



No Cherry-Picking Allowed!

Executive Summary

- If deferring payment did not delay the timing of income recognition, but prepayment accelerated it, then it would become a case of cherry-picking convenience for the tax authorities.
- We will explain a tax dispute based on the National Tax Tribunal Decision on December 21, 2023.

1. Transaction conducted by the Taxpayer

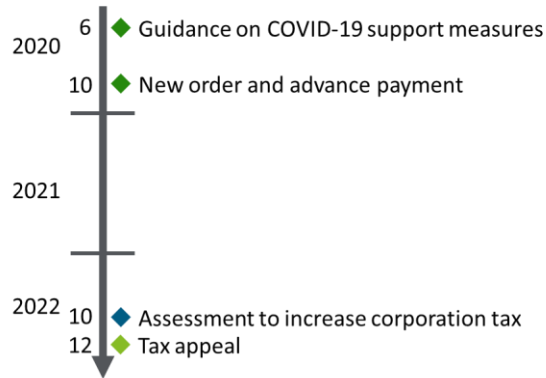
- The Taxpayer in this case was the Parts Making Company. Primarily, it received orders for parts from the Parts Ordering Company. It then created molds specifically for manufacturing those parts, mass-produced the parts using those molds, and delivered them. The Taxpayer retained ownership of the molds it created, but the cost associated with creating the molds was paid by the Parts Ordering Company to the Taxpayer in equal installments over 24 months, starting from the month following the commencement of mass production of the parts.
- 2020 was the year when the COVID-19 pandemic spread in Japan, and a state of emergency was declared. As a support measure for its business partners, the Parts Ordering Company offered to prepay the cost for newly contracted mold production in one lump sum. Therefore, in October of the same year, the Taxpayer received a prepayment for the cost of mold production for newly ordered parts.



- The issue was in regard to when the Taxpayer should recognize the prepaid amount as income. Generally, if revenue from the provision of services such as mold production is recorded as revenue in the fiscal year in which the services were provided, according to fair accounting principles, the revenue is included in the income of that fiscal year.
- According to fair accounting principles, revenue should be included in the income of the fiscal year in which it is realized; that is, when the right that causes the income is established. The timing of the establishment of the right that causes the income should be determined by considering the characteristics of each right. Therefore, in this case, the issue was in regard to when the right that caused the income from the mold production fee was established.

2. Assessment issued by the Tax Authorities

- The Taxpayer recorded the revenue from the mold production fee in equal installments over 24 months, starting from the month of the commencement of mass production of the parts. The prepaid amount was also recorded as revenue in equal installments over 24 months, starting from the month of the commencement of mass production.
- However, since there was no intent that the prepaid amount would be refunded later and could be freely disposed of by the Taxpayer, the Tax Authorities considered the income as being realized at the time the prepayment was received. Thus, the Tax Authorities issued an assessment increasing the corporation tax for the fiscal year ending March 2021.
- However, the Taxpayer could not accept the fact that even though it received a prepayment as a COVID-19 support measure, it would also have to prepay taxes. Moreover, the Tax Authorities claimed that the prepaid amount did not need to be refunded later, but there was no such guarantee anywhere. If the Taxpayer were unable to produce the molds as requested by the Parts Ordering Company, it would rather have to refund the amount. In short, the prepaid amount was merely an advance payment. So, the Taxpayer filed a tax appeal.



3. Decision made by the National Tax Tribunal

- This contract involved the Parts Ordering Company requesting the Taxpayer to manufacture molds as preparation for the production of parts, and the Taxpayer responding by manufacturing the molds, which constituted a contract for services without the delivery of goods. However, the contract also included maintenance and management of the molds produced by the Taxpayer, and it granted certain rights to the Parts Ordering Company regarding the molds.
- Therefore, the services provided by the Taxpayer involved the production of molds exclusively used for manufacturing parts ordered by the Parts Ordering Company. In addition to using these molds to manufacture the parts, the Taxpayer also continuously maintained and managed the molds on a daily basis. These services were characterized by their continuous and daily provision.
- The nature of the contract related to the manufacture of the molds was that the provision of services continued on a monthly basis, with compensation paid based on the services provided continuously on a daily basis; the amount for the services provided in the past month was determined at the end of each month over the 24 installments. In other words, even if the payment for the manufacture of molds was received in advance, the right to the income was determined sequentially at the end of each month over the 24 installments starting from the month when mass production of the parts began.
- Therefore, the Taxpayer recorded the revenue in the fiscal year in which the services were provided, in accordance with fair accounting principles, and included it in the income for that fiscal year. Consequently, the National Tax Tribunal canceled the entire assessment that increased the corporation tax.

4. Tips for resolving differences of opinion

- Generally, it is advantageous for the taxpayer if the timing of income recognition is delayed. This is because the imposition of taxes is postponed. However, even if the taxpayer delays the timing of receiving payment, they cannot delay the timing of income recognition. According to fair accounting principles, even if the payment is delayed, the revenue related to that payment should be included in the income of the fiscal year in which the right to that income is established.
- On the other hand, for the tax authorities, the earlier the timing of income recognition, the more advantageous it generally is, contrary to the taxpayer's perspective. Therefore, in this case, the Tax Authorities may have increased the corporation tax on the grounds that the Taxpayer received an advance payment. However, even if advance payment is received, according to fair accounting principles, the revenue related to that payment should still be included in the income of the fiscal year in which the right to that income is established.
- If the timing of income recognition did not get delayed with deferred payment but were accelerated with advance payment, it would be a case of cherry-picking convenience for the tax authorities. The National Tax Tribunal would not allow cherry-picking.

About Our Tax Controversy Service

1. Rebuttal letter as the first step in resolving differences of opinion

When faced with differences of opinion with the tax authorities, the first step is to submit a rebuttal letter in the name of the taxpayer, outlining the taxpayer's opinion and the reasons for it.

2. Legal opinion as a taxpayer's trump card

When a difference of opinion is not resolved even if a rebuttal letter is submitted, a legal opinion can be the taxpayer's trump card. Increasingly, there are cases where the taxpayer's opinions are accepted earlier due to the taxpayer filing a legal opinion explaining the detailed rationale for why the taxpayer's opinion should be accepted, together with supporting evidence.

3. Tax appeal and litigation as an extension of a tax audit or request for assessment

When a difference of opinion is not resolved during a tax audit or request for assessment, the taxpayer may file a tax appeal and seek a final decision on the matter by the administrative branch. The National Tax Tribunal will issue a decision based on evidence, hearing from both sides in detail. Engaging in tax litigation can also enable the taxpayer to correct an erroneous legal interpretation.

4. We provide a comprehensive end-to-end service to resolve tax controversies

We will examine the cause of the difference of opinion, provide consultation on the chances of having the taxpayer's opinion accepted as well as the procedures and costs it will take, and use our strong credentials to assist in performing the required procedures from filing a rebuttal letter and legal opinion to representing you in tax appeal and litigation.

5. We have strong credentials for resolving differences of opinion with the tax authorities

There have been numerous examples where our clients' opinions were accepted. Recent examples include the following.

2024	<ul style="list-style-type: none">• Rebuttal letter regarding donations• Legal opinion regarding heavy penalty tax• Tax litigation regarding denial of act or calculation of corporate reorganization• Tax appeal against the revocation of blue form tax return approval• Legal opinion regarding the CFC regime• Tax appeal regarding property tax
2023	<ul style="list-style-type: none">• Legal opinion regarding bad debt losses and losses on sale of receivables• Legal opinion regarding taxation on entertainment expenses• Legal opinion regarding denial of act or calculation of corporate reorganization• Legal opinion regarding an advantageous placement of shares• Tax litigation regarding the CFC regime
2022	<ul style="list-style-type: none">• Legal opinion regarding property tax• Tax appeal regarding deemed capital gains• Tax appeal regarding corporate gains on donations• Legal opinion regarding deemed capital gains
2021	<ul style="list-style-type: none">• Tax appeal regarding corporate reorganization
2020	<ul style="list-style-type: none">• Legal opinion regarding stamp tax

■ Services

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