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# TAXES AND THE STRUCTURE OF JAPANESE FIRMS: THE HIDDEN ASPECTS OF INCOME TAXATION

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While governmental intervention into the functioning of a national economy in the form of taxation is commonly observed across our planet,<sup>1</sup> the overall effect of such intervention is far from clear. Those who advocate using taxation to implement particular governmental policies usually discuss whether one tax is better than another, rather than whether using the tax system for policy purposes is wise.<sup>2</sup> In contrast, others simply argue that taxes are no more than an evil that brings about distortions in the marketplace, without identifying the exact effect of such taxes.<sup>3</sup> However, these discussions fail to answer a fundamental question which has seldom been seriously examined: whether and to what extent taxes are relevant.

In examining the role played by taxes, it is important to note that a particular tax's effect, that is, its degree of non-neutrality, is much more far

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\* Professor of Law, The University of Tokyo. An earlier version of this paper was written for a project by the World Bank in 1993. *See* Taxation and Economic Growth: A Final Draft Report from Fair to the World Bank (Sept. 1993) (unpublished manuscript, on file with the author). *See also* THE EAST ASIAN MIRACLE: ECONOMIC GROWTH AND PUBLIC POLICY (1993). I thank Hiroshi Kaneko, Saul Levmore, Tadatsune Mizuno, Minoru Nakazato, Oliver Oldman, Mark Ramseyer, and Mark Roe for their suggestions. Research assistance by John Bodnar and Scott Hayashi is also gratefully acknowledged.

1. *See, e.g.*, HENRY J. GUMPEL, WORLD TAX SERIES: TAXATION IN THE FEDERAL REPUBLIC OF GERMANY (2d ed. 1969); HARVARD LAW SCHOOL, WORLD TAX SERIES: TAXATION IN SWITZERLAND (1976); HARVARD LAW SCHOOL, WORLD TAX SERIES: TAXATION IN FRANCE (1966); HARVARD LAW SCHOOL, WORLD TAX SERIES: TAXATION IN ITALY (1964); R.W. PARSONS, INCOME TAXATION IN AUSTRALIA: PRINCIPLES OF INCOME, DEDUCTIBILITY AND TAX ACCOUNTING (1985); BUSINESS LAWS OF SAUDI ARABIA 4-1 (Nicola H. Karem trans., 1977).

2. *See, e.g.*, THE THEORY OF TAXATION FOR DEVELOPING COUNTRIES (David Newberry & Nicholas Stern eds., 1987); WORLD TAX REFORM: CASE STUDIES OF DEVELOPED AND DEVELOPING COUNTRIES (Michael J. Boskin & Charles E. McLure, Jr. eds., 1990); Walter D. Schwidetzky, *A Comparison of Partnership Income Taxation in the United States and Germany: A Study in Differences*, 10 AM. U.J. INT'L L. & POL'Y 1331 (1995).

3. *See, e.g.*, Walter C. Cliff & Philip J. Levine, *Interest Accrual and the Time Value of Money*, 34 AM. U.L. REV. 107 (1984); Duncan Kennedy & Frank Michelman, *Are Property and Contract Efficient?*, 8 HOFSTRA L. REV. 711 (1980) (arguing that most tax systems cause distortions when viewing the world).

reaching and puzzling than one might think. For instance, a particular tax law may be designed to affect the form and process of capital formation in a country by favoring one form of corporate finance over another. A tax is introduced to encourage or discourage certain methods of financing. But, financial structure affects the form of corporate governance. Thus, a particular form of corporate governance might emerge in response to a particular tax that encourages a particular form of corporate finance. However, to what extent taxation has such “hidden effects” deserves careful examination.

As scholars have noted,<sup>4</sup> income taxation played an important part in Japan’s tax policy. As history shows, tax rules and policies are capable of being transplanted across countries.<sup>5</sup> But, such rules and policies may cause different and unexpected side effects in the destined country if imported in isolation.<sup>6</sup> Whether any “lessons” are learned from Japan’s tax history can be shown only when the overall effect of taxation is identified. Because Japan’s high economic growth may have some correlation with the corporate structure of Japanese firms,<sup>7</sup> it is interesting and important to examine whether and how income taxation affects the way that Japanese firms are organized and structured.<sup>8</sup>

This Article addresses the influence income taxation has had on Japanese firms. Part I examines the tax rule on *tokkin*, a simple rule designed to accomplish a somewhat straightforward goal. Part II focuses on a more general income tax rule—the two-tier taxation of corporate profits—and analyzes whether a separate income tax for corporate profits affects corporate governance. Part III addresses the “hidden” effects of income

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4. See Hiroshi Kaneko & Yoshihiro Masui, Taxation of Interest Income in Japan—History and Current Situation, in *Taxation and Economic Growth: A Final Draft Report from Fair to the World Bank*, *supra* note \* (focusing on interest income taxation).

5. See, e.g., Robin Burgess & Nicholas Stern, *Taxation and Development*, 31 J. ECON. LIT. 762 (1993).

6. See, e.g., G.A. Mackenzie, *Reforming Latin America’s Old-Age Pension Systems, Latin America and the Caribbean: The Challenges Ahead*, 32 FIN. & DEVELOPMENT 10 (1995).

7. See, e.g., Thomas E. McCarty, *Challenge Your Japan Plan; Accessing the Japanese Market*, 17 DIRECTORS & BOARDS 55 (1992); Renee Mathieu, *The Prefabricated Housing Industries in the United States, Sweden and Japan*, 33 CONSTR. REV. 2 (1987).

8. For a discussion of tax law’s effects on corporate governance in the United States, see James R. Repetti, *Corporate Governance and Stockholder Abdication: Missing Factors in Tax Policy Analysis*, 67 NOTRE DAME L. REV. 971 (1992). For an interesting comparison of corporate governance between the United States and Japan, see Ronald J. Gilson & Mark J. Roe, *Understanding the Japanese Keiretsu: Overlaps Between Corporate Governance and Industrial Organization*, 102 YALE L.J. 871 (1993). See also Mark J. Roe, *Some Differences in Corporate Structure in Germany, Japan, and the United States*, 102 YALE L.J. 1927 (1993).

taxation on firm integration. To illustrate whether taxes are an important cause of a particular form of integration, the Japanese *keiretsu*<sup>9</sup> will be considered. Finally, a brief caveat concerning the potentially trivial impact of taxation is provided.

### I. TOKKIN AND CORPORATE STOCKHOLDING

Under Japanese corporate income tax law, when a domestic corporation invests in another corporation's shares, the basis of each share of the same corporation must be adjusted and averaged for income tax purposes.<sup>10</sup> Thus, for instance, when a Japanese corporation, X, buys a share of Toyota at 100 yen and later buys another share of Toyota at 200 yen, the basis of each share in X's hands must be adjusted to 150 yen.

An exception to ordinary Japanese corporate income tax law is the Tokutei Kinsen Shintaku, or *tokkin*. Apparently introduced to encourage trading and boost the Japanese stock market,<sup>11</sup> the *tokkin* system avoids averaging. Under the *tokkin* system, instead of buying additional stock itself, corporation X buys stock through a trust; X puts money into a trust and the trustee buys the stock for X with the trust's money.

In Japan, a trust is usually not a taxable entity.<sup>12</sup> Therefore, the trust's beneficiary is directly taxed at the time when income is realized and recognized at the trust level. Thus, under normal Japanese tax law, corporation X would have no tax advantage in setting up a trust to buy another share of Toyota.

The *tokkin* rule, however, allows corporation X to separate the basis of the securities it holds itself and those held by a trust.<sup>13</sup> Thus, in the above hypothetical, corporation X may maintain a 100 yen basis for the first share it bought and keep the 200 yen basis for the second share purchased through the trust.

The special treatment afforded by the *tokkin* rule gives corporation X wide discretion regarding the realization of capital gains or losses for tax and accounting purposes. For example, suppose the market price of

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9. See, e.g., KENICHI MIYASHITA & DAVID W. RUSSELL, *KEIRETSU: INSIDE THE HIDDEN JAPANESE CONGLOMERATES* (1994).

10. Corporation Tax Law Enforcement Ordinance in Japan, Ordinance No. 97 of 1965, art. 34(1).

11. The intended purpose of, or the policy behind, the *tokkin* rule is not entirely clear.

12. Corporation Tax Law in Japan, Law no. 34 of 1965 [hereinafter CTL], art. 12. See Griffith Way et al., *Business Operations in Japan*, Tax Mgmt. (BNA) 51-7th, at A-30 (1991).

13. See Akira Ikeya, *Four Life Insurers Increasing Stock Funds*, NIKKEI WKLY., Nov. 1, 1993, at 12, available in LEXIS, Asiapc Library, Nikkei File.

Toyota's stock is 160 yen at the end of corporation X's tax year. If the *tokkin* rule is unavailable, corporation X can of course decide not to sell stock, causing no tax consequences. But, if corporation X decides to sell the stock, the normal basis rule determines whether there is any gain or loss. Corporation X can therefore choose not to recognize gain or loss at all by not selling any stock, but it cannot choose whether to sell the share that has risen in value to recognize a gain or to sell the share that has dropped to recognize a loss.

However, under the *tokkin* rule, corporation X has an additional choice not available under the ordinary basis rules: It can realize and recognize a gain or loss. For example, if corporation X wants to recognize a gain, it can sell the first share that it bought on its own account resulting in a gain of 60 yen. But, if corporation X wants to recognize a loss, it can sell its second share held by the trust resulting in a loss of 40 yen.

As seen from this hypothetical the *tokkin* rule encouraged large firms to invest in stocks. Therefore, the trading volume by large institutions in the Japanese stock market increased.<sup>14</sup> In short, large firms could take advantage of this rule when stock prices rose over time. Thus, Japanese firms issued an enormous amount of new stock to obtain capital.<sup>15</sup> Accordingly, the popularity of equity financing was the dominant characteristic of the Japanese corporate finance market in the 1980s. However, individual investors could not take advantage of the *tokkin* rule because they operated under a different income tax rule.<sup>16</sup> Thus, the "institutionalization" of the Japanese stock market was accelerated.<sup>17</sup>

One might think that *keiretsu*, or mutual stockholding, was affected by the *tokkin* rule. The effect of the rule on *keiretsu* is, however, not entirely clear. At first glance, because the *tokkin* rule enables a corporate stockholder to "manipulate" capital gains or losses, if such stockholder frequently buys and sells shares it does not appear to help the institution remain a

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14. See Kaoru Akiyama, *Japan Investment Advisory Firms Face Shake-Out*, REUTERS, Aug. 14, 1991, available in LEXIS, World Library, Allwld File; Jonathan Sprague, *Tokkin Fund Closures Seen Pressuring Tokyo Stocks*, REUTERS, Aug. 9, 1991, available in LEXIS, World Library, Allwld File.

15. See, e.g., Shinji Takagi, *The Japanese Equity Market: Past and Present*, 13 J. BANKING & FIN. 537 (1989).

16. See Way et al., *supra* note 12, at A-117 to A-118.

17. The regulator allowed insurance companies to treat capital gains from stock trading through *tokkin* as income gains for regulatory purposes and include them as a source for distribution to the policyholders. This encouraged stock investment by insurance companies through *tokkin*. It must be noted, however, that two major classes of stockholders in the Japanese stock market are industrial companies and large banks.

friendly and stable stockholder of the issuer firm. An investor, however, may buy and sell a number of shares of the same firm simultaneously and thus recognize a capital gain or loss without changing the size of its stake in the issuing company. In short, a high institutional trading volume of stock does not mean a decrease in stable stockholding. It is thus plausible that the *tokkin* rule helped to increase stable institutional stockholding.

## II. CORPORATE LEVEL INCOME TAX

Whether a separate income tax should be imposed at the entity level is a difficult question. But, entity, or corporate level, taxation for corporations in particular has survived for decades in both the United States and Japan.<sup>18</sup> Despite the recent and repeated attacks on this two-tier income tax, it is difficult to conclude that such a two-tier tax scheme hurts (decreases the productive output of) the national economy. Critics often argue that the corporate level tax is an additional burden and negatively affects the competitiveness of corporations, as opposed to partnerships or proprietorships. However, it is well known in tax practice that the current system of two-tier income taxation may often turn out to be less of a tax burden for investors than one-tier taxation at the stockholder level. In addition, corporate level taxation can be viewed as a device to reduce a firm's agency costs.<sup>19</sup>

Given some form of corporate level income taxation, it is natural to expect that business planning is devised to take advantage of existing tax rules. To take a familiar example, under a normal two-tier tax system, an interest payment for debt is deductible to the debtor corporation while a dividend payment is not.<sup>20</sup> For this reason, a corporation might tend to overissue debt in an effort to reduce its tax liability. Thus, the different treatment between interest and dividends may affect a firm's capital structure. The extent of this effect has been debated in the literature on the subject.<sup>21</sup>

Assuming that the applicable tax law favors debt over equity, there is still another difficult question of whether this is desirable as a matter of tax

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18. See I.R.C. §§ 301-85 (1994); CTL, arts. 1-164.

19. See Hideki Kanda & Saul Levmore, *Taxes, Agency Costs, and the Price of Incorporation*, 77 VA. L. REV. 211 (1991). For recent work on corporate taxation, see Jennifer Arlen & Deborah M. Weiss, *A Political Theory of Corporate Taxation*, 105 YALE L.J. 325 (1995).

20. I.R.C. § 163 (1994).

21. See Jeffrey MacKie-Mason, *Do Firms Care Who Provides Their Financing?*, in ASYMMETRIC INFORMATION, CORPORATE FINANCE, AND INVESTMENT 63 (R. Glenn Hubbard ed., 1990).

policy. As a matter of corporate governance, debt might reduce a firm's agency costs because it signals management's ability to generate cash flow.<sup>22</sup> For this reason, if the amount of equity issued by large corporations is relatively small, the importance of tax rules, such as the *tokkin* rule that favors corporate stockholding, would become even greater.

Another example of tax policy affecting corporate structure may be found in connection with the rule on inter-corporate dividend deductions. Under a normal two-tier income tax system, a corporate stockholder may deduct dividends from its taxable income although typically the deduction is not for the entire amount.<sup>23</sup> Because of this rule, auction rate preferred stock developed in the United States. Such preferred stock became popular in the early 1980s for issuers with tax losses as a substitute for commercial paper.<sup>24</sup> Under this scheme, the issuer has no room (i.e., income) to enjoy the interest payment deduction, and the corporate recipient of the "interest" in the form of a "dividend" is not subject to income taxation.<sup>25</sup> This scheme did not happen in Japan for a variety of reasons, but it is noteworthy that the two-tier tax system has a number of effects on the capital structure of the firm, as well as corporate stockholding.

### III. PARENT-SUBSIDIARY CORPORATIONS

Income taxation in the context of parent-subsidiary corporations is complex, but its existence naturally affects the ownership structure of the firm. Suppose that a parent company, P, has two subsidiaries, S1, a profitable firm, and S2, a firm producing losses for tax purposes. Under the United States tax code, several ways exist to offset S1's profits against S2's losses. First, P, S1, and S2 may file a consolidated return under certain conditions.<sup>26</sup> Second, S1 and S2 may merge and offset profits against losses by taking advantage of a "net operating loss carryover."<sup>27</sup> Third, S1 and S2 can conduct transactions that zero out their gains and losses. Although this option is available, it is interesting to note that S1 and S2 are penalized if they enter into a transaction that seems to be conducted at less

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22. See Michael C. Jensen, *Eclipse of the Public Corporation*, HARV. BUS. REV., Sept.-Oct. 1989, at 61. This does not necessarily suggest that a tax policy should favor debt over equity.

23. I.R.C. § 243 (1994).

24. See, e.g., Linda Ellis, *Preferred Stock Issues Leave Wall Street Divided*, AM. BANKER, Aug. 21, 1987, at 5; William I. Sartoris & Ned C. Hill, *Innovations in Short-Term Financial Management*, BUS. HORIZONS, Nov. 1989, at 56, available in LEXIS, News Library, Mags File.

25. I.R.C. §§ 163, 243.

26. I.R.C. § 1222.

27. I.R.C. § 382.

than at arm's length.<sup>28</sup> For example, S1 may not agree to sell an asset worth \$500 to S2 for \$100. In this setting, conducting transactions arm's length is required for each transaction between S1 and S2.

However, in Japan, none of these three methods are permitted. It should not be surprising that a tax system's attitude toward integration, corporate groupings (*keiretsu*), and arm's length individual transactions varies from country to country. In fact, the United States and Japan have different rules. But, the question is whether tax rules are an important cause of one form of integration rather than another. Why, in Japan, for example, did an intermediate form of corporate integration, or *keiretsu*, emerge and survive over the past fifty years? Did tax rules play "hidden roles" in this field?

In Japan, compared to the United States, the above-mentioned income tax rules encourage integration. If the business operations of P, S1, and S2 are put within a single entity, such entity would enjoy offsetting profits against losses. Once S1 and S2 are maintained as separate corporate entities, there is no way of offsetting the losses.

Another important tax rule, however, must be noted. It is the rule about corporate divisions. In the United States, two corporations may merge into a single corporation, and a single corporation may be divided into two corporations—both without paying income taxes at the corporate level—so long as certain conditions are met.<sup>29</sup> In contrast, in Japan, such favorable treatment is available only in one direction.<sup>30</sup> While such a "tax free" merger of two corporations is recognized, Japanese tax law does not permit a tax-free corporate division. Thus, for instance, two corporations, A and B, which both have appreciated assets, can merge into a single corporation without paying corporate income tax on the amount of asset appreciation. Once they merge, however, they cannot go back and divide into corporations A and B without paying income tax at the corporate level.<sup>31</sup>

This rule appears to discourage integration. What is the overall effect of the above-mentioned two rules that appear to give opposite incentives for integration? In a typical divestiture transaction in Japan, a corporation transfers a part of its operation into a separate company without paying income tax at the corporate level.<sup>32</sup> The transferring corporation then

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28. I.R.C. § 1239.

29. I.R.C. §§ 351, 356 & 368(a)(1)(D).

30. CTL, arts. 2(xix), 27 (recognizing tax-free mergers). See Way et al., *supra* note 12, at A-29 to A-30, A-32, A-41 to A-42.

31. CTL, art. 93. See Way et al., *supra* note 12, at A-40.

32. CTL, art. 51. See Way et al., *supra* note 12, at A-32, A-42 to A-43.

keeps the shares of such company without distributing them to its stockholders. Such distribution would trigger a corporate level income tax on the distributing company.

A somewhat weak form of corporate integration, or *keiretsu*, might have evolved as an equilibrium response to these income tax rules. Under these tax rules, if firms are highly integrated into a single legal entity, it is costly to reverse integration. This suggests that firms avoid high integration in the first place, or when integrated firms want to dismantle, they stop mid-stream. That is, they create subsidiaries and keep the subsidiaries' stock without distributing it to their stockholders.

#### IV. A CAVEAT

A particular income tax rule often has more far-reaching effects on corporate governance and organizational structure than intended by the rulemaker. The corporate governance structure and industrial organization in a particular country may thus be better understood if one focuses on various income tax rules more carefully. The purpose of introducing a special tax treatment for a *tokkin* arrangement was to boost the Japanese stock market. It might also have increased stable stockholding. The survival of two-tier income taxation for the corporate form business might have encouraged corporate form stockholding. While tax rules about corporate integration were sometimes intended to prohibit abuses, they might have unintentionally encouraged a particular form of integration, or *keiretsu*. In sum, the effects of income tax rules could be surprisingly far reaching.

Nevertheless, overemphasizing such effects might be dangerous. In a familiar example, if two-tier income taxation for corporations favors debt, we should observe more debt than we do. There must be a variety of offsetting forces that balance the effects brought on by tax rules.

#### V. CONCLUSION

While the advocates of governmental intervention through taxation tend to focus on the direct effects of a particular tax rule, it is important to note that taxes have greater and farther reaching effects. They can affect corporate governance and organizational structures of firms. Indeed, a particular form of governance and industrial organization may be better understood if the overall effect of tax rules aimed at encouraging a particular form of finance or those designed for stopping abuses are properly identified. To know why and how a particular form of corporate governance and industrial organization has emerged and developed, these

hidden effects of taxes must be understood. Only thorough study of these hidden effects of taxes would enable us to understand the structure of business and industry.

