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Introduction

Amid the aging of the population and declining birthrate and the rapid advances in globalization, promoting structural reform is an urgent task for achieving an invigoration of the Japanese economy and society. It is also necessary to rebuild the tax system so that it will fit the new society of the 21st century. Based on these issues, the Tax Commission published “Policy Guidance on the Establishment of a Desirable Tax System” (“Policy Guidance”) in June of last year, which presented an overall picture of the desirable form of the Japanese tax system in order to achieve a sustainable invigoration of the Japanese economy and society from a medium to long-term perspective. Based on this overall picture, the FY2003 tax reform achieved the reform of a wide range of tax items such as abolition of the “special allowance for spouse” (exceeding the amount of the “allowance for spouse”) as the first step toward simplifying and streamlining personal deductions, enhancement of R&D tax credit and investment incentives, reform aimed at raising the reliability and transparency of the Consumption Tax, introduction of measures to integrate inheritance and gift taxes, introduction of taxation on corporations by the size of their businesses, and review of taxation on financial assets and securities and on land.

In January of this year, the commission received instructions from Prime Minister Koizumi to further enhance considerations regarding issues such as building a tax system that supports the aging of the society from among the ideas presented in “Policy Guidance,” based on the results of the FY2003 tax reform.

Japan is in a phase of major transformation of its social and economic structure, such as the fact that the population will soon start to decrease in line with the aging of the society and declining birthrate. In order to restore the confidence of the people of Japan, who will shape its bright development in the 21st century, it is necessary to promote structural reform in a wide range of fields and build a vigorous private sector along with an efficient and sustainable public sector that supports it. Meanwhile, due to the increasing importance of the stock economy in line with the aging and maturing of the Japanese economy and society, the efficient use of assets such as financial assets is important for maintaining the vigor of the economy and society.

On the other hand, regarding public finances, only about half of Japan’s annual expenditure is covered by tax revenue. Japan’s finances are in a state of crisis, with the national and local governments being liable for large amounts of outstanding long-term government bonds. It is of vital importance to achieve a primary balance at the earliest possible time in the 2010s with the aim of securing sustainable finances. To this end, it is necessary to make efforts to steadily improve the fiscal balance. Pension, healthcare and nursing payments are expected to increase in line with the progress of the aging of the society in the future, and an increase in the burden on the people is unavoidable. In order to gain the people’s understanding about future increases in burden, aiming to improve the efficiency of the public sector by full-fledged administrative and fiscal reform carried out by the national and local governments is a major prerequisite.

Furthermore, as an important pillar of Japan’s structural reform, it is necessary to strive to strengthen local governments’ rights to self-determination and self-responsibility, and to promote decentralization.

The tax system must also be reformed in a manner consistent with such structural reforms. Based on such awareness and in accordance with the instructions of the prime minister, the Tax Commission proceeded with deliberations that focused on issues such as “the aging population and declining birthrate and the tax system,” “decentralization and the tax system,” and “financial and securities taxation.” In the course of the deliberations, the commission sent missions to study related trends in North America and the Nordic countries from late April to early May.

This report further expands on the contents of “Policy Guidance,” and makes proposals regarding a desirable tax system for Japan from both the medium and long-term perspectives. It is hoped that, based on these proposals, constructive discussions will take place among the public toward the rebuilding of the tax system in the future.
I. Aging Population and Declining Birthrate and the Tax System

1. Tax system that supports the aging society with declining birthrate

As the population ages and the birthrate declines, Japan will become a super-aging society with a declining population. Japan has experienced population aging at a rapid rate due to lifespans becoming longer and the birthrate declining, something that has not been experienced in any other advanced country. This trend will continue in the future, and by 2015 when the “baby-boomers” join the older generations, one in four people will be an elderly person. Furthermore, the population is expected to decline after reaching a peak in 2006.

The drastic changes in the population structure will have an enormous impact not only on family structure, but also on Japan’s economy and society. The declining labor force due to the declining birthrate and aging of the population and the lower savings rate may cause a drop in economic growth rate and an increase in the social security burden on working generations. Such concerns about the future echo some pessimistic views on the future of the aging society with declining population. However, by implementing structural reforms in various areas, it is still possible to build a rich society in terms of per-capita wealth even if the economy contracts in line with the population decrease.

Many issues remain to be resolved, including: improvement of productivity through technological innovation, promotion of women and elderly people’s participation in the society, and establishment of sustainable social security systems. It is important to redesign various systems to adapt to the aging of the society and declining birthrate. The tax system also needs to be reformed based on the following three viewpoints.

(1) Tax system that inspires confidence for the future

As the population ages, increases in public services such as social security are inevitable. As both national and local finances are in states of crisis, the people have a sense of uncertainty regarding increases in tax or social security burdens in the future. Consequently, various systems that by nature are supposed to inspire confidence among the people are creating more insecurity and sapping economic vitality. The social security system is an essential safety-net for supporting the aging of the society and declining birthrate. It is necessary to establish a sustainable social security system and financial structure for the future in order to dispel such concerns. For that purpose, carrying out drastic reform of expenditures including social security is necessary. In addition, the establishment of an expenditure structure is also required in order to support the stable provision of necessary public services, with due consideration given to establishing a tax system that maintains a balance among income, consumption, assets, and so forth.

(2) Tax system in which all generations participate

It is necessary to improve tax fairness in order to gain the confidence of the people for future increases in burden.

In recent years, some elderly people have been actively involved in social activities and are not any worse off than the working generations. On the other hand, there are people who are in poor health and have weakened economic strength. This indicates the diverse nature of the aging of the society. In the future aging society with declining birthrate, based on the diversity of the elderly, it will be necessary to alter the system by which elderly people are all treated favorably in a fixed uniform manner based solely on their age. Meanwhile, the working generations are facing difficulties including job insecurity and lower salaries caused by the drastic change in the economic environment following the end of the period of ever-increasing economic growth.
The ratio of the elderly population to the working generations will drop rapidly from 1:3.6 (2000) to 1:1.9 (2025). Under such circumstances, excess burden on the working generations will take away their motivation to exercise their social responsibilities as long as the current structure is maintained. The working generations will not be able to expect large increases in salaries, but they will still be responsible for bearing the burden of public services costs, and such costs are projected to increase rapidly in the future.

The distortion that places priority on the elderly based solely on age needs to be revised in terms of the tax system, while paying adequate attention to the low-income bracket; and it will be important to distribute the burden fairly according to ability and irrespective of age. Doing so will enhance inter-generational fairness as well as the fairness within the older generations.

(3) Tax System that brings out the vitality of individuals and corporations

In order to invigorate Japan’s aging and maturing economy and society, it is necessary to establish a society where individuals and corporations are able to reach their full potential. An important task in that goal is to formulate systems to encourage the participation of vigorous and energetic elderly persons and women so as to establish a lifelong working society with equal opportunities for both men and women. Furthermore, improvement in productivity is a key element for generating economic wealth in a society with a smaller population. Corporations, which play a central role in productivity, need to develop environments where they can cope flexibly with foreseeable structural changes such as globalization. The tax system must be reviewed in a simple, neutral and clear way so that it does not hinder individual employment or corporate choice, in order to bring out the vitality of individuals and corporations. Further structural reforms must also be promoted and necessary measures must be taken in order to invigorate the economy and society in the future.

Based on the above views, the basic concept of tax reform is to recover the fundamental tax functions of individual income tax and increase the role of consumption tax, as stated in “Policy Guidance,” which was published in June of last year with a view to the establishment of a desirable tax system to support the coming era of aging of the society and declining birthrate. Such reform involves an increase in public burden. In order to gain the confidence of the people for this increased burden, reform of expenditures and administration must be carried out; and at the same time, it is important to make efforts to correct distortion and unfairness within the tax system, in particular. The following is a list of the issues pertaining to individual tax items based on the basic concepts mentioned earlier.
2. Reform of Individual Tax Items

1. Individual income tax

(1) Basic concept of individual income tax in the aging society with declining birthrate

The ratio of individual income tax burden to national income in Japan has remained at a very low level (6.1% in FY2003) compared to the double-digit levels of other advanced countries. Looking at the tax rate structure, in particular, the majority of taxpayers belong to the lowest tax-rate bracket, which is a unique situation among the advanced countries. This is mainly a result of repeated tax cuts such as personal exemption expansions, tax rate cuts and tax bracket enlargements. This commission has already pointed out in “Policy Guidance” that the fixed-rate deduction must be abolished and reforms of various exemptions and tax rate structures must be carried out with due consideration given to the economic situation. Based on such a concept, it is necessary to make efforts to restore the functions of the tax as a ‘main tax', such as revenue raising and income redistribution. Establishing the desirable individual income tax structure for the future from this perspective inevitably involves an increase in public burden, and reforms must be carried out while assessing the changing economic situation.

It is necessary, in the course of reform, to respond flexibly to the structural changes in the economy and society in recent years, to correct various tax distortions and unfairness, and to establish a burden structure that does not interfere with individual choice in economic and social activities. This effort does not simply mean to discuss tax increase issues or revenue source issues for pension reform. Instead, the importance of the discussion lies in what sort of burden structure should be sought as the desirable form of individual income tax in the aging society with declining birthrate.

One of the factors causing tax distortion in individual income tax is that there are so many special exemptions or tax-free measures that are applied only to specific incomes such as public pension deductions. As a result, much income is excluded from the tax base, which creates an imbalance of burden with other incomes, brings about a sense of unfairness among taxpayers, and in the end, erects a barrier to free economic and social activities.

For instance, public pension deductions are applied unanimously to all pensions received by elderly people regardless of whether they have other revenue sources, which in turn leads to higher-income elderly people being exempted from the tax base. Burden imbalance is generated not only between different generations but also within the elderly group itself. Furthermore, as forms of employment have become diversified, a dissociation of the tax system from the changes in the economy and society has emerged in respect of deductions for employment income and deductions for retirement income.

The desirable structure of burden sharing for individual income tax in the future is to allocate the burden broadly and fairly. It is desirable to include as many income source factors as possible in the taxation base; hence, consideration should be given to individual cases in a collective manner in the form of personal deductions such as the basic allowance or allowance for dependents.

In the course of establishing such a burden structure, inter-generational fairness must be secured so as not to place heavier burdens on the working generations, and at the same time, it is important to establish systems that are neutral to individual choice in economic and social activities. Also, as the birthrate falls further, it is important to give consideration to supporting children, who will play a central role in the next generation, in consideration of the relation to
social security systems.

The “special allowance for spouse” (exceeding the amount of the “allowance for spouse”) was abolished in the FY2003 tax reform. Its abolishment enlarged the tax base and was intended to achieve neutrality in terms of employment of spouses. It is therefore fair to say that the revision is regarded as the first step toward tax reform that is in line with structural changes in the economy and society.

(2) Revision of taxation on pensions, etc.

Taxation on pensions in Japan is structured in such a way that tax allowances are given for social health insurance premiums on the one hand, and benefits are also practically non-taxable due to the application of public pension deductions and various personal exemptions on the other. The following issues exist regarding pension taxation structure.

- As the population ages and the birthrate falls in the future, both social insurance premiums and pension benefits are expected to grow. If they are omitted from the tax base, individual income tax will increasingly lose its function as a fundamental tax.

- From the viewpoint of pension taxation compliance, the current tax system lacks consistency because benefits are practically non-taxable while premiums have remained non-taxable.

Regardless of the diversified economic conditions of the elderly, higher-income elderly people still receive favorable treatments compared to the working generations, which creates unfairness not only among the elderly group itself but also between generations.

In order to deal with the problems outlined above, it is necessary to revise the pension taxation system with consideration given to the following points.

(i) It is necessary to advance the reform in the direction of enhancing the vitality of working generations in the aging society with declining birthrate. Taxation on pensions needs to be revised so that preferential treatment to benefits is made more appropriate while necessary consideration is given to low-income groups that depend solely on pensions. Revenues from public pensions will be included in the taxation base so that higher-income elderly people can be asked to share the burden in accordance with their ability in the same way as the working generations. This will contribute to fairness not only among the elderly but also between generations.

(ii) Deductions for public pensions were implemented at the time of the FY1987 tax reform in order to reform the system and adjust the burden between different types of income. Before the FY1987 tax reform, employment income deductions had been applied to pension benefits because they were regarded as employment income. However, as far as considerations for the tax-paying ability of the elderly are concerned, the functions and intentions of the public pension deduction overlaps with those of deductions for the elderly. Moreover, it is applicable to everyone over 65 years of age irrespective of income level, as measures for the elderly. This has led to a system that “gives special treatment to the elderly merely because of their age.” More people receive pension benefits and at the same time earn incomes as employees as the number of elderly people in the labor force increases. The deduction for employment income and the deduction for public pension are applied to the elderly, which results in the erosion of the tax base. It is necessary to correct such factors to establish an appropriate tax system in accordance with true tax-bearing ability.
(iii) Voluntary contributions from those who engage in self-help efforts are subject to social insurance premium deductions in addition to the mandatory contributions. The expected increase in social insurance premiums poses a concern over the erosion of the taxable personal income base. A desirable system for future deductions for social insurance premiums needs to be designed and the scale of deductions must be discussed in relation to the pension scheme as a whole. In such a case, some limits should be placed on public pension insurance premium deductions in the future. As for private pensions such as corporate pensions, fundamental reform should be carried out so as to establish a solid framework for applying a tax deduction at the time of making contributions (payment of premiums) and taxing at the time of receiving benefits. In this way, an adequate tax system for private pensions will be established.

(iv) The revision of deductions and taxation treatment on social security benefits should be considered so as to expand the tax base, while giving consideration to the systems of other countries as examples. Contributions for the bereaved and unemployment benefits are nontaxable benefits that are provided regardless of recipients' other income sources or assets. This system must be reconsidered in the future. In such a case, consideration in the form of personal deductions and others should be given to the tax capacity of low-income groups.

In terms of reform of the current pension system, there are issues as to whether the portion funded from tax revenues should be increased, and, if so, with what revenue sources the increase should be funded. As far as state contributions are concerned, a thorough examination of the pension system including the level of benefits should be conducted. Consideration should also be given in relation to the role of funding from tax revenue of the pension system in the future. In doing so, it is necessary to pay adequate attention to the fiscal condition, which is currently heavily dependent on public debt.

(3) Revision of taxation on salaries

(i) It should be clarified that taxation on salaries is regarded as standard deduction for accrued employment expenses. In addition, the scope for itemized deductions (deduction for specified items of expenditure) must be examined so that opportunities are given to salaried workers to deduct expenditure in real terms through a final tax return. Taking such a direction will enable salaried workers to achieve self-accountability for tax-deductible expenses and will help them to establish a more self-reliant status socially. To that effect, it is necessary to raise the level of personal exemptions including the basic exemption in order to adjust the burden level.

Also, some salary earners perceive a persistent sense of unfairness in terms of tax monitoring of income compared to self-employed earners. In order to realize an appropriate taxation system, further efforts are required in the area of tax administration.

(ii) In line with advances in employment mobilization, it becomes necessary for deductions for retirement income to be neutral to various employment choices. The progressive taxation structure of individual income tax has become more relaxed than before and corporate pensions have spread widely in recent years. Based on these facts, excessively favorable treatment must be reconsidered. In addition to that, neutrality of taxation must be attained in salaries, retirement lump sum grants and pensions.

(4) Review of the basic structure of personal deductions

(i) In the aging society with declining birthrate, it is necessary to build a society where public burdens such as social security are shared broadly and fairly by as many people as possible and where everyone regardless of age or gender that has the ability and enthusiasm to work is able
to participate in economic and social activities. From these viewpoints, it is necessary to construct a neutral framework for personal deductions so as to provide employment opportunities for all family members.

(ii) The structure of personal deductions has conventionally been discussed in view of burden adjustment taking households as a unit with due consideration to minimum taxation on a standard household (a working husband and a wife with two dependent children). However, based on the growing diversification of family structures, it is now necessary to place individuals (rather than families), at the center of discussion.

As for the considerations for spouses, it is not appropriate to give favorable treatment to single income households because all households have burdens in terms of housework or child rearing and the number of double income households is expected to increase in the future. As for considerations of support for dependent members of families, considering the importance of child rearing in the aging society with declining birthrate, personal exemptions for child support should be focused on children; they are the ones that are going to be the central players in the coming era and the society needs to support these children. In that case, discussions will be made on the issue of making the deduction framework a tax credit system instead of an exemption from income. These issues need to be addressed and deliberated in line with examples from other nations as well as in relation to social security systems.

(5) Individual inhabitants tax

One of the characteristics of individual inhabitants tax is to distribute the burden of expenditure of the local community broadly among inhabitants according to their ability to shoulder such a burden. At the same time, the correspondence of tax to burden is clearly discernable since it is a burden of expenses for personal services such as welfare services that are provided by local governments in the context of the declining birthrate and aging population. From the perspective of tax revenues, revenue sources are distributed quite evenly and revenues are stable. Based on these characteristics, it is necessary to enhance and secure this tax as a ‘main tax’ within the local tax system.

(i) Taxation on income basis

As far as taxation of inhabitants tax on an income basis is concerned, streamlining of various exemptions and non-taxable income treatments are necessary in consideration of the unique characteristics of local tax.

(ii) Taxation on per capita basis

The tax rate for per capita tax of inhabitants remains at a low level. It is necessary to raise the level including abolition of different tax brackets in accordance with population sizes. Non-taxable treatment for spouses sharing the same livelihood needs to be abolished from the viewpoint of tax fairness.
2. Consumption tax

(1) Importance of consumption tax in the aging society with declining birthrate

Consumption tax has played an important role since its introduction in terms of sharing the burden of the cost of public services such as social security broadly and fairly among all generations. At the same time, its tax sources have been stable and account for about 20 percent of the national tax revenues. Consumption tax has become well accepted by the people as one of the fundamental taxes in the Japanese tax system.

As society ages and the birthrate declines, consumption tax becomes extremely important in order to distinguish the people’s concerns for the future. This is because the establishment of a revenue structure is essential to ensure the stable provision of public services including social security. Therefore, based on drastic reforms of overall expenditure and conditional on gaining the confidence of the public, it may be necessary to raise the tax to double digits in the future. This will be the basis for the revision of the future tax system as a whole. In connection to that, as far as the issue of the regressiveness (to income) of consumption tax is concerned, deliberations must not be conducted on consumption tax alone; rather, judgment must be made on the overall tax system as well as on overall fiscal measures including benefits under social security systems and others.

The reliability and transparency of the consumption tax must be improved in view of the importance of this tax in the aging society with declining birthrate. From that perspective, full-fledged reforms have just been carried out in the FY2003 tax reform including special measures for small and medium-sized enterprises (SME).

(2) Issues to be considered in the future

The reliability and transparency of the consumption tax have improved overwhelmingly. However, further consideration is needed on the following issues as deliberations are conducted on raising the consumption tax in the future.

(i) Tax rate structure

A uniform consumption tax rate is the most desirable structure in view of the simplicity of the system as well as in terms of ensuring neutrality to economic activities. However, when the level of consumption tax is raised as high as European countries in the future, adoption of lower tax rates on foods and others will need to be considered.

(ii) Tax credit for inputs

In order to file for tax credit for consumption tax on purchases under the current consumption tax system, taxpayers are required to keep an account book in which they themselves record taxable purchase entries and to keep documents such as debit notes issued by trading partners to verify the trade. (Method under which keeping of accounting books and of related commercial invoices are required.) This ‘book keeping’ method does not cause much trouble under the uniform tax rate system when filing for tax credit for consumption tax on purchases, but when more than one rate is adopted in the future, an “invoice method” will need to be introduced to facilitate smooth and appropriate enforcement. Under the “invoice method,” tax credit for purchases from exempt businesses would be disallowed and vendors would be required to keep invoices that clearly state the amount of tax on inputs.

(iii) Use of the consumption tax

The consumption tax is a fundamental tax item that plays an important role in Japan's finances.
The intention to use consumption tax revenues (excluding grants to local governments) for basic pension and health and medical care for the elderly has been stipulated in the general annual budget provisions since FY1999. This is what is known as “consumption tax intended for welfare.” When the tax rate is raised, it will be necessary to explain clearly about the costs involved and the relations with social security burden, in order to gain the confidence of the public.

(iv) Local consumption tax

Promotion of decentralization and improvement of local welfare was the aim of establishing the local consumption tax. Because adjustment is carried out among local governments based on consumption related standards, distribution tends to be relatively even, and therefore, it has been firmly established as one of the stable and fundamental taxes; local consumption tax plays an important role in that sense. As society ages and the birthrate declines, it is necessary to improve and secure local consumption tax as a key pillar for covering the various administrative costs of welfare, education and others.

3. Corporation tax

(1) Basic concept of corporation tax in a society with a declining birthrate and aging population

In order to maintain economic and social vigor in a society with a declining birthrate and aging population and amid economic globalization, it is necessary for corporations to enhance their competitiveness and reform their industrial structures through their own innovation and ingenuity. It is also important to nurture various forms of businesses and investing activities. The basic concept of corporation tax in the future, in line with this concept, must comply with international standards and be neutral and without bias against certain businesses. At the same time, structural reforms must continue and necessary measures must be taken in order to invigorate the economy and society.

At the time of the FY2003 tax reform, the corporate sector on the whole had a financial surplus with excess capacity and liabilities. Under such circumstances, concentrated and focused tax measures were taken, which would directly improve research and development capacity and IT investment—essential factors for the creation of new industries and technologies in Japan in the 21st century. Furthermore, the tax system for SMEs was revised to strengthen the management base of vibrant SMEs.

(2) Direction of future measures

(i) As stated in “Policy Guidance,” the issue of reducing corporation tax rates must be examined based on several factors, including: the economic environment, relations with tax burden level and the desirable concept of the whole tax system of Japan, and tax rate balance with other advanced countries.

(ii) Along with the globalization of economic activities and liberalization of financial systems, various forms of businesses and investing activities have emerged domestically as well as internationally. Such forms are expected to bring about flexible and active business and investing activities by individuals and corporations, and be a source of new vitality in the future. Meanwhile, tax avoidance actions using taxation differences among countries have come to light as corporate activities become increasingly complex and diversified. Accordingly, it is necessary to consider the desirable form of an adequate tax system to smoothly promote various forms of business and investing activities.

(iii) It is expected that private and non-profit activities by non-profit organizations (NPO), etc. will increase in the future as the society ages. The role of NPOs will become increasingly important as a substitute for public administration in coping with diverse public needs effectively and flexibly. It is therefore necessary to consider the desirable form of an adequate tax system including the donation tax system so that private and non-profit activities will be
carried out smoothly, while securing transparency.

(iv) Tax on corporations operating in the public interest should be discussed after the conclusion of the considerations on reform of corporations operating in the public interest that are currently taking place. With appropriate disclosure of information, it is necessary to ensure adequate taxation as well as to encourage corporations operating in the public interest to carry out smooth operations.

(v) Taxation of corporations by the size of their businesses was introduced for enterprise tax (local tax) at the time of the FY2003 tax reform and will be effective as of FY2004. This system is designed for corporations with capital stocks of over one hundred million yen. The proportion of such tax to be based on business size is set at one quarter. It is necessary to make efforts to publicize this scheme to the corporations that will be the taxpayers etc.

4. Inheritance tax and gift tax

(1) Basic concept and integration of inheritance tax and gift tax, etc.

Inheritance tax has a unique and non-substitutable function of asset redistribution by focusing attention on asset transfer between generations at the time of inheritance.

Looking at the environment surrounding inheritance taxation, it is clear that a new approach is now needed to cope with the structural changes in the economy and society such as the advancement of a stock-based economy and the substantial postponement of asset transfer to younger generations due to longer lifespans.

With this situation in mind, inheritance and gift taxes were integrated in the FY2003 tax reform through the introduction of a simple mechanism for adjusting gift tax at the time of inheritance. In addition, the tax rate structure was revised, including reduction of the top rate of inheritance tax, in order to correct the disparities with the top rate of individual income tax and with other countries.

(2) Issues to be considered in the future

The burden of inheritance tax has been reduced considerably through repeated tax cuts and expansions of various exceptional tax treatments; however, the expansion of the tax base necessary to bring more balance in terms of tax burden has never been implemented.

The progressive structure of individual income tax has been becoming flatter, and the possibility exists of raising the consumption tax. Taking these factors into consideration, the redistribution function of inheritance tax at the time of asset transfer becomes even more important.

Moreover, looking at the environment surrounding elderly people, social security benefits have improved, which involves burden on the working generations. Elderly people are now looked after more by the society in general than by individuals and families. Because of the social responsibility of care for the elderly, it is likely that more burden will be required on individual assets remaining at the time of inheritance.

Bearing these points in mind, it is necessary in a society with a declining birthrate and aging population to continue to make efforts to expand the tax base aiming at requiring a more appropriate inheritance tax burden and collection from a broader tax base than before.

5. Excise taxes

Various existing excise taxes (tax on the consumption of specific goods and service items) were abolished and simplified when the consumption tax was introduced. However, considering the diversification of lifestyle and changes in social conditions like the development of the service sector in
the economy, it is necessary to examine new taxation possibilities including utilization of the taxation autonomy of local governments.
II. Decentralization and the Tax System

1. Basic concept

The basic concept of local taxes is that local residents make contributions commensurate with their abilities and benefits to cover local administrative service costs. Therefore, it is desirable that local taxes have the benefit principle and are shared broadly and lightly by residents. Furthermore, local taxes should contain less uneven distribution of resources and provide stable revenues. Looking at the current local tax situation, local government expenditures account for about 63% of net national and local government expenditures, while local taxes make up about 42% of total tax revenues. There is thus a wide disparity between local expenditures and tax revenues.

In such circumstances, Japan, faced with a declining birthrate and aging population, is now required to promote decentralization as a major pillar of its structural reform in order to establish more autonomous relations between the national and local governments and develop vigorous and unique local communities. In order to increase the autonomy of local communities, local administration and finance should become more efficient through such measures as the promotion of municipal mergers and the elimination or reduction of national government intervention in local government expenditures. For this purpose, local governments should promote information disclosure. Likewise, the local revenue infrastructure including local taxes and other independent financial resources should be developed to enable local governments to become more conscious of the relationship between benefits and payments, and provide administrative services that meet local needs, based on their own responsibility and decisions.

2. Direction of future measures

As for the 'trinity' reform package (Three part reform package), we should review the burden-sharing relationship between the national and local governments, consider the consolidation and rationalization of state subsidies and contributions to local governments and the financial resources-guaranteeing function of the local allocation tax, and thoroughly reform the allocation of tax revenue sources to the national and local governments including through the transfer of national tax resources to local governments. In this respect, consideration should be given to national and local financial conditions and the impact of any changes on individual local governments.

On the other hand, the expansion of the local autonomy of taxation under the Comprehensive Decentralization Law (2000) has prompted local governments to positively take advantage of taxes not stipulated in the Local Tax Law without applying excessive taxation. Since major tax sources have already been stipulated as national or local taxes in law, limitations exist on the expansion of local tax sources through the utilization of the taxation autonomy within the present framework.

The utilization of the autonomy of taxation could lead to clarification of the relation between benefits and burdens in local communities. Therefore, we should consider allowing local governments to more easily take advantage of taxation autonomy. It is desirable that local governments will give full consideration to fairness, neutrality and other tax principles in utilizing taxation autonomy and base the utilization on their own responsibility and costs while engaging in direct discussion/consultation with residents in their community.
III. Other Issues

(1) Financial and securities taxation

Regarding taxation on income from financial assets, tax incentives have been reformed for savings and tax on capital gains from stocks in response to a policy-oriented request for “a shift from deposits to investment.” Under the FY2003 tax reform, the same tax rate as the 20% tax on interest income was introduced in principle on dividends and capital gains on listed equity shares, and on dividends on publicly subscribed stock investment trusts. For the first five years, the tax rate is tentatively eased to 10% while traditional tax incentives are consolidated. Furthermore, the reform has given consideration to the investors’ convenience by waiving the requirement of self-assessment tax reporting. Based on the reform, we should continue considering the development of a tax system that will be stable over the medium and long term, from a broad perspective. We should also review the deduction of life and nonlife insurance premiums from taxable income, the asset-building savings system and other remaining incentives for savings in consideration of the request for fair tax burdens on these and other various savings instruments.

Financial products have become diversified amid the progress of information and economic globalization and improvements of financial technology in recent years. Various developments have also allowed financial market participants to change income categories through manipulation of trading patterns and manipulate points of income accrual in order to more easily avoid taxation. While raising funds from the capital markets has grown more important, investment patterns have become diversified through the creation of various business entities and funds. In the intensifying international tax competition, the necessity to give considerations to overseas tax systems and international capital transactions has emerged.

While taking comprehensive taxation on financial assets and other incomes as its base in principle, Japan has introduced separate taxation on various financial incomes and different taxation methods for individual income due to problems involving income characteristics, income accrual patterns and income-trapping systems. For the desirable tax system in the future, however, efforts should be made to integrate financial asset incomes as much as possible for taxation, while considering a tax system that is simple, fair and stable and that secures neutrality to a whole range of financial products.

Regarding such a direction, theoretical and practical considerations should be given from various perspectives to a wide range of issues from the scope of financial asset incomes to tax rates and the adjustment of profits and losses. At the same time, we should take into account securing neutrality to savings, investment and business activities, the expansion of tax bases, the impact on redistribution of income, the convenience for taxpayers, appropriate domestic and international tax enforcement, and other matters. In this respect, we may have to develop a tax payment environment including a taxpayer identification number system. New tax arrangements such as dual income taxation have been evident in other countries, while practical tax measures have been implemented to secure taxation balance between financial asset incomes and earnings from work and curtail tax avoidance. In attempting to integrate financial asset incomes, full consideration should be given to these overseas practices.

(2) Development of Tax Payment Environment

The development of a tax compliance environment is very important for securing fairness, neutrality and simplicity in taxation. This will also respond to the traditionally controversial problem of unfairness in income-trapping rates. While continuing to steadily promote tax system development and enforcement efforts, further considerations should be given to the following matters in order to gain taxpayers’ confidence in tax systems and administration.

1. Taxpayer Identification Number
(1) Necessity of the Consideration of a Taxpayer Identification Number (TIN)

The taxpayer identification number system has long been considered at this commission, since it has been expected to contribute to appropriate and fair taxation and to improved efficiency and sophistication of tax administration. More specifically, we have pointed to the necessity of a taxpayer identification number system for comprehensive taxation and appropriate taxation on property, based on relevant experiences in other countries. In recent years, the taxpayer identification number system has become indispensable to the development of a new financial and securities taxation system to integrate incomes from various financial assets for taxation. The time has come for new consideration to be given to the taxpayer identification number system in order to promote the efficiency and sophistication of tax administration, improve taxpayers’ cooperation (taxpayers’ confidence in the tax system and their compliance with the law in tax payment), and respond to international shifts in funds amid the computerization and globalization of economic transactions.

(2) Desirable method for considering a taxpayer identification number system in the future

In recent years, the need has grown to consider specific measures for the introduction of the taxpayer identification number system to develop a financial and securities tax system that includes integration of incomes from financial assets for comprehensive taxation. In other countries, the categories of transactions where taxpayers are required to use their identification numbers have usually been limited in the initial phase of the introduction of taxpayer identification number systems. When Japan introduces TIN, it can make reference to these overseas examples.

From now on, further consideration should be given to specific measures for the introduction of such a system in view of the nationwide use of common identification numbers for other administrative purposes and the protection of personal information. In this respect, the government should appropriately design a system to minimize costs for the private and public sectors and ensure system security including the protection of privacy, in order to enhance the people’s understanding about the taxpayer identification number system. At the same time, the government should consider the desirable picture and utilization method for the system, and the scope of taxpayers and transactions subject to the system in a bid to improve the convenience for taxpayers using identification numbers. For instance, simpler procedures for tax returns could be made possible.

2. Public Announcement System (large income taxpayers) and Information Reporting and Matching System

Problems have been pointed out regarding the system for the public announcement of taxpayers with large amounts of income, from the viewpoint of personal privacy. Relevant improvements should be considered, including the potential abolition of the system.

It will be important to expand the information reporting and matching system and develop other relevant systems that will respond to globalization, information and other structural changes in the economy and society. From this viewpoint, the FY2003 tax reform includes a measure to give tax authorities the right to conduct questioning and carry out inspections in order to collect information at the request of Japan’s tax agreement partners.

The government should give specific considerations to these problems in order to secure taxpayers’ confidence in the self-assessment tax system and ensure appropriate and fair taxation that responds to globalization, information, computerization and other structural changes in economy and society.

Electronic filing of returns and payment of tax through the Internet is scheduled to be introduced from FY2003 to improve the taxpayers’ convenience, etc. Further efforts to take advantage of the Internet and communication technologies will be appropriate.
(3) Measures for Environmental Problems

(1) Basic concept
In recent years, there has been growing interest in global warming and other environmental problems toward the entry into force of the Kyoto Protocol. This commission will have to consider the response in terms of the tax system from a broad perspective as part of Japan’s comprehensive efforts to tackle environmental problems. On the issue of global warming, in particular, broad discussions are required over the necessity of tax measures in addition to regulatory measures, voluntary efforts and non-tax economic measures (see Supplement).

(2) Notes on Consideration of Tax-System Response
Regarding the response in terms of the tax system to environmental problems, there are several points to be considered.

First, based on taxation’s fundamental function of raising revenues for public services, problems emerge with the utilization of taxation for specific policy goals and the gradual decline in tax revenues in line with the accomplishment of policy goals. There is an opinion that any tax with such characteristics would be a surcharge. Sufficient deliberations will have to be conducted on this basic issue in future.

Another problem is whether the tax revenues emerging from the additional burden imposed on generators of environmental load should be used to finance environmental measures including those for global warming. As this commission has reiterated, whether an environmental tax should be regarded as general-purpose financial resources or special-purpose tax resources should be considered in line with the basic concept of taxation.

In any case, the introduction of an "environmental tax" to impose a burden broadly on the people in the future will require the people's understanding and cooperation. In the future, we will continue to consider the environmental tax from a broad perspective, while taking into account the role of taxation in the overall national and local environmental measures, watching the progress in domestic and overseas discussions and based on the polluter-pays principle.

When considering the response in terms of the tax system to the global warming problem, we should also go into this response's relationship with existing energy-related taxes including gasoline, light oil delivery, petroleum and coal taxes.

(4) International Taxation
As business activities grow more global, the role of tax treaties coordinating the taxation rights of different countries is even more important. Japan should actively undertake conclusion and revision of tax treaties with a view to further promoting cross-border investment and developing measures for prevention of tax avoidance. As international business and investment activities have grown more complicated and diversified, tax-avoiding operations such as those involving an inappropriate outflow of tax bases from Japan have become more prominent. Against this background, we should further reconsider various aspects in the area of international taxation in order to sufficiently secure Japan's taxation rights for cross-border economic activities and to realize appropriate taxation.

(5) Non-performing Loan Disposal and the Tax System
In order to revitalize Japan's financial and business sectors, the acceleration of non-performing loan disposal at financial institutions is an important challenge. A tax-related response for deferred tax assets
and other problems should be considered as part of overall examination of related issues, such as financial supervision policies and financial accounting standards. The basic concept is discussed in the Supplement. In considering the response in tax treatments in this area, we should specify the policy objective and prudently decide whether tax-related treatments are effective and suitable for accomplishing the purpose, from the viewpoint of securing equity in taxation.
Supplement

Measures for Environmental Problems

1. Various Environmental Measures and the Tax System

We are facing various environmental problems, ranging from global warming to those that are very familiar to us all, such as air pollution and waste disposal. Among different kinds of regulatory, voluntary and economic approaches to solve these problems, it is necessary to elaborate appropriate combinations according to the characteristics of individual environmental problems and in consideration of the characteristics of these approaches. In addition to conventional regulatory and voluntary approaches, it has been considered effective in recent years to take economic approaches such as internalizing external costs through market mechanisms, in order to solve environmental problems such as CO₂ emission and car exhaust emission, which arise from a number of emission sources and require continuous incentives for reduction.

Economic approaches are generally divided into “taxes/surcharges,” “grants,” “emission trading” and “deposit.” “Taxes/surcharges” are in order to necessitate financial responsibility for polluting activities, suitable for the purpose of the PPP. This approach is also advantageous because individual parties will choose the most effective actions through market mechanisms, and therefore the least cost will be incurred by the whole society regardless of the number of emission sources. Furthermore, it provides continuous incentives for reducing pollution and has a positive effect on technological development in the long run.

In considering measures involving tax systems, it is necessary to develop a scheme under which the above advantages and characteristics of “taxes/surcharges” will effectively be achieved and utilized in the fields suitable for economic approaches (e.g. fields where a number of emission sources are concerned and continuous incentives are required for reducing emissions.)

2. Current Status of the Problem of Global Warming

Among various environmental problems, the problem of global warming is attracting more public attention toward the entry into force of the Kyoto Protocol. At the Third Conference of the Parties to the “U.N. Framework Convention on Climate Change” (COP3, Kyoto Conference) held in December 1997, the Kyoto Protocol was adopted, stating that developed countries, as a whole, should achieve a 5% reduction in emissions of greenhouse gases such as CO₂ from the 1990 level (individually, Japan 6%, the United States 7% and EU 8%) during the period from 2008 to 2012 (the first commitment period). Japan ratified this protocol in June 2002, and it will enter into force when Russia ratifies it.

In 2000 in Japan, the emission of greenhouse gases, such as CO₂, was 8% beyond the 1990 level. In light of this, the Global Warming Prevention Headquarters led by the Prime Minister as the Chief, in March 2002, prior to signing the Kyoto Protocol, reviewed the Guidelines for Measures to Prevent Global Warming, in order to strengthen the promotion of measures through the combined efforts of national and local governments, businesses and citizens, aiming at achieving the 6% reduction of greenhouse gases committed to under the Protocol.

The Guidelines for Measures to Prevent Global Warming provide that various measures should be gradually taken in order to achieve the goal under the Kyoto Protocol. According to the Guidelines, the period from 2002 to the end of the first commitment period shall progress in three steps: the first step from 2002 to 2004; the second step from 2005 to 2007; and the third step from 2008 to 2012 (the first commitment period). The step-by-step approach adopted by the Guidelines is: to demonstrate qualitatively that the measures and actions taken as the first step will surely achieve the commitment
under the Kyoto Protocol for the first commitment period (6% reduction of greenhouse gases), allow
evaluation of the progress of these actions and measures and the status of emissions before going on to
the second and third steps, and take additional actions and measures as necessary.

Reference: The Guidelines for Measures to Prevent Global Warming are set down as follows: “We will
continue to comprehensively consider economic approaches including taxes/surcharges for
various instances with respect to their effectiveness in environmental protection and impact
on various aspects of the national economy including macro-economically and industrial
competitiveness, as well as the current status of measures taken abroad, in comparison with
other types of approaches and taking into account international cooperation so as to properly
ensure their effectiveness in environmental protection.”

**Tax-System Response for Non-Performing Loan Disposal**

The possible response of the financial supervision to the handling of deferred tax assets is still under
consideration at the Financial System Council and its direction has yet to be indicated. Therefore, it will be
necessary to enhance considerations in the area of taxation when the considerations in the areas of
financial supervision and financial accounting are advanced. At the present stage, the basic concepts
for such considerations in the taxation area are outlined below.

1. As for the scope of write-off of or reserve for bad debts that are deductible for tax purposes (the tax
accounting standard), the Financial Services Agency requested in 2002 that financial institutions be
allowed to deduct for tax purposes the total amount of write-off or reserves for bad debts allowed under
financial accounting. However, since tax accounting should be applicable equally to all taxpayers from
the perspective of equity, the review of the tax standards should be considered not as a special measure
applicable exclusively to financial institutions but as a standard applicable equally to all types of
businesses.

In financial accounting, in addition to the guidelines applicable to all types of businesses, other
standards are applicable: the guidance applicable exclusively to financial institutions and the special
guidance (‘manual’) used by financial inspectors. Under these standards, the revocability of bad loans
is assessed, based generally on prudence but also placing importance on assuring sound management
of financial institutions in particular. On the other hand, in tax accounting, “loss” and “potential loss” of
bad debts may be deducted for tax purposes as a tax deduction for loans charged-off or a tax allowance
for loan-loss reserves. The specific tax standards are established with emphasis placed on the
objectivity and reliability of debt collection for the purpose of ensuring appropriate and equitable
taxation.

As a result, the scope of bad debts that are deductible for tax purposes may be more limited than that
for financial supervision or financial accounting purposes with regard to, for example, bad debts
categorized as ‘in danger of bankruptcy’ for financial supervision purposes. Though some differences
between tax accounting and financial accounting are unavoidable because they serve different
purposes, it is desirable to review the tax accounting standards as appropriate so as to diminish the
difference while maintaining the fundamental principles of tax accounting. Such a review will ensure
consistency with the measures taken by the financial supervision authorities to promote bad debt
disposal.

However, in the present situation in which many financial institutions are in the red, the total amount
of deferred tax assets would remain unchanged even if the scope of tax standards is expanded. It
would merely change the composition of deferred tax, from that arising from non-tax deductible
write-offs or reserve to that from losses carried forward. This might rather have an adverse impact on
financial institutions. For this reason, in reviewing the tax standards, it is necessary to take into
consideration their impact on financial institutions and the progress in the discussion on the desirable
composition of financial institutions’ equity capital including the handling of deferred tax assets.
2. As for the period for the carry-back of losses (refund of tax paid in the past), the Financial Services Agency submitted a tax reform proposal in 2002 that the existing freeze be lifted and the period extended (from one year to 15 years) for financial institutions. However, such a measure would actually amount to nothing more than the injection of public funds. Such treatment would result in a major loss of tax revenue, and raise other serious problems in tax policy in that such special measures introduced exclusively for financial institutions would seriously damage equity among taxpayers. Considering that the original purpose of this measure was to encourage financial institutions to increase their equity capital, this issue should be solved by squarely discussing whether the injection of public funds is appropriate and in what conditions it should be implemented, rather than adopting the tax refund method.

3. As for the period of losses carried forward, the Financial Services Agency submitted a tax reform proposal in 2002 that the period of deduction be extended (from five years to ten years) for financial institutions.

   However, such a special measure exclusively for financial institutions would be problematic in terms of equity. Furthermore, in today's highly severe financial environment, it is necessary to carefully consider whether the general extension of the period for loss-carry forward would be a really effective measure to achieve policy objectives such as reforming industrial structure and accelerating non-performing loan disposal.

   In addition, in Japan, where the taxation authorities bear the burden of proof, it is necessary to design a scheme under which the taxation authorities can check the correctness of the amount of loss during the period of loss carry-forward and are able to make corrections to any errors in such an amount. For this reason, the period of deduction should be set so that it will ensure consistency between the obligatory period for keeping financial books/records and the period of statutory limitation.