



Proceedings from the
2009 Sho Sato Conference
on Tax Law, Social Policy,
and the Economy

Reform of the System for Charitable Corporations and Tax System Revision

Tadatsune Mizuno
Hitotsubashi University

All rights reserved by the author.

This paper was presented at a Sho Sato Conference held on March 9-10, 2009, under the auspices of the Institute for Legal Research and in cooperation with the Robbins Religious and Civil Law Collection, School of Law, University of California, Berkeley.

Reform of the System for Charitable Corporations and Tax System Revision

Tadatsune Mizuno¹

I. Introduction

Although study on the reform of the system for charitable corporations was started in fiscal year 2002 under the Koizumi administration, the basis for its realization was established in June 2006, as three laws for charitable corporations were finally promulgated. In addition, in fiscal year 2007, the mechanism of the new system was disclosed, as the related government ordinance and cabinet order were made public. Whereas under the past license system for charitable corporations, criticism was voiced of the opaque decision-making process, collusion of the supervisory authority and charitable corporation concerned, the practice of civil servants retiring into related private-sector jobs and so forth, “small government” and, at the same time, “public services provided by the private sector” are emphasized with expectations for a new and equitable system for charitable corporations in future.

In response to the improvement of the legal system for such a system for charitable corporations, the tax system was recently revised in fiscal year 2008, mainly in the field of Corporation Tax Law.

II. Broad overview of the new system for charitable corporations

(1) Reorganization of the system for corporations

While a new system for charitable corporations is discussed in a separate paper, the existing mechanism is to be reorganized into two systems for an incorporated general association and foundation as well as an incorporated charitable association and foundation. Additionally, it has been decided that an Act on Authorization of Public Interest Incorporated Associations and Public Interest Incorporated Foundations (Act No. 49 of 2006), establishing the measures to ensure a system for the authorization of charitable corporations, the criteria of such authorization and proper implementation of the operation conducted by a charitable corporation, is to be enacted and the authorization of the nature of the charity is to be entrusted to consensual decision making by the Public Interest Corporation Commission, and not, as in the past, to the supervisory authority concerned, as provided for in Article 34 of the Civil Code.

¹ Professor of Law, Hitotsubashi University.

(2) Main requirements to be fulfilled by the incorporated charitable associations and foundations

While the nature of charity is authorized, judging from the involvement in the operation for which the nature of charity is authorized, actual records of activities for charity and the financial condition, it is considered important, when considering taxation, that 23 categories of industry be, in the first instance, listed as operations for charitable purposes. It is up to the judgment of the Public Interest Corporation Commission to determine whether or not an operation corresponds to a operation for charitable purposes, though it has been decided that the operation authorized here as a operation for charitable purposes shall be accepted in the tax system as such operation as is.

i) Operation for charitable purposes – What are the charitable purposes?

Operation for charitable purposes is a type of operation stated in any one of those listed in the separate table for charity such as science, practical art, charity and other operations for charitable purposes, and means one that contributes to an increase in the benefit of many unspecified people (Article 2, Item 4 of the Public-Interest Authorization Law).

It is very difficult to define the meaning of charitable purpose. Therefore, the new statute listed the category of charitable purpose, such as academic and scientific activity, activity which encourages culture and art. I will show the following categories.

When the purpose of the activity qualifies one of these categories, this activity is thought to be charitable or non-profit purpose.

All the profits gained from a operation for charitable purposes listed from (1) through (23) are deemed to be the assets of the operation for charitable purposes, and shall be disbursed by a operation for charitable purposes.

- (1) Academic and scientific promotion
- (2) Culture and art promotion
- (3) Support to the disabled, the poor and the victims of accidents, disasters and crime
- (4) Increase in the welfare of the aged
- (5) Assistance to the employment of people with the will to work
- (6) Enhancement of public health
- (7) Sound nurture of children and young people
- (8) Enhancement of welfare of working people
- (9) Contribution to the sound development of mind and body of citizens through education and sports
- (10) Prevention of crime and maintenance of order
- (11) Prevention of accidents and disasters
- (12) Prevention and eradication of unjust discrimination based on race, sex and so forth

- (13) Respect and advocacy of the freedom of thought, conscience, religion and expression
- (14) Formation and promotion of a gender-equal society
- (15) Promotion of international mutual understanding and international cooperation for developing nations
- (16) Global and natural environment conservation
- (17) Utilization, development and conservation of national land
- (18) Contribution to the assurance of sound operation of the national administration
- (19) Sound development of regional society
- (20) Assurance of the opportunity for fair and free economic activity
- (21) Assurance of the stable supply of goods and energy indispensable for national life
- (22) Protection and enhancement of general consumer benefits
- (23) Those designated by the government ordinance as operations for charity

ii) The more requirements to be charitable activities

- (1) One half or more of the profit gained from the Profit-Making Operation and so forth shall be designated as the assets of a operation for charitable purposes. Namely, it shall be disbursed by a operation for charitable purposes.
- (2) A charitable corporation shall not, in conducting its operation for charitable purposes, gain any income in excess of the amount sufficient to cover the appropriate cost required for conducting the operation for charitable purposes concerned (Article 14).
- (3) A charitable corporation shall determine the ratio of the operation for charitable purposes and conduct the operation for charitable purposes in such a way as to maintain the ratio of the operation for charitable purposes in each operation year (which means the percentage of the amount referred to in Item 1 in the total of those referred to in that item through Item 3) at one half or more (Article 15).
- (4) Assets of the operation for charitable purposes. In order to limit the activities of profit-making-type operations, additional stipulations are provided on the assets of an operation for charitable purposes.

iii) Additional criteria for the authorization of charity

The following criteria are listed for the incorporated general associations or foundations which have applied for “authorization of charity” (Article 5).

- (1) The main objective of the legal entity concerned shall be to conduct a operation for charitable purposes.
- (2) The legal entity concerned shall have the accounting basis and technical capability necessary for conducting a operation for charitable purposes.
- (3) In conducting the operation, the legal entity concerned shall not provide special benefit to its staff members, councilors, administrative officers, auditors, employees and other parties related to the same legal entity as provided for in the government ordinance.
- (4) In conducting its operation, the legal entity concerned shall not provide donation or other special benefits to any person who conducts profit-making-type activities for any stock company or for others or any person who conducts activities aimed at making a profit for any specific individual or any organization as defined in the government ordinance. However, this provision shall not apply to any case where the legal entity concerned provides to a charitable corporation any donation or other special benefit for a operation for charitable purposes conducted by such charitable corporation.
- (5) The legal entity concerned shall not conduct any speculative transaction, high interest rate loans and other operations defined in the government ordinance as those inappropriate for a charitable corporation to maintain its social credibility or possibly offend good public order or morals.
- (6) The income from the operation for charitable purposes conducted shall not be expected to exceed the amount required to cover the appropriate cost of conducting such operation.
- (7) In the case where any operation other than one for charitable purposes (hereinafter referred to as “the Profit-Making Operation and so forth”) is conducted, the Profit-Making Operation and so forth shall not obstruct the operation for charitable purposes from being conducted.
- (8) In conducting the activities for the operation, the ratio of the operation for charitable purposes, as provided for in Article 15, shall be anticipated to equal or exceed 50 hundredths.
- (9) In conducting the activities for the operation, the amount of idle properties provided for in Article 16, Section 2 shall not be anticipated to exceed the limit referred to in Section 1 of the same article.
- (10) The total number of any administrative officer concerned and his or her spouse or relatives within three degrees of kinship (including those who have a similar special relationship with the administrative officer concerned, as defined in the government ordinance) shall not exceed one third of the total number of administrative officers. The same provision shall apply to an auditor.

- (11) Total number of administrative officers or employees of other identical organizations (excluding any charitable corporation or similar organization, as defined in the government ordinance) and other similar individuals with any mutually close relationship, as defined in the government ordinance, shall not exceed one third of the total number of administrative officers. The same provision shall apply to an auditor.
- (12) An accounting auditor shall be employed. However, this provision shall not apply in the event that none of the amount of profit, cost and loss as well as any other item of account defined in the government ordinance reaches the amount of the criteria determined in the government ordinance.
- (13) The criteria for the payment of remuneration and so forth (which means the remuneration, bonus and other benefits in terms of assets and retirement allowance to be received as compensation for job performance. The same provision shall apply hereafter.) of an administrative officer, auditor and councilor shall be determined in such a way as not to be unreasonably large in amount, in consideration of the compensation to the director of a private business operator and so forth as well as the salary to an employee and other circumstances including the financial condition of the corporation concerned.

While the criteria for authorization as stated above are disclosed, there is a common view regarding the ideal framework of the tax system.

III. Direction of the tax system for charitable corporations

1. Basic vision on the tax system for charitable corporations

While the ideal framework of the tax system for charitable corporations was also discussed in the working group of the Research Commission on the Tax System, such corporations have been called "nonprofit corporations of a charitable nature," based on the purport of reviewing a nonprofit corporation as a whole. Consequently, the following items were recognized in advance:

(A) It has been decided that the judgment on the nature of charity should depend on what constitutes the ideal framework of a nonprofit corporation before the tax system. Although the Internal Revenue Service of the United States independently authorized the nature of charity (objective of charity), the tax system of Japan was not based on such a philosophy.

(B) Nature of charity in the aim, operation and so forth of a nonprofit corporation

- (i) To aim at realization of the benefit for an unspecified majority.
- (ii) To absolutely prohibit distribution of the profit to a constituent member.

- (iii) To ensure the residual assets belong to the government and so forth.
- (iv) To maintain the disbursement to a operation for charitable purposes at more than half the total.
- (v) To reject the control by administrative officers composed of relatives and so forth.
- (vi) To prohibit excessive earning retention.

(C) Basic direction in taxation

- (i) Tax on profit of a charitable nature
- (ii) Only the profit gained from the operation in competition with a profit-making corporation shall be taxed. This is so-called taxation on the Profit-Making Operation.

2. Taxation on nonprofit corporations

(1) Basic direction

Nonprofit corporations are diverse. In particular, there may be corporations whose charitable nature cannot be authorized as they cannot fulfill the formal criteria for authorization of the nature of charity such as the requirement for disbursement to a operation for charitable purposes of 50% or more. Therefore, it is necessary to prioritize the substance of the objective, particulars and so forth of the organizational operation and operational activities of the nonprofit corporation.

(2) Treatment in terms of taxation

- a) The temporary surplus is not taxable, such as membership dues of a nonprofit corporation engaged in the activities for operation aimed at the common benefit.
- b) Even a general nonprofit corporation is prohibited from distributing the profit. It is necessary to maintain a balance with the profit-making corporation.

(3) Points of controversy common to ongoing charitable corporations and so forth in terms of taxation

- 1) The scope of the charitable corporation and so forth to be taxed includes 33 categories of industry treated as Profit-Making Operations under the current law. How should this issue be resolved?
- 2) It has been said that preferential treatment such as reduced tax rate and the system of deemed donations should be reviewed in consideration of the

purport of maintaining the balance with a profit-making corporation and taxation on the Profit-Making Operation.

- 3) With respect to the taxation on the profits in relation to financial assets such as interest, dividends and so forth, those in favor of deeming them equivalent to income from Profit-Making Operations and considering them resources supporting the activities for charity respectively are visibly opposed to each other.

IV. New tax system for charitable corporations – Taxation of incorporated charitable associations and foundations

Until chapter III, we discussed the legal requirements or framework of charitable corporations. The requirements and criteria for the legal entities to be authorized as incorporated charitable associations and foundations have finally been defined in detail as stated above.

Now, we will talk about the requirements for a certain tax treatments and tax effects of charitable corporations.

Under the traditional tax mechanism in which everything was left to the discretion of the supervisory authorities, they decided in regard to the corporation tax law to focus only on the Profit-Making Operations of which only those belonging to 33 categories of industry were taxed.

The new mechanism of the tax system for charitable corporations was a major issue in the tax system revision of fiscal year 2008. Here, its outline is stated. However, if “feigned charitable corporations” increase in number for the purpose of enjoying benefits under the tax system, the purport of the reform of the system for charitable corporations will be impaired.

(i) Profit gained from operations for charitable purposes

1. The profit gained from operations for charitable purposes (Article 2, Section 4 of the Public-Interest Authorization Law) is deemed to be the assets of a operation for charitable purposes, which has to be disbursed for a operation for charitable purposes at some future date, but, how is the profit not paid out in the operation year concerned and deemed assets of a operation for charitable purposes to be taxed? It should not be taxed in order to promote operations for charitable purposes. In the past there was no concept of operations for charitable purposes, and a corporation was taxed, depending on whether or not it was included in those belonging to the 33 categories of the profit-making-type operation, designated in the Corporation Tax Law.
2. Under the tax system revision of fiscal year 2008, the profit gained from a operation for charitable purposes, designated in Article 2, Section 4 of the

Public-Interest Authorization Law arises for conducting operations for charitable purposes, and as the operation concerned is excluded from the category of Profit-Making Operation, such profit is not to be taxed (Article 5, Section 2, Item 1 of the Corporation Tax Ordinance).

To amplify the explanation, it is unreasonable to tax the profit gained by a Profit-Making Operation from the operation for charitable purposes, also included in the 33 categories of Profit-Making Operations, though the Profit-Making Operation is not allowed to be taxed because it is excluded from the 33 categories of industry. Therefore, under the tax system revision of fiscal year 2008, it has been decided that such operation is not deemed to be a Profit-Making Operation, provided it is authorized as a operation for charitable purposes. The operation falling under the category of a operation for charitable purposes is excluded from the scope of the Profit-Making Operation.

3. In addition, while it has been deemed necessary to date to review the principle of taxation on the 33 categories of Profit-Making Operations, under the tax system revision of this time, it has been decided to tax the labor dispatch service (Article 5, Section 1, Item 34 of the Corporation Tax Ordinance) in addition to the 33 categories of Profit-Making Operations, increasing the number of categories to 34. Since many profit-making corporations have entered the labor dispatch service industry in recent years and some charitable corporations and so forth have actually been engaged in the labor dispatch service, it has been decided to include the labor dispatch service industry in the profit-making industry category in order to maintain a balance with the fact that contracting and go-between businesses are classified as Profit-Making Operations.
4. In the case where “the income in relation to a operation for charitable purposes exceeds the amount to cover the appropriate cost required for conducting such operation,” there could be, in the first instance, a view negating the fact that it is a operation for charitable purposes and deeming it a possible general Profit-Making Operation.

Since it is stipulated in Article 18 of the Public-Interest Authorization Law that “6. It shall, in conducting a operation for charitable purposes, be anticipated that the income in relation to the said operation for charitable purposes is not to exceed the amount to cover the appropriate cost required for conducting such operation,” and as it shall be anticipated that the income in relation to the said operation for charitable purposes is not to exceed the appropriate cost of such operation, it is considered acceptable to tax the portion of the “profit in relation to the operation for charitable purposes” that exceeds the appropriate cost of such operation for charitable purposes, because it is unreasonable that a operation for charitable purposes

can make a profit. In particular, among the legal entities involved in medical treatment, there are charitable corporations and special administrative corporations as well as general medical corporations. In the new law, it is considered that an operation cannot be included in the category of operation for charitable purposes simply because it is involved in medical treatment. These are points of controversy in relation to the tax system, newly raised in the course of tax system revision accompanying the reform of the system for charitable corporations.

In this connection, since the incorporated charitable associations and foundations are no different from traditional charitable corporations and so forth in that only the Profit-Making Operation is taxed, the incorporated charitable associations and foundations have been added to the category of charitable corporations and so forth listed in Table 2 attached to the Corporation Tax Law (Article 4, Section 1 of the Corporation Tax Law).

(ii) Income gained from a Profit-Making Operation and the operation for charitable purposes

The income gained from a Profit-Making Operation is taxed. As stated before, under the tax system revision of fiscal year 2008 the labor dispatch service is now taxed as well, increasing the number of categories of Profit-Making Operations taxed to 34.

On the other hand, under the tax system revision, among the incorporated general associations and foundations to be stated later, some organizations were recognized as those who pay tax only on their Profit-Making Operations, which are more like charitable corporations rather than business corporations. In particular, in the medical healthcare industry, the medical and healthcare operation conducted accompanying academic research (Article 5, Section 1, Item 29, Sub-Item 50 of the Corporation Tax Ordinance), those fulfilling certain requirements among the member corporations of the Medical Association and so forth (Sub-Item 46 of the same item) and those related to the operation of public welfare hospitals (Sub-Item 16 of the same item) are exempted from taxation, even though they are Profit-Making Operations.

(iii) Deemed donation

In the past, 20% of the amount disbursed from a Profit-Making Operation to charitable operations and common benefit operations was deemed an untaxable deemed donation. Although in the reform of the system for charitable corporations of this time, 50% or more of the income gained from a Profit-Making Operation and so forth must be classified as the assets of a operation for charitable purposes, under the tax system as well, 50% of the income gained from the profit-making is treated as a deemed donation. In addition, treating the actual disbursement to a operation for charitable purposes as a deemed donation has been permitted.

Specifically, the amount recognized as one from the assets belonging to a Profit-Making Operation, applied or surely applicable to its own operation for charitable purposes is deemed the amount of the donation related to its Profit-Making Operation (Article 37 of the Corporation Tax Law and Article 77 - 3 of the Corporation Tax Ordinance).

(iv) Tax rate

The tax rate of 30% is applied to the amount of income for each operation year. However, the reduced tax rate of 22% is applied to the portion of the amount of income that is 8 million yen per year or less.

(v) Donation to charitable corporations

In the past, only donations to charitable corporations deemed specific charitable enhancing corporations were allowed to be deducted from the full amount. The incorporated charitable associations and foundations were added to the category of specific charitable enhancing corporations. The details are discussed in another paper in this bulletin.

V. Taxation on the incorporated general associations and foundations

The duty to pay the corporation tax arises for those listed below among the incorporated charitable associations and foundations that have not received the authorization of charity (hereinafter referred to as “the Nonprofit Type Corporation” – Article 2, Items 9 - 2 of the Corporation Tax Law), only in the case where they have engaged in Profit-Making Operation (Article 7 of the Corporation Tax Law). Consequently, the Nonprofit Type Corporation was added to the existing category of charitable corporations and so forth, since only its Profit-Making Operation is taxed.

1) The incorporated general associations and foundations fulfilling all of the following requirements

- (A) It is stipulated in the articles of association that the retained earnings shall not be distributed.
- (B) It is stipulated in the articles of association that the residual assets at the time of dissolution shall belong to the government, local public authorities, incorporated charitable associations or foundations (Article 2, Items 9 - 2 - 1 of the Corporation Tax Law and Article 3, Section 1 of the Corporation Tax Ordinance).

2) Incorporated general associations or foundations fulfilling all of the following requirements

- (1) It shall be made the main objective to conduct activities aimed at mutual assistance, interaction, communication among the members and other benefits common to the members (Article 3, Section 4 of the Corporation Tax Ordinance).
- (2) The amount of money to be borne by the members (membership dues) shall be specified in the articles of association or clauses for members based on the articles of association, or it shall be stipulated in the articles of association that such amount of money shall be determined by the resolution of the general meeting of members or council (Article 2, Item 9 - 2 - 2 of the Corporation Tax Law).
- (3) It is not stipulated in the articles of association that the right to receive distribution of the retained earnings is granted to any specific individual or organization and the residual assets are to belong to any specific individual or organization (except the government, local public authorities or corporations listed below).
- (4) Incorporated general associations or foundations that have objectives similar to those of the incorporated charitable associations or foundations.
- (5) The total number of administrative officers and those of their relatives shall be one third or less of the total number of administrative officers (Article 3, Section 3 of the Corporation Tax Ordinance).
- (6) The corporation concerned is not conducting any Profit-Making Operation as its main operation (Article 3, Section 4 of the Corporation Tax Ordinance).
- (7) No special benefit shall be granted to any specific individual or organization.

It has been considered unacceptable to tax the surplus such as the membership dues not of a charitable nature nor that of profit making, that are nothing but a temporary surplus arising from the time lag between the revenue and expenditure (WG for the profit-making corporation of the Research Commission on the Tax System). The purport is not to tax such expenditure, including that of nonprofit corporations, that has not been authorized for charity.

i) Scope of the taxable income

The corporation tax is imposed on the income arising from the Profit-Making Operation as a proportion of total income for each operation year. The category of Profit-Making Operations to be taxed is the same as that for the incorporated charitable associations and foundations.

As stated before, in the medical healthcare industry, the medical and healthcare operation conducted accompanying academic research (Article 5, Section 1, Item 29, Sub-Item 50 of the Corporation Tax Ordinance), those fulfilling certain requirements among the member corporations of the Medical Association and so forth (Sub-Item 46 of the same item) and those related to the operation of public welfare hospitals (Sub-Item 16 of the same item) are exempted from taxation, though they are Profit-Making Operations.

ii) Applicable tax rate

A tax rate of 30% is applied to the amount of income for each operation year. However, a reduced tax rate of 22% is applied to the portion of the amount of income that is 8 million yen per year or less.

Incorporated general associations and foundations to which taxation on the entire income is applied.

Incorporated general associations and foundations not corresponding to any of those mentioned above are classified as ordinary corporations under the Corporation Tax Law.

(3) Social medical corporation

Furthermore, the medical corporation is taxed as an ordinary corporation, though, as stated before, the system of social medical corporations was created in 2006 (Article 42, Sections 21 and 2 of the Medical Corporation Law), as the circumstances surrounding the medical treatment were largely undergoing a change, and those authorized by the prefectural governor as medical corporations fulfilling certain requirements such as execution of the operation for securing emergency medical services and so forth are taxed only on the profit gained from the Profit-Making Operation..

VI. Conclusion

As I mentioned in the introduction, the legal system of charitable corporations, especially how to decide whether an applicant organization should be allowed to a charitable corporation was not transparent. Each ministry has strong discretion power to decide charitable corporations. That was the reason why charitable corporations often employ retired government officials recommended by such a ministry. Now, we have set forth a new commission (PICC) which decide if an applicant organizations can satisfy the requirements of charitable corporations set up by new statutes.

Our present concern is whether this commission (PICC) can decide properly which organizations should be allowed to become incorporated charitable associations or foundations. On the other hand, the National Tax Agency is supposed to tax each organization, depending on the decision of PICC whether an organization is a incorporated charitable association or a incorporated general association. I am afraid that these two government agency and commission will make different decisions as to

nonprofit operations, charitable purpose activities and so on, even though the tax agency have to obey the decision of PICC whether an organization is an incorporated charitable association or not. According to the distinction of interpretation of law, the range of taxable income, or deductible donation will be different.

In my feeling, PICC will decide only an applicant organization can be incorporated charitable association or foundation. The will not give any reason or interpretation of law, as far as PICC does not give negative answer. Therefore, interpretation of the National Tax Agency will become important as to the statutes regarding charitable organizations.