TIEA. On the question of the retroactive application, the court emphasized that the ATO audit was continuing — that is, the TIEA request was valid because one of the covered tax years was under audit. A refund of all the taxes collected was at stake.

The taxpayers’ last-ditch argument was that diplomatic relations between the Cayman Islands and Australia would be prejudiced. The judge responded that the argument was speculative, assuming arguendo that remaining in the good graces of the Cayman government was at all necessary to Australian national security.

“If you have a hearing, to what extent can the affected parties participate?” Lowe asked rhetorically. “How do you ensure that the authorities actually put the matter before a judge?” The Cayman authority must understand the contemplated use of the requested information. The requirement of judicial approval is a protection against abuse, Lowe emphasized.

Nonetheless, in the new world order, with jurisdictions like the Caymans trying to preserve important investment fund business, some customers are going to be pushed over the side of the boat. Cooperation in information requests has to be forthcoming for the islands to keep their place in the world financial system.

Lowe reported that the Cayman government is currently seeking to change the law, so that it need only ask for judicial approval of information requests in criminal cases, not in standard civil cases. Moreover, the government does not want to have to notify the taxpayer. “There should be a judicial filter whenever there is to be an infringement of someone’s civil rights, not just when there is a possibility of incrimination,” he said.

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ECONOMIC ANALYSIS

How Will Japan Pay for A Lower Corporate Rate?

by Martin A. Sullivan

I am willing to act like a drill bit, strong enough to break through the solid rock of vested interests.

Prime Minister Shinzo Abe, Jan. 23, 2014

Japanese Prime Minister Shinzo Abe’s second term began in December 2012. In the first 12 months, prices on the previously moribund stock market soared 63 percent. In the following six months, they have dropped by 10 percent. See Figure 1. The rise and fall are largely explained by Abenomics.

The prime minister’s radical break from Japan’s previous economic policies has three components, referred to as the three arrows. The first arrow is an enormous expansion of the money supply by the Bank of Japan. The second arrow is a big boost in government spending.

By all accounts, both of these measures have been successful in providing short-term stimulus to the economy. One prominent result has been the favorable change in the exchange rate. The dollar has appreciated from ¥84 to ¥102 per dollar since the end of 2012. This has increased exports and profits from foreign trade and fueled expectations of more to come.

But Japan’s miraculous made-in-Tokyo recovery is now stalled by a lack of progress on the third arrow of Abe’s program: promised but unspecified structural, supply-side reforms like reduced regulation of the labor market, reductions in trade barriers and other protections of favored industries, and a reduction in the corporate tax rate, currently the second highest in the world after the United States. The government’s fiscal and economic blueprint, due later this month, is expected to offer proposals on these issues.

From 38 Percent to 25 Percent?

As part of Japan’s most recent tax legislation that took effect on April 1, a temporary corporate surtax (instated to help defer the costs of rebuilding after the great 2011 earthquake and tsunami) was terminated a year early. This reduced the corporate tax rate by approximately 2.4 percentage points, from approximately 38 percent to approximately 35.64 percent (taking into account both national and subnational taxes). At the January 23 World Economic Forum annual meeting in Davos, Switzerland, Abe pledged to make further reforms to make the corporate tax internationally competitive.

In February a subcommittee to study corporate tax reform was spun off from the highly influential Liberal
Democratic Party (LDP) tax commission. The subcommittee is chaired by Hiroko Ota, a former finance minister and an advocate of corporate rate cuts paid for by base broadening. The subcommittee began meeting in mid-March to consider the benefits of such a plan and to work out how it could be implemented.

Private sector members of the government’s Council on Economic and Fiscal Policy, another advisory group to Abe, recommended that the ultimate goal of corporate tax reform be a reduction in the rate to 25 percent, so as to be competitive with rates in China and South Korea. But nobody really expects Japan’s corporate rate to drop substantially below 30 percent in the foreseeable future. “We’re not demanding that the government slash the tax rate to that level in a single stroke, but it should draw up a road map for achieving that goal in line with the country’s economic growth,” said council member Norio Sasaki, the vice chair of Toshiba Corp. and chair of the taxation committee at the Japan Business Federation, or Keidanren, the country’s main business lobby (Nikkei Asian Review, Apr. 11, 2014). According to various press reports, plans to reduce the rate by 1 percentage point per year for five years and 2 percent a year over three years are being discussed.

A Debt Crisis

Japan’s gross government public debt now exceeds ¥1 quadrillion. That is approximately $10 trillion. To stabilize its gross debt-to-GDP ratio, which is 240 percent, the government has set the goal of eliminating its primary deficit by 2020. (A primary deficit is the excess of government spending, excluding interest costs, over revenue.) To move closer to primary balance, the consumption tax rate was increased from 5 percent to 8 percent on April 1. Because of tremendous concern about the possibility of this tax increase snuffing out the recovery, an offsetting fiscal stimulus was put into

Corporate Tax Rates in East Asia in 2014

<table>
<thead>
<tr>
<th>Country</th>
<th>Rate</th>
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<tbody>
<tr>
<td>Japan</td>
<td>35.6%</td>
</tr>
<tr>
<td>Philippines</td>
<td>30%</td>
</tr>
<tr>
<td>China</td>
<td>25%</td>
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<tr>
<td>Malaysia</td>
<td>25%</td>
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<tr>
<td>Indonesia</td>
<td>25%</td>
</tr>
<tr>
<td>South Korea</td>
<td>24.2%</td>
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<tr>
<td>Vietnam</td>
<td>22%</td>
</tr>
<tr>
<td>Singapore</td>
<td>17%</td>
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<tr>
<td>Taiwan</td>
<td>17%</td>
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</tbody>
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Source: KPMG Global.
So far the economy seems to have weathered the tax increase fairly well, and it is generally expected that Abe will agree to allow a second rate increase, from 8 percent to 10 percent, to happen on schedule in October 2015.

These painful measures are made possible by Abe’s popularity in the polls and by his party’s firm control of the legislature. Since the December 16, 2012, election, Abe’s LDP has held an overwhelming majority in Japan’s House of Representatives, where it holds 294 seats out of 480. Its coalition partner, New Komeito, has 31 members. After elections for the House of Councillors were held on July 21, 2013, the LDP held 115 seats and New Komeito held 20 seats out of a total of 242, giving Abe’s coalition a majority in the upper house of Japan’s legislature.

**More Than Competitiveness**

Japan has much larger economic problems than the United States does. That its public debt as a percentage of GDP is more than double that of the United States is only part of the picture. Japan’s population is aging faster. Unlike the United States, where immigration is robust, Japan’s population is shrinking. And worst of all, over the last two decades real economic growth has been almost nonexistent. The average growth rate of GDP since 1990 has been 0.9 percent, compared with 2.5 percent in the United States. (See Figure 2.) Combined with deflation, that has kept nominal GDP growth near zero.

So in Japan, a reduction in the corporate tax rate is not an end unto itself but just one piece of a larger economic puzzle. University of Tokyo economist Motoshige Itoh stressed the importance of reducing the corporate rate immediately for political as well as economic reasons. He explained that Japan’s chronic deflation has shrunk income tax revenue, and that it would be extremely difficult to cut the corporate rate when corporate tax revenue is already declining. Now, as a result of the Bank of Japan’s actions, nominal GDP is growing and the pace of revenue growth will probably pick up steam. In particular, Itoh pointed to research indicating that a 1 percent rise in nominal GDP will result in a 3 percent increase in corporate tax revenue. (See his May 12, 2014, presentation to the Foreign Correspondents’ Club of Japan, video available on youtube.com.)

Despite the strong push by Abe and the widespread approval of economists, support for a corporate rate cut in Japan has been far from universal. There are complaints that deficits are too large to allow rate cuts and that cuts will not be effective in promoting growth and investment. These concerns are expressed most prominently by other leaders of Abe’s own party, including Minister of Finance Taro Aso, who also holds
the post of deputy prime minister, and by Takeshi Noda, head of the LDP tax panel.

With so much financial and political pressure on the government to keep its finances in check, it is widely accepted that corporate rate cuts must be offset by other business tax increases. A fact repeatedly cited by government officials and advisers is that only 30 percent of businesses pay corporate taxes, so the tax base should be broadened to include more firms, particularly small and midsize companies. It is frequently noted that Japanese firms often do not pay tax even when profitable because of large loss carryforwards, so there should be tougher restrictions on the use of net operating losses to shelter current income. Other revenue-raising measures under consideration are the elimination or reduction of special tax breaks targeted to particular industries, repeal of accelerated depreciation, and limitations on tax incentives for research.

Recent Developments

There have been two notable developments in Japan’s journey to a lower corporate tax rate. First, it seems that Abe and his allies have won over opponents in his party. Noda, who in February said that “now is not the time to cut the corporate tax,” was reported last week as saying that he and his commission will now proceed on the premise that corporate tax reform is party policy. (See “Government Tax Panel to Set Up Group to Debate Corporate Tax Cut,” Kyodo News International, Feb. 13, 2014; and “Abe Corporate Tax Cut Bid Gains Ground With Party Support,” Bloomberg, May 27, 2014.)

Second, it appears that to tax businesses without taxable profits, the Japanese government is willing to consider an unconventional, non-income approach to corporate taxation. The Japan Times reported twice — once after the latest subcommittee meeting and again after the latest full committee meeting — that the corporate tax should be more “size-based.” Accordingly, the corporate tax base should be broadened to include, in addition to income, external standards, such as number of employees, capital, and other indicators of a company’s scale of operations. “It is believed that a size-based tax would help stabilize revenues because it is imposed on both profit-making and loss-making enterprises, regardless of economic fluctuations,” the newspaper reported. (See “Task Force Seeks Corporate Tax Cut, Broader Base,” May 14, 2014; and “LDP Panel Puts Aside Public Finance Woes, Set to OK Abe Corporate Tax Cut,” May 27, 2014.)

U.S. as Outlier

“From a tax policy point of view, it’s better to have a tax system in which footloose corporations are not heavily taxed while individual income and individual consumption should be taxed more,” said Bank of Japan Governor Haruhiko Kuroda in a May 24 interview with The Wall Street Journal Japan. Abe’s government is clearly following this path. It has a top individual income tax rate of 50.84 percent that applies to taxable income above ¥18 million (about $180,000 at the current exchange rate). Its broad-based consumption tax now has a rate of 8 percent and will likely increase to 10 percent in October 2015. And if Abe’s third arrow hits its target, it is likely that Japan’s corporate rate will decline to close to 30 percent over the next few years.

Given these developments in the world’s third largest economy, the United States — with its relatively low income tax rates, its refusal to consider a value added tax, and the world’s highest statutory corporate tax rates — increasingly will find that its tax system puts it at a competitive disadvantage with the rest of the world.

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