S-co is correspondently reduced. Unless R-country and S-country find different "arm's length price", double taxation does not happen.

(3) "**Legitimate economic purpose**"

If there is legitimate economic purpose in loan without interest, X-co is not considered as giving donation of "ordinary interest" to T-co.

For example, Cabinet Orders of CTA, 9-4-2 provides that when a corporation loans money to its subsidiary without interest and the loan without interest has **legitimate economic purpose**, for example the loan without interest is unavoidable in order to prevent the bankruptcy of the subsidiary and is based on a rational reconstruction plan of the subsidiary, then giving profit by the loan without interest is not construed as donation.

4.2.3. The meaning of "expense"

When a corporation's asset is reduced by capital transactions, then the amount of reduction is not included into its expense.
Dividend payment is a typical example.

When a corporation's asset is reduced by profit-and-loss transactions, then the amount of reduction is included into its expense as a general rule.
However there are some special rules in CTA.

We have already learned CTA §§ 35 and 37: **bonus** payments for directors and **donation**. There are many special rules for bonus and donation. However we cannot find them all in this class.

==========

Special Tax Measures Act § 61-4: **Entertainment** expense is not deductible (unless the special requisitions are met).

Business entertainment is necessary for gaining business profit. Therefore, by nature, entertainment expense is cost for doing business and should be deductible when calculating business income. Why tax law prohibits deducting?

Prof. Kaneko explained that if entertainment expense is fully deductible, there is a possibility of increasing useless expenses or extragavance of a corporation. However, this

explanation is justified from the viewpoint of corporate governance. If a certain corporation pays extra expense, then shareholders or auditors should check the expense; and if the shareholders don't care of the extra expense, the problem is trivial from the viewpoint of corporate governance. Should tax law take care of the matter of corporate governance?

In my view, the same tax result can be justified in another way. Suppose that X-co entertains Y-co's director, Mr. Z in business talking. If the entertainment expense is not necessary for business, the expense is not worthy of being called "expense" and the expense should not be deductible. However we discuss deductibility of the entertainment expense which is truly necessary for business. I think that even if the entertainment is truly business for X-co, the entertainment is considered as consumption for Mr. Z; therefore, regardless whether the entertainment expense is deductible from X-co's income or not, Mr. Z should include the benefit from the entertainment into his taxable income because it is consumption and consumption is one factor of income. However, executing income taxation on Mr. Z's benefit from the entertainment is almost impossible because of the ability of administration. Therefore, in my view, nontaxation on Mr. Z should be compensated by taxation on X-co.

How about **bribery**?

Giving a bribe can also be considered as necessary for business. However, of course, bribe is rarely disclosed.

Special Tax Measures Act § 62 provides that if a corporation keep a secret of a certain payment, the tax amount of the corporation is added by 40% of the undisclosed amount.

4.3. Family-owned company

CTA § 2 (10): Family-owned company is a company, more than 50% of shares or stocks of which are owned by 3 or less persons. Closed company
CTA § 132: When a family-owned company's act or calculation results in the situation that corporate tax burden is unfairly reduced, the director of the tax office can calculate the company's taxable income or loss, ignoring the company's actual act or calculation.
(Income Tax Act § 157 and Inheritance Tax Act § 64 provide similar matters.)

(1) The width of denial
Family-owned company can often make arbitrary transactions with related persons in order to avoid tax burden.

If family-owned companies can reduce their tax burden, and on the other hand, non-family-owned companies (, in other words, other normal corporations) owe relatively heavier tax burden, it is unfair. Therefore CTA § 132 precludes the arbitrary tax avoidance.

However, sometimes other normal corporations also try to make transactions in order to avoid tax burden. If non-family-owned companies can reduce their tax burden, and on the other hand, family-owned companies' attempts to avoid tax burden are always absolutely denied because of CTA § 132, it is also unfair.

CTA § 132 is a general denial provision (, it means that it is not provided concretely and specificly). Therefore the width of denial by the provision is serious and difficult issue. The provision's wording, "tax burden is unfairly reduced", is the object of interpretation.

It is said that case law has two streams.

The first is that when family-owned companies make transactions which can hardly be maid by non-family-owned companies (, in other words, when family-owned companies make arbitrary transactions because related persons commonly share the interest), that act or calculation is denied by CTA § 132.

The second is that when family-owned companies make transactions which are irrational and unnatural from the viewpoint of economic rationality, that act or calculation is denied by CTA § 132.

Which stream is better? There is not a solid answer.

The width of denial by CTA § 132 is, by nature, vague. When the government finds some

arbitrary transactions for tax avoidance, the congress should make specific denial provisions as quickly as possible and tax law should give taxpayers **predictability**.

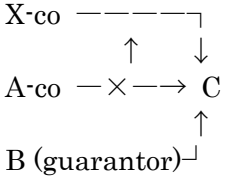
(2) The result of denial

Even if CTA § 132 is applied and a family-owned company's act or calculation is denied, recharacterization is done only for the purpose of tax and it has no effect on the characterization in private law.

(3) Example: the object of denial

Supreme court, 1977 July 12, 訟月(Shôgetsu) vol. 23, no. 8, p. 1523.

Fact: Both X-co and A-co were owned by Mr. B, therefore they were family-owned companies. A-co had a debt to a third party, named Mr. C, who was a friend of B. A-co's business became failed and X-co assumpted A-co's debt. Why X-co did debt assumption from A-co near bankruptcy? B was a guarantor of A-co's debt.



X-co ——loan——→ A-co
←——(interest)
"equivalent to ordinary interest" ¥7 million

1963 X-co ——forgiveness——→ A-co
bad debt loss ¥48 million

X-co made debt assumption from A-co, so A-co needed to pay the consideration. However, of course, A-co could not pay the consideration. Therefore X-co and A-co made a transaction, in which X-co loaned money to A-co. Naturally A-co could not pay interest for the loan. However, even if X-co got no money, X-co had to include the amount "equivalent to ordinary interest" into its revenue, according to CTA § 22 (2) (Please remember this provision). For several years, X-co included the amount "equivalent to ordinary interest" into its revenue, and the amount was about ¥7 million. In 1963, X-co forgave the loan to A-co, and X-co included ¥48 million into its expense as bad debt loss.

However, Y, the director of the tax office, applied CTA § 132. Y denied X-co's loss inclusion.

District court: X's claim is rejected.

X-co's act of assumption of A-co's debt was extremely unnatural and irrational in ordinary economic transactions. That act was possible because X-co and A-co were owned by Mr. B. Even if X-co's debt assumption was irrational, before 1963, X-co included the amount "equivalent to ordinary interest" into its revenue; therefore X-co's tax amount was not unfairly reduced.

In 1963, X-co tried to include the bad debt loss, and, if X-co's irrational act was admitted, X-co's tax amount would be unfairly reduced; therefore, at that time, "**a sequent act or calculation**" from debt assumption to bad debt loss inclusion was all denied. As a result, in 1963, X-co's bad debt loss was denied.

X-co's reason of appeal: If "a sequent act or calculation" was denied, X-co's inclusion of the amount "equivalent to ordinary interest" into it revenue before 1963 should also have been denied. X-co included ¥7 million before 1963, and if X-co's "sequent act or calculation" was denied, ¥7 million should also be included into X-co's expense in 1963.

High court: X-co's appeal was rejected.

Even if X-co included the amount "equivalent to oridinary interest" into its revenue before

1963, that is not the reason that the amount should be included into its expense in 1963.

In 1963, **forgiveness of the loan and bad debt loss inclusion** were denied according to CTA § 132. The amount "equivalent to ordinary interest" was samely not included into its expense because the right of interest was denied **correspondingly with** the right of original principal.

Discussion

(1) The object of denial

According to the logic of the district court or of the high court, the object of the denial by CTA § 132 was different.

[District court] "a sequent act or calculation" from debt assumption to bad debt loss inclusion

[High court] forgiveness of the loan and bad debt loss inclusion

Supreme court also rejected X-co's claim, however, whether supreme court adopted the logic of the district court or of the high court was not clear.

In my view, the logic of the district court is inferior to X-co's reason of appeal. If all acts are denied, X-co's inclusion of the amount "equivalent to ordinary interest" should also be denied and tax amount should be adjusted.

The logic of the high court can be superior to X-co's claim. However there is unclear point: why the right of interest was also denied correspondingly with the right of the original principal, even though the high court denied only the act in 1963?

According to the logic of the high court, X-co should not have included the amount "equivalent to ordinary interest" into its revenue even though CTA § 22 (2) called the inclusion, because X-co's act was irrational from the viewpoint of CTA § 132. However, could X-co apply CTA § 132 before 1963? The answer would be no because X-co's tax amount was not unfairly reduced and the requisition of CTA § 132 was not met before 1963. In the end, the logic of the high court also had contradiction, from my view.

(2) Taxation on A-co

In 1963, X-co's forgiveness of the loan was gain from the viewpoint of A-co; therefore A-co had to include the gain into its revenue.

If X-co's act was denied by CTA § 132, would taxation on A-co also be denied and adjusted?

The answer is no. In the legislative discussion, adjustment processes should be acted.

5. Interpretation and application of tax law

5.1.1. Interpretation

Literal interpretation is basic in interpretation of tax law.
As a general rule, expansive interpretation, analogical interpretation or purposive interpretation is not allowed. Tax law shall give people **predictability**.

"Horse can not pass over the bridge".
How about "cow"?
If "horse" means "big animals" -- expansive

Supreme court, 1997 November 11, 訟月(Shôgetsu) vol. 45, no. 2, p. 421.

http://www.geocities.co.jp/MotorCity-Rally/1906/fj.html
Excise Tax Act at that time had a list of taxable objects. One of them was "小型普通乗用四輪自動車 small type, ordinary, passenger, four-wheel automatic car". In this case, whether a certain racing car (FJ1600: see the left picture) fell into this category was issue.
The answer of the Supreme Court was yes.
In my view, it was a case of expansive interpretation. However, of course, the court, in public, did not do expansive interpretation.

==========

Borrowed concept: Tax law borrows many concepts from other law, such as civil law, commercial law, etc. The examples of borrowed concepts are "spouse", "inheritance", "dividend", etc.

As a general rule, "**borrowed concepts**" should be interpreted as in original law.

Original concept: It is concept used only in tax law and not used in other law. The example is "income".

Of course, original concept is interpreted without referring other law.

Supreme court, 1973 November 16, 民集(Minshû) vol. 27, no. 10, p. 133.

Fact and Issue: Mr. N owed debt to Mr. X. The land was transferred from N to X as mortgage (, so it is called as "**mortgage by transfer**" in civil law). "Mortgage by transfer" is transfer in legal form but is mortgage in substance. If N completely pays off the debt, N can get back the land. Real Estate Acquisition Tax was imposed on the transferee of land. It was issue whether X was subject to real estate acquisition tax. (Cf. Now, mortgage by transfer is explicitly excluded from taxable events. However, at that time, there was no provision which excluded "mortgage by transfer" from taxable events.)

Supreme court: X's claim was rejected.

Real Estate Acquisition Tax is one of transaction taxes, which is imposed on the fact of the transfer of real estate and which is not imposed on the benefit which the transferee of real estate will get from using or diposing the real estate in the future.

"Acquisition of real estate" is not related to whether the transferee gets whole contents of the ownership, and it contains all cases of acquisition of real estate with the form of ownership-transfer.

Discussion:

Acquisition or transfer of real estate is borrowed concept; therefore it is interpreted as in civil law. However, even when "mortgage by transfer" is analyzed from the viewpoint of civil law, we cannot determine whether X acquisited the land. Although, in legal form, X certainly acquisited

the land, we can also consider that X did not acquisited the land and got only the mortgage in legal substance.

Why the court said that X had acquisited the land in the application of tax law? In my guess, the court did not only look at the legal analysis whether X had acquisited the land in civil law, but also looked at the nature of the tax.

5.1.2. Tax saving / tax avoidance / tax evasion

Tax saving: It is reduction of tax burden according to the purpose of tax law. Of course, it is legal.

Tax evasion: It is reduction of tax burden by hiding the fact of meeting of the tax requisition. For example, a taxpayer rewirtes his accounting. Of course, it is illegal.

Tax avoidance: It is reduction of tax burden by avoiding the meeting of the tax requisition. In order to avoid, people use unordinary legal form of contracts, although they reach similar economic results of ordinary contracts.

Example 1: When X sells a land to Y, the built-in gain of the land accrues and X is subject to capital gain tax.

Example 2: X sets the surface right of the land with very very long time for Y and X will get rent. At the same time, Y loans money to X and will get interest. Furthermore, X's rent revenue and Y's interest revenue will be offset.

X ——surface righ——→ Y
←—loan monety——
←—rent————————
————————interest—→

If Income Tax Act § 33 provide the requisition of capital gain taxation as only "transfer" of properties, then, in example 2, there will be no capital gain taxation, because setting the surface right of the land is not "transfer" of the land in civil law. It is said as tax avoidance.

Now, ITA provides the requisition as not only "transfer" but also "setting surface right". It is said as **specific denial provision** of specific tax avoidance.

When there is specific denial provision, tax avoidance is clearly denied, of course (, or speeking accurately, taxpayers did not avoid the meeting of the tax requisition).

The problem is whether tax avoidance is legal or illegal.

The problem is whether the tax officer can deny tax avoidance or not even if there is no denial provision.

(If the tax officer denies tax avoidance, then unoridinary legal form of contracts will be recharacterized to ordinary contracts, only in the context of tax affiars, not in the context of civil law.)

It is difficult problem. As a matter of fact, the people who can do tax avoidance is usually limited to rich people who can hire excellent tax advisors or lawyers. If rich people can avoid tax burden and other people owe tax burden, it might be **unequity**. However, if the tax officer can deny tax avoidance without denial provision, people cannot have **predictability** about tax results. Such situation might be unconstitutional because of Constitution Law § 84, which provides that no taxation without law.

In Japan, the tax office cannot deny tax avoidance without denial provision. As a general rule, tax avoidance is legal.

Then, when taxpayers attempt to avoid tax burden, do taxpayers always win in tax suits? Of course, issue is not so simple.

In example 2 above, we have assumption that contracts are certainly valid in civil law. However, if the contracts are not *bona fide*, tax avoidance is not completed. In example 2, even if X and Y make clear **in contract documents** that they do not do sales contract but do surface right contract and loan contract, the court will try to explore the **real intent** of the contracting party, because, in civil law, documents are only documents, and legal rights and obligations depend on the real intent of the contracting party.

So, even though the tax officer cannot deny tax avoidance without denial provision, can the tax officer defeat the taxpayer's attempt to avoid taxation by recognizing the real intent of the contracting party?

Taxation is not so easy.

Tokyo high court, 1999 June 21, 高裁民集(Kôsai Minshû) vol. 52, p. 26.

Fact and Issue: Mr. X had land-A. D-co wanted land-A, and started the negotiation with X. X said that if D-co offered the substitutive land, X would transfer land-A. D-co bought land-E for ¥700 million from the third party, and land-E would be a substitutive land for land-A.

In contract documents, X and D-co made contracts as follows: (1) X sells land-A to D-co for ¥700 million. (2) D-co sells land-E to X for ¥400 million. (3) As reminding money for offsetting two sales contracts, D-co pays ¥300 million of cash.

X —sell land-A (¥700m)—→ D-co
←—sell land-E (¥400m)—
←offsetting cash (¥300m)—

X —land-A exchange land-E— D-co
←land-E (¥700m) cash (¥300m)—

X had had built in gain in land-A. At the time of transfer of land-A, X needed to recognize the accrual of capital gain. In calculating the capital gain, X said that the revenue was ¥700 million.

However, Y considered the contract between X and D-co as follows: (1) X exchanged land-A for D-co's land-E. (2) Land-E's value was ¥700 million, so X's revenue was ¥1 billion (=¥700 million: land-E + ¥300 million: cash).

Whether the contract was **mutual sales** or **exchange** was the issue in this case.

District court: X's claim was rejected.

Y's argument was basically admitted. The contract was exchange and X's revenue was ¥1 billion.

High court: X's appeal was approved and the original decision was reversed.

X adopted the form of mutual sales, and the court recognizes the motivation of X as reduction of capital gain taxation.

Certainly, the contract type of exchange was suitable to the substance, and was straightforward. However, there is no reason of denying the adoption of the legal form of mutual sales in order to reduce the tax burden on the capital gain.

If the real intent of the contracting parties (*i.e.*, X and D-co) was exchange and they disguise the true fact as mutual sales, then, taxation shall depend on the true agreement which was made between the contracting parties. However, in this case, there was little motivation to disguise because mutual sales would make tax burden being reduced. It is hard to consider the legal form adopted in this transaction as disguise.

Under Constitution Law § 84 (no taxation without law), the tax officer has no authorization without the ground of law to recharactrize the legal form adopted by the contracting parties into ordinary contracts and to treat the situation as meeting the tax requisition.

ITA § 59 provides **considered transfer** in some situations in order to prevent eternal **tax deferral**. However, ITA § 59 does not prevent all tax deferral, so tax law itself permits

tax deferral in other situations. In this case, X's transfer of land-A did not meet the requisition of ITA § 59; therefore tax deferral in some extent was within the plan of tax law.

6. Inheritance Tax / Gift Tax

6.1. Inheritance Tax

6.1.1. Why is there the system of inheritance?

Suppose that Mr. B is a son of Mr. A, who is a rich person, and Mr D is a son of Mr. C, who is a poor person.

From the viewpoint of **equal opportunity**, inheritance is the root of unequality. Because of inheritance, Mr. B has more opportunities to become rich than Mr. D has. This problem is called as **hierarchization** (fixedness of **economic disparity**). If we regard equal opportunity as most important, the rate of inheritance tax should be 100%, which means the prohibition of inheritance.

Even if we prohibit inheritance, it is imperfect when people can gift their son. Moreover, suppose that Mr. E has gifted his son, Mr. F, before death and Mr. G has not been able to gift his son, Mr. H, before death. Mr. H is pitty. If parents fear their death before gift, parents will gift their children as soon as parents earn something.

Should we prohibit gift too? If so, it infringes the liberty of disposition of properties. Japanese Constitutional Law § 29 provides private ownership system.

It is important to pursue simultaneously liberalism and equal opportunity. Some people say that equal opportunity is prerequisite for liberalism or laissez-faire; however there is contradiction between them. Even though inheritance is evil from the viewpoint of equal opportunity, inheritance will continue to exist as necessary evil according to liberalism.

There is also an actual and pragmatic viewpoint: if the rate of Japanese inheritance tax is extremely high than that of other countries, then there is fear of **capital flight**.

6.1.2. Motive of bequest: Why parents leave their children property?

There are three explanations.

(1) (Remainder of) **savings**: People can not predict the time of death and make savings. In usual, people tend to save more than necessity. (If pension is substantial, there will be no problem.)

(2) **Exchange**: A parent makes promise to leave the property to the person who cares the parent. If the parent gives his child property before death, the parent might be abandoned. Legacy is consideration (or exchange) for care services. (In my view, it should be seen as service income. However, normaly, imputed income by housekeeping service is not taxed.)

(3) **Altruism**: When a child feels happy, it is also happiness of his parent. The parent leaves the child property because not only the child feels happy but also the parent himself feels happy. (If we regard **maximization of utility** as most important policy, we should not discourage to make bequest, although it might be the root of fixedness of economic disparity.)

6.1.3. Bequest Tax and Bequest Acquisition Tax

Inheritance tax system has two streams.

Bequest Tax: It is tax on bequest of ancestors and it is one type of property tax. (UK, USA…)

Bequest Acquisition Tax: It is tax on increase of wealth of heirs and it is one complementation of income tax. (Germany, France …)

Japanese inheritance tax belongs to bequest acquisition tax.
However, the two systems above are only ideal types. Every country's inheritance tax actually compromises the two systems. Japanese inheritance tax also has element of bequest tax.

6.1.4. Justification of Inheritance Tax

In Japan, there are four reasons.

(1) **Complementation of income taxation**:

When a child acquisites bequest, it is his income because income is comsumption plus net increase of wealth according to comprehensive income concept. As said above, Japanese inheritance tax is one of bequest acquisition tax. (However, if Income Tax Act is applied to acquisition of bequest, tax rate might be too high and tax burden might be too heavy. ITA § 9 (1) (15) exempts bequest from income taxation. But for rich people, applying inheritance tax tends to make tax burden lighter than under income taxation. See next section.) (If you support limited income concept or comsumption type concept of income, acquisition of bequest does not constitute income. Therefore, inheritance tax needs other justification.)

(2) **Redistribution** of wealth:

For rich people, inheritance tax might be heavier than income tax. (However, the top rate of inheritance tax has recently been reduced from 70% to 50%. Now, the top rate of income tax is also 50% (national tax: 37% or 40% / local tax: 13% or 10%). Function of redistribution has been weakened.)

(3) **Clearance**:

Parents' untaxed income will be taxed at the time of death. (However, in my view, this explanation should be strongly blamed. Inheritance tax is imposed regardless whether parents' income has already been taxed or not. This explanation can not justify inheritance taxation on the bequest if the parents were salary-earners and their income was all captured by tax offices.)

(4) **Socialization** of succession of property:

Parents might have been benefited by social security. Suppose Mr. A has utilized medical services and social security has maid massive part of payment. When Mr. A dies, his bequest might be large because of social security. All of bequest should be successed to his child, Mr. B? (To think precisely, social security has two elements: insurance and aid. Insurance is one of contracts and aid is one of redistribution. The part of aid of social security benefit can be a justification for taxing bequest.)

==========

Actual situation of Japanese inheritance tax:

Tax revenue is very small. It is ¥ 1,446,456,501,000 and all national tax revenue is ¥ 45,589,012,551,000 (in year 2004). The proportion of inheritance tax revenue contributes in Japanese national tax revenue is only about **3.2**%.

How many people are subject to inheritance tax? Only **5**% cases of inheritance are subject to inheritance tax (discussed later). Suppose that 1 million persons die in one year. 950 thousands cases of inheritance are not imposed inheritance tax because the amounts of bequest are under the minimum line of inheritance taxation.

Actually, inheritance tax burden is very light for middle or low class people, although many Japanese people feel that Japanese inheritance tax is heavy.

6.1.5. Taxation system of Japanese inheritance tax

(1) Basic exemption: The amount is **¥50 million + ¥10 million×number of heirs**.

If Mr. C dies and his heirs are his wife, Mrs. D and his children, Mr. E and F, then the amount of basic exemption for inheritance tax is ¥**80** million (**50 + 10×3**).

(2) Next, in calculation of inheritance tax amount, Japanese inheritance tax system adopts some elements of bequest tax.

Even if actual pattern of sharing (or dividing) bequest among heirs can have variety, in calculation of inheritance tax, it is assumed that heirs have acquired bequest according to the default rule of civil law.

For example, Mr. C died and his heirs are D (wife), E and F (his children). In calculation of inheritance tax, it is assumed that D has acquired half of bequest, and E and F have acquired each one-fourth of bequest, even though the actual sharing of bequest among the heirs is different. (Of course, this assumption exists only for calculation of inheritance tax. This has no impact on actual sharing of bequest in the context of civil law.)

Why Japanese inheritance tax has such bothering system?

●Inheritance tax has also graduated rate, under which equall sharing of bequest leads least tax burden. Therefore taxpayers try to disguise as sharing bequest equally. Japanese tax system as above prevent such disuguise.

●Traditional family (for example, farming family) tends to leave almost all property to oldest son in order to maintain the family line or to maintain the business (such as farming). If Mr. E inherits all property of Mr. C, then tax burden will be too heavy under graduated rate system.

(Although Japanese inheritance tax system has some justifications, not small number of scholars criticizes this system, because this system is inconsitent with the nature of Japanese inheritance tax as complementation of income tax.)

(3) Tax rate (Inheritance Tax Act § 16)

¥0 - ¥10 million:	10%
¥10 million - ¥30 million:	15%
¥30 million - ¥50 million:	20%
¥50 million - ¥100 million:	30%
¥100 million - ¥300 million:	40%
Over ¥300 million:	50%
(in the past : Over 2 billion:	70%)

(4) The amount of assumed acquisition of bequest is multiplied by the inheritance tax rate.

Next, all heirs' assumed tax amount are added up.

(Each heir's tax amount) = (total tax amount of all heirs)×(each heir's actual acquisition of bequest)／(total bequest of all heirs)

Example 1: Mr. C died. All of his property is cash and it is ¥100 million. Heirs are his wife (Mrs. D) and his children (Mr. E and Mr. F). According to the legacy division conference, Mr. E (oldest son) gets ¥80 million and Mrs. D and Mr. F get ¥10 million respectively. How to calculate inheritance tax?

(1) The basic exemption amount is ¥80 million.

Therefore, total amount of taxable property is ¥20 million.

(2) Ignoring the actual legacy division conference, in calculation of inheritance tax, Mrs. D is assumed as getting 50% of bequest, and it is ¥10 million. Mr. E and Mr. F are assumed as getting 25% of bequest respectively, therefore it is ¥5 million.

(3) Omitted.

(4) Mrs. D's temporary tax amount is (¥10 million)×10% = ¥1 million.

Mr. E and F's temporary tax amount is ¥0.5 million respectively.

Next, all heirs' temporary tax amount are added up; therefore total tax amount is ¥2 million.

Mr. E's final tax amount is (¥2 million)×(¥80 million)／(¥100 million) = ¥1.6 million.

Mr. F's final tax amount is (¥2 million)×(¥10 million)／(¥100 million) = ¥0.2 million.

Caution

The actual tax rate of Mr. E and Mr. F is same and it is 2%, although their actual acquisition amounts are different.
When the amount of bequest and the number of heirs are determined, then actual tax rate is also determined, ignoring the actual legacy division conference; because total tax amount is determined at that time and tax burden is distributed proportionally with actual acquisition of bequest.

Caution
Mrs. D's tax amount is also ¥0.2 million; however, there is a special rule for spouse provided by Inheritance Tax Act § 19-2. Roughly said, when a spouse inherited half or less than half of bequest, the spouse's tax amount is ¥0. Therefore, in example 1, Mrs. D's final tax amount is ¥0.

Example 2: If Mrs. D gets 80% of bequest (*i.e.* ¥80 million) according to the actual legacy division conference, her tax amount is, not ¥1.6 million, but ¥0.6 million, because the special rule, § 19-2, deducts ¥1 million, which is the virtual tax amount as if Mrs. D gets half of bequest.

(5) Joint obligation of tax

Each heir owes joint obligation of inheritance tax until the amount of actual acquisition of bequest.

What is joint obligation? If Mr. E cannot pay tax, then the tax office can require Mr. F not only to pay ¥0.2 million but also to pay Mr. E's tax amount (i.e. ¥1.6 million).
Example 3: If, according to the legacy division conference, Mr. F's share of bequest is ¥1 million (Mr. E: ¥80 million / Mrs. D: ¥19 million), then Mr. F's final tax amount is ¥20 thousand. When Mr. E cannot pay the tax, the tax office can require Mr. F to pay Mr. E's tax but the amount of requirement is limited to ¥1 million although Mr. E's tax amount is ¥1.6 million, because Mr. F's actual acquisition of bequest is ¥1 million.

(6) Relaxation of tax burden for residence

Example 4: Mr. C's legacy is not cash but a house (residence) and its value is ¥100 million. Before Mr. C's death, Mrs. D has lived with C in the house, and after his death, D will continued to live in the house.

Special Tax Measures Act § 69-4 provides special relaxation rule of inheritance tax burden for small residence. Roughly to say, "small" means residential land "equall to or smaller than 240m²". (From my feeling, it might not be so "small".)

When this special measure is applied, the valuation in tax calculation will be reduced to 20%. Therefore, in example 4, Mr. C's legacy is considered to be ¥20 million in the context of inheritance tax. This amount is under the basic exemption of inheritance tax; therefore, there is no inheritance taxation. (The detail of this relaxation rule is too complicated, so we cannot learn the whole system in this class.)

Naturally, main part of Japanese people's bequest is constituted by residence and it is valued low in the context of inheritance tax. The basic exemption is high (, at minimum, ¥60 million). Therefore, in many cases of inheritance (95% cases of inheritance), inheritance tax does not occur. (Comparing with other developed countries, the figure of "5% cases of inheritance" is still high. In European or American countries, it is said that the figure of taxed inheritance is only 2 – 3%.)

6.1.6. Deduction of liabilities

Bequest can be constituted not only by positive property but also negative property, i.e. debt liability.
Inheritance Tax Act § 13: The amount of liabilities of the ancestor is deducted from the taxable amount of bequest.

Inheritance Tax Act § 14: Deductible liabilities are limited to those which are recognized as "certain".

Tokyo high court, 1980 September 18, 行集(Gyôshû), vol. 2, no. 9, p. 1902.
Fact and Issue: Mr. A died. Mr. A had had share of S-co, which was a limited company (有限会社 Yûgen-Kaisha). S-co had some employees and in the future S-co must make retirement payment to employees.
In valuing the taxable amount of A's bequest, especially the taxable amount of A's share, it was issue whether the future retirement payment was deducted or not.
Judgement: It was not the liabilities which are recognized as certain.

Caution
If S-co clearly made the accounting item of allowance for retirement payment, then the amount would be deducted in valuing A's share of S-co without doubt. In this case, inadequacy of S-co's accounting leaded unhappy tax result.

Discussion
(1) If Mr. A did personal business, the future retirement payment would clearly not be deducted because the liabilities were not certain at the time of inheritance.
(2) If S-co was stock company (株式会社 Kabushiki-Kaisha) and the stock is listed on the market, the future retirement payment would have effects on the value of A's stock; because, in the market, all matters are reflected to the stock value.
(3) In this case, the share of S-co was not listed. The position of this case was between case (1) and case (2).

Although the liabilities have not been certain at the time of inheritance, if the liabilities are actually payed in the future, then the property of heirs will be naturally reduced. At the time of actual payment, can heirs make reclamation of inheritance tax?
Unfortunately they cannot. The ex-post adjustment system of inheritance tax is not provided. (In my view, it is regrettable *de le ge ferenda* (in legislative discussions).)

6.2. Gift Tax

Not only bequest but also gift from individuals is exempt by Income Tax Act § 9 (1) (15); the latter is subject to gift tax provided by Inheritance Tax Act §§ 21 to 21-18.

(1) Inheritance → Inheritance tax
(2) Gift from an individual to an individual → Gift tax
(3) Gift from a corporation to an individual → Income tax (temporary income)
(4) Gift from an individual to a corporation → Corporate tax

The problem of gift tax is that the rate is too high.
(Basic exemption per one year: ¥1.1 million)

¥0 - ¥2 million:	10%
¥2 million - ¥3 million	15%
¥3 million - ¥4 million	20%
¥4 million - ¥6 million	30%
¥6 million - ¥10 million	40%
Over ¥10 million	50%

Example 1: Gift of ¥100 million at once.
Example 2: Gift of ¥10 million annually and it continues ten years.

Example 1

Basic exemption: ¥1.1 million → Taxable amount is ¥98.9 million

$2\times10\%+(3-2)\times15\%+(4-3)\times20\%+(6-4)\times30\%+(10-6)\times40\%+(98.9-10)\times50\%$

$=0.2+0.15+0.2+0.6+1.6+44.45$ ＝¥47.2 million

Example 2

Basic exemption: ¥1.1million → Annual taxable amount is ¥8.9 million.

$2\times10\%+(3-2)\times15\%+(4-3)\times20\%+(6-4)\times30\%+(8.9-6)\times40\%$

$=0.2+0.15+0.2+0.6+1.16$ ＝¥2.31 million

It is multiplied by 10. → Total tax amount is ¥23.1 million.
(In this calculation, we ignore present discounted value.)

==========

Recently, special rule has been legislated: **Clearing system of gift and inheritance tax**.

As we learned above, gift tax burden tends to be heavy and inheritance tax burden tends to be light.

Therefore many people have long said that Japanese gift tax system almost prohibits gift. Gift tax prevents intergenerational transfer of property. For example, when a son wants to buy a new house, the son might want aid from his parents; however, if the parents make gift to the son, gift tax burden will be heavy.

↓

If a taxpayer elects this new special tax system, the amount of gift is added with the amount of inheritance and the rate of inheritance tax will be applied.

The requirements of this new system are too complicated, so in this class we cannot learn this system in detail.

目次