Some Issues Concerning Inheritance Tax and Business Succession in Japan

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There are reported to be 4.83 million[1] small and medium-sized businesses in Japan. In terms of both the number of such companies and the number of people they employ, they are extremely important for the Japanese economy. Just as the risk-averseness of the younger generation has been said by some commentators to have contributed to the decline in Japanese industry by leading to a decline in the number of new business formations, so various obstacles to the smooth transfer of business ownership from one generation to the next (at what amounts to a business's second formation) have been said to have had a similar effect by leading to an increase in the number of business failures. As the managers and proprietors of small and medium-sized businesses tend to be the same people and the transfer of management control tends to be accompanied by the transfer of capital, any loss of capital as a result of inheritance tax liabilities poses a threat to a business's continued existence.

Whereas the notion of "property succession" (i.e., wealth transfer) is well established in connection with inheritance tax, the same cannot be said of the notion of "business succession", and a more flexible approach is needed.

The latest (fiscal 2001) series of amendments to the taxation system therefore included a number of concessions to proprietors of small and medium-sized businesses aimed at making it easier for them to pass on their businesses.

However, these concessions were neither as comprehensive nor as generous as had been hoped. For example, the only business assets to benefit are (equity) shares, while proprietors can no longer opt to have small areas of land designated as "for residential use" and therefore subject to a lower rate of taxation.

This report examines some of these issues and compares the taxation of business succession in Japan with that in Western countries.

1 This number is based on the data in Jigyosho Kigyo Tokei Chosa [Statistical Survey of Businesses and Companies], Ministry of Public Management, Home Affairs, Posts and Telecommunications, fiscal 1999, and Hojin Kigyo no Jittai [Facts and Figures on Japanese Corporations], National Tax Administration Agency, fiscal 1999, and includes one-man businesses.

1. Some of the Problems Faced by Small and Medium-Sized Businesses in Japan

1) Need for businesses to remain going concerns

Under Japanese law (Minor Enterprises Act, Article 2), "small and medium-sized businesses" are defined as enterprises employing no more than 300 people (or 100 people in the wholesale and service industries, and 50 people in the retail and catering industries) on a regular basis, and capitalized at no more than ¥300 million (or ¥100 million in the wholesale industry, and ¥50 million in the retail, catering and service industries). There are more than 4.83 million such companies in Japan and they employ just under 31.2 million people (or roughly 70% of everyone in employment).

As the managers and proprietors of small and medium-sized businesses tend to be the same people, anything that happens to the proprietor in the course of the development of his business is likely to have a greater impact on it than in the case of a public company. In particular, his successor will face the contingent liability of inheritance tax. Also, any property used by such a business or any shares in it will tend to constitute the bulk of its proprietor's personal assets. As a result, proprietors sometimes have to sell such assets in order to pay Japan's onerous inheritance taxes, and this can destabilize a business at the very time it should be making a fresh start.

As life expectancy in Japan rises, the average age of the proprietors of small and medium-sized businesses is also rising, and a system needs to be devised to safeguard those assets that are used as business resources so that full use can be made of them. As businesses find it increasingly difficult to survive, the rate of business failures is already higher than that of business formations,[2] and the increasing age of proprietors is likely to make this situation even worse. Although some of the businesses that have failed in this situation may have deserved this fate, businesses that do not should not be threatened with extinction as a result of Japan's system of inheritance.

2) Some of the obstacles to a smooth business succession

About 40% of proprietors are aged 55 or more—an increase of 10% in the past 10 years. In a survey of proprietors, 52% identified "inheritance tax liabilities" as an obstacle to a smooth business succession. In fact, the figure was even higher (70%) among proprietors of businesses employing at least 100 people.[3] Although many proprietors would like to see their successors take over while they are still alive, the

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2 According to Jigyosho Kigyo Tokei Chosa [Statistical Survey of Businesses and Companies], Statistics Bureau of Ministry of Public Management, Home Affairs, Posts and Telecommunications, 2001.

3 According to Jigyo Shokei ni Kansuru Anketo [Survey of Business Successions], Small and Medium Enterprises Agency, July 2001.

high rate of gift tax makes it difficult for them to transfer ownership of their shares in their businesses to their successors, and they are left with no choice but to try to avoid inheritance tax on shares in their businesses or to maintain high liquidity levels, for example. Also, it seems reasonable to assume that these obstacles to business succession make it difficult to pass on the spirit of enterprise to the younger generation and deter young people from setting up in business, thereby leading to a decline in the number of business formations.

With 45.5% of proprietors interviewed in the above survey citing "a desire to pass on know-how that would otherwise be lost" and 36.6% citing "the prospect of further growth and development," it seems that the desire to preserve the business resources they have accumulated is their reason for looking for a successor.[4] Also, although a growing number of proprietors are looking for a successor who is not a relative and are prepared to pass on ownership of their business along with the right to manage it, most business successions in Japan still form part of an inheritance.

2. Inheritance Tax in Japan

1) Outline

Under Japanese civil law, the rights and obligations pertaining to a person's property while he is still alive are transferred to persons with a particular relationship to that person as a result of inheritance, and their share of that property, which was only potential while he was still alive, becomes actual as a result of his death.

Eligible as heirs are the decedent's spouse and blood relatives, who are liable to pay inheritance tax.

In 1999 the assessed value of property liable to inheritance tax in Japan was ¥13,270 billion, involving 50,730 decedents and yielding ¥1,689 billion in tax revenue. Of this assessed value, ¥440 billion consisted of shares and equity interests in family businesses, involving 10,604 decedents (or some 20% of all the decedents).

This represents about 5% of all decedents, and only a relatively small number of wealthy people are perceived as being involved. However, 36% of proprietors (and nearly 60% of those with businesses employing more than 100 people[5]) had to pay inheritance tax—a significant number in terms of the impact on business successions.

4 Ibid.
5 Ibid.

Figure 1 Inheritance Tax Ready Reckoner

Assessed value for inheritance tax purposes (¥)	Tax rate (%)	Deduction (¥)
8,000,000 or less	10	0
8,000,001～16,000,000	15	400,000
16,000,001～30,000,000	20	1,200,000
30,000,001～50,000,000	25	2,700,000
50,000,001～100,000,000	30	5,200,000
100,000,001～200,000,000	40	15,200,000
200,000,001～400,000,000	50	35,200,000
400,000,001～2,000,000,000	60	75,200,000
2,000,000,001 or more	70	275,200,000

2) Valuing inherited property

Under Japanese inheritance tax law, inherited property is assessed at its "market value" as of the time it was acquired. This does not mean "market value" in the normal sense of the term but is defined, in the case of a public company, in inheritance law and by a directive issued by the National Tax Administration Agency as either "the closing price of a company's shares on the day they were inherited" or "the lowest average daily closing price of a company's shares for each of the three months preceding the month in which the shares were inherited."

In the case of a company whose shares are not traded publicly and therefore have no objectively ascertainable market value, an equivalent value is computed either by comparing the company with comparable companies whose shares are traded publicly ("comparable industry method") or from its net asset value ("net asset value method"). Where the person acquiring the shares has a minority rather than a controlling interest, the "dividend discount method" is used by way of exception. Where the inheritance results in him acquiring a normal controlling interest, however, the comparable industry method, the net asset value method or a combination of the two ("combined method") is used.

Which method is used depends on the size of the company: the comparable industry method is used for large companies, the combined method for medium-sized companies, and the net asset value method for small companies. This is because a comparison with similar, publicly traded companies is considered appropriate in the case of relatively large companies, while a focus on companies' net asset value is considered appropriate in the case of small companies, whose situation is similar to that of proprietors who own the assets of their businesses themselves

Figure 2 Formula for Calculating Comparability Ratios

$$A \times \left[\frac{\frac{(B)}{B} + \frac{(C)}{C} \times 3 + \frac{(D)}{D}}{5(*)} \right] \times \left[\begin{array}{ll} \textit{small company} & 0.5 \\ \textit{medium-sized company} & 0.6 \\ \textit{Large company} & 0.7 \end{array} \right]$$

(*) If (C) = 0, this should be 3.
A…average share price of comparable companies
B…dividend per share of comparable companies
(B)…dividend per share of company being assessed
C…earnings per share of comparable companies
(C)…earnings per share of company being assessed
D…net asset value per share of comparable companies
(D)…net asset value per share of company being assessed

Figure 3 Formula for Calculating Net Asset Value

$$\frac{\textit{market value of net assets} - (\textit{market value of net assets} - \textit{book value of net assets}) \times 42\%}{\textit{total number of shares on issue at time of assessment}}$$

3. The Taxation of Business Successions in Western Countries

1) The taxation of business successions in the UK

In the UK, inheritance tax is levied at a flat rate of 40% and is an estate tax rather than (as in Japan) an inheritance tax.

The system of "business property relief" (BPR) introduced in 1976 was extended in 1992. As a result, 50% of the value of the assets of a business and 100% of the value of its shares are exempt from inheritance tax.

In order to qualify for exemption, a company must actually trade: investment companies and property-leasing companies, for example, do not qualify. In addition, the company must have owned and used the assets for at least two years before they are inherited.

2) The taxation of business successions in France

In France, inheritance tax is levied at a maximum rate of 40%, rising in seven stages from a minimum of 5%, and is an inheritance tax rather than an estate tax.

Since 2000, 50% of the value of the assets of a business and its shares has been exempt from inheritance tax.

In order to qualify for exemption, a company must (1) have owned and used the assets and the shares for at least two years before they are inherited and (2) continue to own them for at least six years afterwards, and the heir(s) and co-subscribers must continue to run the business for at least five years as company representatives.

Property-leasing companies and loan companies do not qualify for exemption. Similarly, financial assets or assets which are managed only as personal assets do not qualify, because they are not considered to create employment. Holding companies also qualify provided their subsidiaries trade, but are subject to various restrictions depending on the nature of their business.

The French inheritance tax system also encourages gifts *inter vivos*, with gifts to children of up to Fr300,000 over a period of 10 years and gifts to spouses of up to Fr500,000 being exempt. As exemption applies recursively for periods of 10 years, the system enables heirs to mitigate their inheritance tax liabilities.

3) The taxation of business successions in Germany

In Germany, inheritance tax is levied at a maximum rate of 30%, rising in seven stages from a minimum of 7%, and is an inheritance tax rather than an estate tax.

Since 1994, reflecting a consensus in German society that the survival and prosperity of small and medium-sized companies is essential to local communities, there has been a DM500,000 inheritance tax exemption on the value of the assets of such businesses and their shares, with a further 40% allowance on their remaining value.

In order to qualify for exemption, a company must continue to trade for at least five years after the assets have been inherited, but there are no requirements for the period beforehand. Property and loan companies also qualify provided they are incorporated.

As in France, the inheritance tax system encourages gifts *inter vivos*, with gifts to children of up to DM400,000 over a period of 10 years and gifts to spouses of up to DM600,000 being exempt.

According to the European Commission, 10% of corporate failures in the EC are the result of inappropriate action at the time of a business succession—a view which presumably reflects a consensus in the above three countries.

4) The taxation of business successions in the United States

In the United States, inheritance tax is levied at a maximum rate of 55% and a minimum rate of 18%. It is an estate tax rather than an inheritance tax. Since 1997, $1.3 million of the value of the assets of a business has been exempt from inheritance tax.

In order for a company to qualify for exemption, (1) the decedent and his family must have owned at least 50% of the assets; (2) the shares must not have been traded during the three years before they are inherited; (3) the heirs must have worked for the company for at least five of the eight years before the assets are inherited; (4) the heirs must work for the company for at least five out of eight successive years during the 10 years after the assets are inherited; and (5) at least 50% of the decedent's property that has not been transferred to his spouse must have been bequeathed to members of the family who were employed by the company for at least 10 years before his death.

4. The taxation of business successions in Japan

1) Recent developments

In fiscal 1999 the system of special tax allowances for small residential areas used for business purposes was extended. This allowed owners of plots of inherited residential land less than 330 sq. meters in area that were still used for business to have the assessed value of the land reduced by 80%. In fiscal 2001 the criterion was raised to 400 sq. meters or less.

In fiscal 2000 the method of assessing the value of non-traded shares was modified to take greater account of profitability, and the weighting of the earnings ratio used by the comparable industry method was increased from one third to three fifths.

Similarly, in fiscal 2001 the basic allowance for gift tax was raised from ¥600,000 to ¥1,100,000.

2) Fiscal 2002 amendments to the business succession tax

One of the fiscal 2002 tax amendments designed to make it easier for small and medium-sized businesses to be passed on was the inclusion of an inheritance tax allowance for non-traded shares.

This allowance reduces the assessed value of up to one third of the non-traded shares issued (with a maximum limit of ¥300 million) by 10% where ownership and control of the company are in the same hands.

For the heirs to qualify for the reduction, (1) the total value of the shares issued must not be more than ¥1 billion on an inheritance tax assessment basis; (2) the decedent must have owned at least 50% of the shares issued; and (3) the heirs must continue to own them and be officers of the company.

If this allowance is used, the special inheritance tax allowance for small residential areas used for business purposes may not be claimed as well.

In order to understand the effect of the tax reduction achieved, it is necessary to know the percentage of companies of that particular size. However, (1) the fact that the method of calculating the assessed value of non-traded shares for inheritance tax purposes varies according to the size of the company concerned and (2) the fact that it is very difficult to establish the market value of a company's net assets means that the maximum value of the tax reduction is calculated without trying to work out the exact figures. First, a minimum figure for all the companies that are not to be included is calculated by finding out how many companies there are with a conservatively estimated inheritance tax value of at least ¥1 billion. This gives a maximum figure for the percentage of companies that are to be included, and this, in turn, gives a maximum value for the tax reduction. Normally, the formula used for large companies, which tends to give a low assessed value, is used to produce a conservative estimate of the inheritance tax value. This method is used together with the tax data from a sample survey of Japanese companies published by the National Tax Administration Agency. To be more precise, the comparability ratio was calculated using an all-industry weighted average of three factors (dividends, earnings and the book value of net assets) for each industry[6] for the denominator of the dividend ratio ((B)/B), earnings ratio ((C)/C) and the net asset ratio ((D)/D) in the formula of the comparable industry method in Figure 2 while the value of the dividends,[7] earnings[8] and the book value of net assets[9] according to different levels of earnings and paid-up capital for each size of company was used in the numerator.

Figure 4 shows the distribution by earnings and paid-up capital of the assessed inheritance tax value of 2,520,000 companies covered in the above sample survey and calculated using the above method. Those categories where the assessed value is at least ¥1 billion are shaded.

If this method is used, about 1% of the companies surveyed would appear to have an inheritance tax assessed value of at least ¥1 billion.

To this must be added the number of small and other companies which were calculated as having an inheritance tax assessed value of at least ¥1 billion using the net asset value method and the market value of their net assets.

6 Extracted from Ruiji Gyoshu Hijun Kagaku Keisanjo no Gyoshubetsu Kabukato no Chubunrui [Industry-by-Industry Share Prices of Medium-Sized Companies Used to Calculate Comparability Ratios, 1999], National Tax Administration Agency.

7 Calculated for different levels of paid-up capital using Table 1 of Kaisha Hyohon Chosa Kekka [Findings of a Sample Survey of Japanese Companies], National Tax Administration Agency, fiscal 1999.

8 Calculated for different levels of earnings using Table 9 of Kaisha Hyohon Chosa Kekka [Findings of a Sample Survey of Japanese Companies], National Tax Administration Agency, fiscal 1999.

9 Calculated using theratio of paid-up capital and shareholders' equity for each level of paid-up capital in Hojin Kigyo Tokei [Financial Statements of Corporations by Industry], Ministry of Finance, fiscal 1999.

Figure 4 Number of Companies According to Earnings and Paid-Up Capital

Paid-up capital	Less than ¥1 mil	¥1 mil or more	¥2 mil or more	¥5 mil or more	¥10 mil or more	¥20 mil or more	¥50 mil or more	¥100 mil or more	¥500 mil or more	¥1 bil or more	¥5 bil or more	¥10 bil or more
Earnings												
Companies in profit												
Less than ¥1 mil	1,955	796	115,622	35,957	89,637	15,103	862	368	11	8	0	0
¥1 mil or more	386	257	35,974	8,161	46,118	9,333	519	246	4	5	0	0
¥2 mil or more	254	93	18,673	7,610	26,713	8,223	1,565	235	2	10	0	0
¥3 mil or more	196	163	18,041	7,607	30,272	8,489	1,125	381	10	11	0	2
¥5 mil or more	206	190	16,631	7,703	39,623	17,974	1,968	739	40	28	1	0
¥10 mil or more	119	73	9,142	6,348	32,219	18,865	3,900	1,188	37	39	2	4
¥20 mil or more	95	54	3,872	3,974	25,963	18,296	5,452	1,970	102	89	2	0
¥50 mil or more	54	38	935	1,008	6,052	8,125	3,414	2,201	115	125	15	9
¥100 mil or more	134	26	1,016	90	3,150	5,106	3,073	2,292	194	174	22	14
¥200 mil or more	29	18	203	139	566	2,019	2,242	2,643	359	433	50	32
¥500 mil or more	11	2	0	4	345	195	635	1,039	314	489	59	28
¥1 bil or more	0	0	0	0	0	107	423	587	225	801	320	583
Loss-making companies	12,019	6,566	775,592	224,107	608,792	98,324	23,712	13,437	1,242	2,228	435	583

Source: NRI, from Kaisha Hyohon Chosa Kekka [Findings of a Sample Survey of Japanese Companies], National Tax Administration Agency, fiscal 1999.

In 1999 there were 181,895 legal heirs compared with a total inheritance tax assessed value of ¥13,246 billion and a total basic allowance of ¥4, 357 billion, giving a per capita assessed value of ¥48.87 million. As can be seen in Figure 1, this figure comes within the 25% tax band on average, and this is also the rate that was applied to the ¥440 billion in shares and equity interests in family businesses included in the total inheritance tax assessed value. As has already been calculated, at least 1% of the companies surveyed had an assessed value of at least ¥1 billion and were therefore unable to claim the tax reduction included in the latest (fiscal 2001) series of amendments to the taxation system. This means that 99% of the above ¥440 billion (i.e., ¥436 billion) was subject to a tax concession[10] reducing the assessed value to ¥421 billion. As a result, the maximum tax reduction achieved by the latest amendments would appear to have been about ¥4.8 billion.

[10] The following formula was used to calculate 10% of one third of the total number of shares issued—the limit for the inheritance tax allowance for non-traded shares: ¥435.8 billion × 1/3 × 10%.

5. Conclusion

Three aspects of the recent amendments could be improved.

The first is the size of the allowance for the inheritance tax assessed value. First let us take the case of three legal heirs[11] to non-traded shares in a family business that were owned 100% by the decedent. Let us also assume that their assessed value for inheritance tax purposes is ¥900 million and that the assessed value of all the inherited assets is ¥1,200 million. In this case, the reduction produced by the recent amendments works out at ¥15 million. However, the inheritance tax charge on the shares is about ¥300 million—still a third of their market value. The reduction can therefore hardly be said to constitute a radical solution to the problem of business succession in Japan. Next let us compare the overall tax reduction of ¥4.8 billion mentioned above with the estimated tax reduction of ¥96 billion produced by the Ministry of Finance's tax reduction for special depreciation included in a fiscal 2001 package of tax measures designed to encourage small and medium-sized businesses to invest. If we assume (1) that the size of the allowance is increased considerably, (2) that the limit of one third of the total number of shares issued is removed and (3) that the assessed value for inheritance tax purposes is reduced by 70%, the tax reduction would be ¥77.3 billion. This would be equivalent to 80% of the estimated tax reduction for special depreciation produced by the Ministry of Finance's fiscal 2001 tax measures—hardly an excessive amount. Given that companies would be unlikely to continue to invest if they thought that they were going to go out of business, most companies interested in their long-term future could be expected to prefer a tax reduction designed to make it easier for them to remain in business to a short-term depreciation allowance designed to encourage them to invest. This suggests that the size of the inheritance tax allowance needs to be increased significantly if it is to have any effect in the current situation.

The second aspect that could be improved is the upper limit on the size of the companies eligible for the reduction. It poses the risk that companies might resort to measures that would hardly be conducive to enhancing enterprise value—e.g., trying to reduce the value of their shares at the point they are being assessed for inheritance tax purposes or breaking themselves up so that they do not exceed ¥1 billion—in order to avoid the limit. If companies continue to be preoccupied with short-term measures to ensure that their business succession goes as smoothly as possible, there is a risk that, as a result of such self-centeredness, society as a whole may miss the opportunity to find solutions to fundamental business succession problems and current inheritance tax problems and continue to focus solely on the transfer of property.

[11] All three heirs are assumed to be children of the decedent's.

The third aspect that could be improved is the fact that the recent amendments apply only to shares, while other business assets are ignored. This contrasts with the systems in Western countries, where the inheritance tax rules reflect local conditions in the way they distinguish between personal assets and the need to ensure business succession. Provided these rules are satisfied, the system is applied comprehensively, with no distinction being made between different types of business assets and different sizes of company. It would seem that, by attaching equal importance to redistributing wealth and avoiding the social costs of a failed business succession (in terms of business failures), these countries' tax systems seek to achieve a balance of wealth within society as a whole.

If we compare the number of business failures in the UK before and after the extension of business property relief in 1992, it is clear that the number of failures roughly halved from 24,425 in 1992 to 12,610 in 1997. Given that there was no significant increase in the number of companies during this period and that the number of business failures caused by non-economic factors is believed to have declined, it would seem that the scheme was successful. Therefore, while no one can say for sure that the adoption of such a scheme in Japan would have an immediate impact on small and medium-sized businesses, there is no doubt, given that ongoing investment appears to be one factor contributing to industrial dynamism, that some sort of action is needed to ensure that problems of succession do not threaten the viability of Japanese businesses and limit their options.