

# Tax Controversy

## Japan updates 2022

This article provides an overview of tax controversy trends and procedures in relation to national taxes (excluding customs duty) in Japan.

### 1. Tax controversy trends

#### (1) The effects of COVID-19 on tax audits

According to the latest fiscal year (FY) 2021 statistics on tax audits (July 2020 through June 2021) recently published by the National Tax Agency, the number of field audits of corporate taxpayers in FY 2021 decreased by 67.3% from FY 2020. In addition, the total amount of income found by field audits of corporations in FY 2021 decreased by 32.3% from FY 2020. The total amount of corporation tax imposed by field audits in FY 2021 decreased by 26.6%. These decreases are considered to be due to the effects of COVID-19.

However, the amount of corporation tax imposed by field audits per case in FY 2021 increased dramatically by 124.3% from FY 2020. Major tax audit targets included corporate taxpayers that (i) were claiming a refund of consumption tax, (ii) were conducting cross-border transactions, or (iii) did not file corporation tax returns. This clearly indicates that the tax authorities were focusing on cases where a taxpayer's misconduct was suspected and the tax amount at stake was larger.

With respect to individual taxpayers, the number of field audits in FY 2021 decreased by 60.1% from FY 2020. Also, the total amount of income found by field audits of individuals in FY 2021 decreased by 47.0% from FY 2020, and the total amount of individual income tax imposed by field audits in FY 2021 decreased by 46.3%. Again, these decreases are deemed to be caused by the effects of COVID-19.

However, the amount of individual income tax imposed by field audits per case in FY 2021 increased by 34.9% from FY 2020. Major tax audit targets included (i) wealthy individuals, in particular those having foreign investments, (ii) individuals conducting business over the internet, and (iii) individuals that did not file an income tax return. This could indicate that the tax authorities were focusing on larger cases possibly involving a taxpayer's misconduct.

	FY 2020	FY 2021	Change (%)
Corporation tax field audits (cases)	76,000	25,000	-67.3
Total corporation income found (JPY)	780 billion	529 billion	-32.3
Total corporation tax imposed (JPY)	164 billion	121 billion	-26.6
Corporation tax imposed per case (JPY)	2.2 million	4.8 million	124.3
Individual income tax field audits (cases)	60,000	24,000	-60.1
Total individual income found (JPY)	564 billion	299 billion	-47.0
Total individual income tax imposed (JPY)	99 billion	53 billion	-46.3
Individual income tax imposed per case (JPY)	1.7 million	2.2 million	34.9

(Source: National Tax Agency)

Due to the decrease in tax audits in FY 2021, the tax authorities have been actively conducting tax audits in the first half of FY 2022 and likely will continue to do so provided that the COVID-19 situation does not worsen in Japan.

#### (2) The effects of COVID-19 on tax appeals and litigation

According to the latest FY 2021 statistics on tax appeals and litigation (April 2020 through March 2021), the number of first tier tax appeals filed with the tax authorities in FY 2021 decreased by 26.4% and those completed in FY 2021 decreased by 34.0% from FY 2020. The number of second tier tax appeals filed with the National Tax Tribunal in FY 2021 decreased by 13.0% and those completed in FY 2021 decreased by 18.2% from FY 2020. Also, the number of tax litigation cases initiated in FY 2021 decreased by 26.0% and those completed in FY 2021 decreased by 16.7% from FY 2020.

These decreases largely could be explained by the fact that the number of assessment notices decreased due to the COVID-19 situation.

Appeals/litigation initiated by taxpayers:	FY 2020	FY 2021	Change (%)
First tier tax appeals initiated (cases)	1,359	1,000	-26.4
First tier tax appeals completed (cases)	1,513	999	-34.0
Successful first tier tax appeals (cases)	187	100	-46.5
Successful first tier tax appeal ratio (%)	12.4	10.0	-19.4
Second tier tax appeals initiated (cases)	2,563	2,229	-13.0
Second tier tax appeals completed (cases)	2,846	2,328	-18.2
Successful second tier tax appeals (cases)	375	233	-37.9
Successful second tier tax appeal ratio (%)	13.2	10.0	-24.2
Tax litigation initiated (cases)	223	165	-26.0
Tax litigation completed (cases)	216	180	-16.7
Successful tax litigation (cases)	21	14	-33.3
Successful tax litigation ratio (%)	9.7	7.8	-19.6

(Source: National Tax Agency)

The number of successful first tier tax appeals in FY 2021 decreased by 46.5% from FY 2020, with the success ratio in FY 2021 decreasing by 19.4%. The number of successful second tier tax appeals in FY 2021 decreased by 37.9% from FY 2020, with the success ratio in FY 2021 decreasing by 24.2%. Furthermore, the number of successful tax litigation cases in FY 2021 decreased by 33.3%, with the success ratio in FY 2021 decreasing by 19.6%.

The number of successful tax appeals and litigation cases decreased as the number of tax appeals and litigation cases filed also decreased. However, the success ratio of tax appeals and litigation cases were almost the same as the recent five-year average, which could indicate that they may not have been affected by COVID-19.

### (3) Fact-finding process

In regard to tax appeals and litigation, major differences of opinion between taxpayers and the tax authorities may arise in the underlying tax audits during the fact-finding process that determines whether tax will be imposed. The National Tax Tribunal and the courts ultimately decide which side's argument is correct by evaluating evidence presented by both sides and generally using a framework where they examine which arguments are more consistent with relevant hard facts. Such hard facts may include those admitted by both contractual parties or found by objective evidence.

As such, when a taxpayer is deciding whether to appeal their case to the tax authorities or the National Tax Tribunal, the taxpayer should use the same framework as above and examine which arguments are more consistent with relevant hard facts. Published National Tax Tribunal cases are great reference sources for how facts are applied to various cases.

## 2. Tax audits

### (1) Advance notice

Before initiating a tax audit, the tax authorities generally are required to notify a taxpayer of the start date, time, and location of the field audit, as well as the tax items and period to be audited. The taxpayer may request a change to the date and time of the audit if there is a legitimate reason to do so.

The tax authorities may commence a tax audit without notification where an advance notice may impede the precise finding of facts or otherwise limit their ability to appropriately conduct the audit.

During a tax audit, a taxpayer may be represented by a certified public tax accountant who may attend the meetings with the tax authorities.

### (2) Field audits

A tax examiner in charge of a field audit who visits a taxpayer's office is required to bring and present an official identification card showing their title and name.

The tax examiner has the authority to require that the taxpayer provide relevant books, documents, and other materials for the tax examiner to inspect and may question the taxpayer if necessary.

Penalties may be imposed where the taxpayer does not provide (or provides incorrect) information in response to the tax examiner's questions, refuses to cooperate with the inspection, fails to present or provide books, documents, or

other requested materials, or knowingly presents or provides materials with false information. In the case of an individual acting on behalf of the taxpayer, penalties may include imprisonment.

The tax examiner may keep the books, documents, or other materials (generally with the taxpayer's consent). Where materials are retained, the tax examiner must provide a receipt and return the materials to the taxpayer as soon as possible when they are no longer required.

If necessary, the tax examiner may question a counterparty to a transaction with the taxpayer (including an individual taxpayer's employer) and request and inspect the counterparty's relevant books, documents, and other materials.

### **(3) Explanation of audit results**

Where the tax authorities find that a tax return was incorrect or that the taxpayer failed to file a return, they will explain their audit findings, including any errors identified and the calculation and amount of any additional tax payable.

The tax authorities usually will encourage the taxpayer to file an amended tax return voluntarily. After doing so, the taxpayer cannot initiate a tax appeal without first requesting that the tax authorities issue an assessment notice decreasing the amount of tax.

Alternatively, where the tax authorities find that the tax return was not incorrect or the taxpayer was not required to file a return, they will notify the taxpayer accordingly, in writing.

### **(4) Assessment notice**

Where the taxpayer does not file an amended return, the tax authorities will issue an assessment notice. When an assessment notice is issued or a request for assessment decreasing the amount of tax from a taxpayer is rejected, the tax authorities must state the reasons for doing so on the relevant notice.

The tax authorities generally must issue an assessment notice within five years after the statutory due date for filing the tax return (within six years for gift tax, seven years for transfer pricing matters, and ten years for matters in relation to net operating losses regarding corporation tax). The assessment period is seven years where the taxpayer reduces its tax liability or receives a tax refund based on false statements or misconduct.

A taxpayer should pay the principal tax due plus any penalty tax assessed and delinquent tax within one month after the date the assessment notice is issued, regardless of whether the taxpayer intends to appeal the assessment.

However, if the taxpayer is unable to pay the tax at one time, the tax authorities may suspend the tax payment (in full or part) for up to one year after the due date, but only if the tax is fixed one year or more after the statutory filing date of the return and upon the taxpayer's request by the due date for paying the assessment.

### **(5) Penalty tax**

Where, after filing a tax return by the statutory due date, a taxpayer files an amended tax return or receives an assessment notice, the taxpayer generally is subject to a penalty tax of 10% of the additional tax payable (5% if the taxpayer files an amended return after receiving advance notice of a tax audit but before anticipating the issuance of an assessment notice due to the tax audit). Where the additional tax amount exceeds the tax originally disclosed on the return or JPY 500,000, whichever is larger, an additional 5% of the excess is added to the penalty tax otherwise due. However, if the taxpayer files an amended tax return before receiving advance notice of a tax audit and before anticipating the issuance of an assessment notice due to the tax audit, the taxpayer is not subject to a penalty tax. Where the taxpayer conceals or disguises facts on which its taxable base or tax payable is calculated and files a tax return on that basis by the statutory due date, the taxpayer generally is subject to a penalty tax of 35% of the additional tax payable.

Where the taxpayer files a tax return or receives an assessment notice but did not file a tax return before the statutory due date, the taxpayer generally is subject to a penalty tax of 15% of the tax payable (10% if the taxpayer files a return after receiving advance notice of a tax audit but before anticipating the issuance of an assessment notice due to the tax audit). Where the additional tax payable exceeds JPY 500,000, an additional 5% of the excess is added to the penalty tax otherwise due. However, if the taxpayer files a tax return before receiving advance notice of a tax audit and before anticipating the issuance of an assessment notice due to the tax audit, the penalty tax is reduced to 5%. Where the taxpayer conceals or disguises facts on which its taxable base or tax payable is calculated and either fails to file a tax return or files a return based on the concealed or disguised facts after the statutory due date, the taxpayer generally is subject to a penalty tax of 40% of the tax payable.

## (6) Delinquent tax

If a taxpayer fails to pay the principal amount of tax payable by the statutory due date, the taxpayer generally is subject to a delinquent tax on the late payment. For example, where the tax authorities issue an assessment notice, the taxpayer generally is subject to a delinquent tax of approximately 2.4% of the unpaid tax for the period after the statutory due date until the payment date. The tax rate varies depending on the period.

Certain periods are excluded in calculating the delinquent tax amount. For example, where the taxpayer files a tax return by the statutory due date, but the tax authorities issue an assessment notice more than one year after that date, the period from one year after the statutory due date until the date the assessment notice is issued is excluded.

## (7) Tax audit duration

The duration of a tax audit depends on the taxpayer's circumstances. Usually, an audit takes between one and six months but may take longer, particularly where a transfer pricing audit is conducted.

The tax authorities may conduct an additional audit of a tax period if, after the initial audit has been completed, they obtain new information indicating a position taken by the taxpayer is incorrect. This is the case even if as a result of the first audit, the taxpayer files an amended tax return, the tax authorities issue an assessment notice, or the tax authorities inform the taxpayer that the return was not found to be incorrect or the taxpayer was not required to file a tax return for the period.

### 3. Tax appeals and litigation

#### (1) Steps to challenge an assessment



A taxpayer may challenge an assessment notice issued by the tax authorities as a result of a tax audit. When the notice is issued, the taxpayer either may accept the assessment or challenge it by initiating a tax appeal.

In general, a taxpayer may appeal to the courts only after the taxpayer has filed a second tier tax appeal with the National Tax Tribunal and such tribunal has rendered a decision that is unfavorable to the taxpayer.

#### (2) First tier tax appeal functions as an extension of the audit

When the opinion of a taxpayer under tax audit differs from that of the tax authorities, the optimal solution generally would be to resolve the difference during the tax audit. However, if the difference cannot be resolved in the tax audit, the taxpayer may choose to file a first tier or second tier tax appeal. Filing a first tier tax appeal generally will offer the fastest manner to resolve any differences or address a contested fact pattern included in the assessment notice.

A first tier tax appeal to the tax authorities that issued the assessment notice generally must be initiated within three months after the date the notice is received by the taxpayer or the date the taxpayer acknowledges its issuance (if it is not received by the taxpayer).

First tier tax appeals are handled by a specific tax division, which often is the same division that internally reviewed the original assessment notice. The tax authorities generally aim to issue their decision on the appeal within three months. The first tier tax appeal essentially is a quick internal review process, and the assessment may be overturned. For example, an assessment may be overturned if it was based on inaccurate information or the taxpayer subsequently obtained favorable evidence that was not available during the tax audit. Even if the taxpayer's first tier tax appeal is denied, the reason for the decision will be disclosed in more detail, which is often useful in conducting a second tier tax appeal.

Where a taxpayer's first tier tax appeal is denied, the taxpayer still may file a second tier tax appeal with the National Tax Tribunal. In such a case, the second tier tax appeal generally must be filed within one month after the date the tax authorities' decision is delivered to the taxpayer. The taxpayer also may initiate a second tier tax appeal if no decision is rendered by the tax authorities within three months after the date the first tier tax appeal was initiated.

### **(3) Second tier tax appeal functions as an extension of the first tier tax appeal or tax audit**

By doing a second tier tax appeal, the taxpayer may seek a final decision on the matter by the administrative branch. The National Tax Tribunal hears arguments from both the taxpayer and the tax authorities, performs its own review of the evidence, and issues a decision. The process is independent, not open to the public, and free of charge and allows taxpayers to address a contested assessment on a timelier basis than if they were to pursue tax litigation. Even if tax litigation becomes necessary (i.e., if the National Tax Tribunal issues a decision that is unfavorable to the taxpayer), clarifying contentious points in advance should allow tax litigation to proceed more efficiently.

Where a taxpayer appeals directly to the National Tax Tribunal without making a first tier tax appeal, the second tier tax appeal generally must be initiated within three months after the date the assessment notice is received by the taxpayer or the date the taxpayer acknowledges its issuance (if it is not received by the taxpayer).

Upon receiving the appeal, the National Tax Tribunal notifies the tax authorities that issued the assessment notice that an appeal has been initiated, and the tax authorities file a response with the tribunal. The taxpayer then may present further arguments and evidence. After the National Tax Tribunal considers the relevant arguments and evidence presented, it ends its examination and issues a decision in writing, generally within one year after the date the appeal was initiated.

More than half of the National Tax Tribunal's staff are seconded from the tax authorities as part of their job rotations. However, it is mostly headed by civil court judges, and attorneys, certified public tax accountants, and certified public accountants are usually hired as fixed-term appeal judges.

There are two major issues in tax controversy: fact-finding and legal interpretation. In most tax appeal cases where the National Tax Tribunal reversed an assessment, it did so because it disagreed with the facts assumed and presented by the tax authorities. Fact-finding is an objective exercise and, by relying on objective facts, the National Tax Tribunal functions as a neutral arbiter of disputes between taxpayers and the tax authorities. However, the National Tax Tribunal rarely rejects the tax authorities' legal interpretations, possibly because it is mindful of the wider impact an interpretation may have on other taxpayers. In such cases, if it upholds the assessment, the taxpayer may bring its case to court.

### **(4) Tax litigation functions as the next step beyond the second tier tax appeal**

When the difference of opinion is still not resolved through the second tier tax appeal, the taxpayer may then pursue tax litigation. By engaging in tax litigation, the taxpayer also may address any legal interpretations it disagrees with, expecting the court rejects them.

If the taxpayer wants to continue to challenge an assessment after the decision of the National Tax Tribunal, the taxpayer may bring the case to court within six months after the date the taxpayer acknowledges the issuance of the tribunal's decision. The taxpayer also may bring the case to court if no decision is rendered by the National Tax Tribunal within three months after the date the appeal to the tribunal was initiated.

Japan has a three tiered judicial system comprised of the district courts (the first level), the high courts (the second level), and the Supreme Court (the final level). A taxpayer must file its initial lawsuit in the district court and may appeal an unfavorable decision to a high court. In general, the Supreme Court deals only with legal matters and has the discretion to refuse to consider cases.

The burden of proof generally lies with the tax authorities issuing the assessment notice, who must provide evidence to support their position.

The timeframe for tax litigation depends on the individual case. It usually takes around one and a half years at the district court and within one year at the high court. It may take longer than one year at the Supreme Court (if it accepts the case).

Although the successful tax litigation ratio is relatively lower compared with most other countries, the Japanese courts generally are considered reliable and free from bias, as the number of successful cases for taxpayers has shown.

#### **4. Alternative dispute resolution**

##### **(1) No official settlement procedure**

In Japan, there is no official settlement procedure between a taxpayer and the tax authorities during tax controversy procedures, other than the mutual agreement procedure (MAP) in an applicable tax treaty. However, the tax authorities often recommend that a taxpayer file an amended tax return during the tax audit in accordance with a de facto agreement between the taxpayer and the tax authorities, which may function as an unofficial settlement.

##### **(2) Mutual agreement procedure**

When an assessment notice results in international double taxation for a taxpayer, the taxpayer may request that the tax authorities enter into a MAP with the relevant foreign tax authorities under provisions to resolve such double taxation contained in the applicable tax treaty.

Japan is a proponent of the MAP. Where a treaty contains MAP provisions, an affected taxpayer should consider filing a MAP request in addition to a tax appeal to the tax authorities or the National Tax Tribunal. The domestic tax controversy procedure may be suspended while the MAP negotiation is ongoing. If the MAP is not available or practical for any reason, Japan's domestic tax controversy procedures would be the last resort for the taxpayer.

#### **5. Advance rulings**

##### **(1) Non-action letters**

A taxpayer may seek a non-action letter from the tax authorities in relation to a transaction that either has taken place or will take place before the due date for filing the tax return reflecting the transaction. A non-action letter may not be requested where (i) there are various alternatives to the transaction, (ii) a tax audit or collection procedure is at issue, (iii) asset valuations or transaction consideration is at issue, (iv) the main purpose of the transaction is to decrease tax or the transaction has no economic rationale, or (v) further fact-finding is necessary.

The tax authorities generally try to issue a non-action letter within three months after the date the request is filed, but it may often take longer. Taxpayers, therefore, tend to seek an informal response from the tax authorities rather than seek a non-action letter or adopt a position without any response or ruling from the tax authorities.

Another potential challenge for a taxpayer is disclosure. A non-action letter generally will be published within two months after its issue date, although the taxpayer may request the tax authorities delay publication for up to one year after the decision is made. Where a taxpayer does not want details of the transaction to be disclosed, it should not seek a non-action letter.

##### **(2) Advance pricing arrangements**

Japan advocates the conclusion of advance pricing arrangements (APAs). To ensure transfer pricing certainty, taxpayers may request the tax authorities to enter into a unilateral APA or a bilateral APA with the relevant foreign tax authority.

The tax authorities' APA team is separate from the tax examination team, and, in practice, no information is exchanged between the two teams. However, the APA team will rigorously investigate profits and losses in respect of transactions with foreign related parties.

In respect of a unilateral APA, the APA team applies a more theoretical approach, although they usually request a premium in the range of 1-2%. In bilateral APA negotiations, the APA team tends to adopt a stronger negotiating stance and opening position.

#### **6. Deloitte Japan offers support throughout the tax appeals and litigation processes**

Deloitte Japan provides consultation services in regard to determining potential outcomes for tax appeals and litigation, assisting in tax appeals and litigation processes, and advising on the public disclosure of assessment notices. We have lawyers, certified public tax accountants, former tribunal officials, and former judges with extensive experience and

prior success in tax audit defense and tax appeals and litigation. Recent successful cases include a second tier tax appeal in a corporate reorganization and a tax litigation case involving the controlled foreign company regime in Japan.

For further information, please contact:

**Yutaka Kitamura**

**DT Legal Japan**

Mobile: +81 7031925611

[yutaka.kitamura@tohatsu.co.jp](mailto:yutaka.kitamura@tohatsu.co.jp)

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