The Responsibility of Judges in Interpreting Tax Legislation: Japan's Experience

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The Responsibility of Judges in Interpreting Tax Legislation: Japan’s Experience

Abstract
This essay examines the Japanese judiciary’s approach to statutory interpretation of tax legislation in Japan. Its goal is to provide a positive, rather than normative, analysis of current Supreme Court of Japan (SCJ) tax jurisprudence. The analysis demonstrates that SCJ justices generally employ a literal approach when interpreting tax legislation, but with due regard to the objective and purpose of specific statutory provisions. This does not mean that SCJ justices constrain their reasoning based on an originalist approach to statutory interpretation. The analysis instead demonstrates that they make their own judgments, taking into account both the plain meaning of the provisions at issue as well as the objective and purpose of the legislation.

Keywords
Taxation--Law and legislation--Interpretation and construction; Jurisprudence; Japan. Saikō Saibansho; Japan

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The Responsibility of Judges in Interpreting Tax Legislation: Japan’s Experience

YOSHIHIRO MASUI*

This essay examines the Japanese judiciary’s approach to statutory interpretation of tax legislation in Japan. Its goal is to provide a positive, rather than normative, analysis of current Supreme Court of Japan (SCJ) tax jurisprudence. The analysis demonstrates that SCJ justices generally employ a literal approach when interpreting tax legislation, but with due regard to the objective and purpose of specific statutory provisions. This does not mean that SCJ justices constrain their reasoning based on an originalist approach to statutory interpretation. The analysis instead demonstrates that they make their own judgments, taking into account both the plain meaning of the provisions at issue as well as the objective and purpose of the legislation.

Cet article examine l’approche judiciaire du Japon de l’interprétation législative des lois fiscales du Japon. Il se propose d’offrir une analyse positive, plutôt que normative, de la jurisprudence fiscale actuelle de la Cour suprême du Japon (CSJ). Cette analyse démontre que les juges de la CSJ adoptent généralement une approche littérale lorsqu’ils interprètent les lois fiscales, mais en respectant strictement l’objectif et l’intention de dispositions.

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légales particulières. Cela ne signifie pas pour autant que les juges de la CSJ s’astreignent à conserver une approche rigide quand vient le temps d’interpréter les lois. L’analyse démontre au contraire qu’ils formulent leur propre jugement en tenant compte à la fois du sens manifeste des dispositions en question et de l’objectif et de l’intention de la loi.

IN A PAPER CONTRIBUTED TO A CONFERENCE held in Sydney, Australia, in May 1995, Neil Brooks argued that judges should act as “pragmatic tax analysts.” According to Brooks, the judiciary’s responsibility in interpreting an income tax statute was to elaborate on the provisions of the statute “in order to ensure … that they conform to a coherent model of how an income tax statute should be structured.”

Brooks surveyed various theories of statutory interpretation and reviewed Canadian tax jurisprudence to demonstrate that his “pragmatic tax analyst approach” to statutory interpretation was preferable to the Canadian judiciary’s conventional originalist approach.

Graeme Cooper described Brooks’s proposition as expressing a “rather less orthodox view,” according to which:

[...] Judes should not ask, What did Parliament say? nor, What did Parliament mean to say? nor even, What was Parliament trying to accomplish? but rather, “What result would reflect the most sensible tax policy?” and then adjudicate on that basis.

Clearly this is heady stuff.

2. Ibid at 98.
4. Ibid at 20.
Cooper went on to observe, correctly in my opinion, that, despite Brooks's argument, courts are "reluctant to participate openly in the law-making process."  

My position on this matter generally favours Brooks's argument, but takes Cooper's critique into account. Although judges make decisions in the context of each case, their decisions inevitably shape broader tax policy. Yet they do so without openly engaging in a political battle in the law-making arena. All lawyers know the trick more or less, despite the fact that many hesitate to admit it as candidly as Brooks.

The purpose of this article is to uncover Japanese judges' approaches to interpreting and applying Japanese tax legislation. This article is not as ambitious as Brooks's paper: it does not make a strong claim for judges to "get their act together." 6 The goal is to contribute a positive, rather than a normative, analysis of current Supreme Court of Japan (SCJ) tax jurisprudence. In doing so, I will demonstrate that Japanese judges indeed play a significant role in the tax law-making process. The SCJ tends to adopt a literal approach to the interpretation of tax legislation, but with due regard to the object and purpose of specific statutory provisions. This does not mean that SCJ justices constrain their reasoning based on an originalist approach to statutory interpretation. Instead, this article demonstrates that they make their own judgments, taking into account the plain meaning of the words as well as the purpose of the legislation.

Part I of this article provides an overview of the constitutional origins of Japanese tax legislation, and the structure of the judiciary and tax-related tribunals in Japan. Part II examines Japanese judges' approaches to statutory interpretation in SCJ tax jurisprudence. The section discusses cases in which the SCJ has adopted either narrow or broad interpretations of statutory language based on literal or teleological approaches to statutory interpretation. The section also examines cases in which SCJ justices have interpreted taxation provisions that incorporated concepts transplanted from private law. Part III turns to legislative and judicial responses to tax avoidance in Japan. Japanese tax legislation has a number of relatively broad Specific Anti-Avoidance Rules (SAARs) but does not have a General Anti-Avoidance Rule (GAAR). The analysis demonstrates that, overall, Japanese judges' responses to tax avoidance are rather constrained, though more

5.  Ibid.
recent decisions indicate a trend toward rejecting abusive tax avoidance schemes based on rather creative approaches to statutory interpretation.

I. JAPANESE TAX LAW, COURTS, AND TRIBUNALS

The Japanese Constitution vests all judicial power in the SCJ and prohibits the establishment of extraordinary courts. Therefore, no special tax court exists in Japan. Tax cases, both civil and criminal, are litigated before judges who may not necessarily be experts in tax matters. The Constitution also declares that all judges shall be independent in the exercise of their conscience and shall be bound only by the Constitution and the laws.

In 2013, there were 15 justices on the SCJ, 2,897 judges on the lower courts of Japan, and 806 judges on the summary courts. Approximately 20 per cent of these judges were women. Almost without exception judges are appointed at a young age (usually in their twenties) and continue to work as judges throughout their career. The Cabinet appoints judges of the lower courts from a list of nominees put forward by the SCJ. All lower court judges hold office for a term of ten years, with the privilege of reappointment subject to mandatory retirement at age sixty-five. The judges at the Secretariat of the SCJ make vital decisions regarding the promotion and positioning of lower court judges.

In contrast to the relative homogeneity of lower court judges, the justices of the SCJ have a more diverse background. Some are career judges, while others are former attorneys at law, criminal prosecutors, bureaucrats who worked in government, or university professors. The SCJ is composed of three Petty

8. *Kenpo (Constitution of Japan)*, 3 Nov 1946, art 76(1)-(2).
11. *Saibansho Shokuin Teisu Ho* [Law Regarding the Full Number of Judges and Court Staff] Law No 53 of 31 March 1951, art 1, as last amended by Law No 18 of 4 April 2014 (Japan). The Japan Federation of Bar Associations provides statistics regarding the percentage of female judges. See Japan Federation of Bar Associations, “Trends in the Numbers of Judges, Prosecutors, and Lawyers,” online: Japan Federation of Bar Associations <www.nichibenren.or.jp/library/ja/publication/books/data/2013/whitepaper_suii_judge_prosecutor_lawyer.pdf>. Translations of the titles of Japanese legislation were provided by author.
12. *Saibansho Ho* [Court Act], Law No 59 of 16 April 1947, arts 40, 50, as last amended by Law No 48 of 19 June 2013 (Japan).
Benches, each consisting of five justices, and one Grand Bench consisting of all fifteen justices. Cases are typically heard by five justices sitting on one of the three Petty Benches.

Tax matters typically make their way to court after two stages of administrative review: reinvestigation by the Regional Taxation Bureau of the National Tax Agency (NTA), and reconsideration by the National Tax Tribunal (NTT). A reform initiative is underway that would allow taxpayers to forgo the first stage and directly request reconsideration by the NTT. The NTT is an external organization of the NTA that has jurisdiction to rule on tax complaints independently. The NTA is constrained by the NTT’s decision regarding a complaint and cannot challenge the result. Taxpayers who are unsatisfied with the NTT’s decision regarding a request for reconsideration can seek judicial remedies in the courts.

The number of tax cases processed by the NTT and the courts between 1 April 2013 and 31 March 2014 is shown in Table 1, along with statistics regarding taxpayers’ success rates. These statistics, when examined along with statistics for previous years, indicate that taxpayers’ rate of success at court is low, and this trend has been consistent for decades. It did not change before and after the changes of administration in 1993 and 2011. It is a matter of debate why taxpayers lose so frequently in court in Japan. One theory is that the NTA, as a rational repeat player, disproportionately favours judicial resolution of matters that it expects will create precedents that are favourable to the government.

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17. Ibid, art 114; Gyosei Jiken Sosho Ho [Administrative Case Litigation Act], Law No 139 of 16 May 1962, art 8, as last amended by Law No 69 of 13 June 2014 (Japan).
According to this theory, taxpayers seem to lose in court because many cases are settled in favour of taxpayers before reaching the litigation stage.

### TABLE 1: TAX CASES DECIDED BY THE NATIONAL TAX TRIBUNAL AND JAPANESE COURTS BETWEEN 1 APRIL 2013 AND 31 MARCH 2014

<table>
<thead>
<tr>
<th></th>
<th>Number of Disputes Decided</th>
<th>Taxpayers' win</th>
<th>Taxpayers' Partial Win</th>
<th>Taxpayers' Loss</th>
<th>Other Result</th>
</tr>
</thead>
<tbody>
<tr>
<td>Tribunal</td>
<td>3,073</td>
<td>73</td>
<td>163</td>
<td>2,678</td>
<td>159</td>
</tr>
<tr>
<td>District Court</td>
<td>159</td>
<td>10</td>
<td>8</td>
<td>119</td>
<td>23</td>
</tr>
<tr>
<td>High Court</td>
<td>102</td>
<td>4</td>
<td>1</td>
<td>95</td>
<td>2</td>
</tr>
<tr>
<td>Supreme Court</td>
<td>67</td>
<td>1</td>
<td>—</td>
<td>66</td>
<td>—</td>
</tr>
</tbody>
</table>


**NOTE:** The classification of cases into the above categories was performed by NTA staff.

In terms of overall statistics, the success rate of taxpayers has remained relatively stable since 1993. It is widely believed, however, that the landscape for tax litigation in Japan began to change around the year 2000. Since then a number of high profile SCJ decisions have held in favour of taxpayers who were large, well-known businesses. These cases generally involved large sums of money and received considerable attention in the popular press.

Indeed, the SCJ has not hesitated to overturn some of the NTA’s established assessment practices. In *Migiyama*, a case that dealt with the income tax treatment of a fee paid to acquire golf memberships, the court expanded the scope of acquisition costs for the purpose of computing capital gains. The NTA quickly changed its position accordingly and issued an interpretative circular following

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the SCJ’s decision. An even more dramatic example is the result in Hamanaka. In this case the SCJ held that an exemption provision in the Income Tax Law should be applied to the future value of an annuity received by a wife under a life insurance product that had been purchased by her deceased husband. Although the monetary value of the exemption at issue in this particular case was small, the decision affected many other taxpayers who had purchased similar life insurance products. After the SCJ issued this decision, the NTA refunded the income tax paid by these other taxpayers retroactive to 2005. Subsequent legislation authorized refunds for the calendar years 2000 to 2004.

II. THE ROLE OF STATUTORY INTERPRETATION IN STATUTE-BASED TAXATION

A. THE PRINCIPLE OF STATUTE-BASED TAXATION

Article 84 of the Constitution of Japan stipulates that “no new taxes shall be imposed or existing ones modified except by law or under such conditions as law may prescribe.” In other words, taxation must be based on statutes created by the National Diet, Japan’s national legislature. This constitutional principle is generally considered to support a literal approach to the interpretation of tax statutes. This position is based on the principles of democracy and liberty.

On the one hand, the supremacy of the legislature is rooted in the ideals of democracy. If judges and tax officers are allowed to step away from the literal meaning of the words chosen by the Diet, they can in effect override the decisions of the Diet, whose members are elected by the people. This would contravene the division of powers among the three branches of government.

26. Shotoku Zeibo [Income Tax Law], Law No 33 of 31 March 1965, art 9(1), no 15, as last amended by Law No 91 of 21 June 2014 (Japan). The provision at issue was renumbered to art 9(1), no 16 under the current law.
27. Sozei Tokubetsu Sochi Ho [Special Tax Measures Law] Law No 26 of 31 March 1957, art 97-2, as last amended by Law No 91 of 27 June 2014 (Japan).
28. Constitution of Japan, supra note 8, art 84.
On the other hand, the principle of statute-based taxation guarantees the liberty of private parties by creating clear *ex ante* rules. Literal interpretation of tax legislation can provide certainty and preclude unforeseen consequences. In a case dealing with the retroactive application of an income tax provision disallowing loss utilization, the SCJ explicitly stated that one of the purposes of Article 84 is to guarantee legal certainty in taxation.31

Thus, Japanese commentators generally tend to emphasize a literal approach to interpreting tax legislation.32 A closer examination of SCJ decisions reveals, however, that judges facing tax disputes often also consider the objective and purpose of the tax provisions at issue and sometimes deviate from a strict, literal approach to statutory interpretation. In these cases, the SCJ has adopted broader or narrower interpretations of the statutory language at issue in an effort to give effect to the objective and purpose of the legislation.

B. EXPANDING AND NARROWING THE MEANING OF A WORD

The SCJ’s decision in *Fujibayashi* is a textbook example of how judges can expand the literal meaning of words contained in a tax statute in order to arrive at a preferred conclusion.33 This case arose under the *Commodity Tax Law* that preceded the present Value Added Tax (VAT) under the *Consumption Tax Law*.34 The commodity tax was imposed only on items specified in the *Commodity Tax Law*. The issue was whether a racing car should be characterized as a “normal passenger automobile” for taxation purposes, even though it could not be driven on the street because it did not satisfy safety standards for road vehicles. The automobile was only used for the purpose of racing on a closed track. The SCJ held that the car was taxable as a “normal passenger automobile” because it was not used for any special purpose. The automobile was not allowed on the street merely because it was designed to fit the purpose of automobile racing. The dissenting opinion of Justice Ozaki countered this point. He argued that the racing car had a special use and fell outside the category of a “normal” passenger vehicle, given its nature, function, and intended use.

31. Supreme Court, 22 September 2011, 65:6 Minshu 2756 at 2762.
32. See supra note 30.
33. Supreme Court, 11 November 1997, 1654 Hanrei Jiho 71.
34. *Buppinzei Ho [Commodity Tax Law]*, Law No 48 of 31 March 1962 (Japan) (repealed on 1 April 1989); *Shohizei Ho [Consumption Tax Law]*, Law No 108 of 30 December 1988 (Japan). The *Commodity Tax Law* was repealed when the *Consumption Tax Law* came into effect on 1 April 1989. This article uses the term “VAT” interchangeably with the term “Consumption Tax” when referring to taxation measures under the *Consumption Tax Law*. 
From a policy perspective, the SCJ’s expansive reading of the word “normal” in this case closed a tax loophole. The tax base of the Commodity Tax Law at the time was narrow and was not suitably updated. In order to be taxable, this rather special car had to fit into the category of a “normal passenger automobile” despite its use for racing purposes. Although the court’s decision closed the tax loophole and arguably represented better tax policy, the majority’s opinion did not expressly discuss the defects of the archaic commodity tax.

Policymakers outside the court were quicker to react to the outdated tax, however. In 1988, a few years before this decision was rendered, the Commodity Tax Law was repealed, and the Consumption Tax Law enacted a broad-based VAT in its place. The tax assessment years at issue in Fujibayashi were 1984 to 1988, and thus the repealed Commodity Tax Law still applied. The current VAT under the Consumption Tax Law, however, is imposed on a broadly defined category of “transfers of taxable assets,” including services, and there is little doubt that it would have applied to the racing car in question.

In contrast, the SCJ’s decision in Suda is an example of narrow statutory interpretation. The VAT under the Consumption Tax Law had been in place for several years when this dispute arose. In this case, a carpenter claimed an input tax credit, but tax officials denied it after the carpenter failed to produce his accounting records. The carpenter later produced his records at the litigation stage. The issue was whether the taxpayer “did not keep books or receipts,” which was a prescribed condition for the NTA’s refusal to grant an input tax credit under the Consumption Tax Law. The carpenter argued that keeping books and receipts in the physical sense was sufficient and that it did not matter that he hid them from the tax auditors at the time of the tax audit.

The SCJ held that a taxpayer must be fully prepared to produce his or her accounting records when audited. According to the court, the taxpayer “did not keep books or receipts” because he failed to arrange his books and receipts in the manner prescribed in the Consumption Tax Cabinet Order, which would have enabled him to produce his records to a tax auditor on a timely basis. In other words, merely “keeping” books and receipts in a physical sense was insufficient to satisfy the threshold required to claim the input tax credit. This put an end to

35. _Ibid._
36. _Consumption Tax Law, supra note 34, art 4._
37. Supreme Court, 16 December 2004, 58:9 Minshu 2458, [2004] JPSC 60 (AsianLII) [Suda cited to Minshu].
38. _Consumption Tax Law, supra note 34, art 30(7), prior to amendment by Law No 109 of 2 December 1994._
39. _Ibid at art 50(1); Suda, supra note 37 at 2465._
a controversy that had produced a number of conflicting lower court decisions.40 The controversy was also reflected in Justice Takii’s dissenting opinion in a companion case in which a majority of the court reached the same conclusion.41

C. LITERAL VERSUS TELEOLOGICAL INTERPRETATION

The SCJ’s decision in Ito is an example of a decision in which the court took into account the purpose of the legislation at issue as well as the literal meaning of its statutory language.42 At issue was the meaning of the phrase “number of days within the accounting period for the amount to be paid” under the withholding provision of the Income Tax Law.43 Under this provision, the owners of a pub (“withholding agents”) must withhold income taxes when they pay remuneration to the hosts and bartenders they employ. The withholding tax is 10 per cent of the amount paid minus an amount stipulated under Cabinet Order.44 The applicable Cabinet Order stipulated that the deductible amount was 5,000 Japanese Yen (JPY) multiplied by the “number of days within the accounting period for the amount to be paid” for one payment to a single person.45

In this case, a pub owner paid remuneration to hosts and bartenders twice a month and calculated the amount of tax withheld based on the view that the “number of days within the accounting period for the amount to be paid” meant the total number of calendar days in each pay period. Thus, the total amount that the pub owner withheld from each employee’s remuneration in each pay period was reduced by approximately 75,000 JPY (5,000 JPY multiplied by half the days in the month). The NTA took a different view. According to the NTA, the “number of days within the accounting period for the amount to be paid” meant the number of days that each host or bartender had worked for the employer within the accounting period. For example, if the host or bartender worked only eight days at the pub in a given pay period, the amount withheld would be reduced by 40,000 JPY (5,000 JPY multiplied by 8 days).

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40. See e.g. Osaka District Court, 10 August 1998, 1661 Hanrei Jiho 31 (allowing an input tax credit); Nagoya High Court, 24 March 2000, 47:7 Shomu Geppo 2016 (denying an input tax credit); Tokyo District Court, 30 March 1990, 46:2 Shomu Geppo 899 (disallowing an input tax credit based on the inference of evidence).
41. Supreme Court, 20 December 2004, 1889 Hanrei Jiho 42.
43. Income Tax Law, supra note 26, arts 204(1), 205(2); Shotoku Zeiho Shikorei [Income Tax Law Enforcement Order], Cabinet Order No 96 of 31 March 1965, art 322, as last amended by Cabinet Order No 338 of 18 October 2014 (Japan).
44. Income Tax Law, supra note 26, arts 204(1), 205(1).
The court decided in favour of the pub owner, relying on a literal interpretation of the word “period.” According to the court, the concept of a period is generally understood as representing continuity of time between two points in a sequence of time. Therefore, the court concluded that the phrase “number of days within the accounting period for the amount to be paid” connoted time continuity from the first day to the last day of the pay period in question.

To reinforce this interpretation, the court stated that provisions of tax statutes should be construed literally unless there is good reason to adopt a more liberal interpretation. Significantly, however, the court went on to justify its adopted interpretation based on the legislative purpose of the deduction rule, which was to reduce the time, effort, and costs involved in refunding excess withholding tax. The court thus considered the purpose of the legislation and sustained a literal interpretation of the term “period” as a result of this substantive consideration.

From a practical perspective, this decision is likely to result in larger deductions from the withholding tax base. For example, suppose that four different pub owners employ the same host or bartender during a particular pay period. Each owner is required to apply deductions to the withholding tax base of the employee on a cumulative full day basis for the entire pay period regardless of how many days the employee worked for each owner. The result is that the sum of tax withheld by all four owners may be less than the tax withheld if the employee worked the same number of days for only one pub owner. The court did not discuss whether this result was appropriate from a tax policy perspective. The court implied, however, that this result is consistent with the legislative purpose of deductions from the withholding tax base: avoiding refunds.

On the other hand, the SCJ’s decision in Zen (Reverse Half-Tax Plan) placed more explicit emphasis on the purpose of the legislation at issue. In this case four executives of a corporation received sizable payments on maturity of policies issued by a life insurance company. The executives included the amount received on maturity of the policies as an amount received in respect of gross income under the category of occasional income on their tax returns. Occasional income is generally accorded preferential tax treatment in the form of a special statutory deduction of 500,000 JPY and a 50 per cent exclusion from the aggregate income tax base. In addition to categorizing the insurance benefit received as occasional income, for the purpose of computing their net income the executives also deducted the full cost of the related insurance premium incurred by their

46. Suda, supra note 37 at 426.
47. Supreme Court, 13 January 2012, 66:1 Minshu 1 [Reverse Half-Tax Plan].
48. Income Tax Law, supra note 26, art 34.
corporate employer. The issue was whether the insurance premium was deductible as “the amount paid for gaining the revenue” under the Income Tax Law.\(^{49}\)

The SCJ held that the taxpayer must bear the burden and pay the amount in order to deduct it as “the amount paid for gaining the revenue.” Although the corporation initially paid the full amount of the insurance premium, half of the premium was treated as a loan to the executives who would ultimately bear the burden of paying this portion of the amount. Therefore, 50 per cent of the insurance premium amount was allowed as a deduction in the hands of the executives. Because the executives did not bear the burden of paying the other 50 per cent, this portion was not deductible in calculating their personal net income but was instead a deductible expense for the corporation.

The court gave two reasons for this holding. First, the purpose of deducting “the amount paid for gaining the revenue” in respect of occasional income was to support taxation under the Income Tax Law based on an individual’s ability to pay.\(^{50}\) The court’s secondary reason was that the phrase “the amount paid for gaining the revenue” presupposes that the same taxpayer is earning the income claimed and making payments in respect of the income source.

Justice Sudo wrote a separate supporting opinion. He agreed with the majority’s decision but made two further points. First, the majority’s interpretation of the provision at issue was consistent with the provision’s object and purpose, and did not conflict with the principle of statute-based taxation required under the Constitution.\(^{51}\) Second, the majority’s opinion did not detract from legal certainty and predictability. Justice Sudo reasoned that it was a commonsense assumption that an income earner and an expense payer should be the same person, and it would be unreasonable to treat the same amount as a deductible expense for both a corporation and an individual.

The court’s decision thus rejected one aspect of a life insurance product tax-planning scheme. The court did not, however, address an undisputed background issue: the under-taxation of fringe benefits at the time when the corporation paid insurance premiums on behalf of its executives.\(^{52}\) In this case the corporation was party to endowment insurance contracts with the life insurance company from 1996 to 1998. The contractual terms specified that

\(^{49}\) Ibid, art 34(2).
\(^{50}\) Reverse Half-Tax Plan, supra note 47 at 7.
\(^{51}\) Constitution of Japan, supra note 8, art 84.
\(^{52}\) The court did not comment on this background issue. See Yusuke Takahashi, “Case Comment” (2012) 1441 Jurist 8. The facts and mortality tables discussed in this paragraph are drawn from Takashi’s case comment.
the insured persons were the executives and their family members. The duration of the contracts ranged from three to five years. The contractual terms specified that if the executives died within this period the benefit would be paid to the corporation, and if the executives were alive at the end of this period, the benefit would be paid to the executives. Mortality tables for 1996 indicated that the probability of death within five years was 2.4 per cent for a fifty-year-old Japanese male. Assuming that the executives had a mean age of fifty when the endowment contracts were executed, the probability that the insured executives and family members would receive the benefit was higher than 97.6 per cent. Thus, the result of the decision in *Reverse Half-Tax Plan* is that, as long as the insured executives bore the burden of paying 50 per cent of the insurance premiums, the executives were untaxed on the fringe benefits and deferred taxation until the receipt of the insurance benefits. Once received, the insurance benefits were only subject to the preferential taxation regime accorded to the category of occasional income.

D. THE TRANSPLANTED CATEGORY

When judges decide a tax case, they often face a number of issues concerning the degree to which they respect the legal form of a transaction or tax structure selected by private parties. These issues have several dimensions. One distinct issue discussed in Japan is how to interpret concepts that are borrowed from other fields of law, most notably private law, in the context of tax adjudication.

Brooks discussed the “fallacy of the transplanted category” in order to illustrate the differences between originalist and pragmatic approaches to tax law interpretation.53 His example was the distinction under Canadian income tax legislation between a taxpayer earning income from “employment” and income from “business.”54 Brooks argued that it was logically fallacious for Canadian judges to base their tax law interpretation of the term “employment” on concepts articulated in tort law or labour law.55 Fortunately this specific issue does not arise under Japanese law because the *Income Tax Law* defines “employment income” rather broadly, and Japanese courts distinguish employment income from business income without relying on jurisprudence from other areas of law.56

In a more general context, however, Japanese courts often refer to private law constructions and interpretations in developing tax law concepts. For example, in

53. Brooks, supra note 1 at 122.
54. See generally *Income Tax Act*, RSC 1985, c 1 (5th Supp), ss 5-8 (income from employment), 9-26 (income from a business or property).
55. Ibid.
56. See Supreme Court, 24 April 1981, 35:3 Minshu 672.
Suzuya Kinyu the interpretative issue was the meaning of “profit dividends” that were subject to withholding tax under the Income Tax Law.57 In the absence of a tax definition of profits out of which dividends are paid, the court stated that the Income Tax Law adopted the Commercial Code concept of profit dividends.58 According to the court, profit dividends under the Income Tax Law were not restricted to dividends that were lawfully distributed under the Commercial Code, but included dividends that were subject of Commercial Code regulation and that were considered illegal under the Commercial Code.59 Applying this interpretation to the facts of the case, the court concluded that the payment in question was not a payment of profit dividends because the company was obliged to make regular payments of the same percentage amount regardless of the existence of accounting profits. The court therefore denied the withholding tax assessment.

Similar to the decision in Suzuya Kinyu, the court in Kangyo Keizai also referred to a private law concept when it denied the application of the withholding tax regime.60 At issue was the concept of Tokumei Kumiai (TK), a tax structure the origin of which was a sleeping partnership in continental Europe.61 The TK structure in this case was utilized as a device to distribute profits out of Japan without the application of Japanese withholding tax. In affirming the validity of this structure, the court relied on the Commercial Code concept of a TK and rendered moot the legislative purpose of the 1953 Income Tax Law amendment, which was intended to cover a wide range of profit distributions in financial structures resembling the TK structure.62

57. Supreme Court, 7 October 1960, 14:12 Minshu 2420, 238 Hanrei Jiho 2 [Suzuya Kinyu cited to Minshu]; Law No 27 of 31 March 1947, as amended by Law No 11 of 27 March 1952, art 9(1), no 2.
58. Shoho [Commercial Code], Law No 48 of 9 March 1899, art 290, prior to amendment by the introduction of Kaisha Ho [Company Act], Law No 87 of 26 July 2005 (Japan).
59. See Commercial Code, supra note 58, arts 290, 293. These articles render dividends containing return of capital and dividends in violation of the shareholder equality principle illegal.
60. Supreme Court, 27 October 1961, 15:9 Minshu 2357 [Kangyo Keizai].
62. Supra note 57, as amended by Law No 73 of 7 August 1953.
An examination of these older cases might give the impression that the SCJ fell into the very “fallacy” that Brooks criticized. Indeed, there are more recent Japanese decisions in which the courts have relied on the private law meaning of a term when interpreting tax statutes.\(^{63}\)

Japanese courts have not always followed private law interpretations uncritically, however. The SCJ’s decision in *Miyagi* illustrates the flexibility of Japanese tax jurisprudence to deviate from private law concepts when the context requires.\(^{64}\) In this case, the court interpreted the concept of a “gift” under the *Income Tax Law* differently from the concept of a “gift” under the *Civil Code*.\(^{65}\) In particular, the court held that the definition of a “gift” in a carryover basis provision did not include an onerous gift the economic benefit of which accrued to the donor. Though the SCJ did not explain the tax logic underlying this holding, it affirmed the lower court’s judgment contrasting the following two scenarios to explain why the carryover basis provision did not apply in this case.\(^{66}\)

In scenario one, Ichiro donates a personal asset of his to Yoko. Although capital gains are generally taxable under Japan’s *Income Tax Law*, Ichiro’s personal income taxation on the unrealized gains or losses of this asset is deferred rather than triggered at the time of the donation. Yoko becomes the full owner of the asset, and her basis and holding period in respect of the asset are carried over from Ichiro under the carryover basis provision. This mechanism ensures that the deferred gains or losses will be taxed in the person of Yoko on her eventual disposal of the asset.

In scenario two, Ichiro donates his personal asset to Yoko on condition that she immediately repay a personal debt Ichiro owes to a bank. This is the case of an onerous gift. An economic benefit accrues to Ichiro to the extent that he is discharged of his debt to the bank. The capital gains or losses accrued in the donated asset are taxable in Ichiro’s hands because the economic benefit to him (relief from his debt) is consideration provided by Yoko for receiving the asset. Under the *Income Tax Law*, this economic benefit is taxable in Ichiro’s hands as gross income.

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63. See e.g. Supreme Court, 9 September 1997, 44:6 Shomu Geppo 1009. In this case the SCJ interpreted the definition of “spouse” under the *Income Tax Law* as requiring a legally effective marriage under the *Civil Code* and limited the scope of marital deductions accordingly. The policy consequence was that marital deductions under the *Income Tax Law* did not apply to spouses of *de facto* marriages and civil unions. See *Civil Code*, infra note 65.

64. Supreme Court, 19 July 1988, 1290 Hanrei Jiho 56 [*Miyagi*].

65. *Income Tax Law*, supra note 26, art 60(1), no 1; *Minpo* [*Civil Code*], Law No 9 of 21 June 1899, art 549, as last amended by Law No 94 of 11 December 2013 (Japan).

66. Tokyo High Court, 9 September 1987, 38:8-9 Gyoshu 987 at 993.
The lower court noted that in scenario two it would be absurd to apply the carryover basis provision to Yoko. Because the gift was an onerous one, her basis in the asset received should be defined as equal to her acquisition cost, which is the amount of debt she repaid on Ichiro’s behalf. Yoko’s holding period in the asset should also be shorter, starting from the day on which she acquired the asset. Consequently, the lower court reasoned that the concept of a “gift” in the carryover basis provision does not include an onerous gift the economic benefit of which accrues to the donor.

Therefore, while the SCJ’s decisions in Suzuya Kinyu and Kangyo Keizai established the principle of reliance on legal definitions from transplanted areas of law when interpreting tax legislation, the more recent case of Miyagi indicates the courts’ willingness to depart from strict reliance on private law concepts when the tax law result would otherwise be absurd and the context so requires.

III. RESPONSES TO TAX AVOIDANCE

A. LEGISLATIVE BACKGROUND

Japan’s tax law does not have a General Anti-Avoidance Rule,67 and its absence was a deliberate choice in 1962 when the General Law of National Taxes was enacted. The Tax Commission, a policy council to the Prime Minister, suggested creation of a general anti-avoidance provision based on economic substance.68 The Commission’s proposal invited fierce debate and did not find its way into the bill.

Instead, Japan has a number of fairly broad Specific Anti-Avoidance Rules.69 SAARs targeting family corporations date back to 1923, with current rules applying to income tax, corporation tax, inheritance tax, and gift tax.70 Similar SAARs were introduced for corporate reorganizations in 2001 and for

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70. Hojin Zeiboku [Corporation Tax Law], Law No 34 of 31 March 1965, art 132, as last amended by Law No 72 of 18 June 2014 (Japan); Income Tax Law, supra note 26, art 157; Sozoku Zeiboku [Inheritance Tax Law], Law No 73 of 31 March 1950, art 64, as amended by Law No 69 of 13 June 2014 (Japan).
consolidated tax returns in 2002.\textsuperscript{71} The scope of these SAARs is quite broad given that nearly 97 per cent of all corporations incorporated in Japan fall into the category of family corporations.\textsuperscript{72} Moreover, these SAARs provide a potentially broad range for administrative discretion in their application. They function together much like a quasi-GAAR. For example, they provide the NTA with authority to recalculate the amount of tax owed if it finds that the burden of taxes is “unfairly reduced.”\textsuperscript{73} The meaning of “unfairly reduced” has been left to judicial interpretation. Aside from these SAARs, there exist numerous narrowly targeted SAARs, which have tended to proliferate over the years.

Despite the relative breadth and number of SAARs in Japan, there are nevertheless situations in which no SAAR applies. In these cases, the issue arises as to whether the court may engage in an interpretive exercise to deny taxpayers’ attempts at tax avoidance, or if the court must respect private parties’ selection of a particular transactional form despite obvious attempts at tax avoidance. There are decisions pointing both ways.

B. RESPECTING PRIVATE PARTIES’ CHARACTERIZATION OF A TRANSACTION

The SCJ has not made its stance clear on the issue of whether, in the absence of a GAAR, private parties can avoid taxation through selection of a particular transactional form that is outside the scope of the SAARs. At the lower court level, the Tokyo High Court has held that private parties’ characterization of a transaction should be respected. In *Iwase* the court noted that, in the absence of explicit legislative authorization, the NTA may not counter private parties’ tax avoidance efforts by recasting the transactional form selected by the private parties.\textsuperscript{74} Commentators awaited the SCJ’s response, but the SCJ refused to hear

\textsuperscript{71.} See *Corporation Tax Law*, supra note 70, art 132-2, introduced by Law No 6 of 30 March 2001 (this article provides the SAAR for corporate reorganizations); *Corporation Tax Law*, supra note 70, art 132-3, introduced by Law No 79 of 3 July 2002 (this article provides the SAAR for consolidated tax returns). Two SCJ decisions in prominent cases involving the application of the SAAR for corporate reorganizations are pending. See Tokyo High Court, 5 November 2014, LEX/DB 25505180 [*Yahoo*]; Tokyo District Court, 9 May 2014, LEX/DB 25503893 [*Japan IBM*]. In *Yahoo* the High Court decided in favour of the government, whereas in *Japan IBM* the District Court decided in favour of the taxpayer.


\textsuperscript{73.} *Corporation Tax Law*, supra note 70, art 132(1).

\textsuperscript{74.} Tokyo High Court, 21 June 1999, 52 Kosai Minshu 26 [*Iwase*].
the government’s appeal of the Tokyo High Court’s decision in Iwase\(^{25}\) and has not pronounced its opinion on this issue.

A more recent case indicates that the SCJ may also favour strict application of tax statutes. In the Takefuji case, the SCJ permitted the taxpayer’s avoidance of gift tax because the donee was found to have no residence in Japan within the meaning of the Inheritance Tax Law.\(^{76}\) The court rejected the lower court’s determination of facts, which had disregarded the tax planning elements of the scheme, and found that the donee was based in Hong Kong at the time of the gift. Justice Sudo, in a supporting opinion, adopted a strict interpretation of the residence requirement. He denounced the tax planning scheme at issue as being extremely unfair, but opined that the court should not tread into the realm of the legislature. Immediately after the scheme became known to the public (and long before the SJC’s decision), the government amended the gift tax to capture certain non-resident citizens.\(^{77}\)

C. COUNTERING TAX AVOIDANCE

On the other hand, there is a line of SCJ decisions in which the court has invoked creative interpretations of tax statutes to deny taxpayers’ claims. In these cases the court did not grant the NTA a general power to recharacterize transactions at will, but the end result in each case was tantamount to a denial of the taxpayers’ attempts at tax avoidance.

In the Resona Bank case, a Japanese commercial bank was involved in a complicated international transaction to take advantage of its unused foreign tax credit allowance.\(^{78}\) This transaction involved various foreign corporations and was conducted as follows. A New Zealand corporation (A) established a wholly-owned subsidiary (B) in the Cook Islands for the purpose of reducing corporation tax on investment returns from Eurobonds purchased using funds collected from investors. The parent company A also incorporated a tax-exempt subsidiary (C) in the Cook Islands. In order to avoid the application of withholding tax, corporation C initially raised and received the funds from investors and channeled the funds to B. B managed the funds.

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\(^{25}\) Supreme Court, 13 June 2003, 253 Zaimu Sosho Shiryo 9367.

\(^{76}\) Supreme Court, 18 February 2011, 2111 Hanrei Jihō 3 [Takefuji].

\(^{77}\) Sozei Tokubetsu Sochi Ho [Special Tax Measure Law], Law No 26 of 31 March 1957, art 69(2), prior to amendment by Law No 8 of 31 March 2003 (Japan). In 2003, the same rule was incorporated in the Inheritance Tax Law. See Inheritance Tax Law, supra note 70, arts 1-4(2), 2-2(1), as amended by Law No 8 of 31 March 2003 (Japan).

\(^{78}\) Supreme Court, 19 December 2005, 59:10 Minshu 2964, [2005] JPSC 76 (AsianLII) [Resona Bank cited to Minshu].
Under this structure, if C lent the invested funds directly to B (in order for B to purchase the Eurobonds), the interest payments that C received from B in respect of the loan would have been fully subject to a 15 per cent Cook Islands withholding tax. In order to neutralize the effect of this withholding tax liability, B and C entered into an arrangement with the Singapore branch of the Japanese bank, in which the bank made a loan of 50 million American dollars to B at an interest rate of 10.85 per cent annually. B agreed to pay this interest to the bank, minus the applicable 15 per cent Cook Islands withholding tax. C, for its part, agreed to make a deposit with the bank of an amount equal to the total funds lent to B under the loan contract. The bank agreed to return the deposit principal to C to the extent that the bank received repayment of the loan principal from B. Additionally, the bank agreed that when it received an interest payment from B, it would pay interest to C on C's deposit. The interest payments to C were calculated as an amount equal to the interest payment received from B, plus the amount withheld under the Cook Islands withholding tax, minus the bank's service charge.

The result of these transactions was that C effectively avoided payment of the 15 per cent Cook Islands withholding tax on the interest payments it received in relation to its indirect loan of funds to B. The bank initially incurred losses on the transaction, but could eventually profit from the arrangement through benefitting from corporate tax credits in Japan for the foreign tax it paid on behalf of B and C. Thus, in computing its tax owed in Japan for three fiscal years, the bank's position was that the Cook Islands withholding tax it paid under the loan contract was creditable against the amount of corporate tax it should pay in Japan, based on the foreign tax credit mechanism.

The SCJ denied the bank's claim. It first explained that the policy objectives of the foreign tax credit system were to avoid international double taxation of the same income, and to maintain tax neutrality on international business activities. The court then held that the transactions in this case, viewed in their entirety, were structured to avoid taxation in a manner that deviated from these policy objectives. Under the arrangement in question, the Japanese bank took advantage of its unused foreign tax credit allowance. The bank participated in a venture under which it was guaranteed to lose money on a before-tax basis; there was no potential for commercial profit without the after-tax benefit that the bank derived from the foreign tax credit. The court reasoned that allowing the foreign tax credit in this case would constitute an abuse of the foreign tax credit system and would harm equity in taxation. It denied the claim accordingly.\(^\text{79}\)

\(^{79}\) \textit{Ibid} at 2970.
The case involved fiscal years from 1991 to 1993. In 2001, after this case and similar cases were brought to the lower courts, the foreign tax credit provision in the Corporation Tax Law was amended specifically to exclude this type of arrangement.80

Another case in which the SCJ engaged in creative statutory interpretation to deny a taxpayer’s attempts at tax avoidance is Palazzina.81 This case involved a circular transaction structure promoted by Merrill Lynch Capital Markets. A Japanese corporation (X) became a partner in a Nin’in Kumiai (NK) structure, a type of partnership contemplated by the Civil Code and treated as a pass-through entity for taxation purposes.82 The NK structure (B) was formed to fund the purchase and distribution of a film. B agreed to purchase the film from corporation C for consideration of 2.62 billion JPY (a contribution from its partners, including X) plus an additional 6.37 billion JPY (a loan that B obtained from a Dutch bank, E). B granted the global distribution rights for the film to corporation D, and D further granted these rights to corporation E. F produced the film and transferred ownership of it to C prior to B’s purchase of the film from C. The result of this structure was that the film returned home to its original producer after a round trip.

The film was subject to a two-year depreciation allowance under Japan’s Corporation Tax Law.83 X claimed a depreciation allowance corresponding to its pro rata share in B, because B was a pass-through entity in which X was a partner.

The SCJ denied X’s depreciation allowance. The court found that B had substantially lost its right to use, make profits from, and dispose of the film, that B did not bear the risk of defaulting on the loan from E because the loan was guaranteed by another bank, and that the partners in B were indifferent to the success or failure of the film distribution business.84 Taking note of these facts, the court stated that the film in question could not be seen as a source of profit in B’s business and therefore could not be said to be employed in B’s business.

80. Corporation Tax Law, supra note 70, art 69, as amended by Law No 6 of 30 March 2001 (Japan); Hojin Zaiho Shikoryo [Corporation Tax Law Enforcement Order], Cabinet Order No 97 of 31 March 1965, art 141(5), as last amended by Cabinet Order No 318 of 30 September 2014 (Japan).


82. Minpo [Civil Code], supra note 65, art 667. See Masui, “Taxation,” supra note 61 at 150.

83. Corporation Tax Law, supra note 70, art 31(1); Corporation Tax Law Enforcement Order, supra note 80, art 13, no 7; Taiyo Nenshu Shorei [Ministerial Ordinance on the Useful Life of Depreciable Assets], Ministry of Finance Ordinance No 15 of 31 March 1965, last amended by Ministry of Finance Ordinance No 55 of 9 July 2014 (Japan).

84. Palazzina, supra note 81 at 256.
The court concluded that the film did not qualify as a depreciable asset within the meaning of the depreciation provision of the *Corporation Tax Law*. The fiscal years litigated in this case were from 1988 to 1992. In 2005, an at-risk limitation on the depreciation allowance deduction was enacted for corporate taxpayers that invest in NK structures.

*Obunsha Holding* is a third example of a case in which the SCJ denied a taxpayer’s attempt at tax avoidance based on a creative interpretation of the *Corporation Tax Law*. This case was an episode in the aftermath of the fierce battle over control of TV Asahi. A Dutch company (S) was a wholly owned subsidiary of Obunsha Holding Co., a Japanese corporation. S issued new shares to another related foreign corporation (A). The shares were issued for a consideration exceeding below fair market value, thus diluting the value of the old shares.

The NTA found that X transferred economic benefits to A through this transaction. The tax authority therefore increased X’s taxable income by an amount equal to those economic benefits, relying upon the basic income computation provision of the *Corporation Tax Law* and a SAAR that disallows actions of family corporations that would unfairly reduce corporate tax payable.

The SCJ held in favour of the government with respect to the application of the basic income computation provision. According to the court, X transferred a clear economic value to A. The transfer of value did not arise out of external factors beyond X’s control, but was intended by X and agreed to by A. Accordingly, the court held that this transfer fell within the meaning of “other transactions” in the context of the basic income computation provision, which provides that

[i]n computing taxable income for each accounting period of a domestic corporation, the amount to be included in gross revenue in the accounting period shall, unless otherwise provided, be the amount of revenue in the said accounting period from sale of assets, onerous or gratuitous transfer of assets, or rendering of services, or gratuitous acquisition of assets, and other transactions other than capital transactions.

In adopting a rather expansive interpretation of the term “other transactions,” the court denied X’s effort to shift income to a foreign entity. It is interesting that the court’s reasoning was based on a relatively broad interpretation of the basic

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85. *Ibid*.
86. Supreme Court, 24 January 2006, 1923 Hanrei Jiho 20 [*Obunsha Holding*].
89. *Obunsha Holding*, supra note 86 at 23.
90. *Corporation Tax Law*, supra note 70, art 22(2) [emphasis added] [translated by author].
income computation provision rather than a recharacterization of the transaction at issue, given the potential applicability of a SAAR in this case. For example, X’s share value in S decreased as a result of the transaction. X lost a corresponding economic value, while A gained a benefit of the same amount. This transaction could be recharacterized as one in which X made a capital contribution to S, and S made a dividend payment to A. An alternate recharacterization could include the private foundation (E) that held shares in both A and X. Under this recharacterization, X made a dividend payment to E and E made a capital contribution to A. The court did not venture to recast the transaction in either of these ways, however. Instead, the court read the words “other transactions” in the basic income computation provision rather expansively. In this manner, the court prevented income shifting from a domestic corporation to a foreign entity.

IV. CONCLUSION

This article has characterized the Supreme Court of Japan’s approach to the interpretation of tax legislation as a literal approach that nonetheless has due regard to the objective and purpose of the statutory provisions at issue in a given case. SCJ justices sometimes interpret the wording of tax statutes narrowly, and sometimes they interpret it expansively. Their literal interpretation is often supported by teleological interpretation. As a general principle, SCJ justices interpret transplanted categories of private law concepts in tax statutes without modification, but deviate from strict reliance on private law meanings when the context so requires. The article also shows that judicial responses to tax avoidance in Japan have been rather restrained, although recent decisions have invoked creative interpretation of tax statutes to reject abusive tax avoidance schemes. As many of these cases worked their way through the courts, legislative amendments were enacted to deny the future efficacy of the very tax avoidance schemes at issue. Overall, Japanese judges play a significant role in the tax law-making process.