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Tax Controversy 2025

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Japan: Law and Practice
& Trends and Developments

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JAPAN

Law and Practice

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Contents

Nagashima Ohno & Tsunematsu has almost 50 years' experience handling tax matters. Six partners are dedicated to tax issues, including three seasoned partners. The firm also consults, as advisers on tax affairs, Hitoshi Sumisawa, a former commissioner of the National Tax Agency, and Professor Emeritus Tadao Okamura, the foremost authority on Japanese corporate tax law and a member of the government Tax Commission. 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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1. Tax Controversies

1.1 Tax Controversies in This Jurisdiction

As a procedural legal matter, a tax controversy will arise when and if:

- a formal tax assessment has been issued upon a taxpayer; and
- 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, 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, VAT – and fixed property tax are also common. While 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 the imposition of a heavy penalty tax means that the taxpayer committed fabrication or concealment of facts, generally viewed among the public as indicating an attitude of non-compliance on the part of 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 is a difference of views in tax audits, it logically follows that this difference would not occur 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 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 that 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 – ie, even a verbal confirmation is well reviewed and respected within the tax authority in practice. In addition, under the so-called J-CAP (Compliance Assurance Programme of Japan), which the National Tax Agency originally launched in 2022, certain very large companies can obtain a written formal advance ruling within 45 business days from the date all relevant information is provided.

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 turn out to be inaccurate or misleading.

Also, in the transfer pricing area, an advance pricing agreement (APA) is commonly used to avoid 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 deductible under the local tax law of the jurisdiction where a foreign subsidiary is located (eg, Brazil) 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 focus more 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 the 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 (PE) in income tax law and corporation tax law in response to BEPS Action 7, to define more properly an agent PE to prevent avoidance of an agent PE through artificial measures;
- Actions 8–10 – Japan has incorporated the so-called commensurate-with-income standard and the discounted cash flow (DCF) method 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; and
- 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 8 January 2025, the MLI will be applicable to the double tax treaties of Japan with 39 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, the firm has not seen a meaningful increase or decrease in tax controversies. However, as these measures generate new issues of interpretation, it is expected that tax controversies will increase in the future. See also **10.6 New Procedures for New Developments Under Pillars One and Two**.

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 apply for a mutual agreement procedure (MAP). In that case, upon request, the taxpayer may be given a grace period for 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 under-reporting of 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 the 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 for 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. However, 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 *"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. 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 huge corporates, the audit may last for a few months. Moreover, transfer pricing audits can last for one or two years, depending upon the circumstances.

The 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 the limitation period is not suspended or interrupted by a tax audit, and its expiry will thus prevent a tax audit. As an exception, however, the statute of the limitation period will be extended where a taxpayer is not co-operative in a tax audit, and tax authorities request another jurisdiction for the 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. The accounting books and records, 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.

From July 2023, the National Tax Agency has expanded the scope of companies subject to a trial project to conduct tax audits remotely using telecommunications (eg, web conferences) with the consent of such corporations, to generally cover all companies whose registered capital is JPY100 million or more.

2.4 Areas of Special Attention in Tax Audits

Key matters for tax auditors vary 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 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 essential to manage the submissions 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, for example, and where feasible, that 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 settle the issue effectively. 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

For the taxpayer's claim to be heard before the courts, an administrative procedure is mandatory. 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 reviewing 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. As in 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 entirely or partially admitting the taxpayer's Request for Reconsideration. The entire process generally takes one year.

One of the most important functions of the Request for Reconsideration process from the taxpayer's viewpoint is to gather documentary evidence 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 submitted by the tax authority. This process is indispensable for preparing for future judicial tax litigation to assess how strong the taxpayer's and the tax authority'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 for 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 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 in the following, 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 a 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, accompanied by supporting exhibits as documentary evidence. The taxpayer needs to pay court filing fees (eg, 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, in 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, addressing other administrative issues 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: 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 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 for Judicial Tax Litigation

The first hearing session will generally be held within a few months of filing 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 occur 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 evidence is documentary, and a witness is rarely called upon, either by the petitioner or by the respondent. This is partly because there is not often a dispute over a finding of *"bare"* facts (eg, whether someone signed the document). The key issues in judicial tax litigation are the interpretation of tax law as well as how the court should view or characterise the proven 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 have the burden of proof to establish that the amount of the assessed tax in the tax assessment is correct. However, with respect to a few items, such as the existence and amount of deductible expenses, the taxpayer or the petitioner will have the burden of proof. In addition, setting aside ordinary reassessments (*kohsei*) or determinations (*kettei*), if the tax assessment is rejecting the taxpayer's request for a downward adjustment of the tax amount from that reported in the originally filed tax return, then the taxpayer will have 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 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, where 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 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 that the Commentary to the OECD Model Tax Convention can be a supplementary measure in interpreting tax treaties. However, in their decisions, it is not very common for Japanese courts to refer to foreign jurisprudence or doctrine formed in a foreign jurisdiction.

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 (eg, the Tokyo High Court has the corresponding jurisdiction over the Tokyo District Court). The appeal period is two weeks from receipt of the official copy of the decision (which is mandatory save for exceptional cases); by that deadline, the petitioner must submit a statement of appeal. Then, within 50 days of submitting the statement of appeal, the petitioner must submit the reasons describing the substantive arguments for the appeal. At the High Court level, there is no restriction on the causes – 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, with only 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 6 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 or administrative law, but tax cases are heard in the general civil divisions along with general civil matters 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 of 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 (where this 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 (where this 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 applying for a writ of certiorari have to persuade the Supreme Court that that important questions of law indeed exist.

If the Supreme Court decides that this condition is not met, 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 enter into a 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 generally takes from six months to several years.

5.3 Judges and Decisions in Tax Appeals

Concerning 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, 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; 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 becomes 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 criminal investigation. Thus, where information is so shared, it can lead to scrutiny 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 the firm's 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 a 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 applies 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 not to institute or withdraw the 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 not been applied in criminal tax cases.

7.7 Appeals Against Criminal Tax Decisions

There is only one route to appeal against the decision of the district court – ie, 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) can 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 apply without any particular restriction on the 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 a MAP if available under the applicable double tax treaty 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, the existence of a 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 110 pending MAP cases (excluding those for APAs) as of the end of 2023, of which 95 cases (approximately 86%) are on matters related to transfer pricing.

Where a MAP 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 seem to have been any particular impact of the measures adopted under the MLI in this domain thus far because the arbitration process provided in the MLI has not become available yet (see **10.1 Application of Part VI of the Multilateral Instrument (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 the scope. There are:

- a few targeted anti-avoidance rules (TAAR) 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 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 in 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, the 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 MAP was not successful), taxpayers would challenge the adjustment via 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 in transfer pricing matters. Unilateral APAs are also used, for example, where the potential tax risks are considered rather small, or when 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 and the agreed approach for economic analysis. Based on such a preliminary consultation, the taxpayer would conduct a detailed economic analysis and prepare an application for an APA. After the application is filed with the tax authorities, the application is first reviewed by the tax authorities of Japan and then, where relevant, a MAP between the competent authorities of Japan and the other applicable 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. State Aid Disputes

9.1 State Aid Disputes Involving Taxes

State aid disputes involving taxes are not relevant because Japan is a not an EU member state.

9.2 Procedures Used to Recover Unlawful/Incompatible Fiscal State Aid

Procedures used to recover unlawful/incompatible fiscal state aid are not relevant because Japan is a not an EU member state.

9.3 Challenges by Taxpayers

Challenges by taxpayers are not relevant because Japan is a not an EU member state.

9.4 Refunds Invoking Extra-Contractual Civil Liability

Refunds invoking extra-contractual civil liability are not relevant because Japan is a not an EU member state.

10. International Tax Arbitration Options and Procedures

10.1 Application of Part VI of the Multilateral Instrument (MLI) to Covered Tax Agreements (CTAs)

Approximately 30 of Japan's double tax treaties provide for mandatory binding arbitration, and among these treaties, competent authority agreements to implement the arbitration process have been signed with seven jurisdictions as of December 2024.

Japan also elected to apply part VI of the MLI to the relevant CTAs; thus, a set of arbitration provisions will be introduced into the relevant CTAs if treaty partners also make the same election. As of 28 June 2022, Japan has signed only one competent authority agreement to implement the arbitration process provided in the MLI, with Singapore.

10.2 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 the residency of a person other than an individual who 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 that the treaty partner has excluded from the scope of arbitration (this reservation is to make the scope of arbitration reciprocal with the treaty partner).

10.3 Application of 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 consistent with Japan's existing competent authority agreements, which generally 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 UK, for which baseball arbitration is provided as an optional mode for arbitration.

10.4 Implementation of the EU Directive on Arbitration and/or the MLI

As mentioned in **10.1 Application of Part VI of the Multilateral Instrument (MLI) to Covered Tax Agreements (CTAs)**, Japan is proactively adopting OECD-based mandatory binding arbitration in its double tax treaties through either bilateral treaty negotiation or the MLI. As a non-EU member state, the EU Directive on Arbitration does not apply to Japan.

10.5 Existing Use of Recent International and EU Legal Instruments

As of 1 April 2025, 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 do not apply to Japan.

10.6 New Procedures for New Developments Under Pillars One and Two

With respect to Pillar Two, Japan's income inclusion rule (IIR) has started to apply for fiscal years (FYs) commencing on or after 1 April 2024. The Japanese government will also apply a qualified domestic minimum top-up tax (QDMTT) and an under-taxed payment rule (UTPR) for FYs commencing on or after 1 April 2026.

With respect to Pillar One, Japan is still committed to implementing it, pending global agreement at the OECD level.

Both Pillars envisage consistent application of the same substantive tax rules across jurisdictions in an unprecedented manner, and this would likely generate uncertainties and controversies – eg, where jurisdictions have a different interpretation of the same rule or have different views on the same set of facts. While it may be premature to judge the effectiveness of the instruments to mitigate controversies and tax certainty procedures, it is possible that they are not sufficient.

10.7 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.

10.8 Most Common Legal Instruments to Settle Tax Disputes

As of 1 April 2025, there is no publicly available information on whether mandatory binding arbitration has already been used in Japan (see **10.5 Existing Use of Recent International and EU Legal Instruments**).

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

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

As mentioned in **10.5 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.

11. Costs/Fees

11.1 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 the 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**.

11.2 Judicial Court Fees

In judicial litigation procedures, a taxpayer has to pay court filing fees by way of revenue stamps when 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.

In 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 equals 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.

11.3 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, such an indemnity requirement is rather strict, and taxpayers can receive it only in very limited circumstances.

11.4 Costs of ADR

No ADR mechanism is available for tax purposes in Japan.

12. Statistics

12.1 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 FY 2023 (1 April 2023 to 31 March 2024) is 189. The breakdown by instance is 141 cases at the first instance, 31 cases at the hearing on appeal and 17 cases at the hearing on final appeal.

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

12.2 Cases Relating to Different Taxes

According to the NTA Statistics, the total number of cases that commenced in FY 2023 was 189. The breakdown by the types of taxes involved is 50 cases on corporate income tax, 62 cases on income tax (including withholding tax), 18 cases on VAT, 22 cases on property tax and 37 cases on other tax or tax-related matters.

The total number of cases that closed in FY 2023 was 172. The breakdown by the types of taxes involved is 41 cases on corporate income tax, 64 cases on income tax (including withholding tax), 18 cases on VAT, 15 cases on property tax and 34 cases on other tax or tax-related matters.

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

12.3 Parties Succeeding in Litigation

According to the NTA Statistics, taxpayers prevailed in 13 cases (8% of the total of 172 cases that closed in FY 2023). To be more precise, taxpayers fully prevailed in six cases and partially in four cases. While this percentage of taxpayer success in tax litigations may appear to be rather low, the denominator seems to include cases that 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.

13. Strategies

13.1 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 using 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 interpretation of tax laws, making an argument based on 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 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 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**.

Trends and Developments

Contributed by:
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Nagashima Ohno & Tsunematsu has almost 50 years' experience handling tax matters. Six partners are dedicated to tax issues, including three seasoned partners. The firm also consults, as advisers on tax affairs, Hitoshi Sumisawa, a former commissioner of the National Tax Agency, and Professor Emeritus Tadao Okamura, the foremost authority on Japanese corporate tax law and a member of the government Tax Commission. 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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Recent Tax Enforcement Trends

The National Tax Agency of Japan is responsible for Japan's tax administration, and enforcement is carried out by the particular National Tax Office that has jurisdiction over a specific taxpayer or, in the case of large taxpayers and important cases, the Regional Taxation Bureaus, including the Tokyo Regional Taxation Bureau, which has jurisdiction over Tokyo (collectively, the *"Japanese tax authorities"*). Recently, Japanese tax authorities have tended to place more focus on mergers and acquisitions, cross-border transactions in general and high net worth individuals. Audits of these transactions and taxpayers are often protracted and can extend from a few months to a few years in some cases. This seems to be because the amounts involved are large, and thus the revenue potential is significant. After the Japanese authorities conduct audits and challenge a taxpayer's position, unless the taxpayer agrees with the tax authorities and voluntarily amends its tax return, the tax authorities would render an assessment of the taxpayer's liability. Tax assessments in these contexts are often disputed in administrative claim proceedings and court litigation. This is presumably because the laws applicable to such transactions or taxpayers have a wide range of interpretations, as exemplified by anti-avoidance rules. Furthermore, where transfer pricing and other valuations are concerned, the nature of the matter leads to varied views between the taxpayer and the tax authorities, causing prolonged disputes between the parties.

Avoiding Disputes With the Japanese Tax Authorities

For mergers and acquisitions, as well as cross-border transactions, a request for an advance ruling or more informal inquiries can be made to the Japanese tax authorities. An example of this is provided by a Japanese semi-conductor manufacturer that abandoned its acquisition attempt in the face of potential taxation in accordance with the controlled foreign corporations (CFC) regime. According to the public disclosure, when a taxpayer tried to acquire a French company, the taxpayer made an inquiry to the Japanese tax authorities, which responded that taxation based on the CFC regime was a real possibility in the contemplated transaction. This adverse response caused the Japanese manufacturer to give up its attempted acquisition to avoid unintended taxation.

In addition, in 2022, the National Tax Agency launched the so-called J-CAP (Compliance Assurance Programme of Japan), whereby certain very large companies can obtain a written formal advance ruling within 45 business days from the date on which all relevant information is provided, which is significantly shorter than the timeline in the previous advance ruling procedure. According to a news report, J-CAP was used in August 2023 when a Japanese tobacco manufacturer received dividends from its foreign subsidiary that did not qualify for the 95% exemption, since the manufacturer inadvertently failed to satisfy the six-month holding requirement of the subsidiary necessary for the exemption. In April 2024, the Japanese tax authorities reportedly replied to the tobacco manufacturer, indicating that the revocation of the dividend payment was valid and that no taxation would result from the dividends that had been declared and revoked from the foreign subsidiary.

From a practical viewpoint, in order to avoid unexpected tax liabilities, it is useful to make inquiries to the Japan tax authorities in advance through these formal or informal routes, given that mergers and acquisitions and cross-border transactions entail the application of complex rules and inevitable uncertainties. It should be noted, however, that inquiries to the tax authorities do not provide a court-like adversary structure; thus, the taxpayer is not afforded sufficient opportunity to convince the tax authorities of the taxpayer's position, which could result in the authorities disagreeing with the taxpayer's view. See **1.3 Avoidance of Tax Controversies** in the Japan Law and Practice chapter of this guide for more information.

Tax Authority Tendencies in Requests for Reconsideration

In the event that a Japanese tax authority renders an assessment, only after the taxpayer first exhausts the two-step administrative claim proceedings may the taxpayer institute a lawsuit before the court. In the first step, Request for Reinvestigation, the taxpayer usually does not expect the assessment to be withdrawn given that the tax authorities, albeit senior officials, review the assessment without involving external parties.

The second step of the administrative claim proceedings, Request for Reconsideration, is adjudicated by the National Tax Tribunal. Since the Tribunal is also an organisation under the National Tax Agency, it undeniably has a tendency to agree with the tax authorities. However, the National Tax Tribunal employs private-sector attorneys-at-law, tax accountants and certified public accountants as trial examiners for fixed terms. In fact, while a panel of three examiners is assigned to individual cases filed with the National Tax Tribunal, one of the three is often a private practitioner – ie, an attorney-at-law, tax accountant or certified public accountant – who can be expected to be more sympathetic to the taxpayer's position given their background. Nevertheless, tax practitioners observe that the Tribunal tends to favour the tax authorities in cases that involve complex legal issues or high stakes. In particular, in cases where anti-avoidance rules apply, the Tribunal is unlikely to overturn the assessment rendered by the tax authorities. For this reason, some taxpayers take advantage of the statutory option to bypass the Tribunal proceeding if the decision is not rendered by the Tribunal within three months of the taxpayer filing their Request for Reconsideration with the Tribunal, in which case the taxpayer can directly proceed to court litigation.

Trends in Court Judgments

Japan adopts a system of separation of powers, and the courts are not bound by the decisions of the executive branch and have the power to make final judgments on the legality of administrative actions, including those of the tax authorities. Accordingly, after the administrative claim proceedings, including the Request for Reinvestigation and the Request for Reconsideration, are exhausted or permissibly bypassed, the taxpayer may resort to litigation before the courts to determine whether or not the assessment rendered by the tax authorities was lawful in light of the provisions of the applicable laws and regulations. According to the latest statistics published by the National Tax Agency, there were a total of 172 cases pending before the courts at the end of fiscal year (FY) 2022 (1 April 2022 to 31 March 2023). The breakdown by instance is 138 cases at the first instance, 22 cases at the hearing on appeal and 12 cases at the hearing on final appeal. In FY 2022, taxpayers prevailed in ten cases, representing around 5% of the total of 186 cases that closed in that FY. Although 5% may appear low, many of the cases in which taxpayers prevailed were high-profile ones, including transfer pricing and CFC matters. This article lays out some of the tendencies of the Japanese courts in cases involving businesses or high net worth individuals.

Acquisitions and reorganisations

Under the principles of Japanese tax law, capital gains are taxable when corporate shares and/or assets are transferred in corporate acquisitions or reorganisations. Specifically, capital gains are taxed at a rate of approximately 30% for transfers of corporate assets. To facilitate corporate reorganisations, tax law allows tax-free treatment for organisational restructuring of corporations under certain conditions. Corporate reorganisations can be even more attractive when the acquirer can succeed to the target's net loss carryovers to offset the acquirer's own taxable income by way of either merging the target with the acquirer or filing consolidated tax returns for the acquirer and the target. For tax-free reorganisations or succession to net loss carryovers of the target, taxpayers may attempt to apply relevant provisions in tax law to the fullest extent by combining various transactions or changing certain elements of transactions in order to tailor them to tax law provisions that afford favourable tax treatment. The tax authorities, on the other hand, may seek to deny the application of the provisions chosen by taxpayers by citing artificial manoeuvring or lack of substance.

Article 132-2 of the Corporation Tax Law

In the context of corporate reorganisation, the tax authorities sometimes invoke Article 132-2 of the Corporation Tax Law, the so-called specific anti-avoidance rule, in order to deny tax-free treatment or succession to net tax loss carryovers that the taxpayer intended to enjoy. The Yahoo case (Supreme Court judgment dated 29 February 2016) has important precedential value for Article 132-2, in terms of expressing the standard for its application, which is described below. In the Yahoo case, succession to net tax loss carryovers hinged on a certain requirement: an officer in a significant position with the merged company had to be appointed as an officer of some noteworthy position of the merging company after the merger. To satisfy such requirement, the officer (president) of the merging company had become an officer (vice president) of the merged company only three months before the merger, meaning that the vice president of the merged company became the president of the merging company after the merger. The tax authorities invoked Article 132-2 and disallowed succession to the net taxable loss carryovers of the merged company. In deciding the case, the Supreme Court established a two-pronged standard for applying the anti-avoidance rule:

- determining whether the subject transaction is unnatural (as opposed to natural) in implementing unusual steps or methods or creating a formality that differs from reality; and
- determining whether the subject transaction is mainly intended for the purposes of decreasing the tax burden (as opposed to reasonable business purposes).

Under said standard, the Supreme Court approved the tax assessment and denied the taxpayer's succession to the net taxable loss carryover, reasoning that that the appointment of the president of the merging company as the vice president of the merged company only three months before the merger created a formality that would meet the requirements in a manner that differed from reality, and was intended for the purposes of decreasing the tax burden rather than for reasonable business purposes.

In 2024, the court illustrated the application of the two-pronged standard established in the Yahoo case in a case known as the *"PGM case"*, where the taxpayer, a corporation engaged in the golf business, assumed the net operating tax losses of a dormant company through a statutory *"tax-qualified"* merger. The Japanese tax authority disputed the assumption of the losses by the merged company and issued a notice of assessment under Article 132-2. The taxpayer challenged the assessment, and the Tokyo District Court sided with the taxpayer – and, in a judgment dated 27 September 2024, ordered that the assessment be cancelled.

The court followed the standard announced in the Yahoo case, which is significant because the taxpayer incurred losses through a tax-qualified merger with a dormant sister company. Prior to this case, the Tokyo High Court's decision dated 11 December 2019 in the *"TPR case"*stated that the rationale for the tax-free merger tax regime and loss assumption is based on the premise that in a merger where the business continues before and after the merger, no profit or loss is realised due to the continuity of the business. The court further stated that the dormant company has no business and no continuity of business, and therefore is not entitled to the tax exemption and loss absorption. However, the Tokyo District Court's decision in the PGM case held that in the case of a tax-qualified merger between companies both under 100% common control, the Code does not require continuity of business for loss absorption and refused to follow the TPR case. In conclusion, the Court agreed with the taxpayer and allowed the acquisition by the merged company of the losses of the merging dormant company.

This case limits the scope of Article 132-2 and, if upheld, would secure a way of using the losses of a dormant company. The case has been appealed to the Tokyo High Court and is currently pending.

Article 132 of the Corporation Tax Law

An important precedent for Article 132 of the Corporation Tax Law is the Universal Music case. This case involved a series of acquisitions and reorganisations by the taxpayer and its affiliates, where part of the transaction was financed by a loan in a large amount that was provided by a group company. The Japanese tax authorities invoked Article 132 and disallowed deduction of a large amount of interest. In its judgment dated 21 April 2022, the Supreme Court established the standard that *"unnatural, unreasonable transactions; namely, transactions lacking economic rationality from an economic and substantive standpoint"* are thus subject to disallowance. Based on this standard, the Supreme Court decided that the loan undertaken by the taxpayer in the course of a series of reorganisations and the relevant interest payments were *"not unnatural or unreasonable"* given that the loan proceeds were used to finance the acquisition of its affiliate's shares and the loan conditions were determined based on the expected profits. Hence, the Supreme Court annulled the assessment rendered by the tax authorities. In applying said standard, the Supreme Court considered the economic rationality in light of the two-pronged standard presented in the Yahoo case for Article 132-2. Apart from academic discussions, the above-mentioned two-pronged test is what practitioners should turn to in order to ensure that acquisitions or corporate reorganisations are planned in an efficient manner.

Taxation of controlled foreign corporations

The CFC regime – ie, the taxation of CFCs – is the taxable regime in which the Japanese parent company must include, in its taxable income, the income that is originally earned by low-taxed foreign subsidiaries. This is another area of Japanese tax law where taxpayers could unexpectedly bear the burden of significant tax. Under the Japanese CFC regime, the Japanese parent taxpayer includes in its taxable income:

- the income earned by the low-taxed foreign entities (the *"entity approach"*) and
- the low-taxed passive income that is not taxed under the entity approach (the *"income approach"*).

A number of technical rules dictate which subsidiaries and how much income are subject to the CFC regime, and changes in the holding structure could result in taxation that the taxpayer did not anticipate.

This type of unexpected taxation was exemplified by a case where a major Japanese bank was forced, as a result of the assessment rendered by the Japanese tax authority, to include, in its own taxable income, the interest income that was earned by its subsidiary incorporated in the Cayman Islands, with its common shares being wholly owned by the parent Japanese bank. At the outset, the Cayman Islands subsidiary had issued preferred shares to public investors in exchange for cash payments that, in turn, the subsidiary provided as loans to the parent Japanese bank. The Cayman Island subsidiary subsequently received interest from the borrower parent Japanese bank and, in turn, the subsidiary paid substantially all of the interest to the public preferred shareholders as preferred dividends. In effect, the subsidiary functioned only as a conduit for the financial transaction. As the conclusion of the contemplated transaction, the Cayman Islands subsidiary redeemed and cancelled the principal of the preferred shares, and as a result, the common shareholder (ie, the parent bank) remained the only shareholder at the end of the FY. This caused an unanticipated twist: the income originally earned on the loan by the Cayman Islands subsidiary became attributable to the parent bank due to its 100% ownership as of the end of the FY in accordance with the regulations, notwithstanding the fact that the interest received by the subsidiary, which constituted virtually all of its income, had been paid out to public preferred shareholders as preferred dividends. What turned out to be tricky was that, despite the fact that the subsidiary had paid preferred dividends to the public preferred shareholders, such payments did not reduce the income subject to the CFC regime. In its assessment, the Japanese tax authority forced the Japanese parent bank to include the subsidiary's income in the parent's taxable income, which the Japanese parent bank disputed.

The Tokyo High Court, in its judgment dated 10 March 2022, agreed with the bank, stating that the income and surplus of the Cayman Island subsidiary was expected to be paid out to its public preferred shareholders, not the common shareholder (ie, the parent bank), and that the parent, as the common shareholder, did not possess control over the subject dividends of the subsidiary, and thus had no basis to assert the attribution of the subject dividends thereto. However, the Supreme Court reversed the High Court judgment and agreed with the Japanese tax authority's view, applying the relevant regulations in accordance with the language therein and rejecting the taxpayer's allegation of over-inclusion under the relevant regulations. The Supreme Court also noted that the common shareholder (ie, the parent bank) would have been able to avoid the alleged unreasonable result if it had ended the subsidiary's FY the day before the redemption date of the preferred shares; that is to say, if the Cayman Island subsidiary's FY had ended before the redemption of preferred shares, the income (interest) earned by the subsidiary would not have been attributed to the common shareholder (ie, the parent bank) since the common shareholder did not own any right to the preferred dividends. Apparently, the Supreme Court regarded a textual interpretation of complicated regulations as serving the purpose of guiding the taxpayer as well as the tax authority well, rather than expanding or narrowing the scope of the regulations on an ad hoc basis.

The National Tribunal's decision of 14 March 2024 provides another example of the complex application of the Japanese CFC rules. The Japanese company had three layers of foreign subsidiaries: first, a Cayman Islands company (Cayman 1); second, a foundation established under Dutch law, which is a company without shareholders and is called a *stichting* under Dutch law; and third, a Cayman Islands company (Cayman 3).

The tribunal found that, after examining the details of the legal relationship surrounding the Dutch foundation, the foundation was *"trust"* for Japanese tax purposes. In conclusion, the tribunal deemed that Cayman 1 directly holds 100% of the shares of Cayman 2 as the beneficiary of the *"trust"* of which the foundation is the trustee; therefore, the distribution of dividends from Cayman 2 to the foundation is deemed to be a dividend distribution from Cayman 2 (a 100% subsidiary) to Cayman 1 (ignoring the foundation), which is excluded for the purposes of the Japanese CFC regime. This illustrates the complexity of the CFC regime, which involves the interaction of the laws of several jurisdictions (Japan, the Netherlands and the Cayman Islands).

While the laws and regulations are minute and intricate in some areas of Japanese tax law, the taxpayer is required to structure a transaction taking into full consideration the relevant tax laws and regulations – with meticulous attention paid to the details of the language.

Transfer pricing

In the area of transfer pricing, the taxation of intangible assets draws attention as these assets create high value and significant profits. The Japanese tax authorities often apply the two-stage residual profit split method (RPSM) to transactions that involve intangible assets. Under the two-stage RPSM, the combined profits from which *"routine profits"* are assigned to each party based on the benchmark analysis (with reference to companies comparable to each party) are identified in relation to the subject transaction. The *"residual profits"*, which are produced by subtracting the foregoing routine profits from the combined profits, will be assigned to each of the relevant parties in proportion to their *"degree of contribution"*.

Following the initial court affirmation of the RPSM in the Tokyo High Court judgment dated 9 July 2019, which was approved by the Supreme Court decision dated 5 March 2020, the court declined to affirm the Japanese tax authority's application of the RPSM in another case involving a leading ceramic manufacturer. On 26 November 2020, the Tokyo District Court ordered the annulment of an assessment that had been rendered based on the application of the RPSM to a licensing transaction between the manufacturer and its Polish subsidiary. The judgment was affirmed to be final by the Tokyo High Court judgment dated 10 March 2022. This case exemplified the court's rigorous review of the fact finding and application of the specific transfer pricing method.

Recently, the Tokyo District Court judgment dated 12 December 2023 annulled an assessment made based on the transactional net margin method (TNMM) on the grounds that the comparable corporations selected by the tax authority were not *"comparable"*. This judgment seems to have been appealed to the Tokyo High Court. Apparently, the court requires stringent comparability in the application of the TNMM. The judgment was further approved by the Tokyo High Court judgment dated 11 December 2024. The court rejected the comparability of the tested party and the government-selected comparable companies based on the finding that the tested party benefitted from the oligopolistic market, which was not true of the government-selected comparable companies. This is an indication of the importance of the comparability of the market in terms of competitiveness.

Asset management of high net worth individuals

Inheritance tax and estate planning is another area of Japanese tax law that requires careful application. Given that Japanese inheritance tax adopts a progressive tax rate with a maximum tax rate of 55% (applicable to the portion exceeding JPY600 million), advance planning is crucial. While Japanese high net worth individuals exercise various tax strategies during planning, the key consideration is reducing the amount of inheritance tax by way of reducing the valuation of the subject property. The Japanese tax authorities have issued the Basic Circular on Valuation of Assets (the *"Circular"*), intended for inheritance and gift tax purposes, with the reservation that the tax authority will be authorised to exercise an ad hoc valuation if the Circular is applied in a manner that is *"materially inappropriate"*. The Circular establishes valuation methodologies for real estate and shares of companies in a way that produces valuations that are significantly lower than the fair market value, in order to ensure that the valuations are not overstated to the detriment of taxpayers. Attempting to reduce a valuation by changing the asset composition in line with the Circular – for example, by purchasing relatively low-value assets with cash – is a legitimate way to engage in tax savings and does not constitute tax avoidance by any means. However, the tax authority may deem any such taxpayer attempts as tax avoidance if the authority deems these attempts to have gone too far.

In recent years, condominiums in high-rise buildings (called tower condominiums) have been popular due to their locations and amenities as well as benefits in terms of inheritance tax. Tower condominiums on the higher floors of buildings trade at very high prices due to their great views, but their valuations for inheritance tax purposes are significantly lower than the fair market value since the price of the land is equally distributed among the high and low floors. In addition, borrowings are taken into account in the negative for inheritance tax purposes; thus, if the taxpayer (the would-be deceased) purchases a tower condominium that is traded at JPY100 million but only valued at JPY50 million with borrowed cash of JPY100 million, the tower condominium and borrowing combined would be valued at minus JPY50 million, and the valuation of all the subject assets (ie, the total legacy) would be JPY50 million less than would otherwise have been the case.

The Supreme Court has ruled that there are limits to this approach. The Supreme Court affirmed the Circular's provision of uniform valuation methodologies and ensuring equal treatment among taxpayers as legitimate, and states that ad hoc valuation without applying the Circular is generally forbidden as such valuation would go against the principle of equality. However, the Supreme Court states that, if an application of the Circular would, in substance, go against the principle of fairness, an ad hoc valuation under the facts and circumstances would be permissible. In the case at issue, the deceased purchased a condominium with significant borrowings, and as a result, the valuation of the inheritance assets was reduced from over JPY600 million to less than JPY30 million, thereby rendering the amount of inheritance tax to be paid – once combined with statutory deductions – to zero. The Court found that the purchase of the condominium with borrowings was intended to reduce the inheritance tax burden at a time when the death of the deceased had been anticipated in the near future. The Court ruled that under such facts and circumstances, the tax authority was authorised to engage a real estate appraiser to assess the property and impose inheritance tax based on the ad hoc appraisal value.

Following the foregoing Supreme Court judgment, the government attempted to follow suit by invoking an ad hoc valuation under the facts and circumstances stipulated in Section 6 of the General Rule of the Circular. The deceased had planned to sell the subject shares and obtained a valuation of JPY105,068 per share. However, he died before the sale was agreed and the heir sold the shares at JPY 105,068 per share, but the heir valued the shares at JPY8,186 in accordance with the Circular. The government adopted an ad hoc valuation approach and valued the shares at JPY80,373 per share by using the discounted cash flow method. The Tokyo High Court, in a decision dated 28 August 2024, rejected that approach by stating that the heir had no intention to avoid taxes and was allowed to rely on the Circular even though its share price was one-twelfth of that at which the shares were sold after the deceased's death.

Another ad hoc government valuation under Section 6 of the General Rule was rejected by the court, at least in the first instance. The family company had been owned by the deceased and, before the deceased's death, the company implemented restructuring of the company using a different valuation methodology. The heirs valued the shares at JPY1,853 per share. The government valued the shares of the company at JPY3,443 per share by ignoring the restructuring and deemed that the company had not undergone restructuring. The Tokyo District Court judgment dated 17 January 2025 rejected the government's approach and accepted the heir's position that the taxpayers was able to rely on the Circular.

These cases show that relying on the Circular is only the starting point of appropriate tax planning, and careful review of the administrative precedents and court cases must be conducted so that the planning will not trigger the tax authority's imposition of its final resort: the ad hoc valuation.

Conclusion

Taxpayers are subject to relentless audits by the Japanese tax authorities, which sometimes result in assessments of a considerable amount of tax. Taxpayers should exercise great caution when they report their income/assets given the increased complexity of laws and regulations in recent years. Even if the laws and regulations appear to be overly inclusive/exclusive, taxpayers ought to align their interpretations with the language of the relevant laws and regulations since the courts' primary response will likely be to adhere to the language of these laws and regulations. However, this does not mean that mere compliance with the letter of the law will guarantee the expected/hoped for results. If taxpayers wind up with unfair advantages, the Japanese tax authorities will resort to anti-avoidance rules or an ad hoc valuation to ensure that the spirit of the law is also respected. Taxpayers should engage in a balancing act, bearing in mind that the fairness standard would be applicable in such cases.

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