Chapter 19

JAPAN

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I INTRODUCTION

During 2006 and 2007, the Japanese tax authorities aggressively pursued reassessments of large amounts of corporate taxes relating to transfer pricing through tax audits, exemplified by an extraordinarily large tax assessment against Takeda Pharmaceutical Company of an additional tax of ¥57.1 billion in 2006. However, some of these tax assessments were eventually withdrawn by the Japanese tax authority following mutual arrangement procedures (MAPs), and recently transfer pricing-related disputes in Japan have become smaller in scale.

According to the National Tax Authority (NTA), the additionally taxed income per transfer pricing case has gradually become smaller, while the number of cases is growing. In the 2012 business year, it was ¥439 million per case (222 cases in total), whereas it was ¥460 million in 2011 (182 cases in total), ¥478 million in 2010 (146 cases in total) and ¥687 million in 2009 (100 cases in total). Among these cases, some larger-scale cases have also been reported. For example, Olympus and Hoya received tax assessments regarding transfer pricing, involving alleged additional tax amounts of ¥4.9 billion and ¥3.3 billion, respectively. On the other hand, the Japanese tax authorities aggressively rejected tax declarations with regard to corporate reorganisations, such as the tax assessments of an additional tax of ¥26.5 billion on Yahoo! Japan, and more than ¥30 billion on IBM Japan, both reported in 2010. Yahoo! Japan and IBM Japan filed tax lawsuits in 2011, and these cases are currently being tried in the courts.

The tax code was thoroughly amended in 2014 to harmonise the Japanese international taxation rules with international standards. The Japanese international

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taxation scheme has adopted the Authorized OECD Approach for recognition of profits attributable to permanent establishments, to achieve consistency with the new Article 7 of the 2010 OECD Model Convention.

II COMMENCING DISPUTES

i Types of procedure, relevant time limits and trigger points

Explanations below apply to a typical case in which a taxpayer challenges his or her tax assessment by the tax authorities regarding national tax, such as income tax or corporate tax, unless otherwise indicated. The tax code governing the proceedings for tax controversies was thoroughly amended in 2014. However, the revised tax code is not yet in force and is planned to be enforced by 2016. The explanations below follow the proceedings under the currently effective old tax code.

Tax authorities, such as the district director of the tax office, may apply assessments against a taxpayer if the taxpayer's tax return does not comply with the applicable tax code and the tax authorities believe that the taxpayer should pay higher taxes. If the taxpayer does not agree with the tax assessment, he or she may request reinvestigation by the tax authority within two months of the day following the one on which the taxpayer came to know of the assessment. If the request is rejected, the taxpayer may submit a request for reconsideration with the National Tax Tribunal (NTT) within one month of the day following the day of service of the decision on the request. Taxpayers may dispense with the reinvestigation proceedings above and may directly file a request for reconsideration with the NTT if the taxpayer is eligible for a 'blue return'. If the tax authority does not make any decision in response to the taxpayer's request for reinvestigation within three months of the day following the date of the request for reinvestigation, the taxpayer may immediately file a request for reconsideration with the NTT. If the NTT makes no decision in response to the taxpayer's request for reconsideration within three months of the day following the date of the request for reconsideration, the taxpayer may immediately file a lawsuit with a court. If the request was again rejected by the NTT, then the taxpayer may file a lawsuit to challenge the assessment at a national court, generally within six months of the day on which the taxpayer came to know of the decision, and generally no later than one year from the date of the decision.

ii Mechanism for dispute resolution regarding local tax

A different mechanism for dispute resolution is provided regarding local tax disputes. Generally, taxpayers must file a request for reconsideration with a higher administrative agency within 60 days of the date on which the taxpayer came to know of the assessment. For disputes regarding the valuation of fixed assets used in levying fixed assets taxes, there is a special filing procedure for review with a fixed assets appraisal and review committee established by local governments.

III THE COURTS AND TRIBUNALS

i The National Tax Tribunal

The NTT is annexed to the NTA and has 12 branch offices in Japan. Its authority is said to be exercised independently from the other national agencies, including the NTA, but many tax practitioners doubt this, as many examiners are dispatched from regional tax bureaux and tax offices.

The NTT examiners investigate requests for reconsideration by taxpayers through examination of submissions from the taxpayers and tax authorities, and also conduct interviews with both parties. The examiners may conduct their own investigation *ex officio* to assess the request. No filing fees are necessary to request reconsideration with the NTT. The proceedings are not open to the public. In the 2013 fiscal year, 96.2 per cent of cases before the NTT were resolved within one year of the commencement of proceedings. The NTT is the administrative authority and its decision is the final determination; if the tax authority receives an unfavourable decision from the NTT, it cannot appeal to a court to request reversal of the decision.

ii Court

The Japanese court system tries tax disputes in three tiers: district courts as the courts of first instance, high courts as the courts of second instance and the Supreme Court as the final court of appeal. All tax disputes are tried by professional judges.

To commence a tax lawsuit, a court filing fee must be paid, the amount of which is based on the amount of the claim. For example, in cases where the claimed amount is ¥100 million, the court filing fee is ¥320,000. In cases where the claimed amount is ¥1 million, the court filing fee is ¥10,000. The filing fee for courts of second instance is 150 per cent of the initial filing fee for courts of first instance and the filing fee for the Supreme Court is 200 per cent of the initial filing fee.

Courts of first and second instance can try issues of fact and law, but the Supreme Court can only address constitutional issues, grave procedural errors and important legal issues. Taxpayers have a right to make a second appeal to the Supreme Court if the grounds for appeal involve constitutional issues or grave procedural errors specifically provided by law. Taxpayers may make a discretionary appeal to the Supreme Court, similar to *certiorari* in the US, if the grounds for appeal involve important legal issues.

In 2013, administrative lawsuits, including tax litigation, lasted an average of 15 months in courts of first instance, 5.9 months in courts of second instance and 4.8 months in the court of final instance (i.e., the Supreme Court). However, tax disputes of greater scale and complexity generally last longer, especially in courts of the first instance, where a case usually remains for approximately two years. No arbitration exists for tax disputes, and formal settlement is not available for tax disputes, but when the tax authority considers it difficult to continue a lawsuit, it may voluntarily annul its previous tax assessment, and the taxpayer can withdraw the lawsuit following this annulment. The total number of tax lawsuits challenging tax assessments pending before courts as of the end of March 2014 is 257. The recent 10 years' rates of success for taxpayers in challenging tax assessments in court are as follows:

	2004	*2005*	*2006*	*2007*	*2008*	*2009*	*2010*	*2011*	*2012*	*2013*
Taxpayer's claims fully granted	8.0%	3.8%	12.1%	9.0%	8.9%	2.8%	4.7%	9.6%	3.7%	5.2%s
Taxpayer's claims partly granted	5.9%	6.4%	7.5%	6.9%	4.1%	3.2%	3.6%	5.8%	3.0%	3.0%
Others (including taxpayer's claims completely dismissed or withdrawn)	86.1%	89.8%	80.4%	84.1%	87.0%	94.0%	91.7%	84.6%	93.3%	91.8%

(Source: the NTA)

IV PENALTIES AND REMEDIES

If a taxpayer does not pay a tax bill by the due date designated by law, the taxpayer will have to pay 'delinquent taxes' on any amount in arrears. Such delinquent taxes accrue on unpaid taxes beginning on the day after the due date for a tax payment, continuing until the day on which the due tax is paid in full. The mechanics of determining the rate of such delinquent taxes applicable is complicated, and the rate will be decided annually with due consideration of a special standard rate to be announced by the finance minister by the middle of December of the year preceding the applicable year. Such special standard rate shall be based on the average interest rate for short term loans by banks. For the first two months, the rate of the delinquent tax is expected to be 2.8 per cent per annum; for the period from two months after the due date until the remaining taxes due are paid in full, the delinquent tax rate is expected to be 9.1 per cent per annum.

If a taxpayer does not comply with required tax obligations, an 'additional tax' will also be imposed in addition to the above delinquent tax. In the event that a taxpayer files a tax return by the due date but the amount paid in the tax return is found to be less than the amount due to be paid, the taxpayer has to pay 10 per cent of the tax amount of the difference as an 'additional tax for understatement' in addition to the tax itself; 5 per cent is further added as an additional tax for understatement if the unpaid tax amount is larger than a certain amount. In the event that a taxpayer does not file a tax return by the due date, the taxpayer has to pay an 'additional tax for failure to file', which is 15 per cent of the tax amount to be paid. In the event that a person who deducts withheld taxes (e.g., from employee's salaries) and is obliged to pay the tax does not pay such tax by the due date, 10 per cent of the tax amount is imposed as an 'additional tax on non-payment'. In the event that a taxpayer does not pay, or reduces payment of tax by concealing or giving a false appearance of all or a part of the facts that should be the basis for the calculation of a tax amount, then 35 per cent of the tax amount to be paid is imposed as a 'heavy additional tax' instead of an additional tax for understatement, and 40 per cent of the tax amount to be paid is imposed instead of the normal 15 per cent additional tax for failure to file.

In addition to the above civil sanctions, a taxpayer may be punished with criminal sanctions. If a taxpayer is exempted from a tax or receives a tax refund by means of deception or other wrongful conduct, then such a taxpayer may be punished by imprisonment with labour for not more than 10 years, or a fine of not more than ¥10 million. In the event that a failure to file a tax return is not connected with deception or other wrongful conduct but reduces the tax to be paid by a taxpayer, such a taxpayer may be punished for his or her failure to file a tax return by imprisonment with labour for not more than 5 years, or a fine of not more than ¥5 million. In the event that a simple failure to file a tax return is not connected with deception or other wrongful conduct, such a failure is not regarded as tax evasion; however, a taxpayer may be punished for his or her simple failure to file a tax return by imprisonment with labour for not more than a year, or a fine of not more than ¥500,000. Other criminal sanctions exist, including penalties for failing to cooperate with a tax audit. These penalties are imposed in the event that a person fails to answer, or gives a false answer, to questions asked by auditors, or refuses or avoids audits, or gives false records to auditors. Imprisonment may be the punishment for such cases.

V TAX CLAIMS

i Recovering overpaid tax

In the event that a taxpayer pays tax based on a tax return, but the amount of tax paid is later found to be excessive, then the taxpayer is allowed to request that the district director of the tax office reassess the tax base or mistakenly paid tax amount stated in the tax return. Without a reassessment of the tax base or tax amount by the district director of the tax office, the taxpayer is generally unable to recover overpaid taxes by filing a litigation against the government.[2] Time limitations for a request of reassessment depend upon the type of tax at issue. Generally, a taxpayer is allowed to request reassessment within five years of the statutory tax return due date; however, the time limitation extends to six years, for example, if the tax in question is a corporate tax relating to transfer pricing.

As explained above, a prior reassessment is required in order to recover overpaid taxes. However, a court precedent holds that taxpayers are able, without a reassessment, to recover the tax amount overpaid based on their own mistake if there are special circumstances, such as if a taxpayer has paid the tax based on an objectively apparent material mistake, and if the restriction of the means of correcting the tax amounts to only a reassessment by the district director of the tax office and brings substantial detriment to the interest of the taxpayer.[3]

ii Challenging inappropriate administrative decisions on depriving equal treatment or legitimate expectations of taxpayers

It is theoretically possible, but practically difficult, to challenge an administrative decision because of inequality, in the event that a taxpayer is harmed when a tax authority treated

[2] *Samukawa v. Japan*, 18 MINSHÛ 1762 (Sup. Ct., 22 October 1964) (holding that a taxpayer must request reassessment first before filing a lawsuit to request a tax refund).

[3] Id.

such taxpayer unequally with other taxpayers.[4] Further, if the tax authority provides taxpayers with a public opinion upon which a taxpayer reasonably relies, and the taxpayer takes action based on reliance upon the tax authority's opinion, then it is theoretically possible, but again practically difficult, that the good faith and fair dealing doctrine may apply to protect the taxpayer in that specific case.[5]

iii Refund claims

Persons whose rights or interests are infringed by administrative tax decisions or orders may bring tax claims. Under the Japanese consumption tax system (Japanese VAT), invoices are not necessarily attached to the tax return in order to deduct the input tax, and the deduction of such input tax is allowed as long as the amount of the input tax is calculated based on properly kept accounting books and invoices. Therefore, the circumstances relating to claims for a refund of VAT are different from those in other countries.

On the other hand, in the case of withholding taxes, a person who pays consideration such as cash (the withholding person) withholds taxes when he or she pays such consideration, and the person from whom taxes are withheld (the withheld person) from earned income or declared revenue, however, does not directly pay taxes on his or her income or revenue, as the tax has already been withheld. Instead, the withholding person is obliged to pay the tax to the tax authority. In the event that the withholding person mistakenly withholds an excessive amount from the withheld person's income and pays this excessive tax to a tax authority, the withheld person may not request a refund of the overpaid withheld tax from the tax authority; instead, the withheld person may directly require the withholding person who mistakenly withheld excessive taxes to refund them to the withheld person.

VI COSTS

Various costs arise in connection with tax disputes, including court costs and the fees for attorneys. One of the typical court costs is the court filing fee necessary to initiate court proceedings (see Section III, *supra*). Regarding the fees for attorneys in Japan, some attorneys charge their fees at an hourly rate based on the time spent on the case, while others work on a contingency-fee basis with some initial payment and the balance only on the success of the claim. The amount of the fees for attorneys for tax disputes depends upon the agreement with the attorneys, but factors such as the value size of the dispute, numbers of issues and complexity of the case will determine the fees. The filing fees are reimbursed by the adversary party (i.e., the government of Japan) if the taxpayer eventually prevails, but fees to retain legal counsel must be borne by the taxpayer. There

[4] *Nakamura v. Japan*, 22 KÔMINSHÛ 682 (Osaka High Ct., 30 September 1969) (holding that a tax treatment against accepted practice is illegal).

[5] *Bunka Gakuen v. Governor of Tokyo*, 16 GYÔSAISHÛ 1033 (Tokyo Dist. Ct., 26 May 1965), rev'd by *Governor of Tokyo v. Bunka Gakuen*, 17 GYÔSAISHÛ 607 (Tokyo High Ct., 6 June 1966).

are no rules that allow tax authorities to charge their costs for tax disputes, except for penalties explained in Section IV, *supra*.

VII ALTERNATIVE DISPUTE RESOLUTION

As explained in Section III, *supra*, no arbitration is available for tax disputes between taxpayers and tax agencies in Japan, and mediation is also not available.

The Japanese tax code does not provide an advance tax ruling system, but the tax authority provides written answers upon taxpayers' requests, except where the administrative guidelines provide an exemption. The written answers of the tax authority, together with the original queries, are publicly disclosed. In reality, the tax authority's system of written answers is not commonly used, especially when the relevant parties contemplate sophisticated and complex transactions, as it often takes more time than anticipated to receive an answer from the tax authority. Further, this system does not apply to inquiries relating to transactions, the main purpose of which is to avoid taxes or financially unreasonable transactions. Instead, parties sometimes informally ask the relevant tax authority for its expected treatment of the issues they encounter. The tax authority does not respond to such informal queries in writing, but it does provide an oral, non-binding answer. Although such an oral answer cannot be relied upon, it does not take a long time, and discussions with the tax authority are useful to improve a tax analysis, so this approach is more commonly used for complex issues instead of a request for written answers.

VIII ANTI-AVOIDANCE

i Anti-avoidance rules in specific circumstances

The Japanese tax code provides some specific anti-avoidance rules, allowing the tax authority to recharacterise transactions, and recalculate the taxable income and the amount of tax, in cases where the transactions or calculations made by the corporations would result in an 'improper decrease' of the tax burden, and where other conditions stipulated in specific provisions such as Articles 132 and 132-2 of the Corporate Tax Act (the CTA) are satisfied.

Article 132 of the CTA provides the anti-avoidance rule regarding taxation on transactions between family corporations, where there are three or fewer shareholders holding more than 50 per cent of the issued shares of the corporation concerned, and their shareholders or related corporations. This provision aims to prevent family corporations from achieving the result of an improper decrease of the tax burden by conducting manipulated transactions or calculating profits inappropriately. Lower court precedents tend to interpret the term 'improper decrease' to mean that the act or computation would be unreasonable and unnatural for a purely economic person, in consideration of a business purpose for the overall transaction and for each of the relevant steps of the transaction.[6]

Article 132-2 of the CTA provides a specific anti-avoidance rule regarding taxation on corporate reorganisations such as mergers, corporate splits, share transfers, share exchanges and dividends in kind. This provision allows the tax authorities to disregard certain manipulated reorganisation transactions to determine the taxable income and the amount of tax of the relevant parties involving corporate reorganisations. Article 132-2 of the CTA was introduced in 2001, but until recently had not seen a great deal of focused audit activity regarding corporate reorganisations. However, recent tax audit trends seem to suggest that audit activity in this area will increase.

ii Anti-avoidance rules in international taxation

Transfer pricing rule in Japan

The Japanese tax code provides the transfer pricing rule in order to prevent evasion of Japanese taxes through manipulation of the amount of consideration in a transaction between a Japanese company and a related foreign company, which basically reflects the arm's-length principle stipulated in the OECD Transfer Pricing Guidelines.

In Japan, there have been relatively few transfer pricing lawsuits, as many disputes have been resolved through MAPs, especially for disputes involving developed countries. However, transfer pricing disputes and litigations may increase as the tax authorities strengthen their tax audits on transactions between Japanese companies and their related companies in developing countries such as China, the south-east Asian countries and India, as APAs and MAPs with these countries have not worked effectively.

A noteworthy case in this area was *Takeda Pharmaceutical Company*, which was the largest transfer pricing case in Japan with a disputed tax amount of approximately ¥57.1 billion, and which involved the issue of an application of the transfer pricing rule to a transaction between Takeda and a joint venture company of Takeda and an unrelated US company on a 50–50 basis. The negotiations between Japan and the United States through the MAP broke down in 2011, but approximately two-thirds of the additional tax amount was repealed in 2012 in the administrative reinvestigation procedure and ¥57.2 billion, including interest, was refunded to Takeda. For the remaining portion, Takeda filed a request for reconsideration with the NTT, and the NTT repealed that portion of the tax assessment as well, and ¥15.2 billion, including interest, was refunded to Takeda in 2013. Also, Honda Motor Co., Ltd. disputed the legality of its tax assessment of approximately ¥7.5 billion issued by the Japanese tax authority, in which the tax authority applied the residual profit split method (RPSM) under the Japanese transfer pricing rule on transactions including an intangible transaction between Honda and

[6] For example, *Chûshô Kigyô Joseikai & Fujita v. Tokyo Reg'l Comm'r*, 24 GYÔSAISHÛ 115 (Tokyo High Ct., 14 March 1973); *Yamabishi Fudôsan v. Nihon Bashi Dist Dir of Tax Office*, 25 GYÔSAISHÛ 1310 (Tokyo High Ct., 29 October 1974); and *Minami Nihon Kôatsu Concrete v. Kawauchi Dist Dir of Tax Office*, 31 GYÔSAISHÛ 1982 (Fukuoka High Ct., Miyazaki Branch, 29 September 1980).

its Brazilian subsidiary. In the *Honda* case[7] in 2014, the Tokyo District Court endorsed Honda's argument, stating that the tax authorities' calculation of the arm's-length price had not complied with Japanese transfer pricing rules because the tax authority inappropriately used another automaker without considering the tax benefits of the free trade zone as comparable to its Brazilian subsidiary in calculating the routine profit of its Brazilian subsidiary under the RPSM.

CFC rule in Japan

The Japanese tax code provides a controlled foreign corporations (CFC) rule, which is also known as the anti-tax haven rule, in order to prevent avoidance of taxes through certain related subsidiaries in low-tax jurisdictions. Under the current rule, when a domestic corporation owns 10 per cent or more of the issued stocks of a foreign subsidiary whose tax rate would be 20 per cent or less, and more than 50 per cent of the stocks are owned by residents or domestic corporations, the profits of the foreign subsidiary attributed to the shares are included in the gross income of that domestic corporation unless the exclusion rule applies.

Some Japanese courts have dealt with issues regarding the exclusion rule in tax disputes. A recent case involving the issues was the *Denso Corporation* case,[8] in which the Tokyo District Court judged in favour of Denso in 2014 by endorsing Denso's argument, stating that the main business of its Singapore subsidiary was not owning shares in related companies, but providing services as a regional headquarters. And thus, Denso satisfied the business purpose test, one of the requirements to be exempted from an application of the Japan CFC rule.

Thin capitalisation rule and earning stripping rule

The Japanese thin capitalisation rule prevents taxpayers from eroding their tax base by paying an unreasonably excessive amount of deductible interest expenses, focusing on the balancing of debts and equities. This rule, however, cannot effectively prevent tax avoidance if the Japanese corporation keeps the balance of debt and equity at a less than three-to-one ratio, and pays interest on an inappropriate amount compared to the company's income. Considering the recent trends of the tax treaties involving developed countries, which provide an exemption from withholding tax on interest in the source country, the 2012 tax reform introduced new earnings stripping rules, similar to those in the United States and some European jurisdictions, to prevent tax avoidance through the payment of excessive interest for certain taxable income.

iii Comprehensive general anti-avoidance rules

The Japanese tax code does not provide a comprehensive general anti-avoidance rule. Lower courts' precedents have been split on the issue as to whether the tax authorities are allowed to deny specific acts and computations if the transactions are unreasonable and unfair in cases where no specific provisions such as Articles 132 and 132-2 of the

[7] *Honda Motor Co. Ltd. v. Japan*, unpublished (Tokyo Dist. Ct.,28 August 2014).

[8] *Denso Corporation v. Japan*, unpublished (Nagoya Dist. Ct., 4 September 2014).

CTA to deny such acts and computations are applicable. Recent court precedents tend to disallow such denial.[9]

IX DOUBLE TAXATION TREATIES

Double taxation treaties provide various tax treatments to avoid double taxation in different jurisdictions. The Supreme Court of Japan rendered a noteworthy judgment with respect to the interpretation of a provision in the double taxation treaty between Japan and Singapore (the Treaty).[10] This case discussed whether Japanese CFC rules, which are intended to serve as a deterrent to the use of tax havens, violate a provision in the Treaty. Under the Japanese CFC rules, in the event that Japanese companies control their subsidiaries in countries with low income tax rates and some other requirements are met, the income of such subsidiaries is included in the revenue of the Japanese parent company (see Section VIII.ii, *supra*). A taxpayer, which was a Japanese parent company that had a subsidiary in Singapore, argued that this treatment is against the principle provided in Article 7 of the Treaty. The Court dismissed the taxpayer's arguments, holding that the current CFC taxation in Japan does not violate the Treaty. To interpret the relevant provision in the Treaty, the Court held that the commentary on the OECD Model Tax Convention can be referred to as a 'supplementary means of interpretation' in Article 32 of the Vienna Convention on the Law of Treaties, although Singapore is not a member country of the OECD.

X AREAS OF FOCUS

i Anti-avoidance cases

IBM *case*

The CTA does not have comprehensive general anti-avoidance rules (see Section VIII, *supra*) but has a specific anti-avoidance rule for taxation of transactions between family corporations (Article 132 of the CTA) and a specific anti-avoidance rule regarding taxation of corporate reorganisations (Article 132-2 of the CTA). There have not been many cases applying Articles 132 and 132-2, but the lower court, in the *IBM* case, recently discussed the applicability of Article 132 of the CTA, and the court of appeals debated whether to apply Article 132-2 of the CTA to the *Yahoo! Japan* case. As both of these cases are still pending, practitioners are concerned about what the courts' opinions in these cases will be in the end.

In the *IBM* case, wherein the national tax authority tried to apply Article 132 of the CTA, the facts found at the lower court were as follows:[11] taxpayer X, a limited private

[9] For example, *X v. Tokyo Setagaya Dist Dir of Tax Offices*, 21 SHÔMU GEPPÔ 1315 (Tokyo High Ct., 30 March 1975); *X v. Tokyo Ueno & Asakusa Dist Dir of Tax Offices*, 47 SHÔMU GEPPÔ 184 (Tokyo High Ct., 21 June 1999); and *X v. Y*, 255 ZEIMU SOSHÔ SHIRYÔ 10180 (Nagoya High Ct., 27 October 2005).

[10] *Glaxo v. Kôjimachi Dist Dir of Tax Office*, 63 MINSHÛ 1881 (Sup. Ct., 29 October 2009).

[11] *IBM AP Holdings YK v. Japan*, unpublished (Tokyo Dist. Ct., 9 May 2014).

company, was part of the IBM group of companies in Japan, and its sole shareholder was a US IBM group company, which sold 100 per cent of the shares in another wholly-owned IBM group company (the Japan Sub) to X. X, as a limited private company, could be regarded as a pass-through entity under the US check-the-box rule, while being simultaneously taxed as a corporation under the Japanese tax code. Following the transfer, the Japan Sub repurchased its shares from X three times, which created a huge tax loss for X. Afterward, X started to tax its subsidiaries in Japan on a consolidated basis, which allowed X to make use of the accumulated tax loss. The relevant district director of the tax office denied X's usage of the tax loss incurred by the Japan Sub's repurchase of its shares by applying Article 132 of CTA, characterising the scheme as an 'improper decrease' of the tax burden. The Tokyo District Court concluded that it could not deny legitimate business purpose to making X an intermediary holding company, and that the price for the Japan Sub's repurchase of its shares could not be considered unreasonable or unnatural, and, as a result, did not allow the application of Article 132 of CTA, as this was not an 'improper decrease' of the tax burden. The case is currently being disputed at the Tokyo High Court.

Yahoo! ***case and*** IDCF ***case***

The following *Yahoo!* case and *IDCF* case were the first and second cases where a court applied Article 132-2 since such an Article was introduced by the amendment to the Japanese tax code in 2001.[12] SoftBank Corp., a large Japanese telecommunications company, held 100 per cent of the shares in SOFTBANK IDC Solutions Corp. (IDCS), and approximately 42 per cent of the shares in Yahoo! Japan Corporation (Yahoo). The president of Yahoo at that time was also appointed as a director and a vice president of IDCS. IDCS demerged its data center business, established a wholly-owned subsidiary named IDC Frontier Inc. (IDCF), and sold all its shares in IDCF to Yahoo. After the transfer took place, SoftBank sold all its shares in IDCS to Yahoo, and IDCS subsequently merged into Yahoo. IDCS held more than a ¥66 billion net operating loss, and IDCS's expected earnings were not large enough to cover it prior to the expiration of the loss. However, the above-mentioned transactions appeared to allow the companies to make use of the net operating loss by (1) setting off a part of the net operating loss of IDCS with Yahoo's earnings, and (2) allowing IDCF to recognise the assets adjustment accounts which were to be amortised and set off against IDCF earnings in five years. The requirements to transfer the net operating loss via merger and to recognise the assets adjustment accounts were both satisfied. However, the district director of the tax office applied Article 132-2 of the CTA and denied the appointment of Yahoo's president, preventing him from becoming a director and a vice president of IDCS, in connection with a reassessment of Yahoo's tax amount. This in turn left the requirements

[12] *Yahoo Japan Corporation v. Japan*, unpublished (Tokyo Dist. Ct., 18 March 2014), *Yahoo Japan Corporation v. Japan*, unpublished (Tokyo High Ct., 5 November 2014) and *IDC Frontier Inc. v. Japan*, unpublished (Tokyo Dist. Ct., 18 March 2014). The Tokyo High Court dismissed the appeal by IDCF; *IDC Frontier Inc. v. Japan*, unpublished (Tokyo High Ct., 15 January 2015).

to transfer the net operating loss to Yahoo unsatisfied. In addition, by an application of Article 132-2 of the CTA, recognition of the assets adjustment accounts was also denied. Both Yahoo and IDCF brought a lawsuit and alleged that the tax assessment should be denied.

Many issues were disputed, among others:

a the meaning of the words, 'improperly decrease the corporate tax burden' in Article 132-2;

b whether Article 132-2 could be applied to the acts or calculation made by corporations other than the ones that the amount of tax would be corrected with;

c whether the appointment of Yahoo's president as a director and a vice president of IDCS could be denied by an application of Article 132-2; and

d whether the tax-unqualified demerger of IDCF could be denied and reclassified as a tax-qualified demerger by an application of Article 132-2 of the CTA.

Both the Tokyo High Court with respect to the *Yahoo* case (pending at the Supreme Court) and the Tokyo District Court with respect to the *IDCF* case (pending at the Tokyo High Court) held against the tax payers on all issues above. As to issue (a), the court held that Article 132-2 applies to corporate reorganisations where it is clear that accepting the decreasing tax effect of reorganisations is contrary to the purpose of the corporate reorganisation taxation system or of the individual tax provisions. For the issue (b), the court found that the wording of Article 132-2 could be interpreted as applying not only to corporations that corrected their tax but also to other corporations. In connection with the issue (c), Article 132-2 can be applied because admitting a decrease in corporate tax as a result of transferring the net operating loss from IDCS to Yahoo would be contrary to the purpose of the individual tax provision allowing the transfer of net operating loss. That is because (1) only two months had passed from when the Yahoo president was appointed as a director and a vice president of IDCS and since Yahoo purchased the shares in IDCS; (2) during those two months, Yahoo's president was not engaged with IDCS's original data centre business; and (3) IDCS directors other than Yahoo's president were not expected to be and were not actually appointed as directors of Yahoo, as it was not necessary in terms of business operations, and therefore, control over the transferred assets did not continue until after the merger, which prevented the requirement for transferring the net operating loss from being met.

Lastly, relating to issue (d), Article 132-2 can be applied because control over the transferred assets continued having considered facts such as whether and how control over the transferred assets would change, whether and how the demerger itself would affect control over the transferred assets and if there was a sufficient business purpose or business necessity to the changes provided by the demerger, and whether there was a sufficient business purpose or business necessity in relation to the acts or facts related to the requirement of expectation to maintain the wholly controlling relationship.

ii Classification of foreign entities

Under the Japanese tax code, entities are classified into three categories: corporations, associations or foundations without legal personalities (non-juridical organisations), and others, including partnerships. Corporations and non-juridical organisations are treated as taxable entities, while entities that are classified as partnerships are generally treated as non-taxable entities ('pass-through' entities). Thus, the entity classification issue entails critical tax consequences involving the entity and its shareholders or partners.

The courts have recently ruled on the issues regarding classification of certain foreign entities. Specifically, three appellate courts have rendered judgments on the entity classification issue in relation to limited partnerships formed under the Delaware Uniform Limited Partnership Act (Delaware LPs) in 2013.[13] Although the facts of these cases are substantially the same, the courts have been split in their opinions. The Nagoya High Court has held that a Delaware LP is not a corporation, but a pass-through entity, while the Tokyo High Court and the Osaka High Court held that a Delaware LP is to be treated as a corporation for Japanese tax purposes.

All the decisions have been appealed to the Supreme Court. Considering the current uncertainty surrounding the tax treatment of foreign entities, it is expected that the Supreme Court, the tax authority or national legislation will provide clear standards on how to address this issue.

XI OUTLOOK AND CONCLUSIONS

Reflecting long-standing low economic growth in the Japanese economy, Japanese corporations are currently very eager to expand their areas of economic activity in foreign countries, especially those in South-East Asia, where economies are growing rapidly. This will result in a growth of tax disputes with tax agencies of these countries, but it is difficult to resolve such tax disputes by MAPs, as explained in VIII.ii, *supra*. In those cases, taxpayers must resort to domestic tax controversy proceedings to avoid double taxation, and their importance will be much greater reflecting the trends in economic activities of Japanese companies.

Further, because of the court judgment in the *Yahoo* cases involving the issue of an application of an anti-tax avoidance rule regarding corporate reorganisation under Article 132-2, tax practitioners will pay closer attention to business purposes and comply carefully with the intent and purpose of the applicable provision in their tax planning for corporate reorganisations.

[13] *Japan v. X*, unpublished (Nagoya High Ct., 24 January 2013), *Japan v. X*, unpublished (Tokyo High Ct., 13 March 2013), *X v. Japan*, unpublished (Osaka High Ct., 25 April 2013).

Appendix 1

ABOUT THE AUTHORS

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Akihiro Hironaka has been a partner of the dispute resolution group since 2007. He has extensive experience dealing with large-scale and complex litigation, including tax disputes. He represented Tokio Marine & Nichido Fire Insurance when it contested its tax assessment of complex reinsurance transactions, and he succeeded in recovering ¥6.7 billion for his client. While representing the Sumitomo Trust & Banking Corporation in challenging its tax assessment related to securities repurchase transactions, he succeeded in recovering ¥8 billion for his client. Mr Hironaka worked as a judge assigned to a special division that heard administrative litigation cases, including numerous tax disputes, during his judgeship at the Yokohama District Court from 1998 until 2000. He also worked at Arnold & Porter (Washington, DC) from 2003 until 2004. He has authored numerous publications, including *Treatise on Japanese Taxation* (co-author, Yuhikaku), *Frontiers of Transfer Pricing* (co-author, Yuhikaku), and *Frontlines of International Tax Litigation* (co-author, Yuhikaku). He is a graduate of the University of Tokyo (LLB, 1993) and Harvard Law School (LLM, 2003), and is admitted to the bar in both Japan and New York.

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Michito Kitamura has been a partner with Nishimura & Asahi since 2011, working primarily in the firm's tax group. As a lawyer focusing on tax matters, Mr Kitamura has extensive experience dealing with tax planning, tax advice and tax disputes, including tax litigation. In particular, he has won judgments in the Tokyo and Nagoya district courts on behalf of individual investors in a tax litigation case involving an important legal issue regarding entity classification of Delaware limited partnerships, and is representing these clients in appellate courts. Mr Kitamura is also currently representing companies in a large-scale tax litigation case involving corporate restructuring matters, as well as counselling on tax planning regarding mergers and acquisitions and other international taxation matters. Prior to joining Nishimura & Asahi in 2000, he worked as a certified public accountant at one of the Big Four audit firms in Japan. Mr Kitamura has authored numerous tax-related publications, including *Frontiers of CFC Rules* (co-author, Yuhikaku). He is a graduate of Keio University (1994), Georgetown University Law Center (LLM, 2006) and New York University School of Law (LLM in international taxation, 2007), and is both admitted to the bar and as a certified public accountant in Japan.

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Masaki Noda has been a partner at Nishimura & Asahi since 2013. His practice focuses mainly on corporate matters, especially mergers and acquisitions (M&A), and he has extensive experience in tax planning and structuring for complicated and sophisticated M&A transactions. Mr Noda also has experience advising companies that are subject to tax investigation, providing advice on international taxation and M&A taxation, allowing such companies to minimise their potential tax liabilities. He has authored numerous publications, including *Scheme and Taxation of M&A and Corporate Reorganization – the Leading Edge of Strategic M&A Tax Planning* (co-author, Okura Zaimu Kyoukai), *Handbook for Share Options* (co-author, Shoji Homu) and *The Practical Commentary on the Companies Act of Japan* (co-author, Yuhikaku). Mr Noda lectured in law (taxation) at Seikei University from 2006 to 2008, and also since 2012. He worked at Sullivan & Cromwell (New York) from 2009 to 2010, and at a Japanese IT-related company from 2010 to 2011. He is a graduate of the University of Tokyo (LLB, 2000 and LLM, 2001) and the University of Virginia School of Law (LLM, 2009), and is admitted to the bar in both Japan and New York.

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