



Civil Society Monitor

Japan Center for International Exchange

No. 8 December 2003

New Legal Reform Efforts Receive Mixed Welcome

SEVERAL NOTEWORTHY SHIFTS have been taking place within the legal environment surrounding Japan's nonprofit sector recently, with important implications for the sector's future growth. Over the past five years, starting with the 1998 Law to Promote Specified Nonprofit Activities (the "NPO Law"), various

legislative actions and reforms have succeeded in establishing a foundation for the growth of newly emerging nonprofit organizations (NPOs) in Japan. At the same time, a series of administrative reforms, underway since late 2000, has triggered efforts to reevaluate the basic legal framework governing the traditional types of civil society organizations. Although the two tides of reforms ultimately are heading toward the same goal, the sector's future remains uncertain. Both efforts face many issues and challenges and will require close attention.

One focus of reforms involves "public interest corporations" (*koeki hojin*), which are incorporated under Article 34 of the 1898 Civil Code, while another involves NPOs that are incorporated under the provisions of the 1998 NPO Law. Public interest corporations, numbering approximately 26,000, are defined as incorporated associations and foundations that provide services for the public good and without a profit motive. Their fields of activity include health, employment and labor, education, and arts and culture, among others. In order to be incorporated as a public interest corporation, an organization must undergo a lengthy and complicated approval process. Approval is given at the discretion of the appropriate national or local gov-

ernment agency with jurisdiction over that organization's field of activities.

There are now roughly 14,000 NPOs incorporated under the 1998 law. NPOs in this category are those involved in specifically designated activities, including health and welfare, social education, NPO support, and community development. Under the NPO Law, incorporation is based solely on a set of objective criteria (authentication process) rather than on an approval process involving the discretion of government agencies. Because the incorporation process is simpler, there has been a rapid proliferation of this type of NPO.

However, while the NPO Law represented a significant step toward creating a more enabling environment for nonprofit

activities in Japan, there were several aspects of the system that called for reevaluation. As a result, important amendments were made recently—both to the NPO Law and to tax measures concerning NPOs—that further strengthened the framework supporting NPO activities. These are outlined in the following article.

Also, as described in the article on page three, these amendments have been accompanied by a reevaluation of the legal framework for public interest corporations in response to widespread calls for reform. The resulting proposal has become the source of much debate within the nonprofit sector, as the potential impact has broad and uncertain implications not just for public interest corporations but for the sector as a whole. 

Major Legal Developments Relating to Japan's Nonprofit Sector

- December 1998: NPO Law enacted, facilitating establishment of nonprofit organizations as legal entities
- March 2001: Law Amending in Part the Special Tax Measures Law approved, setting objective criteria regarding eligibility of NPOs to receive tax-deductible donations
- April 2002: Chukan Hojin (Mutual Benefit Nonprofits) Law enacted, giving legal status to these organizations
- December 2002: Amendments made to the NPO Law and to the 2001 tax bill
- June 2003: Proposal for legal reforms concerning public interest corporations announced

Amendments to the NPO Law and Tax Bill Bring Increased Flexibility to Nonprofits

In December 2002, amendments were made to the NPO Law and the tax bill affecting NPOs to address specific issues that have hampered the growth of Japan's nonprofit sector.

Amendments to the NPO Law

The amendment of the NPO Law involved several noteworthy changes aimed at promoting greater flexibility in the implementation of nonprofit activities, specifically with regard to the newer category of NPOs. A supplementary provision in the original law had stipulated the reevaluation of the specified nonprofit corporation system within three years. NPOs played an active part in the amendment process through a liaison council set up in June 1999. The council worked closely with the nonpartisan Parliamentary Caucus on NPOs, which was formed in August 1999. The council submitted an amendment proposal to the Caucus and held public forums throughout Japan to provide the opportunity for legislators to hear local opinions on reforms to the taxation and incorporation systems for NPOs and NGOs. The main amendments that resulted from this process, which were approved in December 2002 and came into effect on May 1, 2003, are as follows (see insert for full text of the amended NPO Law):

- The expansion of the authorized fields of nonprofit activity from 12 to 17 to allow a greater range of nonprofit organizations to be incorporated under the NPO Law. The following five fields were added: information technology; science and technology; economic revitalization; job training and employment; and consumer protection.
- The repeal of the provision regarding budget adherence to allow greater flexibility in nonprofit operations. The accounting-related clause (Article 27.i) stating that all revenues and expenditures must be based on an initial budget

was removed, reflecting a dismissal of the notion that "good governance" implies that organizations must adhere strictly to the budget they establish at the beginning of the fiscal year. NPOs in Japan now have increased flexibility to respond to urgent concerns in their field of activity that may arise after the start of the fiscal year.

- The strengthening of measures to prevent criminal organizations from becoming incorporated or from extending their influence from within incorporated NPOs.
- The simplification of the application process. The original law required the submission of 16 types of documents in the application process, but the amendment has condensed these categories into 11, resulting in a more streamlined incorporation process.

Amendments to the Tax Measures for NPOs

Along with these amendments to the NPO Law, the tax bill applying to the newer category of NPOs also underwent revision in response to sharp criticism of various aspects that ran contrary to the bill's original purpose of enabling NPOs to become eligible for tax-deductible status. The original tax legislation, passed in March 2001, marked an important development for the nonprofit sector in that it set objective criteria for according tax-deductible status to NPOs, thereby establishing a much more concrete basis for eligibility than the subjective evaluations by supervising government authorities that public interest corporations must undergo.

However, it soon became clear that the provisions that determined eligibility for tax-deductible status for NPOs were overly restrictive and that the application process was cumbersome and confusing. In fact, after more than one year, only 10 NPOs had been authorized to receive this tax privilege, representing an authorization rate of 0.1percent. This led to rising criti-

cism of the system from various quarters—including the Cabinet Office and various ministries as well as NPOs themselves. The NPO liaison council led efforts within the sector to urge the related government agencies and legislators to move forward with the reform process. As a result of this process, the following amendments were approved in December 2002, and came into effect on April 1, 2003.

- Various aspects of the "public support test," which stipulates that more than one-third of an organization's total revenues must come from donations and grants, were relaxed. For example, the one-third minimum is being lowered to one-fifth for a trial period of three years.
- The condition requiring NPOs to conduct their activities in more than one municipality in order to become eligible for tax-deductibility has been removed. This amendment has made it possible for small-scale community-based nonprofits to obtain tax-deductible status.
- The requirement stipulating that NPOs approved for tax deductibility must submit advance notification to the National Tax Administration Agency before making overseas remittances or taking money abroad has been amended. Now, notification is only required for amounts exceeding ¥2 million. (Amounts equaling ¥2 million or less can be reported to the agency at the end of the fiscal year.)
- The unique type of tax-exempt donation (*minashi kifukin*) already recognized in the public interest corporation system is now applicable to NPOs. Up to 20 percent of an NPO's taxable income from profit-making activities that is used toward nonprofit activities will be treated as this type of donation.

The extent of the impact that these legal amendments will have on the nonprofit sector has yet to be seen. In order to evaluate their effectiveness, it will be important to monitor the increase in the number of NPOs with tax-deductible status over FY2003. 🌸

Proposed Reforms Affecting Public Interest Corporations Spark Heated Debate

A major issue currently facing the nonprofit sector is a proposal that has been evolving since mid-2002 to significantly reform the legal framework surrounding public interest organizations in Japan. Unlike the two NPO-related legal revisions approved in December 2002, which have been welcomed as positive steps toward enabling the sector's growth, the discussion of reforms related to public interest corporations has generated feelings of confusion and uncertainty. These feelings are linked to concerns that the reforms proposed by the government may not necessarily result in a supportive framework for the development of the nonprofit sector. As a result, a heated debate has developed among members of the nonprofit sector, the bureaucracy, and the Diet.

The most controversial element of the proposal is a possible move to abolish the current favorable tax treatment of public interest corporations in what would amount to a tradeoff for a reform that would eliminate government involvement in the incorporation process. Essentially, the proposed reform may result in the abolishment of the current system of automatically awarding corporate-tax exemption to an organization once it has been established as a public interest organization. Instead, incorporation and favorable tax treatment would be treated as two separate issues, and it is possible that under the new plan only certain authorized incorporated entities would be exempt from corporate tax.

Factors Leading to the Reform Process

The reform of the public interest corporation system has been a subject of discussion for many years within Japan's nonprofit sector. The system is based on the Civil Code, which was established more than 100 years ago, and has received criticism for putting up various

obstacles to the sector's development. These obstacles include heavy government control, which has led to many public interest corporations essentially serving merely as subcontractors for government agencies. Critics also have pointed out the inconsistency in the provisions governing the various types of nonprofit corporations that have evolved over the past century. Another issue is the lack of objective criteria in the incorporation process and in determining eligibility for receiving tax-deductible contributions.

Japanese nonprofit leaders have long been calling for a reform of the public interest corporation system, but criticism of the system has come from the Japanese public as well. One complaint concerns the preferential tax treatment given to public interest corporations operating in competition with private businesses and to those that carry out activities for common profit rather than for public interest. The repeated reports of misconduct in recent years, involving politically tied donations, kickbacks, and embellished accounting, have also led to criticism of the inefficiencies and lack of transparency in their operations.

All of these factors prompted the government to reevaluate the public interest corporation system as part of its large-scale administrative reforms. The reform efforts initially focused on restructuring only those public interest corporations closely connected to the government. However, a series of major scandals has forced the government to expand its scope and reconsider the entire system.

Outline of Proposed Reforms

In March 2002, the government began discussions on a series of reforms to the legal framework of public interest corporations. The initial scheme was announced later that summer and advisory councils consisting of scholars and practi-

tioners were formed to examine both the incorporation system and tax system for public interest corporations. The discussions have yet to produce a clear path for reform. However, an outline of the basic reform guidelines was passed as a Cabinet resolution in June 2003 and can be summed up as follows:

- Revise the Civil Code to create a new legal framework for "nonprofit corporations" (*hieiri hojin*). The current public interest corporations would be placed under this new category of nonprofit corporations.
- Simplify the legal process for incorporation by basing it on standard criteria. Similar to the establishment of for-profit corporations, the new system would allow organizations to simply register as incorporated entities if they meet certain criteria set by law, thus enabling incorporation without the approval of government agencies.
- Consider abolishing the favorable tax treatment that automatically accompanies incorporated status. As such, the nonprofit corporations would have to qualify under the system described below in order to receive tax exemption.
- Introduce a system of awarding tax-exempt status to select nonprofit corporations that are considered to contribute greatly to the public interest and to society. How this will be carried out has yet to be determined. Items under consideration include the establishment of clear and objective criteria to determine eligibility for tax-exempt status and the feasibility of an independent entity to make the judgment.

Implications and Reactions

The government is striving to pass a bill before the end of FY2005 within the above guidelines. These reform efforts are notable for their basic approach of positioning and promoting the nonprofit sector as an important member within Japan's

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socioeconomic system based on its ability to respond flexibly and actively to new social issues that are not being sufficiently addressed by the government or private sectors. This stance represents a major shift in direction for the government, which until now has supported tighter regulation of public interest corporations. However, in the past several months, these guidelines have prompted strong protests from the nonprofit sector.

The tax system has emerged as the most contentious point, as the reform proposal departs sharply from the current system in practice, which is based on the principle that nonprofit corporations should not be taxed. Currently, public interest corporations are subject to a reduced corporate tax rate of 22 percent only on income from profit-generating activities. All other income is tax-exempt. The proposed revision calls for the application of a uniform 30 percent corporate tax rate—the same as that of for-profit corporations—on all income. This implies that, if the evaluation system for awarding tax exemption is extremely strict, many nonprofit corporations will face paying taxes on all income including contributions, membership dues, and grants, which had been tax-exempt until now. Many have raised strong objections to this proposed change, asserting that for such a measure to be established without first specifying the basis for determining eligibility for tax-exempt status would be equivalent to starting a game without first

stating the rules. There is also concern that a heavier tax burden will lead to financial difficulty for many public interest corporations.

Another source of concern is the uncertainty regarding whether the “independent entity” that will be appointed to evaluate eligibility for tax-exempt status will truly be an institution independent of the government or whether it ultimately will be a government-related organization or one of the ministries. It is feared that, in the latter case, the measure will simply lead to further strengthening of government control.

Moreover, the tax exemption issue is being treated as separate from the issue of allowing contributions to nonprofit corporations to be tax deductible. Nonprofit corporations may therefore have to undergo a third layer of approval—in addition to those for incorporation and tax-exempt status—in order to obtain the necessary status to receive tax-deductible donations. This potential triple layer of authorizations is widely seen as excessive. While the government’s proposal to take away preferential tax treatment and impose taxes on public interest corporations can be explained by a desire to increase tax revenue and to forestall abuses of the tax system, it is highly debatable whether the imposition of taxes would actually help to reduce cases of misconduct.

Another point of concern is the potential implication for other nonprofits. At this point in time, the government’s reform

proposal is directed solely at public interest corporations, but it is anticipated that the focus soon will be expanded to include NPOs and mutual benefit nonprofits (*chukan hojin*). The impact may even extend to social welfare, educational, and other nonprofit institutions in the future, which would change the entire legal framework of the nonprofit sector.

After a brief interlude due to the November general elections, the debate on these reforms has been reignited through the initiation of a second round of discussions. In fall 2003, the government relaunched two advisory councils initially formed in mid-2002 on the incorporation and tax systems, with several new members. (New appointments to the incorporation-system advisory council include JCIE’s Managing Director, Hideko Katsumata.) The councils will submit recommendations to the government in the fall of 2004, based on which more concrete reform guidelines will be drafted. In the meantime, civil society organizations are launching initiatives to enhance internal governance, public disclosure, and peer evaluation with the goal of addressing the challenges facing the nonprofit sector and bringing about positive reforms that lead to a more flexible and enabling operating environment. 🌸

Note: The sections on the amendments to the NPO Law and the NPO tax bill draw heavily on two NPO-related references published in 2003 by C’s (the Coalition for Legislation to Support Citizens’ Organizations).

Civil Society Monitor

Publisher: Yamamoto Tadashi

Co-Editors: Itoh Satoko, Ema Shimada Layout & Design: Patrick Ishiyama

Japan Center for International Exchange

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