

# Japan's tax administration reform and the self-assessment system

Presented by Yukitoshi Kimura, Commissioner of the National Tax Agency, Japan

At the Tax Administration Course III, Asian Development Bank Institute

Siem Reap, Cambodia, March 22, 2006

The views expressed in this paper are the views of the author and do not necessarily reflect the views or policies of the Asian Development Bank Institute (ADBI), the Asian Development Bank (ADB), or its Board of Directors, or the governments they represent. ADBI does not guarantee the accuracy of the data included in this paper and **accepts no responsibility for any consequences of their use**. Terminology used may not necessarily be consistent with ADB official terms.

## **1 Introduction**

Today, I would like to speak on the topic of Japan's tax administration reform and the self-assessment system.

I had the pleasure of meeting with tax commissioners from Asian countries last year at the SGATAR Meeting. I have also enjoyed opportunities to speak with commissioners from western countries at various international conferences. It seems that responding to a changing world and reforming tax administration to raise its standard are high on the agenda for all countries concerned.

Unlike private sector businesses, there is usually only one tax authority in a country, so it is very important to learn from examples of administrations in other countries. International conferences such as this provide a great opportunity to share common concerns and best practices. "Ensuring compliance", "enhancing taxpayer service", and "managing a large organization" are some of the keywords we hear when sharing our experience.

Currently, basic tax payment procedures and the way tax authorities interact with taxpayers are being reviewed in countries in Asia. I have been told that many countries have identified the introduction of the self-assessment system and upgrading of its standard as their main challenge.

Tax administration in Japan has gone through various reforms to improve its standard. The introduction of the self-assessment system was the particular highlight of tax administration reform after World War II. Even after the system had taken root, we continued to work toward smoother operation of the system that lies at the core of Japan's tax administration.

Today, I would like to share with you some of our reforms and initiatives concerning the self-assessment system, and how they relate to the various challenges we are working on today.

## **2 Introduction of the self-assessment system**

In the period following the Meiji Restoration of 1868, the start of Japan's modernization, major tax revenues in Japan were comprised mostly of land tax and liquor tax. Income tax was first introduced in Japan in 1887. Since at that time income tax existed in only a handful of countries, including Great Britain, I'd say it was an epoch-making event for Japan. In 1940, corporate tax was separated and became independent from income tax law and these taxes on income have come to replace land tax as the main sources of tax revenue in Japan.

The taxation method in the pre-war period was called the official assessment system. Under this system, the tax office would notify the taxpayer of the amount of tax payable based on the results of an

ex-ante audit, and the taxpayer was then asked to pay that amount. For individual income tax, the amount of tax payable was determined upon the approval of the income assessment commission whose members were selected from among taxpayers.

This taxation method was switched to today's self-assessment system right after the end of World War II. From 1947, the self-assessment system was applied to all the major sources of tax revenue at that time, namely, individual income tax, corporate tax and inheritance tax.

### **3 Major challenges after the introduction of the self-assessment system**

The self-assessment system is a system under which the taxpayer himself or herself calculates taxable income and the amount of tax payable. The taxpayer then files with the tax authority and pays the tax.

The introduction of the self-assessment system was a huge change in the taxation method and it was the start of a series of major tax administration reforms in the post-war era. We believe that this system better suits postwar democratic thought. It is conducive to establishing a relationship of trust between taxpayers and the tax authority, and it greatly contributes to efficient tax administration. Allowing the system to take root in Japan was the major challenge of the tax administration in the initial days of introduction. Once the system was firmly established, winning the trust of taxpayers and enabling fair and proper taxation became the focus. Japan has had about 60 years of experience with the self-assessment system.

However, because the self-assessment system was introduced hastily and across the board as part of post-war reforms under US occupation, there were many twists and turns in the process before the system operated smoothly. Creative ideas and efforts were required to overcome the initial period of confusion, to gain the understanding of taxpayers, and to operate it in a manner so that it serves its original purpose and realizes its full potential.

### **4 The initial days of introduction**

In the period following the end of World War II, inflation was running at more than 100% per annum in Japan. Since the existing taxation system was based on the previous year's income, it was no longer possible to secure the necessary tax revenue in the hyper-inflationary environment. A decision was taken to adopt a new system under which taxpayers would calculate and file their own income for the current year. The self-assessment system was essential in weathering the post-war hyper-inflation period.

Since inflation effectively lowered the minimum taxable income threshold, this resulted in a sudden

surge in the number of people who now had to pay tax. Tax officers were in short supply and not yet skilled, and they were not able to cope with the increasing number of taxpayers to tax them fairly. This was another reason why it was no longer possible to maintain the existing official assessment system.

Japan was under occupation in those days, and it was a time when the various social systems went through major changes. The way this new system was introduced was a far cry from best practice where the tax authority would be fully prepared and the general public fully informed ahead of time. Operation of the tax authority, as well as taxpayers, therefore had to keep up and be reactive, rather than being proactive, with this sudden change in the system.

## **5 Confusion in the initial days of introduction of the self-assessment system**

The handling of sole business proprietors proved particularly difficult after the introduction of the self-assessment system. It is always difficult for a tax office to have a grasp on individuals running their own business. In addition, individual income tax has a minimum taxable income threshold, making it more difficult to identify those with tax obligations. Many sole proprietors found it difficult to adapt to the new system, and many did not even keep accounting books. The same challenge was faced by family-owned small and medium corporations which also did not practice proper bookkeeping.

In the initial period of introduction of the system, the actual amount of taxes paid turned out to be far short of the budget. It became necessary to allocate tax to taxpayers based on the target tax amount. Tax officers were making adjustments and assessments without any clear basis to meet the target, resulting in the public further losing trust in the tax authority. By 1948, many anti-tax protests were staged in various parts of Japan. Some had escalated into threats and violence against tax officers. Petrol bombs were flung into tax offices and homes of tax executives resulting in casualties.

The difficulty did not end with tax filing. Collection of tax after filing was also another big challenge. In 1948 and 1949, delinquency ran at an extraordinary rate of more than 40%. With the instruction of the occupation forces, forceful methods were sometimes used such as loading foreclosed assets on a truck bearing a banner reading "foreclosure due to delinquency" and taking them to auction sites. In hindsight, these are incredible tactics unfathomable today, but we must not forget that Japan was in the extraordinary circumstance of being under occupation. The picture shows tax officers being accompanied by soldiers of the occupation forces for such collection of tax from delinquents.

## **6 The establishment of the National Tax Agency**

The self-assessment system is a system which asks taxpayers to be more proactive in fulfilling their

tax obligations. To facilitate taxpayers calculating their tax and paying taxes, the right infrastructure is required. The operation of the tax office had to be switched from the ex-ante audit system, where tax officers conducted audits prior to filing and notified the taxpayer of taxable income and tax payable, to a new ex-post audit system.

To enable such a major shift in tax administration, a more specialized tax administration organization was needed. In June 1949, the National Tax Agency was established as a separate body from the Tax Bureau of the Ministry of Finance. The tax bureau now became responsible solely for research, planning and legislation of the tax system, and the National Tax Agency for tax assessment and collection.

The picture shows the National Tax Agency building at the time the agency was first established.

## **7 Making the system take root (1)**

### **(a) Elevating the sense of moral duty toward tax**

Though the self-assessment system had a disorderly start, various efforts were made thereafter for it to take root among the public.

First was an effort to make taxpayers aware of their duty to pay tax. Efforts were made to inform taxpayers about the tax system and to provide advice for those requiring assistance, so that in the end, they would have a higher sense of moral duty toward tax payment. At the same time, the NTA focused on human resources development including improved staff training to maintain discipline and elevate a sense of morality in the organization with the aim of winning the trust of the people.

This is a picture of the then commissioner of the National Tax Agency taking to the street in a “Listen to the voice of taxpayers” campaign in 1954, which was recorded for later radio broadcasting.

While such public relations efforts were being made, systems were being put into place for taxpayers to be able to seek guidance on tax law and to ask for advice on calculation for self-assessment.

### **(b) Promotion of bookkeeping and proper tax filing**

For businesses to carry out proper tax self-assessment, they first needed accurate accounts. Guidance on bookkeeping was another area of focus at the NTA to enhance the standard of bookkeeping, especially in small and medium businesses. Meanwhile, various incentives were offered to businesses with good bookkeeping practice.

Where it was deemed necessary, letters were sent to some taxpayers to invite them to come to the tax

office during the tax filing period, where they would receive guidance on bookkeeping and proper filing.

This is a poster created with the aim of spreading the practice of bookkeeping among taxpayers. From the top, it says, "Keep correct books for filing a blue return", and the line below that says, "Notification on books must be made by January 31st", and at the bottom is "Tax Office" in Japanese.

Keeping books would also allow proprietors to analyze the state of their businesses and to think about measures for further development. We believe that promotion of bookkeeping not only brought benefits in the tax area, but also contributed to the growth of businesses and the economy as a whole.

Even today, not all businesses are keeping books to a satisfactory level, and we have various programs in place to promote bookkeeping practice.

### **(c) Support from tax associated bodies in the private sector and CPTAs**

In promoting bookkeeping and proper filing, support from certified public tax accountants as well as from various tax associated bodies in the private sector was sought to turn this into a national campaign.

Activities aimed at elevating the sense of moral duty to pay tax, calling on taxpayers to keep books, file and pay tax on time, and tax education for the general public were conducted with cooperation from tax accountants' associations, business associations and volunteers in local communities. The National Tax Agency deployed personnel at each tax office to welcome, promote and support such activities.

This picture is from a campaign conducted jointly by tax associated bodies in the private sector and local tax offices. When it first started, the campaign had the slogan "Listen to the voice of taxpayers". It is being continued today under the new slogans of "Know your tax" followed by "Think about your tax". Through various programs such as town meetings, soliciting compositions on tax from junior high school and high school students and calligraphy from primary school children, public relations efforts were implemented nationally to elevate the sense of moral duty regarding tax among the public. The calligraphy on the right says "Learning about tax", "Duty of tax payment", "Tax", and "Tax and society".

## **8 Making the system take root (2)**

### **- Ensuring compliance**

#### **(a) Tax audits**

Under the official assessment system, the tax authority would conduct a review and make an assessment before determining the tax amount payable. However, under the self-assessment system, after filing and payment of tax by the taxpayer, if the filing is found to be incorrect, the tax authority raises it with the taxpayer and asks for correction, possibly followed by an additional tax payment. Under this system, an ex-post tax audit becomes the main means of ensuring compliance.

For this reason, tax audit was positioned as the central task of tax officers under the self-assessment system, and efforts were made to improve the infrastructure for audits, enhance the audit capability of officers, and to better utilize reference information.

The entire operation was rationalized so that more resources could be allocated to the area of tax audits. Improvement was made in the training on tax law, accounting and audit techniques in an effort to secure and foster competent tax audit officers. Today, of the total of 56,000 employees, about 70% are working in areas related to tax audits at local tax offices and at regional tax bureaus.

Despite such efforts to strengthen and improve the infrastructure, the number of taxpayers, including corporations and sole proprietors, grew tremendously in line with post-war economic growth, and it was no longer possible to carry out annual audits on all taxpayers. The rate of field audits gradually declined, and today we conduct field audits on only about 4% of corporations and even fewer individuals.

To deal with this situation, we have tried to make our back office operations more efficient to allow more capacity for tax audits. Tax offices tried to better understand the state of the local economy, businesses and taxpayers. By systematically gathering and utilizing reference information, audit targets can be selected more intelligently. We also tried to vary the size and formation of our audit teams, and the length and depth of such audits depending on the status of the taxpayer.

Regional tax bureaus created special departments which only carry out audits of large corporations so that specialists could be fostered and deployed. At local tax offices, people specializing in wide area and international cases were deployed as well as those specializing in computer-aided audits in order to cope with socio-economic changes.

## **(b) Dealing with serious tax evasion and tax avoidance**

In order to preserve people's trust in the system and their belief that tax is applied fairly, and to maintain their motivation to file and pay taxes properly, it is essential that those who intentionally try to avoid taxes, especially through fraudulent means, be dealt with firmly, sometimes by making them the focus of prioritized tax audits.

The depth of tax audits varies according to the status of the taxpayer. Those suspected of serious tax avoidance will be prioritized in tax audit selection, and no limits will be placed on the audit length to allow for a thorough review. Regional tax bureaus established special departments to deal specifically with wide area cases which are more complex and difficult to deal with at the tax office level.

They also assigned personnel dedicated to gathering reference information with high utilization value and attempted to raise the quality of information gathered. In the case of serious tax avoidance, in addition to additional tax payment, a higher than normal additional tax would be levied.

With the introduction of the self-assessment system, an act of serious tax avoidance became a crime which carried a prison sentence in 1948. Since criminal investigation procedures must be followed and rigorous evidence collection is required in investigating and building a criminal case, the tax criminal investigation department was established in the tax authority.

By steadily working toward the realization of fair and proper taxation based on law, the tax authority has gradually won the trust of the people in the system. Since wage earners, who comprise a majority of the population, have their tax deducted automatically from their salaries through the withholding tax system, they complained that the system was not fair because businesses were not filing their tax properly. But such demand from the public for more fairness in taxation spurred further efforts by the tax authority.

### **(c) Tax collection**

As I have said, collection operations started in an extraordinary environment where delinquency rates were running at more than 40%. Initially, forceful methods of collecting delinquent tax were promoted, such as seizures and other forcible collection techniques. Later, the collection system was improved to allow grace periods for tax payment, and to design collection arrangements to meet the situation of each delinquent taxpayer. Prevention of delinquency and prompt addressing of new delinquency became the focus. While calling upon taxpayers to pay tax in time, automatic debiting of tax against their accounts at financial institutions was also promoted.

As a result of such efforts, delinquency rates fell markedly and collection operations started to improve.

## **9 Certified Public Tax Accountants**

The Certified Public Tax Accountant System also played an important role in the penetration of the self-assessment system among the public.

With the enactment of the Certified Public Tax Accountant Law in 1951, tax accountants' legal status as private sector tax experts was firmly established. After passing official tests and having been duly registered, they would represent and assist taxpayers in their calculation of taxable income and tax amounts. Tax accountants have a public mission to respond to the trust placed in them by taxpayers and to facilitate proper fulfillment of tax payment duties consistent with the philosophy of the



self-assessment system. Today, some 69,000 tax accountants are supporting taxpayers in proper tax filing. About one third of these tax accountants are former tax officers.

In the initial period of the introduction of the self-assessment system, tax officers gave help and guidance to those who were unable to file taxes on their own. But as the tax accountant system became more widely used, many taxpayers, especially those running their own businesses, started to utilize tax accountants' services in filing and paying tax.

Tax accountants, through the association of certified public tax accountants, also cooperate with the tax authority in public activities such as free tax consultation services for small business owners and wage earners, as well as other activities to educate the public on tax matters.

## **10 Introduction of consumption tax (1989)**

The tax system and tax administration in post-war Japan was centered on direct taxes. But over the years, reviews were conducted to find a more balanced tax system between tax on income, consumption and assets, and in 1989 consumption tax or value added tax was introduced. Consumption tax also adopts the self-assessment method of taxation.

Consumption tax in Japan uses a bookkeeping method rather than allowing credits for invoices. Although there is an obligation to keep receipts and other records, credit for tax paid on purchases will be made based on entries in the books.

Tax returns for consumption tax are prepared based on the same books as individual income tax and corporate tax. Because of this close linkage, it was decided that the newly introduced consumption tax be processed integrally with income tax and corporate tax. Following that decision, the National Tax Agency was reorganized in 1991 to change from the previous tax item-based organizational structure to a new taxpayer-based one.

This is a poster used at the time of introduction of consumption tax. Active public relations efforts were made for smooth acceptance of the tax, including posters, television and newspaper advertising.

## **11 Acceptance of the self-assessment system**

The self-assessment system celebrated its 50<sup>th</sup> anniversary in 1997. At that time, the NTA organized its basic principles about tax administration operation in the future and published them.

In it, we note “although initially people faced difficulties in adapting to the new system, the self-assessment system has gradually taken root among the public as the basis for stable tax revenue

required for running the nation". As for future challenges in tax administration, we recognize that "we need to contribute to the further development of the self-assessment system", and to do so, "we must run our tax administration to live up to the expectations and the trust of the people. We must respond flexibly to the dramatically changing environment surrounding tax and promote efficient operation as we head into the 21<sup>st</sup> century".

There were those who were skeptical about the highly held ideals of the system, saying that as long as there are taxpayers who are not willing to fulfill their tax obligations, the self-assessment system would never take hold. Yet now that the majority of taxpayers are fulfilling their tax obligations properly, and the tax authority's role has been firmly established over the past 50 years, we declared that the system has now firmly taken root and laid out the next challenges for the 21<sup>st</sup> century.

## **12 Contemporary challenges in Japan's tax administration**

The basic principles presented on the occasion of the 50<sup>th</sup> anniversary of the introduction of the self-assessment system have remained unchanged in the ten years since.

However, as we move into the 21<sup>st</sup> century there are many developments in the environment surrounding tax administration, such as globalization, high usage of IT, the declining birthrate and the ageing of the population. Against this backdrop, the number of taxpayers has risen and cases of tax assessment and collection are getting more and more complex and difficult.

In such an environment, we believe that contemporary challenges in tax administrative reform lie in further clarifying the roles played by taxpayers, the tax authority and tax professionals under the self-assessment system. We feel that the tax authority will need to endeavor to efficiently and effectively allocate limited resources so as to better respond to the emerging situation. We have identified the following five basic themes for tax administration.

### **(a) Taxpayer service**

Firstly, the taxpayer service. On the assumption that taxpayers are to follow what is intended in the self-assessment system and take the initiative to file tax returns, we will strive to provide the necessary support to them at the time of tax filing and payment so as to enhance their convenience and satisfaction. Though there is a limit to how many resources the tax authority can deploy, we feel it is important to improve the infrastructure to allow taxpayers to obtain information they want at any time. We also feel that we must work proactively with tax accountants' associations and other bodies in the private sector to provide education on tax to the public.

### **(b) Ensuring compliance**

Secondly, ensuring compliance.

We feel it is important that more of our staff be deployed directly in the areas of ensuring compliance, while not sacrificing the quality of taxpayer service. Acts of tax evasion, tax avoidance, and serious delinquency may shake the foundations of the self-assessment system and therefore must be dealt with firmly. It is crucial that we do our utmost to promote tax administration that is both fair and proper.

As various cross-border transactions increase due to the economic and social globalization, measures to cope with international tax avoidance which reduce tax amount with abusing these transactions arise as common challenge for developed countries. The NTA needs to prevent international tax avoidance with deepening cooperative relations with other countries.

### **(c) Use of IT and streamlining operations**

Thirdly, to do the above, it is important to utilize IT and to streamline our operations. With a view to the planned replacement of our computer system in 2010, we are currently studying ways to streamline our operations so that the whole chain of back office procedures at the tax authority, from handling of tax filing and payment to refunds, will be conducted more smoothly and efficiently. Our shift from tax item-based processing to a function-based processing system was part of this effort. We are also examining the structure of the organization to best meet this objective.

### **(d) Role of tax accountants**

Fourthly, certified public tax accountants. We are calling upon tax accountants to play an even more active role in the future.

We feel that if more taxpayers filed returns properly, either on their own or with the support of tax accountants, it would make it possible for us at the National Tax Agency to deploy more of our resources and time in dealing with unscrupulous taxpayers.

### **(e) Human resources development**

All of the above reforms are supported by our human resource development efforts. Human resources are the basis of the national tax organization, and if we want to win the trust of taxpayers, our officers must be equipped with technical knowledge, high moral standards, and the capacity to respond to change in society.

We must further improve our training programs. It is important that tax officers' levels of skill and quality be enhanced through training. We are currently conducting a review of our entire training

framework including training for new recruits as well as adding new programs with the aim of strengthening the organization, promoting higher efficiency in training, and responding to emerging needs.

## **13 Significance of the self-assessment system in today's world**

### **(a) Processes from filing to payment of tax**

I have so far been discussing the Japanese experience with the self-assessment system. I understand there are many people in the audience from tax authorities which are trying to adopt this system on a full scale, so I would like to end my speech with a few remarks on the significance of the system in today's world.

In Japan, the self-assessment system was brought in along with other reforms such as the introduction of a more democratic political system under the new constitution. The system was cast as a symbol of post-war tax administrative reform, and efforts were made to raise among the public a sense of moral duty in tax payment by holding up the ideals of a democratic nation where taxpayers would come forth voluntarily to file and pay tax.

The processes from filing to payment of tax, as well as the role to be played by the tax authority may vary according to the type and nature of tax in question, so a variety of approaches may be possible. Furthermore, taxpayers also disclose their taxable income information to the tax authority and bear the obligation to pay tax under the official assessment system. It could be argued that just because it is a self-assessment system, it doesn't necessarily mean it is more democratic.

It may be more practical to look at the procedures of tax filing and payment not from the perspective of which system is better, but rather from the viewpoint of better service to the taxpayer. To make it easier for taxpayers to comply and to fulfill their obligations, and easier for the tax administration to process the operation, we feel it is important to constantly strive to improve the processes while incorporating the power of IT.

Having said that, however, I believe the philosophy of the self-assessment system – taxpayers voluntarily assessing and paying their own taxes to pay for the cost of running society – still carries importance today.

### **(b) Taxation on businesses**

Secondly, when it comes to business taxes, the approach taken differs greatly depending on whether the official assessment system or the self-assessment system is used.

In order to tax businesses based on their income and value added, cooperation and information disclosure from businesses are essential.

Under the pre-war official assessment system in Japan, it was the tax office that calculated the taxpayers' taxable income and assessed the tax payable. Under that system, assessments were often made based on estimations and deemed taxation, and there was room for allocating tax to taxpayers to meet collection targets. With the introduction of the self-assessment system, determinations are made in the first instance by respecting the calculations presented by the taxpayer, and taxation is in principle based on actual figures. This was a major turning point in tax administration.

The introduction of the self-assessment system was a daunting challenge in particular for small and medium sized businesses which were not keeping proper accounts. I think many countries in Asia are faced with the same challenge.

I imagine that many countries practice the official assessment system of estimating the taxable income of small and medium sized enterprises based on their deemed net sales. For small- and medium-sized businesses, even if you wanted to tax them based on actual figures, if they don't keep books, then there is no other choice but to find ways to estimate their taxable income. Spreading the practice of bookkeeping among such businesses so as to include them in the self-assessment system and promoting taxation based on actual figures is an important challenge which requires a lot of contrivances and much effort.

### **(c) VAT**

Thirdly, I would like to point out some issues with value added tax.

Japan did not have value added tax when we introduced the self-assessment system. Today, as VAT is used in many countries, it would be necessary to study potential introduction of the self-assessment system with regard to both profit tax and value added tax. In Japan, since the practice of bookkeeping was well established after the introduction of the self-assessment system for both corporate and income tax, we decided to develop a system under which taxpayers would file VAT based on their books. We also designed it so that individual income tax or corporate tax and VAT would be processed in an integrated manner.

Many countries require the use of officially certified invoices for getting credits for tax on purchases, and there are countries that administer VAT in a separate organization or department. But once the self-assessment system is introduced, it is possible to have taxpayers calculate their taxable base for both income tax and VAT. The question is to what extent profit tax and VAT operation should share the same platform.

#### **(d) Tax audits**

Lastly, I believe that the biggest challenge for a tax authority under the self-assessment system is to improve the quality of tax audits.

Under the self-assessment system, if taxpayers keep proper books, their own calculations are respected in the first instance in determining the tax amount to be paid. For this reason, in order to correct errors or fraudulent acts on the part of the taxpayer, an ex-post audit becomes very important. Cases of serious tax evasion or tax avoidance, in particular, must be dealt with firmly.

The history of the Japanese tax administration is a series of steady steps taken to strengthen tax audits and other activities to ensure compliance.

Better tax audits cannot be realized overnight. It requires relentless efforts on the part of tax officers. We should not be impatient, we should take time and move steadily and not try to bite off more than we can chew in working on this task. Use of IT is drawing a lot of attention these days, and while its importance is fully recognized, we should remember that tax audits are conducted by people with the aid of IT. I believe it is important to make steady efforts to work on the basics such as developing human resources and the right organization.

The subject is too extensive for me to cover in my allocated time, but I hope to continue to share our experiences with tax authorities which are studying full scale introduction of the self-assessment system.

Thank you very much for your kind attention.