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Tax Controversy

Japan: Law & Practice
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Japan: Trends & Developments
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Law and Practice

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1. TAX CONTROVERSIES

1.1 Tax Controversies in this Jurisdiction

As a procedural legal matter, a tax controversy will arise when and if (i) a formal tax assessment has been issued upon a taxpayer; and (ii) the taxpayer initiates the procedure to dispute the assessment, as discussed below. However, because a formal tax assessment is made only if the difference of views between the taxpayer and the tax authority was not resolved during the preceding tax audit, as a matter of fact and practice, a tax controversy would begin at the tax audit.

1.2 Causes of Tax Controversies

Every type of Japanese tax may give rise to tax controversies. However, in practice, a significant majority of controversies involve income tax. Among income taxes, for sophisticated corporate taxpayers, corporation tax (ie, national corporate income tax) and withholding tax are the major ones. Also, for high net worth individuals, individual income tax as well as inheritance and gift taxes are major sources of tax controversies. Tax controversies relating to consumption tax – ie, value-added tax (VAT) – and fixed property tax are also common. While being rare, transactional taxes such as stamp duty and liquor tax may also be litigated.

As to the value, there is no threshold for taxpayers to dispute a tax assessment. Sometimes, aggravated and upset individual taxpayers will dispute even if the amount of tax at stake is very small. However, sophisticated corporate taxpayers will generally weigh the benefit of disputing against the associated time and costs; so, it is not common for such sophisticated corporate taxpayers to dispute the tax assessment if the amount of tax at stake is small. The only exception may be an assessment of a heavy penalty tax (along with the principal tax at hand), because an imposition of a heavy penalty tax means that the taxpayer committed fabrication or concealment of facts, which is generally viewed among the public as indicating an attitude of non-compliance on the part the taxpayer. So, especially when the taxpayer is a well-known corporate, conscious of its public reputation, it sometimes disputes the assessment of a heavy penalty tax no matter the amount of tax at stake.

1.3 Avoidance of Tax Controversies

Because a tax controversy arises when there exists a difference of views in tax audits, it logically follows that this difference of views would not arise if the taxpayer had confirmed the view of the tax authority in advance with respect to the tax treatment of a particular transaction. This can formally be made by way of seeking a written formal advance ruling with the tax authority; however, because this formal procedure usually takes three to six months in practice, this is not very popular. Instead, many taxpayers use an informal confirmation with the tax authority on a verbal basis, which is much easier to obtain than a written formal advance ruling and, solely as a practical matter, the effect would not be significantly different from a written formal advance ruling; that is, even a verbal confirmation is well reviewed and respected within the tax authority, in practice.

It should be noted that even if the taxpayer secures a written formal advance ruling or a verbal informal confirmation, a tax controversy in the tax audit (and then in the administrative and judicial procedures) could still arise, if the tax authority finds that the facts as represented by the taxpayer at the time of the ruling or confirmation turned out to be inaccurate or misleading.

Also, in the transfer pricing area, an advance pricing arrangement (APA) is commonly used, for the purposes of avoiding future tax controversy

relating to an arm's-length price for a controlled transaction.

1.4 Efforts to Combat Tax Avoidance

To date, Japan has implemented the following Base Erosion and Profit Shifting (BEPS) Actions of the OECD by amending its domestic tax law or tax treaties.

- Action 1 – Japan has amended the consumption tax law to impose taxes upon digital or electronic service transactions conducted by foreign enterprises having no base in Japan.
- Action 2 – Japan has amended the corporation tax law so that Japan's foreign dividend exemption system does not apply to dividends that are deductible under the local tax law of the jurisdiction where a foreign subsidiary is located (eg, Brazil), in order to prevent a D/NI (deduction/non-inclusion) outcome.
- Action 3 – Japan has overhauled its controlled foreign corporation (CFC) regime by amending the income tax law and the corporation tax law through the 2017 annual tax reform, in line with BEPS Action 3, to place more focus on the substance of the business conducted by the CFC.
- Action 4 – Japan has tightened the earnings stripping rules, in response to BEPS Action 4, by including interest payable to third parties (unless the interest is taxed in Japan at the recipient level) and lowering the threshold rate from 50% to 20%.
- Action 5 – in response to BEPS Action 5, Japan has implemented measures to ensure spontaneous exchange of information on tax rulings.
- Action 6 – Japan has incorporated in its tax treaties, particularly with advanced countries (such as the USA, the UK, the Netherlands, Switzerland and Germany), various anti-abuse measures suggested by BEPS Action 6, such as the limitation on benefits (LOB), the principal purpose test (PPT) and the beneficial owner concept.
- Action 7 – Japan has amended the definition of a permanent establishment in income tax law and corporation tax law, in response to BEPS Action 7, so as to define more properly an agent permanent establishment to prevent avoidance of an agent permanent establishment through artificial measures.
- Actions 8–10 – Japan has incorporated the so-called commensurate-with-income standard, as well as the discounted cash flow (DCF) method, in order to value so-called hard-to-value intangibles, by amending its transfer pricing regulations, in line with BEPS Actions 8–10.
- Action 13 – Japan has amended its transfer pricing documentation rules to introduce the master file, country-by-country reporting and the local file, in line with BEPS Action 13.
- Action 15 – Japan has signed the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting (MLI), which took effect on 1 January 2019; as of 2 April 2021, the MLI is applicable to the double tax treaties of Japan with 31 countries, including Australia, Canada, France, Germany, India, Indonesia, Ireland, South Korea, Luxembourg, the Netherlands, Singapore and the UK.

As these BEPS measures are still relatively new, at present this firm has not seen a meaningful increase or decrease in tax controversies owing to these measures. However, as these measures generate new issues of interpretation, it is expected that tax controversies will increase in the future.

1.5 Additional Tax Assessments

Under the Japanese legal system, even if a taxpayer disputes a tax assessment, in principle it must first pay the assessed tax. The only exception is a transfer pricing assessment, where the

taxpayer will file an application for a mutual agreement procedure (MAP). In that case, upon request, the taxpayer may be given a grace period for the payment until the resolution of the case via the MAP. However, the taxpayer must provide collateral to secure the payment of the assessed tax.

When a tax return is filed but the tax authority finds an under-reported tax as a result of the tax audit, a reassessment (*kohsei*) will be made. When a tax return is not filed at the outset and the tax authority finds any amount of tax due, a determination (*kettei*) will be made. As for withholding tax, a notice of collection (*nozei kokuchi*) will be made. As for taxes that do not require a filing of a tax return (other than withholding tax), an assessment determination (*fuka kettei*) will be made. Another kind of administrative disposition is a tax assessment to reject the taxpayer's request of a downward adjustment of the tax amount from that reported in the originally filed tax return. However, the required procedures to dispute these assessments are substantially the same.

2. TAX AUDITS

2.1 Main Rules Determining Tax Audits

There is no formal rule under Japanese tax law to determine whether and when a tax audit should be made. It is entirely at the discretion of the tax authority. Having said that, in practice, many corporate taxpayers are audited every three to five years and certain very large corporates are audited every one to two years. It should be noted that the tax authority has launched a "corporate governance in tax" programme for certain very large corporates, whereby certain highly compliant taxpayers will receive the benefit of a prolonged (by one year or more) audit cycle. On the other hand, the tax authority has recently launched a programme to monitor high net worth individuals, and if the tax authority determines that the individual in question needs close scrutiny, a tax audit may be launched, particularly with regard to individual income tax, and inheritance and gift taxes.

2.2 Initiation and Duration of a Tax Audit

There is no formal rule under Japanese tax law that would limit the duration of tax audits. In practice, it varies; some are finished in a few days, whereas, in the case of very large corporates, the audit may last for a few months. Moreover, transfer pricing audits can last for one or two years, depending upon the circumstances.

Japanese tax law has a statute of limitation of generally five years from the original statutory due date of the return filing (which will be extended to seven years when the issue involves fabrication or concealment of facts). In general, this statute of limitation period is not suspended or interrupted by a tax audit, and thus, its expiry will prevent a tax audit. As an exception, however, the statute of limitation period will be extended where a taxpayer is not co-operative in a tax audit and tax authorities make a request to another jurisdiction for exchange of information for that reason.

2.3 Location and Procedure of Tax Audits

In practice, in most cases, tax audits are conducted at the premises of the taxpayer. Because of COVID-19, tax authorities refrained from commencing new tax audits for a while, but they resumed in October 2020, and tax audits are generally conducted in the same manner as before (eg, at the premises of the taxpayer).

The accounting books and records as well as the minutes of the board of directors and other corporate documents will be examined first. If the taxpayer prepares the accounting books and

records in paper form, the paper form will be reviewed and if the taxpayer prepares them electronically then the electronic data will be examined. Moreover, in recent practice, external and internal email communications of the taxpayer are frequently examined, where evidence favourable to the tax authority can often be found.

2.4 Areas of Special Attention in Tax Audits

This varies depending upon the type of tax to be examined. For example, in the case of a corporation tax audit, major issues include:

- timing differences of income recognition and cost deduction;
- tax-free reorganisations;
- deductibility of officers' remunerations;
- whether the deducted payments are non-deductible donations; and
- various international tax regimes (CFC, transfer pricing, etc).

2.5 Impact of Rules Concerning Cross-Border Exchanges of Information and Mutual Assistance Between Tax Authorities on Tax Audits

Due to the increasing prevalence of information exchange, in some audits, particularly those of high net worth individuals, the tax authority will have gained, in advance, extensive information on the foreign bank accounts of the taxpayer, which presumably were brought to the tax authority by way of the common reporting standard. In addition, there appear to be:

- an increasing number of tax audit cases where the tax auditors say that the tax authority will request information regarding the relevant foreign jurisdiction by way of an information exchange under the tax treaty; and
- more tax controversy cases where the Japanese government submits as evidence the results of a tax audit conducted by a foreign tax authority pursuant to a request from the Japanese tax authority.

2.6 Strategic Points for Consideration During Tax Audits

If the taxpayer expects that the issue being audited may develop into a tax controversy, it is very important to manage the submissions to be made to the tax authority properly, particularly the external and internal email communications of the taxpayer mentioned in **2.3 Location and Procedure of Tax Audits**. For example, a situation should be avoided where email communications critically adverse to the position of the taxpayer are inadvertently placed in the hands of the tax authority. Under Japanese tax law, while the tax authority cannot physically force the taxpayer to submit the requested information and documents, it can do so somewhat indirectly, via the enforcement of criminal penalties if the taxpayer refuses to submit the requested information and documents where they are obliged to do so under law. Under the controlling Supreme Court decision, a taxpayer is obliged to respond to the information and document request of the tax authority, so long as:

- there is an objective necessity to examine the requested information and document in light of the issue being examined;
- that necessity outweighs the privacy of the taxpayer; and
- the discretion of the tax auditor to make such a request is considered reasonable.

Taxpayers may want to argue that, for example and where feasible, there is little need to examine the requested email communications in light of the issue being examined, so that it may lawfully avoid the submission.

Because no alternative dispute resolution (ADR) mechanism is available for tax purposes in

Japan and no settlement is allowed in administrative or judicial tax litigation, in practice, at the stage of the tax audit, the taxpayer and the tax authority often cut a deal to effectively settle the issue. In other words, the tax audit is practically the only stage where an effective settlement can be made. Accordingly, the taxpayer is expected to form a decision, at the tax audit, on whether to try to settle; if not, the taxpayer must continue the tax litigation process, devoting substantial time and expense to it, until the final decision or until the taxpayer gives up.

3. ADMINISTRATIVE LITIGATION

3.1 Administrative Claim Phase

A formal notice of tax assessment will be served upon a taxpayer once:

- the tax audit has been concluded;
- the taxpayer has made it clear that it will not file an amended tax return reflecting the position of the tax authority voluntarily; and
- the tax authority's internal approval procedures for issuing the tax assessment have been completed.

As a legal matter, the tax assessment takes effect once served upon the taxpayer and will continue to be effective unless cancelled by the ensuing tax controversy procedure.

Request for Reconsideration before the National Tax Tribunal

In order for the taxpayer's claim to be heard before the courts, an administrative procedure is mandatory. That is, within three months of receipt of the formal notice of tax assessment, the taxpayer must file a Request for Reconsideration with the National Tax Tribunal, which is an administrative but quasi-judicial body to review taxpayers' claims. Then, in principle, if the taxpayer's Request for Reconsideration is dismissed by the formal decision of the National Tax Tribunal, the taxpayer can, within six months of the receipt of the decision, initiate a lawsuit to request cancellation of the subject tax assessment with the competent District Court. Alternatively, before filing a Request for Reconsideration with the National Tax Tribunal, where appropriate, the taxpayer may elect to take the additional step of filing a Request for Reinvestigation with the director of the competent Regional Taxation Bureau; however, this Request for Reinvestigation is, for reasons of cost as opposed to benefit, not very often used in practice. No filing fees are required for a Request for Reconsideration or a Request for Reinvestigation.

The National Tax Tribunal will review the taxpayer's Request for Reconsideration by designating a panel of three administrative judges. The administrative judges include attorneys and tax accountants who used to be in private practice, as well as incumbent officials of the tax authority. There, as in a court litigation, the taxpayer and the tax authority will submit and exchange their respective arguments and evidence. Once the panel determines that the review is complete, the National Tax Tribunal will render a decision, dismissing, or entirely or partially admitting, the taxpayer's Request for Reconsideration. The entire process will generally take one year.

One of the most important functions of the Request for Reconsideration process from the taxpayer's viewpoint is to gather documentary evidence that was submitted by the tax authority, in anticipation of future judicial tax litigation. Upon request, the National Tax Tribunal will allow the taxpayer to take copies of the documentary evidence that was submitted by the tax authority. This process is indispensable for preparing for future judicial tax litigation, in order to assess how strong the taxpayer's and the tax author-

ity's arguments are in light of this documentary evidence.

3.2 Deadline for Administrative Claims

As mentioned in **3.1 Administrative Claim Phase**, within three months of receipt of the formal notice of tax assessment, the taxpayer must file either a Request for Reconsideration with the National Tax Tribunal or a Request for Reinvestigation with the director of the competent Regional Taxation Bureau. This deadline is absolutely mandatory save for exceptional cases, and not complying with the deadline ensures that the claim will be dismissed without consideration of its merits or an opportunity of a further administrative or judicial appeal.

If the taxpayer's Request for Reconsideration is entirely or partially dismissed by the decision of the National Tax Tribunal, the taxpayer may, within six months of the receipt of the decision, initiate a lawsuit to request cancellation of the subject tax assessment with the competent District Court. This deadline is also absolutely mandatory, save for exceptional cases. Furthermore, even before the decision of the National Tax Tribunal is rendered, the taxpayer can initiate a lawsuit, so long as three months have passed since the filing of the Request for Reconsideration, thereby effectively bypassing the procedure at the National Tax Tribunal. Such bypassing is often used in practice, where the nature of the issue indicates that it may be difficult to obtain a favourable decision from an administrative body like the National Tax Tribunal.

Unlike judicial tax litigation discussed below, if the taxpayer prevails at the National Tax Tribunal, the tax authority cannot appeal and the decision in favour of the taxpayer will be final. No settlement is available at the National Tax Tribunal.

4. JUDICIAL LITIGATION: FIRST INSTANCE

4.1 Initiation of Judicial Tax Litigation

Judicial tax litigation will be initiated by the taxpayer, as petitioner, by filing a complaint, against the Japanese government as respondent, by the deadline discussed in **3.2 Deadline for Administrative Claims**. The complaint will identify the subject tax assessment to be cancelled and the reasons for the cancellation, and will accompany supporting exhibits as documentary evidence. The taxpayer needs to pay court filing fees (for example, if the amount of tax to be cancelled and refunded is JPY100 million, the court filing fees will be around JPY320,000). Once the court has reviewed and approved the formalities of the complaint, it will be served upon the respondent.

In Japan, there is no special judicial court for tax litigation, which at the first instance is heard by general District Courts along with other general civil and criminal cases. However, in large cities such as Tokyo and Osaka, there are special divisions for handling administrative law matters and tax litigation will be assigned to one of these administrative law divisions. The administrative law divisions are not specific to tax matters but handle other administrative matters such as immigration and social security, but the judges within the administrative law divisions are generally more familiar with technical tax matters than other general civil divisions. In the case of the Tokyo District Court, there are four administrative law divisions; ie, the 2nd, 3rd, 38th and 51st civil divisions. The taxpayer is not allowed to cherry-pick the division to which its case is assigned, and the assignment will be made at random, pursuant to the predetermined rules within the District Court. In practice, the presiding judge of the administrative law division, generally with 25 to 35 years of experience as a professional judge, mainly in the area of administrative law, is regarded as an "elite" within the

Japanese judicial branch. The panel consists of three judges including the presiding judge and two associate judges, each of whom is a professional judge (ie, not from the private sector).

4.2 Procedure of Judicial Tax Litigation

The first hearing session will generally be held within a few months from the filing of the complaint. By that time, the respondent should have submitted an answer to the complaint; however, due to the time constraints, it is common for the answer not to contain substantive arguments regarding the issues raised in the case. Then, the petitioner and the respondent will exchange briefs and evidence to establish their respective positions and rebut the other party's position. In doing so, the court will, as appropriate, instruct each party to elaborate on a particular point or points that the court considers important. At the District Court level, in most cases the exchange of briefs will take place four to six times and the hearing sessions will be held accordingly. In some complicated cases, the exchange may be made ten times or more. In practice, the interval between each hearing session is generally two to three months, during which the party with the initiative will prepare its brief.

After these exchanges, if the court considers that the review is complete, and if each party has no intention to submit further arguments, the hearing session will be concluded. Then, a court decision will be rendered in a few months. Judicial tax litigation is always concluded by a court decision and no settlement is available.

The entire procedure at the District Court level up to the decision will generally take 12–30 months.

4.3 Relevance of Evidence in Judicial Tax Litigation

In judicial tax litigation, most of the evidence is documentary and it is rare that a witness is called upon, either by the petitioner or by the respondent. This is partly because it is not often that there is a dispute over a finding of "bare" facts (eg, whether someone signed the document). The key issues in judicial tax litigation are interpretation of tax law as well as how the court should view or characterise the proved facts. From the petitioner's perspective, key documentary evidence should be submitted during the early stages of the litigation; ie, with the complaint or the petitioner's first brief, with a view to persuading the court at the outset of the litigation.

4.4 Burden of Proof in Judicial Tax Litigation

The general rule is that the Japanese government or the respondent will owe the burden of proof to establish that the amount of the assessed tax in the subject tax assessment is correct. However, with respect to a few items such as existence and amount of deductible expenses, the taxpayer or the petitioner will owe the burden of proof. In addition, setting aside ordinary reassessments (*kohsei*) or determinations (*kettei*), if the subject tax assessment is the one rejecting the taxpayer's request for downward adjustment of the tax amount from that as reported in the originally filed tax return, then the taxpayer will owe the burden of proof to establish that such adjusted tax amount as asserted by the taxpayer is correct.

4.5 Strategic Options in Judicial Tax Litigation

As discussed in **4.3 Relevance of Evidence in Judicial Tax Litigation**, from the petitioner's perspective, key documentary evidence should be submitted during the early stages of the litigation – ie, with the complaint or the petitioner's first brief – with a view to persuading the court at the outset of the litigation. As the litigation progresses, where the petitioner thinks that the counter-argument of the respondent is not clear, it often requests a clarification of that counter-

argument through the court and will accordingly rebut such argument.

It often happens that some facts that the petitioner asserts (eg, courses of negotiation and planning of the subject transaction) cannot be supported or established by available documentary evidence. In such cases, it is very common in practice that the petitioner will submit as evidence a written statement describing the relevant facts authored and signed by a person involved in and responsible for that matter, instead of calling them as a witness. In other words, it is very common in practice to "substitute" witnesses with such written statements. The court will generally prefer this approach, as it is more time-efficient and easy to understand for the judges, as such written statements are usually first drafted by the petitioner's counsel, bearing in mind the logical and chronological order of the facts as well as the implication of the facts upon the issue of the case.

Also, as to the matter of interpretation of tax law, it is recent common practice that the petitioner, or in some cases the respondent, will submit an expert opinion of a tax law academic to support their own interpretation of the issues involved in the case. Petitioners will generally select highly regarded tax academics in the given field of tax law.

4.6 Relevance of Jurisprudence and Guidelines to Judicial Tax Litigation

The Supreme Court, the highest court of Japan, has expressly recognised in its decisions that the Commentary to the OECD Model Tax Convention can be a supplementary measure in interpreting tax treaties. However, it is not very common for Japanese courts to refer to foreign jurisprudence, or doctrine formed in a foreign jurisdiction, in their decisions.

5. JUDICIAL LITIGATION: APPEALS

5.1 System for Appealing Judicial Tax Litigation

If the decision of the District Court entirely or partially dismisses the petitioner's claim, the petitioner is entitled to appeal up to the competent High Court (for example, the Tokyo High Court has corresponding jurisdiction over the Tokyo District Court). The appeal period is two weeks from receipt of the official copy of the decision (which is absolutely mandatory save for exceptional cases); by that deadline, the petitioner must submit a statement of appeal. Then, within 50 days of the submission of the statement of appeal, the petitioner must submit the reasons for appeal, describing the substantive arguments for the appeal. At the High Court level, there is no restriction on the causes of appeal; ie, the High Court is still a trial court and its role is not limited to legal review. The court filing fees for the appeal are one and a half times the amount at the District Court level. If the petitioner prevails at the District Court, the Japanese government or the respondent is also entitled to appeal; it is very common for the Japanese government or the respondent to appeal if it has lost in the District Court.

Some appeal cases will be concluded at the first hearing session; ie, only with one session. Some will be reviewed by a few or several ensuing hearing sessions. The entire procedure at the High Court level up to the decision will generally take from six to 18 months.

Unlike the District Court, as mentioned in **4.1 Initiation of Judicial Tax Litigation**, High Court Judges are generally not specialists in tax law or administrative law, but tax cases are heard in the general civil divisions along with general civil cases such as contract and tort. The panel consists of three judges including the presiding

judge and two associate judges; in High Courts, even associate judges generally have more than ten years' experience. In practice, it is a challenge for the counsel to persuade such judges in complicated and technical tax matters.

5.2 Stages in the Tax Appeal Procedure

If the decision of the High Court entirely or partially dismisses the petitioner's appeal, the petitioner is entitled, under certain limited circumstances, to appeal up to the Supreme Court within two weeks from receipt of the official copy of the decision (which time limit is mandatory save for exceptional cases); by that deadline, the petitioner must submit an application for a writ of certiorari. Then, within 50 days of the receipt of notice from the Supreme Court (which time limit is again mandatory save for exceptional cases), the petitioner must submit the reasons for the application for a writ of certiorari, describing the substantive arguments for the appeal. In the context of tax litigation, practically, the appeal is limited to, or a writ of certiorari is only granted, where the issue at hand involves an important question of law. As such, the reasons for application for a writ of certiorari have to persuade the Supreme Court that there indeed exist important questions of law.

If the Supreme Court decides that this condition is not met, then it will dismiss the appeal without considering the merits. On the other hand, if the Supreme Court decides otherwise, it will accept the appeal, grant a writ of certiorari and will enter into substantive review. This review is technically made solely within the Supreme Court and neither party is required to submit arguments or evidence unless and until requested to do so by the Supreme Court; however, in practice, the parties will voluntarily do so in an attempt to do their best. As a result of the substantive review, the Supreme Court will render a decision, either dismissing the appeal, reversing the High Court decision and deciding on its own, or reversing the High Court decision and remanding the case to the lower courts. Except for the case of remand, the decision of the Supreme Court will be final.

The entire procedure before the Supreme Court up to the final result will generally take from six months to several years.

5.3 Judges and Decisions in Tax Appeals

See **5.1 System for Appealing Judicial Tax Litigation**.

6. ALTERNATIVE DISPUTE RESOLUTION (ADR) MECHANISMS

6.1 Mechanisms for Tax-Related ADR in this Jurisdiction

No ADR mechanism is available for tax purposes in Japan.

6.2 Settlement of Tax Disputes by Means of ADR

No ADR mechanism is available for tax purposes in Japan.

6.3 Agreements to Reduce Tax Assessments, Interest or Penalties

No ADR mechanism is available for tax purposes in Japan.

6.4 Avoiding Disputes by Means of Binding Advance Information and Ruling Requests

A written formal advance ruling is available under somewhat narrow circumstances and subject to certain conditions; eg, publication of the ruling in an anonymised form. A written formal advance ruling is not technically legally binding, but it is considered that, under the general principles of good faith and estoppel, the tax authorities

are not allowed to issue a tax assessment that is inconsistent with the issued advance ruling, as long as the relevant information provided to the tax authorities in the ruling process remains accurate. For transfer pricing matters, advance pricing agreements (APAs) are commonly used measures to ensure certainty. See also **1.3 Avoidance of Tax Controversies**.

6.5 Further Particulars Concerning Tax ADR Mechanisms

No ADR mechanism is available for tax purposes in Japan.

6.6 Use of ADR in Transfer Pricing and Cases of Indirect Determination of Tax

No ADR mechanism is available for tax purposes in Japan.

7. ADMINISTRATIVE AND CRIMINAL TAX OFFENCES

7.1 Interaction of Tax Assessments with Tax Infringements

Procedures for tax assessment and criminal tax cases are separate from each other, and thus, the former procedure would not automatically initiate the latter. A criminal case would normally be initiated when the criminal investigation division of the tax authorities became aware of any potential tax crime. Judicial precedents, however, allow the taxation division of the tax authorities to share the information acquired through a tax audit with the criminal investigation division of the tax authorities, unless the tax audit was conducted for the purposes of criminal investigation. Thus, where information is so shared, it can lead to an investigation by the criminal investigation division.

Generally speaking, in practice, a criminal case would be initiated only where the taxpayer wilfully conducted fabrication or concealment of facts or numbers, or wilfully failed to submit tax returns. Application of a general anti-avoidance rule (GAAR) or a specific anti-avoidance rule (SAAR), or tax assessments arising from a difference of views between the taxpayer and the tax authority, are generally for tax assessment purposes only, and would not develop into a criminal case in practice. In our experience, it is very rare that tax controversy cases of sophisticated corporate taxpayers develop into criminal cases.

7.2 Relationship Between Administrative and Criminal Processes

The procedures for tax assessment and criminal tax cases are separate and independent from each other, and there is no legal requirement that one procedure must be suspended while the other procedure is pending. Similarly, once the criminal tax case is initiated, the taxpayer may be indicted and tried in a criminal court, even if they voluntarily admit the position of the tax authority, file an amended tax return and pay the assessed tax in full together with penalties. However, such voluntary admittance and payment of the assessed tax, if made before indictment, can be taken into account when the prosecutor decides whether to indict a particular case based on the malicious nature of such case.

7.3 Initiation of Administrative Processes and Criminal Cases

A criminal tax case would be initiated when the criminal investigation division of the tax authorities has become aware of any potential tax crime; eg, the fact or suspicion that the taxpayer wilfully conducted fabrication or concealment of facts or numbers, or wilfully failed to submit tax returns.

7.4 Stages of Administrative Processes and Criminal Cases

The criminal investigation division of the tax authorities first conducts its investigation and

if it considers that evidence sufficient for the prosecutor's consideration has been collected, it makes a criminal accusation with the prosecutor. The prosecutor will then conduct its investigation and if they consider that evidence sufficient for indictment has been collected, they indict in court.

The general criminal division of the court will review the criminal tax case, but large District Courts such as Tokyo and Osaka have a specialised criminal tax division. In contrast, the legality of the tax assessment will be reviewed by the general civil division of the court (see **4.1 Initiation of Judicial Tax Litigation**).

7.5 Possibility of Fine Reductions

Upfront payment of the tax assessment could be taken into account by the judge as a mitigating factor in determining the amount of a fine or the period of imprisonment, but this is within the discretion of the judges, and there is no legal system that requires reduction in potential fines or the period of imprisonment in the corresponding criminal case.

7.6 Possibility of Agreements to Prevent Trial

Under a recently introduced criminal proceeding bargaining system, which is applicable to certain specified economic or financial crimes (including tax crimes), a prosecutor and a taxpayer can enter into an agreement under which the prosecutor agrees to not institute, or to withdraw, indictment of the taxpayer on the condition that the taxpayer provides testimony or evidence for, or otherwise co-operates with, the prosecutor's investigation of a certain crime of another person (but not the taxpayer themselves). This system became effective in June 2018, and to the author's knowledge, it has been applied in three cases so far, none of which were criminal tax cases.

7.7 Appeals against Criminal Tax Decisions

There is only one route to appeal against the decision of the District Court; that is, first to the High Court and then to the Supreme Court. Both the taxpayer (if convicted) and the prosecutor (if the taxpayer was acquitted or the amount of fines or the period of imprisonment sentenced at the preceding instance were considered insufficient from the prosecutor's perspective) are able to make an appeal to the higher court. The prosecutor's appeal is permitted as not contravening the constitutional principle of prohibition against double jeopardy.

7.8 Rules Challenging Transactions and Operations in this Jurisdiction

Under Japanese tax law, the SAAR, transfer pricing rules and anti-avoidance rules are for tax assessment purposes only. Tax assessment under these rules, therefore, would not generally give rise to criminal tax cases, unless the taxpayer also committed tax evasion or another tax crime (eg, the taxpayer wilfully conducted fabrication or concealment of facts or numbers, or wilfully failed to submit tax returns). At this stage, Japanese tax law has no GAAR that could be applied without any particular restriction on scope.

8. CROSS-BORDER TAX DISPUTES

8.1 Mechanisms to Deal with Double Taxation

In transfer pricing cases, where economic double taxation arises as a result of a tax assessment, it is common to use the mutual agreement procedure (MAP), if available under the applicable double tax treaty, in order to avoid such economic double taxation.

In non-transfer pricing cases, if the taxpayer considers that it has received taxation in contravention of the applicable double tax treaty (eg, existence of a permeant establishment (PE) in Japan, the amount of profits attributable to a PE, withholding tax in contravention of the treaty) in Japan or the counterparty jurisdiction, that taxpayer can also rely on the MAP. In practice, however, economic double taxation as a result of tax assessment often arises without regard to the double tax treaty, in which case, the taxpayer's sole remedy would be to initiate domestic litigation.

According to the MAP statistics published by the OECD as part of the implementation of BEPS Action 14, Japan had 84 pending mutual agreement procedure cases (excluding those for APAs) as of the end of 2019, of which 75 cases (approximately 89%) are on transfer pricing-related matters.

Where a mutual agreement procedure is not available at the outset, or does not effectively solve economic double taxation, the taxpayer can still initiate domestic litigation to solve economic double taxation.

There does not yet seem to have been any particular impact of the measures adopted under the MLI in this domain, because the arbitration process provided in the MLI has not become available yet (see **9.1 Application of Part VI of the MLI to Covered Tax Agreements (CTAs)**).

8.2 Application of GAAR/SAAR to Cross-Border Situations

While the definitions of GAAR and SAAR would vary depending on the commentators, Japanese tax law has no GAAR that could be applied without any particular restriction on scope. There are:

- a few targeted anti-avoidance rules (TAAR) that are applicable to certain situations in rather general terms (eg, closely held corporations and corporate reorganisations); and
- other more specific SAARs, including the CFC rules that apply in cross-border situations.

The validity of the CFC rules has been challenged in the past and the Supreme Court held that taxation under the CFC rules does not contravene the applicable double tax treaty.

While the principal purpose test (PPT) and amendment to the preamble of double tax treaties, both as introduced by the MLI, should help tax authorities combat BEPS in cross-border situations in one way or another, the scope/impact of the PPT and amendment to the preamble remain ambiguous. Therefore, where the tax authorities deny taxpayers' positions relying on these measures, it is expected that taxpayers would initiate the dispute procedure under the available dispute resolution measures. If the matter is litigated at court, the court would be required to assess the scope/impact of these measures, taking into account, for example, the relevant OECD materials.

8.3 Challenges to International Transfer Pricing Adjustments

Generally speaking, taxpayers often prefer to challenge transfer pricing adjustments via a MAP under the existing double tax treaties mechanism, since in many cases a resulting agreement between the competent tax authorities would allow the taxpayer to avoid economic double taxation. Where a solution through a MAP is not available (including where the negotiation under the mutual agreement procedure was not successful), taxpayers would challenge the adjustment by the domestic tax controversy procedure. See also **8.1 Mechanisms to Deal with Double Taxation**.

8.4 Unilateral/Bilateral Advance Pricing Agreements

Bilateral APAs are a common mechanism to avoid or mitigate the risks of future tax assessment on transfer pricing matters. Unilateral APAs are also used, for example, where the potential tax risks are considered as rather small, or bilateral APAs are not available in relation to particular jurisdictions. Information on unilateral APAs would be exchanged with relevant jurisdictions under the framework for spontaneous exchange of information in accordance with BEPS Action 5.

As to the main stages of APA procedures, a taxpayer would, after conducting a preliminary economic analysis of the transaction in question, normally have preliminary consultations with the tax authorities to discuss the possibility of an APA as well as the agreed approach for economic analysis. Based on the result of such a preliminary consultation, the taxpayer would conduct detailed economic analysis and prepare an application for an APA. After the application is filed with the tax authorities, the application will be first reviewed by the tax authorities of Japan and then, where relevant, a MAP between the competent authorities of Japan and the other relevant jurisdiction(s) would commence.

8.5 Litigation Relating to Cross-Border Situations

In a cross-border context, withholding tax has historically been a major source of litigation. During the past several years, CFC and transfer pricing matters have generated a considerable volume of litigation. There has also been litigation involving corporate reorganisations with cross-border elements. In contrast, there are only a few cases under which the existence of a PE was litigated in court. These trends equally apply to additional or new litigation.

In order to mitigate the risk of litigation, it would be advisable to seek advice from tax advisers at the planning stage and structure transactions in a manner less susceptible to challenges by the tax authorities. For transfer pricing matters, the use of APAs is a common approach among Japanese taxpayers. See also **1.3 Avoidance of Tax Controversies** and **6.4 Avoiding Disputes by Means of Binding Advance Information and Ruling Requests**.

9. INTERNATIONAL TAX ARBITRATION OPTIONS AND PROCEDURES

9.1 Application of Part VI of the MLI to Covered Tax Agreements (CTAs)

Approximately 20 of Japan's double tax treaties provide for mandatory binding arbitration, and among these treaties, competent authority agreements to implement arbitration process have been signed with eight jurisdictions as of 1 April 2021.

Japan also elected to apply part VI of the MLI to the relevant CTAs, and thus, a set of arbitration provisions will be introduced into the relevant CTAs, if treaty partners also make the same election. As of 1 April 2021, no competent authority agreement has been signed to implement the arbitration process provided in the MLI, and thus, the arbitration process provided in the MLI has not become available yet.

9.2 Types of Matters That Can Be Submitted to Arbitration

The general treaty policy of Japan is to submit any types of matters to arbitration, as long as they relate to taxation not in accordance with the provisions of the relevant double tax treaties.

Japan generally followed this policy under the MLI, and will submit any types of matters to arbitration, with the following two minor exceptions:

- cases to determine residency of a person other than an individual where such person would otherwise be treated as a dual-resident (this exclusion is already provided for in the Explanatory Statement to the MLI and as such, this reservation was made only for clarification purposes); and
- matters which the treaty partner has excluded from the scope of arbitration (this reservation is to make the scope of arbitration reciprocal with the treaty partner).

9.3 Application of the Baseball Arbitration or the Independent Opinion Procedure

Under the MLI, Japan has opted for the independent opinion procedure. While no official explanation was provided for this choice, it seems to be consistent with Japan's existing competent authority agreements, which in general do not adopt baseball arbitration, as mentioned below.

The existing competent authority agreements to implement an arbitration process do not provide for a specific mode of arbitration, except for:

- the double tax treaty with the USA, for which baseball arbitration is adopted as the sole mode for arbitration; and
- the double tax treaty with the United Kingdom, for which baseball arbitration is provided as an optional mode for arbitration.

9.4 Implementation of the EU Directive on Arbitration

As mentioned in **9.1 Application of Part VI of the MLI to Covered Tax Agreements (CTAs)**, Japan is proactively adopting OECD-based mandatory binding arbitration in its double tax treaties though either bilateral treaty negotiation or the MLI. As a non-EU member state, the EU Directive on Arbitration is not applicable to Japan.

9.5 Existing Use of Recent International and EU Legal Instruments

As of 1 April 2021, there is no publicly available information on whether mandatory binding arbitration introduced into double tax treaties has already been used in Japan. As a non-EU member state, EU legal instruments are not applicable to Japan.

9.6 Publication of Decisions

Under the existing competent authority agreements to implement an arbitration process, no information on arbitration decisions will be published, unless both jurisdictions and the relevant taxpayers agree in writing. With respect to the arbitration process provided in the MLI, while no competent authority agreements have been signed, it is expected that Japan will adopt a similar approach therein.

9.7 Most Common Legal Instruments to Settle Tax Disputes

As of 1 April 2021, there is no publicly available information on whether mandatory binding arbitration has already been used in Japan (see **9.5 Existing Use of Recent International and EU Legal Instruments**).

With respect to choice of dispute resolution measures under double tax treaties (other than arbitration) and domestic rules, see **8.1 Mechanisms to Deal with Double Taxation**.

9.8 Involvements of Lawyers, Barristers and Practitioners in International Tax Arbitration to Settle Tax Disputes

As mentioned in **9.5 Existing Use of Recent International and EU Legal Instruments**, there is no publicly available information on whether

mandatory binding arbitration has already been used in Japan. However, it seems reasonable to believe that taxpayers will be allowed to hire independent professionals for the arbitration process. Where the matter is complex, the government may also want to retain independent professionals to achieve the best possible outcome from its point of view.

10. COSTS/FEES

10.1 Costs/Fees Relating to Administrative Litigation

In administrative litigation procedures, there will be no costs/fees that a taxpayer has to pay to the tax authorities or National Tax Tribunal, aside from fees for making copies of evidence submitted by the tax authorities or collected by the National Tax Tribunal. See **3.1 Administrative Claim Phase**.

10.2 Judicial Court Fees

In judicial litigation procedures, a taxpayer has to pay court filing fees by way of revenue stamps at the time of filing its complaint with the District Court. The amount of such fees will be calculated in accordance with certain formulae prescribed in the law. For example, where the amount in dispute is JPY100 million, the amount of such fees is JPY320,000.

At the second and third instances (ie, hearing on appeal and hearing on final appeal), the appealing party has to pay the court filing fees when filing its appeal. The amount of such fees at each instance is an amount equal to the amount of such fees at the first instance multiplied by one and a half or two respectively.

Where a taxpayer ultimately prevails, it can demand that the Japanese government pay the court filing fees back to the taxpayer, but not the attorneys' fees.

10.3 Indemnities

Even if the court decides that the tax assessment is illegal and invalid, the taxpayer is generally not entitled to indemnity under Japanese tax law. Where a taxpayer suffered damage that was unlawfully inflicted by a public officer intentionally or by negligence, the taxpayer can request indemnity under the State Redress Act. Generally speaking, however, the requirements for such an indemnity are rather strict and taxpayers can receive it only in very limited circumstances.

10.4 Costs of Alternative Dispute Resolution

No ADR mechanism is available for tax purposes in Japan.

11. STATISTICS

11.1 Pending Tax Court Cases

According to the latest statistics published by the National Tax Agency (the NTA Statistics), the total number of tax court cases pending at the end of the fiscal year (FY) 2019 (1 April 2019 to 31 March 2020) is 210. The breakdown by instance is 150 cases at the first instance, 32 cases at the hearing on appeal and 28 cases at the hearing on final appeal.

Information on the amount of tax in dispute is not publicly available.

11.2 Cases Relating to Different Taxes

According to the NTA Statistics, the total number of cases that commenced in FY 2019 was 223. The breakdown by the types of taxes involved is 36 cases on corporate income tax, 76 cases on income tax (including withholding tax), 33 cases on VAT, 28 cases on property tax and 50 cases on other tax or tax-related matters.

The total number of cases that closed in FY 2019 was 216. The breakdown by the types of taxes

involved is 58 cases on corporate income tax, 56 cases on income tax (including withholding tax), 22 cases on VAT, 32 cases on property tax and 48 cases on other tax or tax-related matters.

Information on the amount of tax in dispute is not publicly available.

11.3 Parties Succeeding in Litigation

According to the NTA Statistics, taxpayers prevailed in 21 cases (9.7% of the total of 216 cases that closed in FY 2019). To be more precise, taxpayers fully prevailed in 16 cases and partially in 5 cases. While this percentage of taxpayer success in tax litigations may appear to be rather low, the denominator seems to include cases which had slim chances of success at the outset. In the author's view, sophisticated corporate taxpayers, which commence tax litigation after receiving merits advice from experienced tax attorneys, tend to have higher chances of success.

12. STRATEGIES

12.1 Strategic Guidelines in Tax Controversies

The importance of taking appropriate actions at each stage of a transaction cannot be emphasised enough.

At the planning stage, well advised tax planning (including making use of formal or informal advance rulings or APAs, where available and appropriate) would reduce the future risks of challenges by the tax authorities. See also **1.3 Avoidance of Tax Controversies** and **6.4 Avoiding Disputes by Means of Binding Advance Information and Ruling Requests**.

At the stage of tax audit, while the tax authorities sometimes stick to their own interpretation of tax laws, making an argument based on actual facts and evidence at an early stage can often prevent the tax authorities from issuing a tax assessment. At the same time, flexibility on the side of the taxpayer may be needed to try to settle the case effectively, when the taxpayer's position is not very robust, in light of the time and costs that may be required for the future tax litigation proceedings. See also **2.6 Strategic Points for Consideration During Tax Audits**.

At the stage of litigation, effective presentation of complicated tax matters in an easy-to-understand manner, supported by actual facts and evidence, will increase the chance of success. See also **4.3 Relevance of Evidence in Judicial Tax Litigation** and **4.5 Strategic Options in Judicial Tax Litigation**.

Nagashima Ohno & Tsunematsu has almost 50 years' experience in handling tax matters. Six partners are dedicated to tax issues, including three seasoned partners. The firm also has as advisers Mr Mamoru Toba, a former director-general of the Tokyo Regional Taxation Bureau, and Professor Emeritus Hiroshi Kaneko (not admitted to the Bar), the foremost authority on Japanese tax law. Key practice areas are tax advice and planning (for all types of commercial transactions, particularly those involving M&A, financing and capital markets), and tax disputes (including tax audits, administrative appeals and court proceedings).

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NAGASHIMA OHNO & TSUNEMATSU

Trends and Developments

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While the number of tax controversy cases in Japan is somewhat modest compared to the other major jurisdictions (see the **Japan Law & Practice chapter** in this guide), recently, there have been several noteworthy tax decisions. These decisions may appear to be sporadic but some trends can be observed among them, as discussed below.

The Supreme Court's Interpretation of Tax Law

Supreme Court decision, 11 March 2021

The Supreme Court decision dated 11 March 2021, commonly known as the Kokusai Kogyo Kanri case, held that a problematic provision of the corporation tax cabinet order (a subordinate regulation under the statute) was null and void in favour of the taxpayer and affirmed the lower courts' decisions to reverse the corporate tax assessment. This case involved distributions from a US subsidiary to its Japanese parent company out of its retained earnings and capital reserves, and quite an unreasonable result was to be drawn from the calculation under that cabinet order provision.

It is extremely rare for the Supreme Court to nullify a cabinet order promulgated by the executive branch and affirm a taxpayer's argument. This was due to the taxpayer successfully establishing the legislative intent of the statute conferring authority on the cabinet order as well as the deviation of the calculation result from the legislative intent of the statute.

This decision is extremely significant in that the Supreme Court reaffirmed the basic principle that tax cabinet orders are not an unlimited prerogative of the executive branch, but they can only be legal and valid within the limitation of statute – ie, rule of law must be observed when enacting subordinate tax regulations. At the same time, this case reminds the taxpayer of the need to adhere to the legislative intent of the statute as closely as possible and to establish the same vis-à-vis the courts by citing authoritative treatises.

Supreme Court decision, 24 March 2020

By its decision dated 24 March 2020, the Supreme Court held that textual interpretation – a well-established basic principle of tax law interpretation – does not apply to administrative tax circulars. This is because administrative tax circulars are not statutes or regulations but are only interpretations of tax statutes by the tax authority. The Supreme Court then further held that it is crucial to carefully consider whether the interpretations drawn from the administrative tax circulars conform to the legislative intent of tax statutes.

In other words, it makes little sense to develop arguments based upon textual interpretations of administrative tax circulars without paying attention to what the legislative intent of the relevant tax statute is. While leading tax controversy practitioners had already shared this notion and acted accordingly, it is significant that the Supreme Court expressly so held.

In this case, the Supreme Court reversed the High Court's decision and remanded the case to the High Court. This is by no means rare and the Supreme Court, as the final court, has been very active in reviewing lower court tax decisions with fresh eyes and a sense of justice. This means that tax litigation outcomes are some-

what unpredictable – the taxpayer may either ultimately prevail at the Supreme Court even if it has lost at lower courts or may ultimately lose even if it has won at lower courts after several years of litigation and significant costs.

Taxpayers and tax controversy practitioners should once again bear this in mind and make efforts to develop arguments that are as robust as possible, even at the Supreme Court level considering what the Supreme Court may hold according to its sense of justice as inferred from its past tax decisions.

High-Profile Tax Controversy Cases Involving Sophisticated International Corporate Transactions

Tokyo High Court decision, 14 April 2021

The Tokyo High Court decision dated 14 April 2021, commonly known as the Shionogi case, affirmed the District Court's decision reversing the corporate tax assessment that had denied the tax-free nature of an in-kind contribution of a partnership interest in a Cayman Islands exempted limited partnership, which was made by a Japanese company taxpayer to its foreign subsidiary in connection with an intra-group reorganisation.

The Court effectively held that the subject of the in-kind contribution was the taxpayer's share of the partnership property rather than the partnership interest per se and that it qualified as a tax-free in-kind contribution because the partnership property was managed outside Japan. The government did not appeal and the decision is now final.

Tokyo District Court decision, 16 March 2021

The Tokyo District Court decision dated 16 March 2021, commonly known as the Mizuho Bank case, related to a corporate tax assessment made based upon the anti-tax haven rule or the Japanese controlled foreign corporation (CFC) rule. The Court accepted the government's argument that Mizuho's offshore subsidiary, which was a special purpose vehicle in the Cayman Islands to issue preference shares for Mizuho to meet the capital adequacy regulations for banks, had income that should be subject to the CFC rule, and rejected the taxpayer's argument that such taxation was not presupposed by the law.

The basis of the taxation was certain provisions of the special taxation measures cabinet order, and the Court affirmed that they are fully valid, rejecting the taxpayer's argument that they contravene the law. This matter is now under appeal and is now pending before the Tokyo High Court.

Tokyo District Court decision, 1 December 2020

The Tokyo District Court decision dated 1 December 2020, commonly known as the Sumitomo Mitsui Trust Bank case, related to a withholding tax assessment made upon interest on so-called Japanese eurobonds (ie, bonds issued by Japanese corporations overseas), based on the ground that the taxpayer failed to file a tax exemption document in a timely manner. The Court fully accepted the government's argument that the provision of the special taxation measures cabinet order setting forth the deadline for the filing of the tax exemption document is within the authority conferred upon it by the statute, and totally rejected the taxpayer's argument that the statute did not intend to have this deadline set by delegating to the cabinet order.

Here again, the Court rejected the taxpayer's argument regarding tax cabinet orders. This decision is in contrast with the above Supreme Court decision dated 11 March 2021 holding that the corporate tax cabinet order was null and void. This reminds taxpayers of the fact that it is inherently difficult to overcome the explicit text of tax cabinet orders unless the taxpayer can

make robust arguments based on the legislative intent of the underlying statute. This matter is now under appeal and is pending before the Tokyo High Court.

Tokyo High Court decision, 24 June 2020

The Tokyo High Court decision dated 24 June 2020, commonly known as the Universal Music case, held in favour of the taxpayer and affirmed the District Court's decision reversing a corporate tax assessment that denied deductions taken by a Japanese subsidiary of a multinational media conglomerate in respect of the interest on an intercompany loan from an offshore group financing company. This assessment was based on an anti-avoidance statute embedded in the Corporation Tax Act.

The intercompany loan was made for the Japanese subsidiary to acquire the shares of another Japanese group company, in the form of a so-called international debt pushdown, as part of an intra-group reorganisation of the group's Japan operations. The tax authority alleged that the intercompany loan was made for the principal purpose of reducing the tax burden of the Japanese subsidiary by taking the interest deduction and was a tax avoidance transaction.

However, the Court held that the loan could not be found to be economically unreasonable because the overall reorganisation had valid business purposes, not only for the whole group but also for the Japanese subsidiary, respecting the business judgment made by the taxpayer. Therefore, the government could not invoke the anti-avoidance statute to deny the interest deduction as the loan was not a tax avoidance transaction.

This case demonstrates that, even if the tax authority alleges tax avoidance, the Court will impartially hear the taxpayer's argument and hold in its favour if the taxpayer successfully establishes a bona fide business purpose for the transaction. This matter is not yet final and is now pending before the Supreme Court.

Tokyo High Court decision, 11 December 2019

While this is purely a domestic matter, the Tokyo High Court decision dated 11 December 2019, commonly known as the TPR case, affirmed the District Court's decision and upheld the corporate tax assessment denying the succession of net operating loss carryforwards by the taxpayer from another group company through an intra-group merger by invoking an anti- avoidance statute applicable to mergers and other corporate reorganisation transactions.

The Court held that the merging company in the intra-group merger was substantially a shell company that had no substantial business and only held the net operating loss carryforwards as tax attributes and that the intra-group merger had no substance as a business succession and contravened the legislative intent of the rules concerning succession of net operating loss carryforwards through an intra-group merger. Then, the Court concluded that the attempted succession of the net operating loss carryforwards was an abuse of these rules, justifying application of the anti-avoidance statute.

While there are debates among practitioners on this case, it is a reminder of the need to substantiate transactions with proper business reasons – other than avoiding taxes – and to establish such business reasons vis-à-vis the tax authority with sufficient contemporaneous evidence at tax audits. Without such facts and evidence illustrating convincing business reasons, a court would be unlikely to be persuaded to hold in the taxpayer's favour no matter what technical legal arguments the taxpayer develops. In other words, when executing corporate reorganisation transactions, it would not suffice if the taxpayers

were only to take care of the technical requirements under the individual tax rules (such as the requirements of tax-free reorganisations); they will also have to take into consideration the defences against the anti-avoidance statute. The Supreme Court has rejected the taxpayer's appeal and the decision is now final.

National Tax Tribunal decision, 1 August 2019

The National Tax Tribunal decision dated 1 August 2019 upheld a tax assessment denying the tax-free nature of a US spin-off transaction conducted by Hewlett Packard (HP) and imposing income tax on a Japanese shareholder of HP. Before discussing the tax-free nature of such a spin-off or company split, the Tribunal held that the spin-off transaction under US law did not fall under the concept of a "company split" under Japanese corporate and tax laws at the outset. This part of the holding may be viewed as problematic as the spin-off transaction under US law in the given case was typical, spinning off an entire integrated business unit of HP from other business units.

While it is not clear whether this matter proceeded to in-court litigation, the holding should hopefully be rectified. At the same time, this case presents difficulties for Japanese shareholders of foreign companies – in practice, when structuring a transaction, the tax-free qualification for Japanese tax purposes would not even be considered on top of the tax-free qualification in the home jurisdiction (in this case, the USA).

Impact of court decisions

The foregoing cases remind taxpayers and practitioners that it is imperative to undertake careful tax structuring and planning, bearing in mind not only the individual tax rules but also the anti-avoidance statute, for the intended tax position to be eventually sustained through tax controversy procedures. Furthermore, many of the court cases mentioned above suggest that courts are generally impartial, independent and not very pro-government and that a taxpayer's arguments would most likely be accepted if the taxpayer is well represented and advised by experienced counsel in a case that has merit.

It could also be said that the National Tax Tribunal is not necessarily a reliable venue for high-profile tax controversy matters arising from sophisticated corporate transactions as the Tribunal is, after all, effectively an alter ego of the tax authority even though it claims to be independent. Sophisticated corporate taxpayers are expected to take that into consideration and may want to bypass the procedures before the Tribunal (see the Japanese **Law & Practice** chapter in this guide) to go directly to the courts where appropriate and at the same time, should not be too concerned even if they lose at the Tribunal.

Tax Controversy Cases Relating to High Net Worth Individuals and Wealth Management

Tokyo High Court decision, 24 June 2020

The Tokyo High Court decision dated 24 June 2020 affirmed the District Court's decision, upholding an inheritance tax assessment, which was made by invoking a general anti-avoidance provision embedded in the inheritance tax valuation administrative circular. The taxpayers allegedly intended to reduce their inheritance tax liability by borrowing significant amounts of money from banks and acquiring a whole condominium building a few years before the death of the deceased. The valuation method provided in the inheritance tax valuation administrative circular had produced a value for the condominium building that was significantly lower than the fair market value and they intended to take advantage of that provision.

The Court did not allow this attempt and justified the inheritance tax assessment made by invoking the general anti-avoidance provision.

The Court reasoned that the valuation was not appropriate because there was a substantial disparity between the fair market value and the valuation under the inheritance tax valuation administrative circular and the taxpayers clearly intended to avoid the inheritance tax.

This decision gave rise to a substantial amount of controversy among practitioners. Buying a condominium building by borrowing had been widely recognised – and practised – as a common and legitimate means to reduce the value of the inheritance estate and thus reduce the amount of inheritance tax but the tax authority attacked this case alone. Furthermore, the taxpayers simply followed the valuation method provided in the inheritance tax valuation administrative circular, which would generally apply to all inherited estates; however, the application was denied for this case alone under the general anti-avoidance provision. Moreover, the value of an asset does not differ depending upon a subjective element such as the taxpayer's tax avoidance motive. As such, many commentators have criticised the decision as effectively undermining the basic tax law principles of certainty and foreseeability and contravening the rule of law in taxation.

The matter is now under appeal and is pending before the Supreme Court. In any event, this decision can be perceived as an indication that even the courts may take a notably strict attitude towards tax avoidance by wealthy individuals. There is another substantially similar decision of the Tokyo District Court dated 12 November 2020.

Tokyo High Court decision 27 November 2019

The Tokyo High Court decision dated 27 November 2019 held in favour of the taxpayer and affirmed the District Court's decision to reverse an income tax assessment. The tax authority assessed that the taxpayer, a top corporate executive of a Japanese company, was a resident of Japan for tax purposes; however, the Court held that the taxpayer cannot be found to be a resident of Japan. Determination of the tax residency of an individual has been one of the most controversial issues in practice and the tax authority took the position that the taxpayer is a resident of Japan if, among other factors, the taxpayer has stayed in Japan for some significant period of time (eg, around six months) and occupies a significant executive role in a Japanese company.

However, the Court focused on the substance of the specific activities undertaken by the taxpayer in the case and determined that the important part of his activities was undertaken outside Japan and his principal residence was outside Japan. This case indicates that finding a wealthy individual working worldwide to be a resident of Japan is still an active means for the tax authority to impose tax on wealthy individuals and that, at the same time, during in-court litigation, making arguments based upon the specific facts is imperative to persuade the court in favour of the taxpayer and achieve a favourable outcome. The government did not appeal and the decision is now final.

Newspaper reports, 3 April 2020

Nikkei and other newspapers reported, on 3 April 2020, that the tax authority issued an income tax assessment on the founder/former chairman of a well-known Japanese houseware maker, Sazaby League, in connection with the management buyout and privatisation transaction of the company, which was then a publicly listed company.

It was reported that the founder/former chairman allegedly sold, in 2015, the preferred shares of the Japanese acquisition vehicle to the vehicle itself (ie, a share repurchase), through his Dutch asset management company, at a value signifi-

cantly lower than the fair market value as determined by the tax authority and the assessment was made based upon such fair market value. The founder is reportedly disputing the assessment at the National Tax Tribunal and arguing that the repurchase price of the preferred shares was predetermined by the articles of incorporation of the Japanese acquisition vehicle.

No decision has yet been made public yet on the matter but the case appears to involve various complicated but intriguing issues; eg, whether the provision predetermining the share repurchase price in the articles of incorporation of the acquisition vehicle would override the basic tax law principle that a sale should be made at the then fair market value. In any event, this case suggests that the tax authority closely monitors, and scrutinises in tax audits, the tax planning attempts of wealthy individuals.

Future expectations

Tax controversy cases relating to high net worth individuals and wealth management are definitely expected to increase, principally because the tax authority has recently been taking a very rigorous attitude towards the tax planning made by wealthy individuals and has established dedicated teams within the organisation to cope with these matters. The difficult part of these cases is that the tax controversy procedures may not always be the go-to option for wealthy individual taxpayers. This is because many wealthy individuals care about their reputation and want to avoid sensational press reports that they underreported their tax liability and are disputing an assessment.

This reputational risk, caused by press reports, tends to deter wealthy individuals from vigorously disputing a tax assessment once it is made and it is sometimes the case that they just acquiesce. This would in turn deter them from creative or novel tax planning at the outset. This is obviously not a healthy situation under rule of law but practitioners should be aware of this practical issue.

Conclusion

Overall, the foregoing trends will likely continue in the near future. This will particularly be the case as the COVID-19 crisis continues and the need for tax revenue increases and dissatisfaction towards “rich” corporates and individuals grows among the non-wealthy general public, who were severely affected by the crisis. There seems to be no reason for the tax authority to halt its aggressive enforcement of tax law even if taxpayers dispute assessments. There are, however, hopes that, even in this situation, the judicial branch will maintain impartiality, equity, integrity and justice when deciding tax controversy cases.

Contributed by: *Yushi Hegawa,* ***Nagashima Ohno & Tsunematsu***

Nagashima Ohno & Tsunematsu has almost 50 years' experience in handling tax matters. Six partners are dedicated to tax issues, including three seasoned partners. The firm also has as advisers Mr Mamoru Toba, a former director-general of the Tokyo Regional Taxation Bureau, and Professor Emeritus Hiroshi Kaneko (not admitted to the Bar), the foremost authority on Japanese tax law. Key practice areas are tax advice and planning (for all types of commercial transactions, particularly those involving M&A, financing and capital markets), and tax disputes (including tax audits, administrative appeals and court proceedings).

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