On the Dividend Exclusion for Life Insurers and Other Corporations — The Need for Further Reform

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1. Introduction

As Japan continues to struggle with the aftermath of the bubble economy, economic and fiscal structural reforms remain a top priority to reinvigorate the economy.

In fiscal structural reform, the debate has moved toward an aggressive stance of not only reviewing social security and other expenditures, but effecting tax reforms in the hope of building an infrastructure for a “fair and vigorous society.”

Given this situation, the government’s Tax Commission released a report last July (“The Current Situation and Issues Regarding the Japanese Taxation System — Working for Participation and Making Choices Towards the 21st Century”) which presents tax reform proposals based on the principles of fairness, neutrality, and simplicity.

According to the report, further personal income tax cuts will be difficult, given that tax cuts recently implemented as part of tax reforms and fiscal stimulus measures already make Japan’s income tax burden low by international standards. As for the corporate income tax, the effective tax rate has already been slashed to international levels to enhance Japan’s business competitiveness. As a result, corporate tax reforms will focus on improving fairness, neutrality and transparency.

In other words, further reform of personal and corporate income taxes will focus on neutrality and fairness, with little emphasis on reduction.

Meanwhile, the consumption tax is deemed critical for maintaining economic vitality in the face of the aging population, particularly since it can fairly allocate the expense burden of public services and provide stable tax revenue.

While the public must inevitably shoulder a larger burden to restore public finances and maintain the social security system, a minimal level of economic growth will still be essential for achieving these policy objectives. This lends strength to the argument that any increase in the public’s tax burden must be weighed against the effect on economic activity.

This argument is presented in the Keidanren's tax reform proposal in September 2000 ("Fiscal 2001 Tax Reform Proposal — For Building a Vigorous Economy and Society"). It contains specific proposals to reform the corporate tax (such as introducing consolidated tax payment), income tax (a sweeping tax cut), and tax measures related to finance and securities. The main reform proposal for finance and securities calls for the complete elimination of double taxation of dividends for both corporations and individuals.

The double taxation problem was addressed within the LDP in March as an area for securities tax reform to invigorate the ailing stock market. However, since a higher priority was given to helping individual stockholders — such as cutting the tax rate for the self-assessed separate taxation from other income from 26 to 20 percent — the double taxation problem was largely ignored.

In this paper, we describe the double taxation problem affecting life insurers and other corporations, and present pertinent information to advance the debate on medium-term corporate tax reform.

2. The Dividend Exclusion for Corporations

Under present corporate tax law, corporate stockholders are allowed to exclude the following received dividends from income. These measures were adopted to prevent multiple taxation at the corporate stockholder level.

1. For specified stocks (i.e., when stock ownership ratio is at least 25 percent) — all received dividends are excluded.
2. For other stocks — up to 80 percent of received dividends are excluded.

The tax treatment of received dividends came about as described below.

Historically, there have been two perspectives on the nature of the corporate tax. The first view is that since the corporation is an independent economic entity like individuals, corporate income should be taxed similar to individual income (real entity theory of the corporation). The second view is that corporations should be treated not as independent taxable entities, but as a collection of the individual stockholders who exist in the background, and that the corporate tax should be understood as a prepayment of the income tax of individual stockholders (fictional theory of the corporation).

In terms of dividend income, corporations must pay taxes on dividends under the first view, while the second view holds that dividends should not be taxed to avoid double taxation.

Prior to what are known as Shoup's recommendations, which greatly influenced Japan's postwar tax system, Japan had adopted the real entity theory. But the tax reform of 1950 introduced the following system based on the fictional theory.

1. The corporate tax rate was set uniformly at 35 percent (other special tax rates were not allowed).
2. To eliminate double taxation, corporate stockholders were allowed to exclude dividends from income, and individual stockholders could exclude 25 percent.

The fictional theory standpoint was subsequently revised amid changing economic conditions, and the actual tax system has been conducted under a mixture of the two perspectives.

For example, measures to revise the fictional theory view have included the following: (1) a lower tax rate was established for small and medium-sized corporations in 1955, ending the uniform proportional tax rate system; (2) in 1961, to enhance investment attractiveness and thereby expand equity capital, a lower tax rate was applied to that part of corporate income allocated to dividends (introduction of a reduced tax rate on dividends paid); (3) based on a growing view since the late 1960s that the corporate tax should be borne by corporations alone, and that tax credits for dividends were too generous to individual stockholders, the tax credit was reduced and the corporate tax rate increased.

Furthermore, the 1988 basic tax reform, on which the present tax system is based, recognized the need to address double taxation based on developments following Shoup's recommendations as well as prevailing practices abroad. Yet it called for abolishment of the reduced tax rate on dividends paid, which is applied on corporations when they distribute dividends. As a result, the lower tax rate on dividends was abolished, while the exclusion of dividends from income by corporations was set at 80 percent, where it now stands.

In considering the tax treatment of dividends, another important issue that arises is the deduction of interest on borrowed funds from the dividend exclusion.

When a corporation receives dividends, the interest paid on any debt used to purchase the stock is deducted from the dividend exclusion amount with the aim of preventing tax evasion. For example, suppose that one million yen is received in dividends from a stock investment that was financed entirely with loans. If the interest on the loans is 600,000 yen, the dividend exclusion is reduced to 400,000 yen. If less than the full investment amount is borrowed, the debt interest deducted is in proportion to the book value of the stocks divided by book value of total assets.

One characteristic of this system is that debt interest includes not only interest on deposits, but such items as the scheduled interest paid to policyholders out of the reserves of life insurers.

3. The Dividend Exclusion for Life Insurers

As we explain below, dividends received by life insurers are not actually excluded from income.

Corporate tax rules for life insurers are in principle similar to those of ordinary companies in that prescribed adjustments are made to income (surplus fund in the case of mutual companies) to calculate taxable income. What is peculiar to life insurers is that no special provisions exist for dividend income.

Until the late 1950s, life insurers were treated similarly to ordinary companies in that the full amount of received dividends could be excluded from income. Furthermore, since the premiums that life insurers paid back to policyholders — known as policyholder dividends — were included in expenses, there was a time when taxable income was consistently negative.

The fact that dividend income was excluded while dividends paid to policyholders (reserve transfers) were treated as an expense drew criticism that expenses were being deducted twice. To correct the situation, reforms were implemented in 1961 as follows:

- Deduction of debt interest from the dividend exclusion (for banks, interest to depositors was already included in debt interest)
- Debt interest to be deducted: (1) the scheduled interest paid out of reserves (the reserve for paying out benefits in the future, which is the largest liability of life insurers), and (2) interest income included in policyholder dividends.

In other words, since life insurers used premiums to fund stock investments, the corresponding interest they paid on those premiums was deducted from dividends. As a result, the dividend exclusion for life insurers was: (Dividends received – Debt interest) x 75 percent.

Despite this tax reform, life insurers were subjected to a further reform measure in 1967 that effectively abolished the exclusion of dividend income.

Under the new measure, if the dividend exclusion was invoked, the maximum recognized expense for policyholder dividends was to be calculated as follows:

Policyholder dividends – 75 percent of the dividend exclusion

Thus when life insurers invoked the dividend exclusion, 75 percent of this exclusion was subtracted from the maximum recognized expense for policyholder dividends, and the remaining 25 percent was treated as a separate income entry (a special tax measure in effect at the time). As a result, 100 percent of the dividend income became taxable.

This method was revised in the basic tax reform of 1988 by abolishing the reduced tax rate on dividends paid and adopting the present treatment (80 percent dividend exclusion, the same as for other corporations). However, because the following limit was maintained on policyholder dividends recognized as expense, life insurers are still prevented from excluding dividends from income.

Policyholder dividends – Dividend exclusion

In this way, the tax treatment of dividend income is more strict for life insurers than for ordinary companies.

4. Conclusion

Due to the difficulty of distinguishing between the real entity theory and fictional theory perspectives, the tax treatment of received dividends has developed with a combination of both perspectives. However, it is nonetheless true that historically, the tax treatment of dividends initially leaned toward the fictional theory perspective of Shoup's recommendations, later undergoing reforms in response to changing economic conditions. As such, the present tax system is basically an extension of Shoup's tax system.

In formulating the basic tax reform of 1988, which established the present treatment of dividends, the Tax Commission recognized the need to prevent double taxation of individuals and corporations. However, regarding dividends paid between corporations, the commission also expressed the opinion that aside from stockholdings meant to control subsidiaries, dividend exclusion was a low priority in light of the increase in cross-shareholdings and in speculative *zaitech* shareholdings. However, we must not ignore a dissenting view expressed with regard dividends paid between corporations: that the dividend exclusion should be maintained because it is meant to make the corporate tax system as neutral as possible with respect to differences in types of stockholders and forms of corporate management.

From the perspective of eliminating double taxation, the deduction of debt interest is a separate issue, and has little rationale as a tax theory. Even if interest paid by corporations is treated as an expense, it is still taxable income for the recipient, and thus does not involve tax evasion when the overall picture is considered.

Furthermore, since policyholder dividends paid by life insurers are actually refunds of paid-in premiums, they clearly have the characteristic of an expense. Thus there is little justification for reducing the maximum recognized expense of policyholder dividends by the amount of the dividend exclusion.

In addition to the above perspective of neutrality, conditions have changed since the present system was constructed (during the bubble economy): (1) cross-shareholding is on the decline, (2) the *zaitech* investment boom has abated, and (3) in the mature economy, corporations increasingly need to supply risk capital by investing in stock.

In light of these conditions, from the perspective of neutrality as well as policy, we encourage active debate on enhancing the dividend exclusion for life insurers and other corporations.