

December, 2021 No.30

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RESTRUCTURING AND INSOLVENCY/ M&A

Restructuring and Insolvency of Distressed Businesses in Japan during COVID-19

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Compliance with the Anti-Monopoly Act in light of the Introduction of the Invoice System

RESTRUCTURING AND INSOLVENCY/ M&A

Restructuring and Insolvency of Distressed Businesses in Japan during COVID-19

I. Introduction

Since the onset of the COVID-19 pandemic, as in many other countries around the world, Japan has seen an increase in the number of companies that have experienced serious cash flow issues. However, the number of bankruptcy and insolvency cases in Japan has not necessarily increased in the same way because of the level of support provided by the Japanese government and the banking sector. For example, with the encouragement of the government, banks have acted to reschedule companies' repayments of debts and to grant new loans to companies. The government itself also positively rescheduled payments of taxes imposed on companies experiencing capital issues, and provided a variety of subsidies in order for those companies to continue operating.

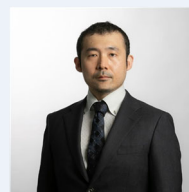
Despite their best efforts, the Japanese government and the banking sector cannot support all companies indefinitely. In addition, many of companies receiving support now ironically have excessive debt issues. In order to face their current cash flow challenges, a lot of companies will need to consider how to fundamentally reorganize their business models. For example, many restaurants do not expect to reach pre-COVID-19 levels of patronage in the near term and are pivoting to service the catering industry instead. This kind of fundamental shift of the business is not easy and many may have to consider liquidating their business or at worst filing for bankruptcy. Consequently, many restructuring professionals in Japan (e.g., attorneys, CPA, and tax accountants) predict that the number of bankruptcy and insolvency cases in Japan will increase in the near future.

II. Outline of Japanese Restructuring and Insolvency Proceedings

Japanese restructuring consists of out-of-court proceedings and in-court proceedings.

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There are several forms of out-of-court proceedings in Japan that all follow the same fundamental rules. In principle, a debtor will stop making repayments on its bank loans, which will be subject to negotiation and the preparation of a separate repayment plan, but will continue to pay all other debts in accordance with its obligations. The repayment plan will include the forgiveness or rescheduling of debts owed to the banks provided that, if the repayment plan includes the forgiveness of unsecured debts, the total repayment amount for each bank under the repayment plan must be greater than the distribution amount that would otherwise be received in a bankruptcy case. The proceedings are closed with only banks and debtors involved, and the repayment plan only becomes binding if all the banks provide their consent.

On the other hand, in the case of civil rehabilitation proceedings (i.e. a major form of in-court and debtor-in-possession proceedings in Japan), a debtor is obligated to stop essentially all payments including bank loans and all other prepetition debts and obligations with certain exceptions, such as taxes and employee wages. The repayment plan (i.e. rehabilitation plan) will include the forgiveness of the prepetition debts and obligations in relation to which the debtor is obligated to stop payments. The repayment amount pursuant to the repayment plan must be greater than the distribution amount that would otherwise be received in a bankruptcy case. In order for the repayment plan to be binding on the parties, consent from the majority of voting right holders and at least a half of the total amount of the voting rights is required, as well as court approval. The consent of all creditors is not required. Lastly, in-court proceedings are conducted publicly.

As a debtor's business value is more easily retained due to the closed nature of out-of-court proceedings compared with in-court proceedings, debtors usually try to proceed with out-of-court proceedings in the first instance. If out-of-court proceedings are not possible, then a debtor will consider in-court proceedings. In general, restructuring may involve selling the debtor's business under both out-of-court and in-court proceedings. In Japan a significant number of restructuring cases proceed with the sale of the debtor's business.

If the debtor cannot proceed with civil rehabilitation proceedings, it will be forced to enter into bankruptcy proceedings. Under Japanese bankruptcy proceedings, a trustee is appointed by the court to liquidate all assets and make distributions on prepetition debts to the extent possible. The debtor company ceases to exist after the completion of the bankruptcy proceeding.

III. Perspectives from Debtors and Purchasers of Debtor Businesses under COVID-19

(i) Debtor

As a result of the support described above, excessive debts including tax debts and late loans made after the onset of COVID-19 have created additional barriers to restructuring for debtors. For example, a debtor is required to pay taxes under civil rehabilitation proceedings, which means that if a debtor owes excessive taxes, it may not be able to enter into out-of-court proceedings or civil rehabilitation proceedings, and will have no option but to file for bankruptcy.

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Late bank loans made after the onset of COVID-19 can also raise issues for debtors attempting to restructure their business. Many banks that provide such late bank loans expect to be treated as a priority creditor. Ideally, the debtor and the banks should agree on the priority ranking and the treatment of the new loan before the execution of the late bank loan; however that is not always the case. This kind of situation may make it difficult for debtors to successfully obtain the required consent of all the banks in out-of-court proceedings.

Additionally, numerous debtors are forced to enter into bankruptcy proceedings because they cannot complete restructuring proceedings due to insufficient capital or their inability to prepare a satisfactory repayment plan to obtain the consent of the required creditors.

In light of the trends above, it is important for debtors to consider their restructuring options and consult with experienced professionals as early as possible. The earlier a debtor begins to consider restructuring, the easier it will be to successfully complete the restructuring process. If a debtor considers restructuring several months before it is unable to make its monthly repayments, it has time for negotiation in out-of-court proceedings; but if a debtor only begins thinking of restructuring one day before it is unable to pay the majority of its debts and obligations, it may be difficult to enter into out-of-court proceedings and, at worst, it will have no option but to file a petition for bankruptcy at that time. The process to sell a debtor business also generally takes several months to complete.

(ii) Purchasers of Debtor Businesses

A debtor's restructuring is also an opportunity for a purchaser to buy the debtor's business. Offering the appropriate consideration for the business is important as the debtor will need to pay certain debts and obligations using the consideration paid by the purchaser. Those certain debts and obligations include secured claims, and unpaid taxes and wages.

In the case of out-of-court proceedings, in addition to the payment of the secured claims and unpaid taxes and wages, the debtor is generally required to use the remaining consideration to pay all other debts and obligations (except bank loans) and a certain portion of unpaid unsecured bank loans. The payment for the unsecured bank loans must be at least more than the amount that would be distributed in the case of the debtor's bankruptcy. Fees and costs for liquidation must also be paid in full if the debtor liquidates and sells all of the business. Generally, consent from all the banks is required to purchase the debtor's business. The purchaser should also consider the risk of avoidance being alleged in later in-court proceedings occurring after the closing of the business transfer.

In case of the civil rehabilitation proceedings, as mentioned above, the debtor's unsecured prepetition debts can be partially forgiven provided that the amount repaid is at least more than that what would otherwise be distributed under bankruptcy proceedings. Post-petition claims, however, must be paid in full. The process for obtaining the consents of, or hearing from, the unsecured prepetition creditors for the transfer of the debtor's business will depend on the structure of the business transfer. If the debtor includes the planned business transfer in the repayment plan, the consent of the majority of the creditors and at least a half of the total amount of voting rights is required. On the other hand, court approval is required if the debtor plans to complete the business transfer before finalizing the repayment plan. The court will decide whether or not to approve the business transfer after convening a hearing with creditors and other certain related parties on the proposed business transfer.

If a debtor cannot satisfy the requirements above to sell the business under out-of-court proceedings or civil rehabilitation proceedings, it may still be able to sell the business under bankruptcy proceedings. However, a business transfer under bankruptcy proceedings tends to have difficulty retaining the value of the business.

If the debtor can identify a purchaser before the beginning of the restructuring proceedings, the debtor's restructuring becomes much easier because creditors, suppliers, and customers will be less concerned about potential continuity issues resulting from the restructuring. Having said that, care should be taken to ensure that the purchaser is identified through appropriate means, such as an auction process. If the purchaser is identified through other means and the debtor subsequently enters into in-court proceedings, the court and the creditors may require the debtor to take such appropriate means at that time to confirm the suitability of the purchaser. In relation to out-of-court proceedings, it is important that the sale of the business is agreed by all the banks.

IV. Conclusion

Restructuring and insolvency cases are expected to increase in Japan in the near future and, in the current COVID-19 circumstances, restructuring may prove to be more difficult for the various reasons outlined above. Debtors would be well advised to consider restructuring as early as possible to ensure sufficient capital and time to find, negotiate and implement the best restructuring plan with creditors and/or to find the most suitable purchaser.

Purchasers of debtor businesses should carefully evaluate the target business and offer an appropriate price after taking all additional considerations in the current circumstances into account. Purchasers should also be aware that distressed businesses can also be acquired under bankruptcy proceedings as well as out-of-court proceedings and civil rehabilitation proceedings, although there may be additional challenges to doing so under bankruptcy proceedings. Purchasers would be well served to be aware of all available options when considering the acquisition of a distressed business in the current market.

ANTITRUST AND COMPETITION/TAX

Compliance with the Anti-Monopoly Act in light of the Introduction of the Invoice System

I. Introduction - The Invoice System and Abuse of Superior Bargaining Position

On October 1, 2023, Japan will introduce the so-called invoice system (the “Invoice System”), a new regime to input tax credits for Japanese Consumption Taxes (“JCT”). Applications to register as a qualified invoice issuer under the Invoice System have been accepted since October 1, 2021.

The Invoice System will have a significant financial impact on both suppliers and purchasers of goods and services in Japan; illustrated by the following two examples.

First, the financial impact on purchasers. In this example, the purchaser, a taxable business person, purchases parts for JPY2.2 million (which includes JPY200,000 JCT) from each of ten tax-exempt suppliers, and after processing the parts, sells them as merchandise for JPY55 million (which includes JPY5 million JCT). Under the Invoice System, as purchases from tax-exempt suppliers are no longer eligible for input tax credits, the purchaser will lose the ability to claim JCT input tax credits for each of the ten purchases. This means that the purchaser can no longer obtain JPY200,000 JCT x 10 = JPY 2 million JCT input tax credits, which in effect reduces the purchaser’s income by JPY 2 million (see below table).

[Impact on Purchaser]

	Current Law (JPY)	Under the Invoice System (JPY)
Sales	55,000,000	55,000,000
Purchases	22,000,000	22,000,000
Tax Payable (JCT Payable)	3,000,000 ¹	5,000,000 ²
Amount of Income	30,000,000	28,000,000
Amount of Impact		(2,000,000)

Second, the financial impact on suppliers. In this example, one of the tax-exempt suppliers in the above example purchases parts for JPY1.1 million (which includes JPY100,000 JCT) from a taxable business person. After the Invoice System is introduced, if the supplier becomes a taxable business person (and further registers as a qualified invoice issuer), the supplier will be obliged to pay the JPY 100,000 JCT amount that it receives as JCT to the Japanese tax authorities, which it is not obliged to pay under the current regime. This means that, in effect, the supplier’s income is reduced by JPY100,000 (see below table).

¹ JPY5,000,000 (JCT on sales) - JPY2,000,000 (JCT on purchases)

² JPY5,000,000 (JCT on sales)

[Impact on Supplier]

	Current Law (JPY)	After Election as a Taxable Business Person (JPY)
Sales	2,200,000	2,200,000
Purchase	1,100,000	1,100,000
Tax Payable (JCT Payable)	0 ³	100,000 ⁴
Amount of Income	1,100,000	1,000,000
Amount of Impact		(100,000)

Given these financial impacts, there is a risk of purchasers potentially breaching the Anti-Monopoly Act (specifically, the prohibitions against the abuse of a superior bargaining position) depending on how purchasers communicate and negotiate with their suppliers. For example, unilaterally requiring tax-exempt suppliers to change their status to a taxable business person (and further register as a qualified invoice issuer) or terminating transactions with tax-exempt suppliers if they do not change their status would likely violate the Anti-Monopoly Act. Purchasers should, therefore, carefully consider appropriate measures beforehand in light of the introduction of the Invoice System.

For example, some platform operators may be involved in continuous purchase transactions covering the same activities with many freelancers and gig workers who are presumed to be tax-exempt business persons. Given that such platform operators will no longer be able to obtain input tax credits for JCT imposed on such purchase transactions, the way that such purchase transactions with the freelancers and gig workers are structured should be reviewed. That said, if platform operators unilaterally require the freelancers and gig workers to become taxable business persons and register as qualified invoice issuers by October, 2023 as a prerequisite to continuing the purchase transactions on the basis that platform operators will no longer be able to obtain input tax credits, the platform operators may be at risk of abusing of a superior bargaining position under the Anti-Monopoly Act as the resulting financial impact on freelancers and gig workers could be significant. This is not unique to purchase transactions between platform operators and freelancers and gig workers but is an unavoidable issue, especially for purchasers placing a large number of purchase orders with tax-exempt business persons. Purchasers must carefully consider this issue in light of the cost structure of their businesses. As the Invoice System will commence on October 1, 2023, Purchasers have only a limited time to negotiate and reach agreement with their suppliers on this issue.

The following is an overview of the Invoice System and a concise explanation of some possible measures that can be taken to lessen its impact. Additionally, a summary has recently been issued of the second meeting of the Cabinet Secretariat's Liaison Committee between the relevant government ministries and agencies on how to efficiently implement a reduced rate consumption tax system which was held on November 18, 2021. The summary includes a draft Q&A document explaining measures that can be taken for tax-exempt business persons and the Invoice-System in relation to, among other related matters, the risks of abuse of a superior bargaining position and related anti-competition issues. The summary can be accessed at https://www.cas.go.jp/jp/seisaku/keigen_kaigi/index.html (Japanese only).

³ The amount of JCT payable is zero for tax-exempt business persons.

⁴ JPY200,000 (JCT on sales) - JPY100,000 (JCT on purchases)

II. Overview of the Invoice System

(i) The Invoice System

The JCT system is, in simple terms, a system where taxable business persons pay JCT equal to the difference between, on the one hand, the JCT levied on the sale and provision of their own goods and services (i.e., JCT on sales) and, on the other hand, the JCT paid on their purchases of materials and services connected to the sale and provision of their own goods and services (i.e., JCT on purchases). For example, in relation to parts purchased by Company A for JPY550,000 (which includes JPY50,000 JCT) and processed and sold by Company A as merchandise for JPY1,650,000 (which includes JPY150,000 JCT), the total JCT payable would only be JPY100,000, i.e., the difference between the JPY150,000 JCT on the sale (received by Company A as part of the sales price to the customer) and the JPY50,000 JCT on the purchase (paid by Company A as part of the purchase price to the supplier). The deduction of the JCT difference in these two transactions (i.e., JPY50,000) in calculating JCT payable is referred to as an input tax credit.

Under the Invoice System, taxable business persons (purchasers) will need to retain the invoices (i.e., qualified invoices) for their purchases issued by suppliers to obtain input tax credits.⁵ Further, such invoices must contain the following specified details:⁶

- name and registration number of the business person issuing the invoice (i.e., the qualified invoice issuer);
- the date and details of the applicable transaction; and
- total amount paid per tax rate, the applicable tax rate, and the amount of JCT, all of which are necessary for calculating JCT.

Accordingly, JCT on purchases from business persons not registered as qualified invoice issuers will no longer be deductible by purchasers as they are not registered and are not allowed to issue qualified invoices, subject to the transitional measures detailed in section (iii) below.

(ii) Qualified Invoice Issuer Registration

In general, to become registered as a qualified invoice issuer as of October 1, 2023 when the Invoice System will be introduced, the applicant must submit a registration application to the specified district tax director by March 31, 2023.⁷ ⁸ However, to become registered as a qualified invoice issuer, the applicant must first be registered as a taxable business person.⁹ Therefore, any tax-exempt business persons must become taxable business persons before applying for registration as qualified invoice issuers.¹⁰ ¹¹

⁵ Article 30, Paragraphs 1 and 7 of the Consumption Tax Act

⁶ Article 30, Paragraph 9 and Article 57-4, Paragraphs 1 and 2 of the Consumption Tax Act.

⁷ Article 44, Paragraph 1 of the Supplementary Provisions of the 2016 Amendment Act

⁸ The list of qualified invoice issuers will be posted on the National Tax Agency's website (<https://www.invoice-kohyo.nta.go.jp/>)(Japanese only).

⁹ Article 57-2, Paragraph 1 of the Consumption Tax Act

¹⁰ Article 9, Paragraph 4 of the Consumption Tax Act

¹¹ However, regarding registration during the taxable period that includes October 1, 2023, tax-exempt business persons can become taxable business persons (and subsequently register as qualified invoice issuers) by submitting an application for registration without submitting a Notification of Selection of Taxable Proprietor Status (Article 44, paragraph 4 of the Supplementary Provisions of the 2016 Amendment Act, Circular Notice 5-1 on the Method of Retaining Qualified Invoices, etc. under the Consumption Tax Input Tax Credit System).

(iii) “Tax Profit” Issues and Transitional Measures

Under the current law, input tax credits are also available for JCT imposed on purchases from tax-exempt business persons.¹² One reason for this is to avoid tax-exempt business persons from being excluded from transactions and competitively disadvantaged due to purchasers’ inability to obtain input tax credits for JCT imposed on purchases from tax-exempt business persons.¹³ However, it should be noted that under the current law, tax-exempt suppliers are not obligated to pay the JCT portion of the sales price that they receive from purchasers, while purchasers are entitled to tax credits for JCT amounts paid to tax-exempt suppliers. The retention of the JCT amount received by tax-exempt business persons is referred to as “tax profit” (*ekizei*), and some observers criticize this as the government effectively extending financial assistance to tax-exempt businesses by way of such “tax profit.” The higher the consumption tax rate, the larger the “tax profit,” which leads to JCT tax revenue leakage from the national treasury. This has long been considered a national fiscal issue.^{14 15}

The status of a tax-exempt business person will continue in place after the Invoice System is introduced. In order to ensure that tax-exempt business persons not registered as qualified invoice issuers are not immediately excluded from transactions, transitional measures will be put in place. Under these transitional measures, purchases from tax-exempt business persons will be eligible for an input tax credit of 80% of the JCT for three years after the introduction of the Invoice System and up to 50% for the following three years as long as, among other conditions, the requirements for such input tax credits under the current law are met.¹⁶ Eventually, input tax credits will not be available for purchases from tax-exempt business persons. Therefore, if more tax-exempt business persons become taxable business persons and register as qualified invoice issuers, transactions with tax-exempt business persons will likely decrease, thereby alleviating the “tax profit” issue.

(iv) Simplified Tax System

As mentioned above, in light of the future introduction of the Invoice System, tax-exempt business persons will need to consider whether to remain tax-exempt business persons or register as qualified invoice issuers after becoming taxable business persons. In addition, if they choose to register as qualified invoice issuers, they will also need to consider when to register. When considering these matters, they will need to take into account the risk of a decline in business and the potential financial impact of not becoming a qualified invoice issuer.

In this context, utilizing the so-called “simplified tax system” is worth consideration. The simplified tax system was established to ease the administrative burden on small and medium-sized businesses. Under the simplified tax system, the amount of input tax credit is obtained by multiplying the amount of JCT payable on taxable sales during the taxable period by the deemed purchase rate instead of the JCT payable on the monetary amount of actual purchases. This simplified tax system is available to taxable business persons with taxable sales of JPY50 million or less during the reference taxable period (i.e., the calendar year before the previous year for individuals and the fiscal year before the previous year for companies¹⁷).

Therefore, although differing from the original purpose of the simplified tax system of reducing administrative burdens, it may be advantageous for tax-exempt business persons to use the simplified tax system if their deemed amount of input tax credit, which is calculated based on their deemed purchase rate, is expected to be higher than the input tax credit amount calculated based on the monetary amount of their actual purchases upon becoming taxable business persons (and further registering as a qualified invoice issuer).

12 Article 30, Paragraphs 1 and 7 of the Consumption Tax Act

13 For example, Toshihiro Mochizuki, “Issues Concerning Multiple Tax Rates for Consumption Tax,” *Journal of National Tax College*, No. 42 (June 2003), pp. 231-233.

14 On the other hand, such “tax profit” enables tax-exempt business persons to recover the JCT amounts that they bear on their own purchases but for which they cannot obtain input tax credit (see Article 30, Paragraph 1 of the Consumption Tax Act).

15 See, for example, the articles cited in Ryo Sato, “Background and Issues Concerning the Introduction of the Invoice System,” [Investigation and Information—ISSUE BRIEF], No. 949 (March 23, 2017), pp. 9-10.

16 Articles 52 and 53 of the Supplementary Provisions of the 2016 Amendment Act

17 Article 37, Paragraph 1 of the Consumption Tax Act

Such previous tax exempt business person can potentially benefit from the difference in JCT by choosing the simplified tax system and thereby potentially alleviate the decrease in “tax profit” following their change from a tax-exempt business person to a taxable business person (and further registration as a qualified invoice issuer).¹⁸

¹⁹ Therefore, tax-exempt business persons considering becoming taxable business persons (and further registration as qualified invoice issuers) following the introduction of the Invoice System should also consider whether to opt to use the simplified tax system.

The deemed purchase rates for each type of business under the simplified tax system are as set out below:²⁰

Class - 1	Business (Wholesale)	90%
Class - 2	Business (Retail)	80%
Class - 3	Businesses (Manufacturing)	70%
Class - 4	Business (Other Businesses)	60%
Class - 5	Businesses (Services)	50%
Class - 6	Businesses (Real Estate Business)	40%

III. **Requiring Suppliers to Register as Qualified Invoice Issuers and Anti-Monopoly Act Issues**

Anti-monopoly issues and considerations from a purchaser’s perspective in setting the terms and conditions for transactions with suppliers after the introduction of the Invoice System, with a particular focus on tax-exempt suppliers, are discussed below.

(i) Risk of Abuse of Superior Bargaining Position

Registration by suppliers as qualified invoice issuers would obviously benefit purchasers as it will enable them to obtain tax credits as before. If suppliers are already taxable business persons, their tax burden will remain unchanged compared to before the introduction of the Invoice System, even if they register as a qualified invoice issuer under the Invoice System. However, tax-exempt suppliers will face significant adverse tax consequences, such as the loss or reduction of “tax profit” if they become taxable business persons and register as qualified invoice issuers under the Invoice System.

In these circumstances, purchasers who (i) require tax-exempt suppliers to register as qualified invoice issuers, implying that the purchasers would otherwise immediately terminate, or lower unit prices under, their agreements with the suppliers, or (ii) actually terminate or reduce unit prices under agreements with suppliers who do not register as qualified invoice issuers, are highly likely to breach the prohibitions against abuse of a superior bargaining position under the Anti-Monopoly Act as such behavior amounts to a unilateral setting of terms and conditions by a party in a superior bargaining position.

In addition, if any purchasers were to require a large number of tax-exempt suppliers to uniformly and hastily register as qualified invoice issuers, the financial impact on those suppliers would be significant, creating a risk that the Japan Fair Trade Commission could investigate the cases on a large scale as potential abuses of a superior bargaining position.^{21 22}

¹⁸ To use the simplified tax system, businesses to which the transitional measures stated in footnote 11 apply must submit a “Notification of Election of Simplified Tax System for Consumption Tax” to the specified district tax director, indicating that they elect to use the simplified tax system from the taxable period that includes the date of registration as a qualified invoice issuer, and upon approval will be deemed to have submitted such Notice on the day preceding the first day of the taxable period (see Article 18 of the Supplementary Provisions of the 2018 Cabinet Order Amendment). Therefore, for example, tax-exempt business persons that are also registered as qualified invoice issuers as of October 1, 2023 (i.e., the commencement date of the Invoice System), and have submitted a “Notification of Election of Simplified Tax System for Consumption Tax” to the specified district director, indicating that they elect to use the simplified tax system from the taxable period that includes October 1, 2023, will be subject to the simplified tax system from the date of registration as a qualified invoice issuer.

¹⁹ This is also a type of “tax profit.”

²⁰ Article 37, Paragraph 1, item (i) of the Consumption Tax Act and Article 57, Paragraph 1 of the Enforcement Order for the Consumption Tax Act)

²¹ Although transactions with suppliers constitute subcontracting transactions under the Subcontracting Act, the above-mentioned purchaser actions (i) and (ii) will not necessarily constitute any of the prohibited acts of the principal under the Subcontracting Act such as “forced price reduction” or “compulsory purchasing.” In addition, unless the purchaser were to commit any of the other prohibited acts under the Subcontracting Act such as “price reductions” after orders are placed, it would be difficult for a supplier to successfully claim that the above described purchaser actions (i) or (ii) violate the Subcontracting Act.

²² See Japan Fair Trade Commission, “Perspectives on Abuse of a Superior Bargaining Position under the Anti-Monopoly Act,” Item

(ii) Would Removal of “Tax Profit” Negate Abuse of a Superior Bargaining Position?

Purchasers may like to believe that they would be justified in unilaterally forcing tax-exempt suppliers to disgorge the “tax profit” through negotiation with the suppliers on the grounds that the “tax profit” is just a side-benefit windfall which should be reduced or removed from a national fiscal viewpoint, and that input tax credits will be phased out for purchasers from tax-exempt suppliers after the introduction of the Invoice System. However, the “tax profit” is not unlawful and the status of “tax-exempt business persons” will remain even after the introduction of the Invoice System. Furthermore, purchasers enforcing disgorgement of the “tax profit” against suppliers would likely have a significant adverse effect on suppliers. Accordingly, it would be difficult for purchasers to justify any such unilateral action against tax-exempt suppliers and/or successfully rebut claims of abuse of a superior bargaining position by arguing that their actions reduced the “tax profit” – even though this appears to be one of the purposes of the Japanese government in introducing the Invoice System.

(iii) Balancing the Interests of Tax-exempt Suppliers and the Principle of Freedom of Contract

Freedom of contract is a fundamental principle of a capitalist economy. Purchasers should not be obliged to engage in business with tax-exempt suppliers on the same terms and conditions as before and after introduction of the Invoice System, even in the context of laws regulating abuse of a superior bargaining position. Continuing to engage in business with tax-exempt suppliers on the same terms and conditions as before introduction of the Invoice System would essentially result in higher unit prices for purchasers given the tax effect of phasing out input tax credits for purchasers after the introduction of the Invoice System, which could be critical to the profitability of purchasers.

Strengthening business relationships with suppliers who offer better terms and conditions and reducing or terminating business relationships with those who do not is a direct consequence of the principle of competition, and it is not *per se* unlawful to require tax-exempt business persons to register as qualified invoice issuers. Some tax-exempt suppliers even may seek to expand their business and strengthen their competitiveness by becoming qualified invoice issuers in order to allow their purchasers to continue to receive input tax credits. As long as tax-exempt business persons properly analyze the advantages and disadvantages of registration as a qualified invoice issuer, overly restricting tax-exempt business persons from becoming qualified invoice issuers would impede competition, which would not facilitate the purpose of the Anti-Monopoly Act either. Therefore, purchasers should seek solutions acceptable to both themselves and suppliers under the Invoice System, while at the same time recognizing the circumstances and position of suppliers.

(iv) Sample Practical Measures

In asking tax-exempt business persons to register as qualified invoice issuers, it is critical that such requests are not made as unilateral requirements. To avoid claims of “unilateralism,” purchasers should (i) consider the circumstances of suppliers (especially those of tax-exempt business persons), (ii) give suppliers sufficient time to make a decision after they have understood the circumstances and position of the purchaser, and (iii) avoid pressuring suppliers to indicate their willingness to register as qualified invoice issuers.

There is no single approach to reaching a balanced and reasonable agreement to avoid abuse of a superior bargaining position. The number of suppliers, their characteristics (e.g., whether or not they are sole proprietors who conduct their business as a side business), the power balance between the supplier and purchaser, the extent of dependence of the supplier on the purchaser and other aspects of the supplier-purchaser relationship can vary widely. To this end, although these are only examples, purchasers could adopt the following practical measures:

- Purchasers could thoroughly explain the Invoice System to their current tax-exempt suppliers, including the transitional measures under the Consumption Tax Act, and inform them that the phasing out of the input tax credits for purchases from them will have a significant impact on purchasers.

- Subsequently, purchasers could ask their tax-exempt suppliers to consider registering as a qualified invoice issuer (after becoming a taxable business person) and give the suppliers sufficient time to do so while simultaneously showing the purchaser's consideration and understanding of the difficulties that such registration entails for suppliers.
- If possible, a package of unit prices and terms and conditions could be proposed in order for suppliers and purchasers to share the financial burden, and incentives could be offered to those switching from tax-exempt to taxable status.
- In proposing these packages and incentives, the transitional measures could be also taken into account.

It will likely take some time to reach agreement through negotiations and discussions on these packages and incentives. If a purchaser takes appropriately timed step-by-step measures to reduce or terminate business with a supplier with whom it is difficult to reach agreement after a certain reasonable time period, the risk of claims of abuse of a superior bargaining position will be relatively low.

(v) Possibility of New legislation on Dealings with Start-ups and Freelancers

Coinciding with the previous increases in the JCT rate, the Act Concerning Special Measures for Correcting Practices Impeding Consumption Tax Pass-on, etc. with the Aim to Ensure Smooth and Proper Pass-on of Consumption Tax was passed as a temporary measure to protect both tax-exempt and taxable suppliers. Under this Act, it would constitute a "forced price reduction" if purchasers did not raise their purchase prices to cover the increase in JCT. However, no special measures are expected to be introduced to provide protection to suppliers in connection with the introduction of the Invoice System.

In March 2021, the Japan Fair Trade Commission issued the following guidelines jointly with other relevant ministries and agencies:

- Guidelines for Business Collaboration with Start-ups (issued by Japan Fair Trade Commission and Ministry of Economy, Trade and Industry); and
- Guidelines for Creating an Environment for Working as a Freelancer (issued by Cabinet Secretariat, Japan Fair Trade Commission, Small and Medium Enterprise Agency, and Ministry of Health, Labour and Welfare).

None of these Guidelines will change the existing requirements or prohibitions under the Subcontracting Act or the Anti-Monopoly Act. However, new legislation similar to the Subcontracting Act is being considered by the Japanese government in order to protect start-ups and freelancers. If such new legislation is introduced, purchasers should take such legislation into account when considering the approach to requesting suppliers to register as qualified invoice issuers.

IV. Conclusion

The Invoice System is likely to have significant financial impact on both purchasers and suppliers. Against this background, inappropriate acts by purchasers, such as unilaterally requiring tax-exempt suppliers to register as qualified invoice issuers or immediately terminating business with suppliers who do not register as qualified invoice issuers under the Invoice System, are highly likely to constitute abuse of a superior bargaining position under the Anti-Monopoly Act, as they amount to a unilateral setting of terms and conditions by a party in a superior bargaining position. Therefore, in preparation for the introduction of the Invoice System on October 1, 2023, when negotiating with their suppliers, purchasers should take a cautious approach over a reasonable period of time taking into consideration their suppliers' circumstances in order to reach a mutually acceptable conclusion while tax-exempt suppliers should consider registering as qualified invoice issuers in order to continue, and even expand, their business with their customers.

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