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The Fiscal Year 2003 Tax Reform Proposal

With the need to increase fiscal spending and carry out government reforms, the government is set to submit ① the fiscal 2003 Budget Plan of ¥81.79 trillion (up 0.7% from the initial budget for fiscal 2002) and ② the fiscal 2003 Tax Reform Plan featuring a ¥2 trillion tax-cut primary for companies and a tax-hike of ¥200 billion on alcohol and cigarettes, to the ordinary Diet session convening on January 20.

Based on both plans, the government has projected 0.6% growth in real gross domestic product for fiscal 2003, while tax revenue is expected to drop 10.7% from the initial fiscal 2002 forecasts to a total of ¥41.79 trillion. The ratio of bond issuance to the total spending budget will rise to a postwar high of 44.6 % in fiscal 2003. According to the Ministry of Finance, the combined outstanding debt of the central and local governments is expected to climb to ¥686 trillion at the end of fiscal 2003. This amount is 137.6% of GDP, the worst among the Group of Seven nations.

Most economists say the draft budget for fiscal 2003 indicates the failure of the government to provide a clear message and satisfactory answer on how to deal with deflation and weak demand — two major issues long confronting Japan's economy. A stepped-up bad-loan cleanup by domestic banks by the government's imposed deadline of fiscal 2004 year end will likely lead to an increase in the unemployment rate as well as contribute to deflation. The net tax cut of ¥1.8 trillion planned in fiscal 2003 is deemed insufficient to prop up the economy. The key points

of the fiscal 2003 Tax Reform Plan (effective dates will be different, depending on revision items.) are as follows:

(1) Introduction of tax credit for total costs of research and development

A maximum of 12% (15% for small-to-midsize firms) of total R&D costs may be created from the tax liability for three years starting from January 1, 2003. The amount will be limited to 20% of the tax liability. For IT related equipment purchased between January 1, 2003 though March 31, 2006, a 10% investment tax credit or a 50% special depreciation is allowed. However, the amount of the tax credit will be limited to 20% of the current tax liability, and a one-carry forward for the excess.

(2) Standardization of tax rates on securities transactions

Tax rates on capital gains from stock trading, dividends and revenue distributions from stock investment trusts will be at a single rate of 20%. However, a reduced rate of 10% will be applied for approximately 5 years (effective dates; January 1, 2003 for stock capital gains, April 1, 2003 for dividends and January 1, 2004 for revenue distributions).

(3) Introduction of a new scheme to consolidate inheritance and gift taxes

Under the new scheme, gift tax will be levied at the flat rate of 20% for amounts exceeding the tax exemption of ¥25 million (¥35 million for housing acquisitions) and will be deducted from the inheritance tax

on the sum of inherited and donated properties. Effective January 2003, taxpayers will be able to choose from either the new scheme or existing scheme.

(4) Assistance to venture businesses and small-to-midsize companies

① Exemption from the tax on undistributed profits of family held companies for 3 years from April 1, 2003. ② Reduction of the non-deductible portion of entertainment expense to 10% for companies with capital below 100 million yen. ③ Deduction of the entire cost of depreciable assets of less than ¥300,000 in the year of purchase (duration from April 1, 2003 until March 31, 2006).

(5) Reduction of the registration and license tax rate and the real property acquisition tax rate to 1% and 3%, respectively, for 3 years starting from April 1, 2003.

(6) Taxes on low-malt “happoshu” beer for a 350-ml can and wine for a 720-ml bottle will both rise by ¥10 from May 1, 2003. **Tobacco taxes per cigarette** will also increase by ¥1 from July 1, 2003, which translates into a hike of ¥20 per pack.

(7) Premium deductions for spouses whose annual income is ¥1.03 million or less will be removed from January 1, 2004.

(8) Small-scale businesses exemptions from reporting consumption taxes will be limited to those with annual taxable sales of no more than ¥10 million, instead of the current ¥30 million, from April 1, 2004.

(9) Introduction of a pro forma standard tax system into the corporate enterprise tax for companies with capital of more than ¥100 million (effective April 1, 2004)

Under the system, one-fourth of the corporate enterprise tax will be levied based on the size of capital and value added items, such as salaries and interest payments.

II Capital gains taxes from stock transactions

The new taxation system on capital gains from stock trading already went into effect on January 1, 2003. Major amendments are: ① abolition of a 1.05% withholding tax on the value of share sales, ② investors are required to file tax returns at a rate of 20% (10% if the fiscal 2003 Tax Reform Plan is approved by the Diet) and ③ the so-called special account system which permits investors to have securities houses file tax returns on their behalf has been introduced; the deadline for transferring shares to the special accounts from ordinary ones has been extended to the end of 2003.

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