

Japan Tax & Legal Inbound Newsletter

Tax Controversy Trends amid the COVID-19 Pandemic

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Background

Japan's National Tax Agency recently published its latest statistics on tax audits in FY 2020 (July 2019 – June 2020), as well as FY 2020 statistics on tax appeals and litigation (April 2019 – March 2020), which indicate how these activities have been affected by the COVID-19 pandemic.

This article summarizes the statistics and some key impacts of the pandemic, and includes Deloitte's view on tax controversy trends.

Tax audits amid COVID-19 pandemic

The number of field audits of corporate taxpayers in FY 2020 dropped by 22.9% from FY 2019, an apparent impact of the COVID-19 pandemic. As COVID-19 started to spread across Japan from January 2020 and the state of emergency was declared in April 2020, Japan's tax authorities refrained from doing field audits in the first half of 2020. This helps explain why the number of field audits dropped.

In addition, the total amount of income found by tax audits of corporations in FY 2020 decreased by 43.5% from FY 2019, and the total amount of corporation tax imposed by tax audits in FY 2020 decreased by 15.4%. These decreases are considered to be due to the drop in the number of field audits in FY 2020 largely as a result of the COVID-19 pandemic.

Despite these statistics, the amount of corporation tax imposed by tax audits per case in FY 2020 increased by 9.7% from FY 2019. This may reflect the trend that the tax authorities now tend to focus more on cases where a taxpayer's misconduct is suspected and the tax amount at stake is large, by systematically selecting target cases through the use of a database of taxpayer information. In addition, the tax authorities continue to focus on international transactions, actively examining issues regarding Japan's controlled foreign company tax regime and transfer pricing, which tend to be unchanged by the COVID-19 pandemic.

	FY 2019	FY 2020	Change
Corporation tax field audits	99,000 cases	76,000 cases	(22.9)%
Total corporation income found (JPY)	1.381 trillion	780 billion	(43.5)%
Total corporation tax imposed (JPY)	194 billion	164 billion	(15.4)%
Corporation tax imposed per case (JPY)	2.0 million	2.2 million	9.7%
Individual income tax field audits	74,000 cases	60,000 cases	(18.9)%
Total individual income found (JPY)	602 billion	564 billion	(6.4)%
Total individual income tax imposed (JPY)	96 billion	99 billion	3.2%
Individual income tax imposed per case (JPY)	1.3 million	1.7 million	26.7%

(Source: National Tax Agency)

With respect to individual taxpayers, the number of field audits in FY 2020 dropped by 18.9% from FY 2019, and the total amount of individual income found by tax audits in FY 2020 decreased by 6.4%. These decreases are considered to be due to the COVID-19 pandemic.

However, the total amount of individual income tax imposed by tax audits in FY 2020 increased by 3.2% from FY 2019, with that per case jumping by 26.7% from FY 2019. This may be mainly because the tax authorities tend to focus on wealthy individuals, in particular those having international investments, frequently utilizing information obtained from foreign counterparts under the Common Reporting Standard (CRS) regime. This trend has continued regardless of the COVID-19 pandemic.

Tax appeals and litigation amid COVID-19 pandemic

The number of tax appeals initiated by taxpayers to the National Tax Tribunal in FY 2020 dropped by 17.6%, and the number of tax appeals completed in FY 2020 decreased by 2.6% from FY 2019. These numbers, however, are not very different from the previous five-year average, and so may not be due to the COVID-19 pandemic. On the other hand, the number of successful tax appeals to the National Tax Tribunal in FY 2020 jumped by 73.6% from FY 2019, such that the successful tax appeal ratio for taxpayers in FY 2020 increased by 78.4%.

The year over year changes with respect to tax litigation are larger. Tax litigation initiated by taxpayers in FY 2020 increased by 23.2% from FY 2019, and completed litigation in FY 2020 increased by 22.0%. Further, the number of cases successfully litigated in FY 2020 jumped by 250.0%, such that the successful tax litigation ratio for taxpayers increased by 185.3% from FY 2019.

Appeals/litigation initiated by taxpayers:	FY 2019	FY 2020	Change
Tax appeals initiated	3,104 cases	2,559 cases	(17.6)%
Tax appeals completed	2,923 cases	2,846 cases	(2.6)%
Successful tax appeals	216 cases	375 cases	73.6 %
Successful tax appeals ratio	7.4 %	13.2 %	78.4 %
Tax litigation initiated	181 cases	223 cases	23.2 %
Tax litigation completed	177 cases	216 cases	22.0 %
Successful tax litigation cases	6 cases	21 cases	250.0 %
Successful tax litigation ratio	3.4 %	9.7 %	185.3 %

(Source: National Tax Agency)

These positive changes imply that tax appeals and litigation have not been negatively affected by the COVID-19 pandemic. Although Japan used to be a country where tax controversy was not prevalent, the fact that there are at least 375 successful tax appeal cases and 21 successful tax litigation cases gives a sense of assurance to a taxpayer facing an erroneous assessment notice and seeking for it to be overturned through one of these processes.

The taxpayer success ratio in FY 2020 increased from FY 2019 but is still lower compared with most other countries. However, this ratio itself is not a decisive factor for determining whether a country executes tax laws fairly, as it would be expected to be lower if most assessment notices challenged by taxpayers are in fact issued based on accurate facts in accordance with tax laws. Rather, what matters is whether an erroneous assessment notice is actually overturned through tax appeals or litigation.

Deloitte's View

A taxpayer expecting to face a tax audit in 2021 should know the latest tax controversy trends amid the COVID-19 pandemic, as they could provide insight into how to plan for tax audits in advance.

The above statistics indicate that, although the number of field audits in FY 2021 may drop as compared to a normal year, the tax authorities are expected to continue to focus on cases where a taxpayer's misconduct is suspected and the stake is high, particularly those involving international transactions and investments, by using information obtained through the CRS regime.

Accordingly, taxpayers should actively prepare for a tax audit, assuming that the tax authorities already have substantial knowledge of their transactions and assets.

At the same time, however, the above statistics show that tax appeals and litigation have not necessarily been negatively affected by the COVID-19 pandemic. Rather, the number of taxpayer success cases may persuade a taxpayer to challenge an erroneous assessment notice.

Thus, when a taxpayer faces a questionable assessment notice, the taxpayer should examine whether the assessment is based on accurate facts in accordance with tax laws, seeking an advice from tax controversy experts where necessary. Assessments issued in error should be challenged.

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