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The Japanese Tax System: Due Process and the Taxpayer

Tadao Okamura†

In this article, Professor Okamura addresses several issues concerning the structural organization of Japanese tax law. First, he examines the tensions resulting from the power struggle between the Diet's constitutionally enacted tax law and the tax authority's administratively implemented rules. Professor Okamura examines the conflicting roles of these two bodies, and demonstrates the consequences of this conflict to corporations subject to Japanese taxation.

Second, Professor Okamura addresses the tax authority's attempt to increase its power by manipulating Japanese law. He questions the discretionary limit of the tax authority's ability to recharacterize a taxpayer's formulation in an effort to prevent taxpayers from escaping statutory taxing conditions. Professor Okamura shows that the tax authority also attempts to create new conditions by reinterpreting the Corporate Tax Act in order to deny international tax avoidance.

Third, Professor Okamura addresses the relative scope of the power of the Diet and the tax authority. He illustrates the significance of the struggle between these two bodies by examining the deductibility of business expenses. Fourth, Professor Okamura questions the constitutionality of measures attempting to reconcile the divergent actions taken by these two bodies.

I.

INTRODUCTION

In Japan, a constant tension exists between the tax authority and the legislative law which controls tax administration. Within the legislative realm, an additional source of tension exists between the laws created by the Diet¹ and the Japanese Constitution. Within the context of due process in tax law, this article discusses three problems in which these tensions are most evident: (1) the tax authority's use of circulars to alter legislated tax law (Circular Taxation), (2) the tax authority's recharacterization of taxpayers' transactions to prevent tax avoidance (Denial of Tax Avoidance), and (3) the

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1. The Diet creates the law, the courts interpret the law, and the tax authority enforces it.

Diet's refusal to permit the deduction of employee business expenses. All three of these problems share a common concern: In what way and to what extent are the tax authority and the Diet bound by the rule of tax law and the Constitution?

First, this paper will address the issue of determining the overall framework of the Japanese tax law, including the sources of the tax law. In spite of the constitutional requirement that tax law be enacted by the Diet, the tax authority frequently attempts to implement its own self-made rules.

Second, this paper will address tax avoidance, or whether, and in what ways, taxpayers can manipulate legal formulations in order to escape the statutory tax conditions. Throughout this discussion, this paper will examine the tax authority's discretion to interpret tax laws and its ability to create new taxing conditions in order to deny tax avoidance. This paper will also analyze how the tax authority manipulates the law to prevent tax avoidance through non-arm's-length transactions when using Corporate Tax Act Article 22.

Third, this paper will discuss the methods of taxing employment income. In particular, it will address the non-deductibility of employee business expenses. After describing the Japanese individual income tax system, this paper will examine a case in which a professor challenged the non-deductibility of employee business expenses based upon arguments of unconstitutional discrimination against employees.

A central question to all three issues is how the Diet is bound by the Constitution when enacting tax law.

II.

SOURCES OF TAX LAW AND CIRCULAR TAXATION

This section will focus on the sources of tax law. It will first explore who has the authority to create the tax laws so that the law is valid and binding on taxpayers. Then, this section will examine problems caused by substantive rules promulgated by the National Tax Administration Agency. These rules, which are not based on tax law, are called "circular taxation." Circular taxation illustrates the way in which the tax authority exercises its rule-making power without a legal mandate and the effects of the resulting administrative rules.

A. Sources of Tax Law

Statutes, treaties, administrative rules and possibly case law constitute the sources from which Japan's tax law is derived. The authority to tax originates in the Diet's power to enact statutes. Articles 30 and 84 of the

Japanese Constitution state that taxes shall be imposed by statutes,² and Article 41 of the Constitution grants the Diet exclusive power to enact such statutes.³ The power of the Diet to tax through the enactment of statutes⁴ embodies the democratic notion of "no taxation without representation."

Although statutes are the main source of authority in Japanese tax law,⁵ treaties⁶ are another potential source of tax law. Because the Japanese Constitution requires that treaties be approved by both the House of Councilors and the House of Representatives,⁷ treaties and statutes are equally legitimate sources of law. Nevertheless, most commentators think that, under Article 98 of the Constitution, treaties are superior to statutory law.⁸

In addition to rules made or approved by the Diet, administrative rules are also binding on taxpayers. These administrative rules include Enforcement Orders (*Shikōrei*) promulgated by the Cabinet and Ministerial Ordinances (*Syōrei*) promulgated by the Ministry of Finance. While some of these orders and ordinances concern only taxation procedure and are enacted under the general rule-making power of the Cabinet provided by the Constitution,⁹ most of these orders and ordinances are substantive rules. The promulgation of substantive Cabinet Orders or Ministerial Ordinances is permitted only when the statute explicitly delegates rule-making power to the Cabinet or the Ministry. Orders cannot be made which are inconsistent with

2. "The people shall be liable to taxation as provided by law." KENPŌ [Constitution] art. XXX (Japan).

"No new taxes shall be imposed or existing ones modified except by law or under such conditions as law may prescribe." *Id.* art. LXXXIV.

"Under such conditions as law may prescribe" has been interpreted to refer to Cabinet Orders and Ministerial Ordinances as discussed below.

3. "The Diet shall be the highest organ of state power, and shall be the sole lawmaking organ of the State." *Id.* art. XLI.

4. This ability is referred to as "the principle of taxation through statutes" (*Sozei Hōritsu Shugi*).

5. See, e.g., Shotoku Zeihō [Income Tax Act], Law No. 33, 1965 (as amended 1993); Hōjin Zeihō [Corporate Tax Act], Law No. 34, 1965 (as amended 1993); Sōzoku Zeihō [Inheritance Tax Act], Law No. 73, 1950 (as amended 1992).

In addition to these statutes there is a very important law named the Sozei Tokubetsu Sochihō [Special Taxation Measures Act], Law No. 26, 1957 (as amended 1993). This Act provides many exceptions to the above Acts, including withholding of interest income, accelerated depreciation, and special measurements for capital gains. These provisions are generally favorable to taxpayers, especially rich individuals and large corporations, because the purpose of this law is to promote savings and the accumulation of capital. Indeed, before the oil shock there were many more favorable provisions in this law, but they have since been repealed or simplified. More recently, transfer-pricing rules and anti-tax-haven base company provisions were codified in this law. These anti-avoidance provisions are of course not favorable to taxpayers.

6. Tax treaties are mainly aimed at avoiding international double taxation, and they ordinarily do not increase tax liabilities determined by domestic law.

7. KENPŌ [Constitution] arts. XLII; LVI, ¶ 2; LX, ¶ 2; LXI; LXXIII, ¶ 4 (Japan).

8. This is a common interpretation of the constitutional provision which states that "the treaties concluded by Japan and established laws of nations shall be faithfully observed." *Id.* art. LXXXVIII, ¶ 2. Japan had concluded tax treaties with 38 countries by 1992. The United States is a party to 39 income tax treaties.

9. The Cabinet has the power "to enact cabinet orders in order to execute the provisions . . . of the law." *Id.* art. LXXIII, ¶ 7.

existing statutes. Furthermore, the delegation by statute must be specific, not general.

In addition to these methods, most commentators agree that case law should also be included as a source of tax law. The commentators who disagree with this premise stress that a court's decision deals with an actual, concrete problem, and the legal effect of the decision is limited to that specific case. Moreover, they suggest that even if the court's decision yields some abstract legal statement, the scope of its application is so unclear that taxpayers cannot predict future applications by the court. Thus, they argue that principles derived from case law should not be universally applicable since the tax law should be definite and foreseeable.

On the other hand, when courts continue to rule the same way in similar situations, taxpayers and the tax authority are presented with a definite and foreseeable result. Taxpayers and the tax authority have no choice but to follow these rulings. These established court rulings effectively bind taxpayers as well as the tax authorities. Thus, case law is a source of law to the extent that the cases present an "established" rule.¹⁰

B. Circular Taxation

In contrast, the National Tax Administration Agency (NTA or *Kokuzeichō*), the tax authority of Japan, often promulgates substantive rules called "circulars" (*Tsūtatsu*). In the practice of tax law, circulars are very important because they contain concrete interpretations of statutes or orders by the tax authority. Although these rules are made without explicit statutory authority, the NTA is allowed to make such rules because these circulars are aimed not at taxpayers but at the personnel of the NTA. In other words, the Commissioner of the NTA issues orders, in the form of circulars, which instruct its personnel about the interpretation or application of a statute, Cabinet Order, or Ministerial Ordinance at issue.¹¹ Thus, circulars appear to be legally effective only within the Agency. Taxpayers are not legally bound by circular rules, because they are not passed by a tax authority. The circulars are not a source of tax law because they are merely interpretations of that law.¹² However, because the personnel of the NTA are subordinate to the Commissioner and must follow her orders, taxpayers are eventually subject to this "Commissioner-made law," albeit in an indirect manner. This phenomenon is called "circular taxation."

Because circulars are not included as a source of the law, they have limited legal effect. Since the NTA does not have the power to promulgate tax

10. Note also that in Japan lower courts are not bound by the decisions of upper courts.

11. The technical definition of a circular in Japanese administrative law is the documented order or regulation of a superior agency to subordinate agencies concerned. They are published in the official gazette (*Kanpō*), which is similar to the Federal Register in the United States.

12. The Supreme Court has made this clear. See Judgment of Dec. 24, 1963, Saikōsai [Supreme Court], 10:2 *Shōmu Geppō* 381, 389 (Japan).

laws, the circular is not binding on the courts.¹³ From the viewpoint of the courts, the circular is just one possible interpretation of the statutes. If a taxpayer's interpretation is more reasonable than that of the Commissioner's circular, the taxpayer will prevail in the court.¹⁴

Consider, for example, a circular that contradicts the law (statutes or Cabinet Orders). If it is disadvantageous to the taxpayer, the taxpayer can challenge the assessment in court, and the court will invalidate any assessments based on that circular as the assessments are per se illegal. The court judges the assessment itself without regard to the circulars because the circulars are not binding on the court.¹⁵

What if the circular contradicts the law but is advantageous to the taxpayer? Indeed, a famous circular¹⁶ states that fringe benefits in the form of interest-free loans with imputed interest not exceeding ¥5,000 are tax-free. This circular was promulgated to reduce administrative costs, but is not supported by any code section that states that such fringe benefits are tax-free. Despite the circular, the Commissioner has no discretion to exempt certain kinds of income from taxation.¹⁷ The circular is illegal, but as may be imagined, no taxpayer who benefits from this circular has challenged it. It is impossible for taxpayers who do not benefit from it to challenge it, because courts do not recognize their standing.¹⁸ As a result this circular still exists.

A conflict would exist if the NTA attempted to repeal this circular, especially retroactively. A majority of scholars would consider the content of the circular to have become customary law. Because customary law is a source of tax law, the content of the circular would be considered valid tax law which can only be changed by the Diet and not by the Commissioner.

13. Before bringing an action in court, taxpayers should first appeal the case to the agency which took the original action and then file a request for reconsideration with the National Tax Tribunal. The agency is of course bound by circulars. The National Tax Tribunal can make decisions contrary to a circular, but to do so is very unusual and the permission of the Commissioner is required. Kokuzei Tsūsokuhō [National Tax General Rules Act], arts. 99, 100, Law No. 66, 1962 (as amended 1991).

14. One important point here is that the Ministry of Finance and the National Tax Administration Agency have no discretion over the interpretation of law under the principle of taxation through statutes.

15. In Japan it is impossible to challenge the circular itself. The object of an administrative lawsuit must be a concrete administrative action. See Gyōsei Jiken Soshōhō [Administrative Litigation Act], art. 3, Law No. 139, 1962. If an illegal circular is disadvantageous to the taxpayer, the tax authority cannot argue that the circular has become customary law or claim that it should be applicable for the purpose of the equal treatment of taxpayers.

16. Kokuzzeichō Shotokuzei Kihon Tsūtatsu [National Tax Agency Income Tax Basic Circular] No. 36-28 (1970) (Japan).

17. This is said to be an important aspect of the principle of taxation through statutes. See Judgment of Apr. 18, 1950, Fukuoka Chisai [District Court], 1:4 Gyōshū 581, 589 (Japan).

18. There are two reasons why other general taxpayers cannot challenge this circular. First, the object of an administrative lawsuit must be a concrete administrative action, not a general rule. Second, even if taxpayers were to challenge a concrete administrative action exempting some fringe benefits, their disadvantage is too indirect and small to give them legal standing.

However, some controversy exists as to whether there can be customary tax law. Stressing the exclusive power of the Diet to make tax law, some commentators do not recognize any customary law.¹⁹ If customary law is not recognized, then taxpayers who have calculated their taxes in reliance on the circular would have to pay deficiency and penalty taxes should the NTA repeal the circular.

It can be argued that the taxpayer's reliance on the circular should be protected, at least in some circumstances. In other words, the tax authority should not freely change the position stated in the circular. In some situations, namely those involving the principle of estoppel, the tax authority should be forced to follow the circular. The principle of estoppel has been recognized by the Tokyo District Court,²⁰ but the court has strictly limited its application. It is difficult to predict when the taxpayer's reliance on the circular would be protected.

An interesting situation arises when a taxpayer files her return in reliance on a circular which is inconsistent with the statute and where the circular has not yet become customary law. When a tax official later assesses the return based on the statute rather than the circular, one may contend that the taxpayer's reliance on the circular should be protected. At the same time, the content of the return violates the statute. Should protection of the taxpayer's reliance have precedence over statutory law? An answer to this question cannot be derived from case law or other sources of law, but equity requires that the statute should prevail.

A third problem arises if and when the tax authority makes an assessment on only one of those taxpayers who are not following the law. That assessment constitutes a discriminatory enforcement of law, violating Article 14 of the Constitution, which guarantees equal treatment under the law.²¹ For example, consider the situation where the circular at issue is illegal, and the tax authority legally (by refusing to follow the illegal circular) assessed only one taxpayer. Some courts have held that the assessment was unconsti-

19. The Supreme Court refused to recognize customary law in the field of taxation, stating that even if the tax authority had treated "pachinko" (betting) machines as non-taxable products for many years under the commodity tax law, it could subsequently override this treatment by issuing a circular, because the circular was not in conflict with any statute and assessment under the circular was thereby a proper enforcement of the law. Judgment of Mar. 28, 1958, Saikōsai [Supreme Court], 12:4 Minshū 624, 626 (Japan).

20. Judgment of May 26, 1965, Tokyo Chisai [District Court], 16:6 Gyōsū 1033, 1041-42 (Japan). In this case the tax authority expressed its position not in a circular but in another form, such as within an audit or consultation.

21. "All of the people are equal under the law and there shall be no discrimination in political, economic or social relations because of race, creed, sex, social status or family origin." KENPŌ [Constitution] art. XIV, ¶ 1 (Japan). The Supreme Court has further held that "political, economic or social relations because of race, creed, sex, social status or family origin" represents an exemplification, rather than a limitation. Judgment of Apr. 4, 1973, Saikōsai [Supreme Court], 27:3 Keishū 265, 266 (Japan).

tutional although consistent with the legislative law.²² The reasoning behind these decisions is that nullification of an assessment on the grounds of equal treatment under the law is much more acceptable than nullification on the grounds of estoppel. The former is expressly provided for in the Constitution, while the latter is not.

The above analysis of circular taxation demonstrates the way in which the tax authority exercises its rule-making power without a delegation of authority by law. These rules have no direct legal effect on taxpayers and do not bind the courts. Therefore if the circulars are disadvantageous to taxpayers, the taxpayers can challenge the assessments because the circular is not based on law. However, taxpayers may claim the benefits derived from favorable circulars, given the concepts of customary law, estoppel, and equal treatment under the law.

III.

TAX AVOIDANCE AND NON-ARM'S-LENGTH TRANSACTIONS

This section will first discuss what tax avoidance is and when tax avoidance is legal. Then the section will discuss the differences among tax avoidance, tax evasion, tax fraud, and tax savings. This section will also discuss anti-avoidance provisions and non-arm's-length transactions.

A. Tax Avoidance

The concept of tax avoidance came to Japan from Germany, like many other concepts in tax law and administrative law. In German, tax avoidance is called "Steuerungumgehung." "Steuerungumgehung" can be illustrated best by a typical example often cited in German textbooks.

Ancient German real estate acquisition tax law provided that if real estate was transferred between a parent and his or her child, the transferee was not subject to the tax. Using this provision, a sister could transfer Blackacre to her brother without paying real estate acquisition tax, by first transferring it to one of her parents, and then from this parent to her brother.²³

German commentators defined this tax avoidance in terms of the following three elements: (1) the taxpayer chooses an unusual legal formulation, instead of the normal or ordinary one which tax law expects the taxpayer to choose to conduct her economic transaction; (2) the taxpayer achieves basically the same economic results as if she conducted the transaction in the normal legal formulation; and (3) the taxpayer reduces or removes the tax liabilities which are connected to the normal legal formulation.²⁴

22. See, e.g., Judgment of Sept. 30, 1969, Osaka Kōsai [High Court], 22:5 Kōminshū 682, 699 (Japan).

23. This is an actual case. See *Steuer und Wirtschaft* Sp. 238 (Nr. 138) (1922).

24. German law once codified these elements. See ENNO BECKER, *DIE REICHSABGABE-NORDNUNG* 19-27 (1922).

Generally, tax avoidance is the reduction of tax liability by preventing the satisfaction of the required tax condition (*tatbestand der Besteuerung*). The taxing conditions are connected to the legal formulation of civil law. Taxpayers are able to reduce their tax liability by choosing an unusual legal formulation which is not covered by the existing tax condition, while achieving the desired economic result.

Tax avoidance comes into question because it concerns equity between taxpayers. Tax avoidance is unjust because it violates the principle of fairness or equity in taxation, which requires that taxpayers in the same economic situation be taxed similarly.

One question to consider in defining what actions constitute tax avoidance is whether the intent of the taxpayer is relevant. If the taxpayer has no intent to avoid tax or if there is a good reason to choose an unusual legal formulation, then should the taxpayer's actions be considered tax avoidance? If these actions should not be considered tax avoidance, then the intent to avoid tax should be included.

In reality, the taxpayer's intent is irrelevant. Only the economic result is relevant to the definition of tax avoidance. This is because both avoidance with and without the intent violate the principle of fairness or equity in taxation, which requires that taxpayers in the same economic situation or achieving the same economic results be taxed equally.

B. Tax Evasion

Tax evasion is distinguishable from tax avoidance. Tax evasion (*Steuerhinterziehung*) is a failure to pay the tax due. In other words, in tax evasion the conduct of the taxpayer has met the taxing condition, and the tax liability has accrued, but the taxpayer does not discharge the tax liability. The difference between evasion and avoidance is that in tax evasion, the taxing condition is satisfied and the tax liability has accrued, while in tax avoidance the taxing condition has not been satisfied.

In determining satisfaction of taxing conditions, fictitious conduct by a taxpayer is meaningless. The fictitious conduct does not determine which legal formulation is applicable²⁵ and has no legal or economic effect. According to the Civil Law Act,²⁶ the party's intent creates the actual legal formulation. Even if a taxpayer attempts to conceal the true nature of the transaction through fictitious conduct, the civil law disregards the fictitious conduct and creates the legal formulation according to the actual nature of the transaction and its economic effects. For example, if a taxpayer transfers her property to a third party in order to avoid its attachment under a secret agreement with the third party, then the actual ownership in the property will not change. The transfer of the property is ignored in civil law in accordance with the

25. MINPŌ [Civil Law Act], art. 94, ¶1, Law No. 89, 1896 (as amended 1991) (Japan).

26. *Id.*

actual intent of the parties. Therefore there is no realization of a gain on the property.

In tax evasion, taxpayers usually try to conceal the actual legal formulation which satisfies the taxing condition through deceitful conduct. False documentation of a contract which understates the consideration is one example. In tax avoidance, taxpayers choose an unusual legal formulation, which does not satisfy the taxing condition without intending to deceive. For example, if the actual consideration is set below fair market value in order to reduce tax liability, but no documents are falsified, there is no deceit. Since there is no deceit, there is no tax evasion.

When tax evasion is discovered, it is almost always subject to an administrative penalty, that is, a tax penalty assessed by the tax authority without any court decision. Two tax penalties, which are called "additional taxes," can be assessed against the taxpayer. When the taxpayer files a timely return,²⁷ the tax authority can assess a penalty of up to 10% on the amended return.²⁸ This is called "short return additional tax." When the taxpayer does not file the original return by the due date, the tax authority can assess a penalty of up to 15%.²⁹ This is called "no return additional tax."

C. Tax Fraud

Tax fraud is defined as a deliberate act in which the taxpayer intentionally conceals or disguises facts that satisfy the taxing condition (i.e., tax evasion by intentional concealment or disguise of facts). Tax fraud is subject to both a judicially determined criminal penalty³⁰ and an administrative penalty. Administrative tax penalties consist of a timely 35% increase where the taxpayer files the return and a 40% increase where the taxpayer does not file one original return by the due date. These increased administrative penalties are called "heavy additional taxes."³¹

27. The deadline to file a return is March 15 in the case of individuals, and two months after the end of the fiscal year in the case of corporations.

28. Kokuzei Tsūsokuhō [National Tax General Rules Act], art. 65, Law No. 66, 1962 (as amended 1992).

29. *Id.* art. 66. If the taxpayer voluntarily files the return after the due date, the rate is reduced to 5%.

30. The judicial penalty is:

- 1) imprisonment for a term not exceeding 5 years; or
- 2) a fine not exceeding ¥5,000,000 or the amount of the fraud, whichever is larger; or
- 3) both 1 and 2 above.

Shotoku Zeihō [Income Tax Act], art. 238, Law No. 33, 1965 (as amended 1993); Hōjin Zeihō [Corporate Tax Act], art. 159, Law No. 34, 1965 (as amended 1993); Sōzoku Zeihō [Inheritance Tax Act], art. 68, Law No. 73, 1950 (as amended 1992).

31. Kokuzei Tsūsokuhō [National Tax General Rules Act], art. 68. Failure to file a return (as opposed to concealing or disguising facts) is not considered tax fraud. But a taxpayer who fails to file may be subject to other penalties, i.e., imprisonment for a term not exceeding one year

D. Tax Savings

Tax savings (*Steuersparung*) are savings allowed by law. For example, when Blackacre is transferred from the daughter to her father, the removal of the tax liability is a tax savings that the law allowed and intended to give to the taxpayer.

However, what if the father lends Blackacre to his son for a long time? Does this two-stage transaction (the transfer of Blackacre from the daughter to the father and its extended loan from the father to the son) achieve “basically the same economic result”³² as the direct transfer from the daughter to the son? Sometimes the distinction between avoidance and savings is unclear. In this case, because the similarity of the result is not very clear, the distinction is difficult to discern.

E. Anti-Avoidance Provision

How can the tax authority prevent tax avoidance? First, the tax authority can amend the provision, which effectively enacts a new taxing condition covering the tax-avoiding legal formulation at issue. Then, the tax avoidance disappears. In our example, the legislature can enact a provision specifying that real estate transferred to a child immediately after acquisition from another child is subject to tax. This provision creates a new taxing condition and solves the tax avoidance problem. One problem with this method is that the legislature cannot anticipate every unusual legal formulation. Thus, this method requires the legislature to attempt to cope with new forms of avoidance as they arise. Since tax lawyers will always devise new methods to avoid tax, the law will be in constant flux. Further, the constant amendment of the law to counter these new formulations will make the tax law very complex, difficult, and costly to administer.

A second method of preventing tax avoidance is to have the legislature enact an anti-avoidance provision. Through such a provision, the legislature delegates a general and broad power to the tax authority to “deny” or prohibit tax avoidance.³³ The legislature enacted such a provision in 1923, but

or a fine not exceeding ¥200,000. See, e.g., Shotoku Zeihō [Income Tax Act], art. 241; Hōjin Zeihō [Corporate Tax Act], art. 160; Sōzoku Zeihō [Inheritance Tax Act], art. 69.

Nor does it constitute tax fraud if the taxpayer makes a false reply or no reply to a tax auditor, or if he refuses or disturbs an audit. But such actions are subject to other penalties, i.e., imprisonment for a term not exceeding one year or a fine not exceeding ¥200,000. Shotoku Zeihō [Income Tax Act], art. 242, ¶¶ 8, 9; Hōjin Zeihō [Corporate Tax Act], art. 162, ¶¶ 2, 3; Sōzoku Zeihō [Inheritance Tax Act], art. 70, ¶¶ 2, 5.

32. See *supra* note 26 and accompanying text.

33. The most common provision is ABGABENORDNUNG [AO] art. 42 (F.R.G.), of Germany, which provides: “The application of tax law cannot be avoided through the abuse of the possibility of legal construction. When there is abuse, the tax liability should accrue as if the legal construction proper to the economic conduct were adopted.” *Id.*

its application is limited to domestic³⁴ family³⁵ corporations. This provision is codified in the Corporate Tax Act, the Income Tax Act, and the Inheritance Tax Act.³⁶ Under these provisions, when a domestic family corporation carries out transactions or computes income in such a way as to improperly reduce tax liability, the district director can deny that transaction or computation, and "recompute" the amount of income, loss, or tax.

Although denial provisions authorize the district director to "recompute" the amount of tax liability, how should the amount of the liability be computed? In the example of Blackacre, the answer is intuitive. The son will be taxed as if he acquired Blackacre directly from his sister. This recharacterization of the transaction will satisfy taxing conditions. In other words, the son will be taxed because the unusual transaction will be denied and recharacterized. In this example, recharacterizing the transaction denies tax avoidance although the technical conditions of the statute are not met.

This type of taxation, i.e., the denial of tax avoidance, is based on a hypothetical reformulation by the agency.³⁷ Since in principle tax law connects tax liability to the actual formulation chosen by the taxpayer, taxation on the basis of the hypothetical formulation is an exception to this principle. In other words, the denial of tax avoidance through the hypothetical formulation amounts to the tax authority making new tax law, that is, a new taxing condition which covers the taxpayer's actual unusual formulation at issue.

34. A domestic corporation is a corporation which has its head office or principal place of business in Japan. Shotoku Zeihō [Income Tax Act], art. 2, ¶ 6; Hōjin Zeihō [Corporate Tax Act], art. 2, ¶ 3; Sōzoku Zeihō [Inheritance Tax Act], art. 68.

35. The term "family" corporation is defined as a corporation, 50% or more of the capital of which is owned by one, two, or three shareholders. Hōjin Zeihō [Corporate Tax Act], art. 2, ¶ 10; Hōjin Zeihō Shikōrei [Corporate Tax Act Enforcement Order], art. 4, Cabinet Ordinance No. 97, 1970 (Japan). Therefore a subsidiary is always a family corporation. In counting up the number of shareholders, there are very broad attribution rules under which the shares of the following persons who have a special connection with the shareholder are attributed to, i.e., deemed to be held by, that shareholder:

1. Relatives.
2. A de facto spouse.
3. Employees.
4. Individuals who are economically supported.
5. Relatives of group 2, 3, or 4 above living with the shareholder.
6. Any corporation where 50% or more of the stock is owned by the shareholder or groups 1 to 5 above.
7. Any corporation where 50% or more of the stock is owned by the shareholder and the corporation is classified as 6 above.
8. Any corporation where 50% or more of the stock is owned by the shareholder and the corporation is classified as 6 and 7 above.

Note that by virtue of this attribution rule, almost all related corporations are classified in the family corporation and subject to this provision.

36. Hōjin Zeihō [Corporate Tax Act], art. 132; Shotoku Zeihō [Income Tax Act], art. 157; Sōzoku Zeihō [Inheritance Tax Act], art. 64. The statute providing general tax rules for local governments also has a similar provision. Chihō Zeihō [Local Tax Act], art. 72-43, Law No. 226, 1950 (as amended 1993) (Japan).

37. However, of course the tax authority cannot nullify the taxpayer's actual transaction or its effects in the field of civil law, or in the real world. It just denies it in the field of tax law.

Since the Diet has the exclusive power to promulgate statutory taxing conditions, characterizing a transaction to deny tax avoidance creates tension between the tax authority and the Diet. Because of this tension, most commentators suggest that the tax authority cannot deny tax avoidance without a special statutory provision empowering it to do so,³⁸ since to do so would infringe on the exclusive law-making power of the Diet.³⁹ For example, for non-family corporations and foreign corporations, some believe that the tax authority should not deny tax avoidance. Lower court decisions are divided.⁴⁰ The Supreme Court has not decided the issue, but has said that anti-avoidance provisions, in general, are constitutional.

Nevertheless, some commentators doubt the constitutionality of the anti-avoidance provisions because these provisions delegate very broad power to the tax authority. The administrative agency can only make taxing conditions in the form of Cabinet Orders or Ministry Orders when the Diet specifically delegates limited rule-making power to it. These commentators argue that the wording of the provision "reducing tax liability improperly" allows the tax authority to set up taxing conditions although in principle it should have no discretion.⁴¹ They also argue that the power delegated by the anti-avoidance provision does not clearly delineate what kind of transaction or computation of income the tax authority can deny.

Another constitutional problem is that only family corporations are subject to the anti-avoidance provision. Hence, it appears to discriminate against family corporations and would therefore be unconstitutional under Article 14, which guarantees equal treatment under the law.⁴² The Tokyo High Court stated that the anti-avoidance provision was not discriminatory or unconstitutional because family corporations, which are controlled by a few interests, are much more likely to formulate transactions in an unusual manner in order to reduce tax liability.⁴³ The Court also noted that it was not unreasonable for the Diet to pay special attention to this kind of tax avoidance in order to maintain equity in taxation.⁴⁴

Although the courts have justified the anti-avoidance provision, it is more desirable to have the Diet make new statutory taxing conditions because of planning and consistency considerations. The Diet has passed new statutes

38. See, e.g., KEIJI KIYONAGA, *ZEIHŌ* [TAX LAW] 45 (rev. ed. 1990); HIROSHI KANEKO, *SOZEIHŌ* [TAX LAW] 117 (4th ed. 1992).

39. See *supra* note 5 and accompanying text.

40. See, e.g., Judgment of Apr. 25, 1972, Tokyo Kōsai [High Court], 22:4 Gyōshū, 238, 240 (Japan) (holding that the tax authority could not deny avoidance without an empowering provision). *But see* Judgment of Sep. 24, 1964, Osaka Kōsai [High Court], 15:9 Gyōshū 1716, 1725 (Japan) (holding to the contrary).

41. See, e.g., HIROSHA KITANO, *ZEIHŌGAKU GENRON* [PRINCIPLES OF TAX LAW] 184-85 (3d. ed. 1992).

42. See KENPŌ [Constitution] art. XIV, ¶ 1 (Japan).

43. Judgment of Nov. 30, 1978, Tokyo Kōsai [High Court], 25:4 Shōmu Geppō 1145 (Japan), *aff'g* Judgment of July 20, 1976, Chisai [District Court], 22:11 Shōmu Geppō 2621, 2630 (Japan).

44. *Id.*

to remedy tax avoidance. For example, before 1964 several types of tax avoidance schemes, such as interest-free loans or the payment of excessive salaries to the director-shareholder, were listed in a circular under the general anti-avoidance statutory provision in order to prevent misuse of these devices. Subsequently, most of the transactions listed in that circular were codified in the Fundamental Tax Reform of 1964.

Thus, the Diet has enacted new statutory taxing conditions to deal with tax avoidance. Because prevention of tax avoidance is a principal objective of the Diet, it should enact new taxing conditions to make the abusive legal formulations subject to tax. Furthermore, if there is neither a taxing provision nor an anti-avoidance provision, the tax authority should not assume the authority to deny the avoidance, however unusual the formulation.⁴⁵ This means the unusual legal formulation is recognized and permitted by the tax law. The maxim of tax law that taxpayers may arrange their economic affairs in the manner they deem most beneficial for them prevails in Japan as well as in the United States.

However, the accretion of income should be considered when scrutinizing a transaction because the Japanese income tax system is comprehensive. Income from all sources is subject to tax. Under this concept, if the taxpayer achieves the same economic result or economic benefits as in the normal formulation, the amount of the income accrued to the taxpayer should be the same regardless of the form the taxpayer chooses. In other words, the definition of income is so comprehensive that there is very little that is not covered by it.

F. Non-Arm's-Length Transactions and Corporate Tax Act Article 22

This subsection discusses tax avoidance, would-be avoidance through non-arm's-length transactions,⁴⁶ and anti-avoidance provisions against those transactions. In addition, it will examine how Article 22 of the Japanese Corporate Tax Act works against transactions.

Non-arm's-length transactions are most often used in international trading.⁴⁷ In order to prevent international tax avoidance, the legislatures of

45. KIYONAGA, *supra* note 38, at 45.

46. The words "arm's-length" indicate that there is a proper distance between the parties to the transaction. It means that the parties are independent of each other, and therefore that the conditions of the transaction, especially the consideration offered by each party, are those which independent parties would set up. In this article the arm's-length price means the fair market value.

47. For example, assume that *A* is a U.S. manufacturing corporation, *B* is a German sales company, and *C* is a "base company" established in some tax haven just as a paper company. Assume the cost of the product per unit in the hands of *A* is \$100 and the sales price by *B* in Germany is \$200. The profits from the sales of the products can be shifted to *C* in the tax haven using a non-arm's-length transaction. *A* sells it to *C* for \$101 and *C* sells it to *B* for \$199, and they will pay almost no tax either to the United States or to Germany.

most developed countries have enacted transfer-pricing regulations.⁴⁸ These rules regulate the price charged between related corporations. For example, section 482 of the Internal Revenue Code (I.R.C.) allows the Internal Revenue Service (I.R.S.) to allocate income or deductions between related parties according to the arm's-length standard.⁴⁹ The United States has had this provision since 1928. Germany enacted a transfer-pricing regulation in 1972, but its application is limited to international transactions.⁵⁰ Japan enacted a transfer-pricing rule in 1986, and its application is also limited to international transactions.⁵¹ Japan and Germany were late in enacting transfer-pricing rules and limited their application to international transactions because they already had general anti-avoidance provisions.⁵²

Additionally, Japan was late in enacting transfer-pricing regulations because of the existing special tax-haven base company provisions.⁵³ Under these provisions, if more than 50% of the stock of a corporation (with headquarters or a main office located in a tax-haven country specified by a Cabinet Order) is owned directly or indirectly by resident individuals and domestic corporations, and it does not engage in active business, then it is assumed that shareholders having at least 5% of its stock are receiving *pro rata* profits and are subject to tax on that profit.⁵⁴ These provisions, enacted in 1978, were modeled on the controlled foreign corporation (CFC) provisions of Subpart F of the I.R.C. The CFC, promulgated in 1962, was the first anti-tax-haven provision in the world.⁵⁵ Unlike the United States, transfer-pricing regulation was introduced in Japan after the anti-tax-haven provisions because the

48. See, e.g., Income Tax Act, R.S.C., pt. 1, § 69(2) (1990) (Can.); Income and Corporation Taxes Act, 1988, ch. 6, § 774 (Eng.); CODE GENERAL D'IMPOT art. 57 (Fr.); AUSSENSTEUERGESETZ §§ 1-22 (F.R.G.). For the analysis of these provisions, see U.S. TREASURY DEP'T, THE SECTION 482 WHITE PAPER app. C (1988).

49. In the example discussed *supra* note 47, if the arm's-length price between *A* and *B* would have been \$150, the I.R.S. will assume the hypothetical arm's-length transaction and allocate profit of \$49 per unit from *C* to *A* to be subject to U.S. taxation.

50. AUSSENSTEUERGESETZ § 1 (F.R.G.).

51. Sozei Tokubetsu Sochihō [Special Taxation Measures Act], art. 66-4.

52. Japan has an anti-avoidance provision for family corporations, and, as mentioned *supra* note 33, Germany has AO art. 42 (F.R.G.), a general anti-avoidance provision not limited to family corporations. In many cases AO art. 42 was used against tax-haven base companies.

53. The Foreign Affairs Committee of the House of Representatives in the Japanese Diet has passed a resolution stating that international tax avoidance through tax-haven companies and transfer-pricing should be prevented. TAKOKUSEKI KIGYŌ NADO KOKUSAI KEIZAI NI KAN SURU KEN [RESOLUTION CONCERNING MULTINATIONAL COMPANIES AND INTERNATIONAL ECONOMICS], Resolution of June 8, 1977, Foreign Affairs Committee of the House of Representatives. In response to the resolution, the Diet enacted anti-tax-haven base company provisions first in 1978, as Special Taxation Measures Act Articles 40-4, 40-5, 40-6, 66-6, 66-7, 66-8 & 66-9.

54. In the example discussed *supra* note 47, if the United States applied this provision, the profit of *C* is deemed to be paid to the controlling shareholders in the United States and treated as a dividend. The purpose of this provision is, however, not to deny non-arm's-length transactions, but to deny the deferral which is otherwise enjoyed by domestic shareholders of tax-haven corporations.

55. See I.R.C. §§ 951-964 (1962).

existence of anti-tax-haven provisions reduced the need for transfer-pricing regulations.⁵⁶

As stated above, the main reason for delayed enactment of Japanese transfer-pricing regulations, and their limitation to international transactions, is that the tax authority and some commentators thought that an arm's-length regulation was contained in the Corporate Tax Act.⁵⁷ According to their theory, Article 22 of the Corporate Tax Act (which defines the concept of comprehensive income as does section 61 of the I.R.C.) replaces a non-arm's-length transaction by imposing a hypothetical arm's-length transaction plus constructive repayment of the countervalue.⁵⁸ In other words, by virtue of Article 22, all revenues and expenses from any transaction should be calculated as if the transaction were carried out at arm's length. If this theory is correct, no transfer-pricing regulation is needed.

Article 22 contains five paragraphs.

Paragraph 1 states:

The amount of taxable income of a domestic corporation for each business year shall be the amount of gross revenue minus the amount of deductible expenses for the business year.

Paragraph 2 of the Article defines the term "gross revenue." It states:

In computing the amount of taxable income of a domestic corporation for each business year, the amount included in gross revenue shall, unless otherwise provided by special stipulations, be the amount of revenue in the business year resulting from: (1) sale of property; (2) transfer of property or rendering of services⁵⁹ with or without consideration; (3) acquisition of property without consideration; and (4) other transactions (such as interest), but not from financial capital transactions.

56. However, the differences between anti-tax-haven provisions and the transfer-pricing regulations must be noted. In the example discussed *supra* note 47, assume *S*, the U.S. resident, is the 100% common shareholder of the United States corporation *A*, the German corporation *B*, and the tax-haven base company *C*. If I.R.C. § 482 is applied, *C*'s profit of \$49 per unit is allocated to *A*, which increases *A*'s income and is subject to tax at the corporate level in the United States. If *A* then distributes all of this income to *S*, it is again subject to tax at the shareholder's level in the United States. Thus, transfer-pricing regulations like I.R.C. § 482 and accrual basis taxation as in subpart F work differently. In theory, both provisions apply in this case since the aims of the provisions differ, and probably the transfer-pricing regulation will apply first.

There is also the unitary method in state corporate taxation, under which all the profits and losses of related corporations constituting a unitary business are summed up and apportioned to each entity using some formula. Therefore, non-arm's-length transactions do not work to reduce the net tax liability, because wherever the profits are shifted they are ultimately summed up.

57. See, e.g., MASAHIDE HAYUKA, INTENKAKAKUZEISEI [TAX SYSTEMS FOR TRANSFER-PRICING] 16-17 (1988); YUJI GOMI, ITENKAKAKU NO ZEIMU [TRANSFER-PRICING TAXATION] 26 (1987); Toshio Nakamura, *Hōjinzei no Kazeishotokukeisan to Kigyō Kaikai* [The Calculation of Taxable Corporate Income and Company Accounting], 10 ZEIMUDAIGAKKORONSŌ 168, 179-224 (1976); Hiroshi Kaneko, *Mushō Torihiki to Hōjinzei* [Gratuitous Transactions and Corporate Tax], 2 HŌGAKUKYŌKAI HYAKU-SHUNEN KINEN RONBUNSHU 162, 171-79 (1984).

58. See, e.g., HAYUKA, *supra* note 57, at 16-17; GOMI, *supra* note 57, at 26; Nakamura, *supra* note 57, at 179-224.

59. "Rendering of services" is interpreted very broadly and includes any kind of transaction other than the transfer of property. For example, lending money or other property is covered by this concept.

This second paragraph refers to the comprehensive income concept. All types of income, including operating and non-operating income, income from illegal or invalid transactions such as interest at usurious interest rates, and cancellation of indebtedness, are included as revenue by this provision.⁶⁰ At the same time, the transaction requirement of this article excludes unrealized appreciation in value (i.e., holding gains) from gross revenue. These principles are thought to be consistent with Generally Accepted Accounting Principles (GAAP).⁶¹

The most important part of paragraph 2 is the term "without consideration" (item 2). This subpart requires that corporations recognize gross revenue from free transactions. Controversy surrounds the interpretation of this term, and court decisions are not consistent in their outcomes.⁶² However, it is clear that the term "without consideration" relates to non-arm's-length transactions. We will analyze its operation later using some examples.

Paragraph 3 defines deductible expenses and includes: (1) cost of sales, cost of completed construction work, and other costs corresponding to gross revenue in the business year; (2) besides those mentioned above, sales expenses, general administrative expenses, and other expenses including depreciation cost, except for those expenses where the obligation to pay is not definite; and (3) the amount of loss⁶³ in the business year other than the loss from capital transactions.

Paragraph 3 is commonly interpreted to allow only a deduction for necessary expenses.⁶⁴ But at least one court has held that to be deductible an expense should not only be necessary, but also ordinary.⁶⁵

Paragraph 4 of Article 22 provides that gross revenue and deductible expenses are calculated in accordance with GAAP. This paragraph was introduced in 1967 to simplify the Corporate Tax Act.⁶⁶ By virtue of this paragraph, taxable income is determined by computing profit for the purpose of financial accounting. Unless otherwise provided, the taxable income of the corporation is the profit computed when calculating financial accounting. However, many statutes provide otherwise.⁶⁷

60. See, e.g., Judgment of Nov. 16, 1971, Saikōsai [Supreme Court], 15:8 Keishū 938 (Japan) (illegal interest under the Usury Act); Judgment of June 24, 1966, Saikōsai [Supreme Court], 20:5 Minshū 1146, 1147 (Japan) (stock option); Judgment of May 6, 1975, Tokyo Chisai [District Court], 26:5 Gyōshū 683, 693 (Japan) (cancellation of indebtedness).

61. Hōjin Zeihō [Corporate Tax Act], art. 22, ¶ 4.

62. See Tadao Okamura, *Murisoku Kashitsuke Kazei ni kan suru Ichikōsatsu* [Comment on the Taxation of Interest-Free Loans], 122:1 HŌGAKURONSŌ 1, 1-24 (1987); 122:2 HŌGAKURONSŌ 1, 1-17 (1987).

63. In this sentence, "loss" refers to spoilage, theft, casualty loss, and the like.

64. KANEKO, *supra* note 38, at 228.

65. Judgment of Sept. 25, 1958, Tokyo Chisai [District Court], 9:9 Gyōshū 1948, 1949 (Japan).

66. ZEISEI CHŌSAKAI [TAX SYSTEM INVESTIGATIVE COUNCIL], ZEISEI KANSOKA NI TSUITE NO CHUKAN HŌKOKU [MIDTERM REPORT ON TAX SIMPLIFICATION] 3-I, 1(1) (1966).

67. Actually, most of the provisions of the Corporate Tax Act create exceptions to the profit computation methods of financial accounting.

Paragraph 5 of Article 22 provides guidance regarding financial capital transactions, or transactions which bring about increases or decreases in a corporation's capital, including distribution of profits and surpluses. Premiums on stocks, gains from stock retirement, and part of the gains from capital reductions in mergers are covered by this paragraph, rather than in the gross revenue category of Paragraph 2.

When analyzing the operation of Article 22 in relation to non-arm's-length transactions, it is informative to pay particular attention to the "without consideration" term of paragraph 2. The examples which follow illustrate the effects of paragraph 2.

Example 1. Corporation *A* obtained property from its sister corporation *B* without paying consideration. Assume the basis⁶⁸ of the property in the hands of *B* was ¥30,000, and the fair market value (FMV) is ¥100,000. Both *A* and *B* are Japanese domestic corporations subject to Japanese tax law. As noted above, Article 22, paragraph 2, subpart 3, provides that gross income includes amounts of revenue resulting from "acquisition of property without consideration." Thus, Article 22, paragraph 2, subpart 3 can be interpreted to mean that the FMV of the property donated to *A* from *B* is included in *A*'s gross revenue. *A* will have ¥100,000 gross revenue. Its basis in the hands of *A* is the FMV of ¥100,000. GAAP also support this conclusion.

Two problems exist concerning *B*. First, is the outflow of the property deductible? Second, what is the value of that outflow? In answer to the first question, it is possible to recharacterize the gift of property differently, depending on the relationship between the donor and the donee. For example, if *B* employed *A*, the gift could be recharacterized as salary, which is normally deductible. Or if *A* is a shareholder of *B*, the gift could be characterized as a dividend. In this case, however, since *A* and *B* are sister corporations, the transaction constitutes a "contribution" within the meaning of Article 37 of the Corporate Tax Act.

Article 37 provides that the contribution paid by a corporation shall be deductible only up to the amount provided by a Cabinet Order.⁶⁹ The only exceptions are contributions to national and local governments and other designated contributions for public purposes which are fully deductible.⁷⁰ The term "contribution" in Article 37 is construed very broadly to include almost all transactions in which a corporation grants any kind of economic benefit without receiving reasonable consideration or counter-value.⁷¹ Thus, in this

68. The basis is the value assigned to an asset for the purpose of determining gain or loss on the sale or transfer of the asset. BLACK'S LAW DICTIONARY 151-52 (6th ed. 1990).

69. Hōjin Zeihō [Corporate Tax Act], art. 37, ¶ 2. A Cabinet Order further provides that the deductible amount of contributions in one taxable year shall be half of the amount of the sum of 2.5% of profits plus 0.25% of the capital of the corporation. Hōjin Zeihō Shikōrei [Corporate Tax Act Enforcement Order], art. 73, Cabinet Ordinance No. 97, 1965 (Japan).

70. Hōjin Zeihō [Corporate Tax Act], art. 37, ¶ 3.

71. KANEKO, *supra* note 38, at 255-57.

example, the transfer of the property is a "contribution" within the meaning of Article 37, and its deductibility is subject to the limitations under the Cabinet Order.

As for the second question, Article 37, paragraph 6, provides that if a corporation donates property or offers economic benefit, the amount of the contribution shall be the FMV of the property or the benefit donated, not the basis or the cost. Therefore, in this example, the contribution is the FMV of the property, or ¥100,000. This means that the appreciation should be recognized by the contributing corporation and included in gross revenue. However, which provision authorizes the recognition of that gain? The only authority to recognize the gain is the phrase "without consideration" in Article 22, paragraph 2. Thus, in Example 1, by virtue of Article 22, paragraph 2, the holding gain of ¥70,000 (¥100,000 minus ¥30,000) is included in gross revenue as a gain from the transfer of property "without consideration." The FMV of ¥100,000 is the amount of the contribution, the deductibility of which is subject to the limitation under the above mentioned Cabinet Order. If the basis is not deductible, *B* will have ¥100,000 net income from this transaction.

However, some commentators and the tax authority explain the operation of Article 22, paragraph 2, differently, using a hypothetical two-stage transaction model. Their theory is called the "constructive transaction theory" or "two-stage theory."⁷² According to this theory, by virtue of Article 22, paragraph 2, a gratuitous transfer is recharacterized as two separate hypothetical transfers. The first transfer is an arm's-length sale of the property. The second transfer is a constructive repayment (a constructive contribution, in this case) to the transferee from the transferor because the transferor of the property actually receives no countervalue. Thus, no transfer-pricing regulation is needed, because Article 22, paragraph 2, replaces a non-arm's-length transaction with an arm's-length transaction plus a constructive repayment of the countervalue.⁷³

In this example, since *B* constructively receives the arm's-length countervalue of the property transferred in the first hypothetical transaction, *B* must include the FMV of the property under Article 22, paragraph 2, in its gross revenue, and deduct the basis of ¥30,000 under paragraph 3. (Remember that Japanese income tax law has no concept of gross income.) This means that *B* recognizes a holding gain of ¥70,000 (¥100,000 minus ¥30,000). In the second transaction, since *B* constructively contributes to *A* the FMV of the property of ¥100,000, *B* has to characterize that amount as a contribution within the meaning of Article 37, none of which is deductible under the limitation.

The problem with this theory is that it interprets the basic provision of Article 22, paragraph 2, as if it were an anti-avoidance provision, authorizing

72. See, e.g., Kaneko, *supra* note 57, at 162.

73. See *supra* note 58 and accompanying text.

taxation on the basis of hypothetical transactions, which denies tax avoidance. As explained above, in ordinary cases, taxation is based on the actual transactions, and taxation on the basis of hypothetical transactions should be the exception. With this principle in mind, it does not seem proper to read the basic provision of Article 22 as an anti-avoidance provision. If it were read this way, the tax authority could always deny the actual transactions, or at least non-arm's-length transactions.

Rather than interpreting Article 22 as an anti-avoidance provision, it is more correct to interpret it in light of Article 37, paragraph 6, which states that the amount of the contribution should be the FMV of the property and makes the taxpayer recognize the holding gain under Article 22, paragraph 2. The important point is that Article 22, paragraph 2 is an authority not for the taxation on the hypothetical transactions, but for recognition of the holding gain in the actual transaction.

Example 2. The same facts as Example 1, but *A* paid *B* ¥60,000.

In this case, property is transferred at a price lower than the FMV. For *A*, the acquisition of the property below market value consists of two transactions: first, a purchase of part of the property at arm's length, and second, the receipt of the residual part of the property without consideration. In the first part of the transaction, it is as if *A* bought 60% of the property paying the arm's-length consideration of ¥60,000, which constitutes the basis of that part of the property. As for the second part, the same rule applies as in Example 1. *A* must include the FMV of 40% of the property in its gross revenue under Article 22, paragraph 2, subpart 3. The total basis of the property is the FMV of ¥100,000 (the ¥60,000 consideration paid plus the FMV of the other 40% of the property). *A* will then have ¥40,000 net income from this transaction.

For *B*, this transaction constitutes a contribution under Article 37. *B* confers an economic benefit on *A* because *B* does not receive the total arm's-length consideration. Article 37, paragraph 7, concerning transactions where the consideration is below-market value, provides that the amount of the contribution shall be the difference between the price paid and the FMV of the property. Similarly to Example 1, donor *B* must recognize the gain of ¥70,000 from the appreciation of the property under Article 22, paragraph 2. The contribution amounts to ¥40,000, the FMV of the economic benefit contributed. If this amount is not deductible, *B*'s net income from this transaction should be ¥70,000.

Example 3. The same facts as Example 1, but *A* paid *B* ¥120,000 for the property.

Where *A* paid more than the FMV, the difference between the price paid and its FMV is not a necessary expense and is not included in the cost of the inventory or basis of the property. Only the FMV constitutes its cost or basis. Thus, the basis of the property in the hands of *A* is ¥100,000. The payment greater than the FMV is characterized as a monetary contribution. If it does

not exceed the deductible limitation, *A* can deduct the contribution, unless it constitutes the basis. For *B*, the full amount of consideration is included in gross revenue. The basis of the property is deductible under Article 22, paragraph 3. Therefore, *B*'s net income from this transaction is ¥90,000 (the actual price of ¥120,000 minus the basis of ¥30,000).

Example 4. *A* lends *B* ¥1,000,000, interest-free. (Assume the market interest rate is 10%.)

Under Article 37, paragraph 6, the FMV of the economic benefit (provided without consideration) is included in the contribution which is subject to the limitation of the deductible amount. In this example, the imputed interest is ¥100,000. Similarly to Example 1, the lender must recognize the gain corresponding to the amount of the contribution. Therefore, under Article 22, paragraph 2, *A* must recognize ¥100,000 in gross revenue (¥1,000,000 times the rate of 10%).

For *B*, it is difficult to determine the tax consequences because Article 22 and GAAP are silent regarding this type of transaction. The tax authority usually treats an interest-free loan as a no loss or gain situation for corporate borrowers.⁷⁴

However, it seems that these tax consequences are somewhat odd, because those conferring the economic benefit through an interest-free loan are taxed on that benefit, while those receiving the benefit are not. Remember that if *B* reinvests the money borrowed from *A* in a money market or in its own business operation, the interest on the profit from that reinvestment will be subject to tax.

In summary, Article 22, paragraph 2, taxes those corporations which receive economic benefits from non-arm's-length transactions (Corporation *A* in Examples 1 and 2). As for the corporation from which the economic benefit flows, a holding gain or imputed interest can be recognized only if there is a special provision which authorizes the recognition, such as Article 37, paragraphs 6 and 7.

G. Advantageous Methods of Working with the Tax Provisions

In the above analyses, we have seen how Article 22, paragraph 2, coupled with Article 37, paragraphs 6 and 7, deals with non-arm's-length transactions. The consequence to the corporation which receives the economic benefit of a non-arm's-length transaction is covered by Article 22, paragraph 2. However, for the corporation from which the benefit flows, we notice a

74. There is no official explanation of that treatment. One possible explanation may be that if they were to include the economic benefit of the interest-free loan (i.e., imputed interest in the gross revenue), then they could also deduct the amount which would offset the imputed interest. In the case of individual borrowers who cannot always deduct interest, the imputed interest would have to be included in their income. For income taxation in the United States, see I.R.C. § 7872 (1988); *Greenspun v. Commissioner*, 72 T.C. 931 (1979); *Dean v. Commissioner*, 35 T.C. 1083 (1961).

problem — the existence of a deductible limit in the amount of the contribution. This limit makes the tax consequences of the transaction at issue depend on the amount of other contributions, profits, or capital of the corporation. It is inequitable that in some cases the amount of the contribution resulting from a non-arm's-length transaction happens to be deductible, while in other cases it is not. Unfortunately, this is the current rule in Japan. Despite the rule, international transactions between commonly controlled corporations are not affected by such disparate outcomes because they are covered by the transfer-pricing regulation.⁷⁵

Let us consider how this unfortunate result can be avoided. What if a provision were enacted under which the amount of the contribution resulting from non-arm's-length transactions could not be deducted? In that case, a problem of double- or over-taxation would result. In Examples 1, 2, and 3, if *A* and *B* rendered the transactions at arm's length, only *B* would realize the holding gain of ¥70,000. But if the contribution were not deductible, the aggregate amount of the net income of *A* and *B* in Example 1 would be ¥170,000; in Example 2 it would be ¥110,000, and in Example 3 it would be ¥90,000. These differences occur because the profit which the taxpayers attempted to shift through the non-arm's-length transactions was included in gross revenue as receipt of contributions, in addition to the recognition of the holding gain of ¥70,000 in the hands of *B*.

What would be the effect of enacting a new provision which allowed the amount of the contribution to the donee to be deducted to make their aggregate net income ¥70,000?⁷⁶ The result is almost the same as applying the I.R.C. § 482 transfer-pricing regulations to domestic transactions. Applying this section to Example 2, the shifted profit of ¥40,000 is reallocated to *B*, as if *A* and *B* rendered the transaction at arm's length. It becomes very easy to explain the operation if we use a hypothetical transaction, which we will call "the first tier hypothetical transaction." Under that transaction, *A* constructively pays *B* ¥100,000, and *B* recognizes a ¥70,000 gain (¥100,000 minus ¥30,000). The basis of the property in the hands of *A* was the constructive acquisition cost of ¥100,000 (the FMV). In the end, *B*'s income increases by ¥40,000 from the original non-arm's-length transaction. This is called a primary adjustment in the application of I.R.C. § 482. *A*'s income decreases by ¥40,000, which is called a correlative adjustment.⁷⁷ The important point is that the aggregate net incomes of *A* and *B* remain the same because of the correlative adjustment. *A*'s income is reduced and the donor (not the donee) has to pay the tax on the shifted profit, which prevents profit-shifting through non-arm's-length transactions.

75. Sozei Tokubetsu Sochihō [Special Taxation Measures Act], art. 66-4.

76. If donors could fully deduct their contributions (in order to make the aggregate net income of *A* and *B* ¥70,000—as with an arm's-length transaction), then taxpayers could shift their profit through contributions at will.

77. Treas. Reg. Sec. 1.482-1T(e) (1992).

However, unless *A* actually pays ¥100,000 (an additional ¥40,000) to *B* according to the application of the transfer-pricing regulations, a problem results. Because the actual payment is only ¥60,000, despite the FMV of ¥100,000, we have to characterize the ¥40,000 difference in taxation terms. Herein lies the serious problem with this treatment.

When applying section 482, the I.R.S. assumes that in addition to the first tier hypothetical transaction, there is a second tier hypothetical transaction in which a constructive distribution of ¥40,000 is paid by *B* to a common shareholder *S* (not directly to *A*), and a constructive contribution of the same amount is paid by *S* to the capital of *A*.⁷⁸ Therefore, *S* is subject to collateral taxation on that constructive dividend even if *S* receives nothing. However, because *S* contributes ¥40,000 to *A*, the basis of *A*'s stock in the hands of *S* increases by ¥40,000, and *A* has no gain in the second tier hypothetical transaction. This is called a triangular constructive dividend.⁷⁹ In the Japanese corporate tax system, a new provision similar to the triangular constructive dividend is needed to solve this problem.

Finally, the above operation of the transfer-pricing regulations of section 482 is similar to that of Article 22, paragraph 2, under the two-stage theory.⁸⁰ However, under Article 22, paragraph 2, *A* will be taxed on the benefit of ¥40,000 in the second hypothetical transaction. This demonstrates that the two-stage theory interprets Article 22, paragraph 2, as an anti-avoidance rule (the transfer-pricing regulation), reconstructing unusual non-arm's-length transactions as normal arm's-length ones. As explained above, such an interpretation is not proper.

IV. TAXATION OF EMPLOYMENT INCOME

This section discusses the problems involved in taxing employment income, including the constitutionality of taxing such income. This section will describe the basic structure of individual income taxation in Japan and analyze the role of Japan's constitution in the tax law.

A. Basic Structure of Individual Income Tax

The Income Tax Act sets forth 10 categories of income ("baskets"):

- (1) interest;
- (2) dividends;
- (3) income from immovables;
- (4) business income;
- (5) employment income;

78. Rev. Proc. 65-17, 1965-1 C.B. 833; see also Rev. Proc. 65-31, 1965-2 C.B. 1024; Rev. Proc. 71-35, 1971-2 C.B. 573.

79. See Tax Management Portfolios, No. 230-3, pt. 2, ch. 2, § A n.129(a) (1989).

80. See generally Kaneko, *supra* note 57.

- (6) retirement income;
- (7) forest income;
- (8) capital gain;
- (9) occasional income; and
- (10) miscellaneous income.⁸¹

Each of these categories is calculated by deducting necessary expenses from gross revenue.⁸² However, there are some exceptions to this principle, one of which concerns employment income.

Three categories of taxable income can be derived by following a complicated procedure of set-offs between losses (negative baskets) and gains (positive baskets), including several deductible items and allowances:

- (A) taxable ordinary income;
- (B) taxable forest income; and
- (C) taxable retirement income.

Progressive tax rates apply to these three categories of taxable income.⁸³ The total amount of tax is the sum of these three amounts.⁸⁴

The Special Taxation Measures Act provides for two categories of net income: (1) capital gains on land and buildings, in which long-term and short-term gains are separated,⁸⁵ and (2) capital gains with respect to stocks or shares.⁸⁶ These two categories of income are subject to separate taxation. In the case of a sale of listed stocks or shares, the Special Taxation Measures Act also provides that taxpayers can choose to apply the withholding tax treatment, allowing 1% of the gross revenue from the sale to be withheld.⁸⁷ The Special Taxation Measures Act imposes a 20% withholding tax on interest income, where deduction of expenses is not permitted.⁸⁸ Taxpayers can also choose a separate withholding taxation on dividends when the amount of the dividend from one corporation is less than ¥500,000 in a year.⁸⁹ These separate taxations are final and the income subject to them is not included in the other categories of income.

81. Shotoku Zeihō [Income Tax Act], art. 22.

82. *Id.* arts. 36, 37. Unlike the United States tax system where the computation of income starts from gross income, the starting point in the Japanese system is gross revenue. The basis and other costs and expenses are then deducted from gross revenue. In other words, there is no systematic distinction between costs which constitute a return of capital and those which do not.

83. *Id.* art. 89.

84. *Id.* arts. 21, 22. Note that for taxable forest income, the amount of tax is calculated by a five-year averaging as follows: first, divide taxable forest income by 5; second, apply the progressive rates to that amount; and third, multiply that amount by 5. *Id.* art. 89. This method has the effect of mitigating the progressive rate because timber is usually cut at long intervals. Note also that even though taxable retirement income is subject to the same tax rate, the amount of taxable retirement income is half the amount of retirement income. This calculation also takes into account the weakness of the ability to pay retirement income. *Id.* art. 30, ¶ 2.

85. Sozei Tokubetsu Sochihō [Special Taxation Measures Act], arts. 28-4, 28-5, 31, 32.

86. *Id.* art. 37-10.

87. *Id.* art. 37-11.

88. Fifteen percent is for national income tax and 5% for local tax. *Id.* arts. 3, 3-3, 8-3, 8-4, 41-10; Chihō Zeihō [Local Tax Act], arts. 71-5 to 71-25.

89. Sozei Tokubetsu Sochihō [Special Taxation Measures Act], art. 8-4.

World income tax systems are classified as comprehensive or schedular. In the pure comprehensive income tax system, income from all sources is put into one basket and is subject to the same tax treatment.⁹⁰ There is no distinction between the categories of income. In the schedular system, there is a list of categories of income (baskets), which is called a schedule, and each category of income is accorded differential tax treatment. However, income which is not included in any basket is not subject to tax.

The Japanese system lies midway between the comprehensive and schedular systems. On the one hand, the tax rate applies separately to the five categories of taxable income, and there are separate taxations. On the other hand, some of the categories of income are related in the set-off procedure, and there is a catch-all basket, namely miscellaneous income.

B. Computation of Business Income and Employment Income

The amount of business income is computed by taking gross revenue and subtracting necessary expenses.⁹¹ Some necessary expenses include the basis of the property sold, the cost of inventory, and compensation for personal services, to name a few.⁹² It should be noted that the Japanese income tax system, including the corporate income tax system which is codified separately, does not encompass all possible deductible items or their methods of calculation. Such particulars are determined by financial accounting principles.⁹³

Before 1988, business expenses were not deductible when computing employment income. Instead, the standard employment income deduction was available when computing the amount of employment income. The amount of the standard employment income deduction was determined according to the gross receipt of salaries or wages.⁹⁴ Government statistics from 1981

90. A typical phrase that illustrates the comprehensive income concept is section 61 of the Internal Revenue Code. Section 61 provides "gross income means all income from whatever source derived." I.R.C. § 61 (1988). However, the United States income tax system has an important exception—capital gains.

91. Shotoku Zeihō [Income Tax Act], arts. 36, 37. Courts have defined the word "necessary" to mean "appropriate" and "helpful." See, e.g., Judgment of Apr. 24, 1975, Takamatsu Kōsai [High Court], 26:4 Gyōshū 594 (Japan).

92. See Shotoku Zeihō [Income Tax Act], art. 37.

93. See 3 DHC COMMENTAR SHOTOKU ZEIHŌ 3284-95. The most important principle is that of matching costs with revenues. See also KANEKO, *supra* note 38, at 211.

94. The standard employment income deduction is calculated as follows:

1. When gross receipts are not over ¥1,650,000, 40% of gross receipts (minimum amount ¥650,000).
2. When gross receipts are over ¥1,650,000 but not over ¥3,300,000, 30% of gross receipts over ¥1,650,000, plus ¥660,000.
3. When gross receipts are over ¥3,300,000 but not over ¥6,000,000, 20% of gross receipts over ¥3,300,000, plus ¥1,155,000.
4. When gross receipts are over ¥6,000,000 but not over ¥10,000,000, 10% of gross receipts over ¥6,000,000, plus ¥1,695,000.
5. When gross receipts are over ¥10,000,000, 5% of gross receipts over ¥10,000,000, plus ¥2,095,000.

show that the average employee had a salary or wage of ¥3,091,000 and a standard employment income deduction of ¥1,068,000.⁹⁵ This translates into a 34.6% deduction. Recent trends indicate that for those who choose to take the standard deduction, it represents slightly more than 30% of salary or wages at present.⁹⁶

C. *Historical Perspective and Changing Definition of Deductible Items*

The standard employment income deduction was introduced in 1913⁹⁷ and at that time allowed a deduction of 10% of employment revenue.⁹⁸ After World War II, six taxation and public finance experts headed by Professor Shoup of Columbia University formed the Shoup Mission and went to Japan to study and reform the Japanese tax system.⁹⁹ At the time of the study, taxpayers were allowed to deduct 25% of employment revenue up to a certain limit. The Mission analyzed the reasons for the standard employment income deduction.¹⁰⁰ It advocated a comprehensive income tax; that is, the idea that all income should be taxed in the same manner without regard to its source.¹⁰¹ They considered the standard employment income deduction unreasonably excessive.

The Japanese Government gave the Mission the following four reasons in favor of the standard employment income deduction:¹⁰² (1) it represents a sort of depreciation allowance for the exhaustion of the working life of the individual; (2) it represents a recognition of the effort and sacrifice of leisure involved in "earning"; (3) it is a rough allowance for additional expenses incurred because of the work which cannot for administrative reasons be allowed as specific deductions, since they are often almost indistinguishable from normal living expenses; and (4) it operates to offset the relatively merely adequate assessment of wages and salaries as compared with other forms of income.¹⁰³

The first reason corresponds to the argument concerning the ability to pay of employment income. The third reason deals with the notion that the

Shotoku Zeihō [Income Tax Act], art. 28, ¶ 3.

95. Zeisei Chōsakai Shiryō [Tax System Investigative Council Reference Report], 837 JURISUTO 37 (1985) [hereinafter Tax System Report].

96. *Id.*

97. Shotoku Zeihō [Income Tax Act], art. 4-4, Law No. 13, 1913 (Japan).

98. See 2 DHC KOMMENTAR SHOTOKU ZEIHŌ 2055-56.

99. The Shoup Mission arrived in Japan on May 10, 1949, did research on the Japanese tax system for three and a half months, and on September 15, 1949, published their "Report on Japanese Taxation by the Shoup Mission." The Shoup Mission returned to Japan in July 1950, and published the "Second Report on Japanese Taxation by the Shoup Mission" on September 21 of that year.

100. 1 SHOUP MISSION, REPORT ON JAPANESE TAXATION BY THE SHOUP MISSION 68 (1949).

101. This is clearly seen in the recommendation that capital gains should be taxed and capital losses should be fully deductible. See *id.* at 91.

102. *Id.* at 69.

103. The adequacy of assessment or degree of tax compliance is called the "capture ratio."

standard employment income deduction is a proxy for the deduction of actual business expenses.

The Mission argued that the first two reasons were true of all earned income, so it was unfair to permit the standard deduction only with regard to employment income.¹⁰⁴ The Mission stated that the fourth reason appeared to recognize the taxpayers' right to evade taxes and should be abolished.¹⁰⁵ In response to the recommendations issued by the Mission, the Diet reduced the deduction of employment revenue from 25% to 10%.¹⁰⁶ The yen limit was reduced by half, because the Mission and the Diet thought that the business expenses of employees were not sufficient to permit a deduction in excess of 10%.¹⁰⁷

In 1956, the Tax System Special Investigative Council, a consultant body to the Ministry of Finance, reported that the standard employment income deduction should be based on the following four reasons:¹⁰⁸

- (1) given the difficulty of determining the exact amount of the business expense portion of employment income, a deduction approximately related to business expenses was needed;
- (2) employment income should be treated as earned income, with its ability to pay tax lower than the income from capital or income from capital and labor;
- (3) the capture ratio for employment income was higher than for other income; and
- (4) because of the withholding, employees had to pay tax earlier than other types of income earners, so compensation for the time value of money was needed.

These four reasons, which differ slightly from the reasoning of the Shoup Mission, are considered important among commentators. These four reasons were also discussed in the Supreme Court's *Oshima* decision.¹⁰⁹

D. The Oshima Case and Standard Employment Income Deduction

Before 1988 earners of employment income could not deduct business expenses, and the standard employment income deduction was very small. Many wage earners felt that this system was discriminatory and Professor Tadashi Oshima filed a lawsuit to challenge it.¹¹⁰ Professor Oshima argued

104. 1 SHOUP MISSION, *supra* note 100, at 69.

105. *Id.*

106. Shotoku Zeihō [Income Tax Act], art. 9, ¶ 1-5, Law No. 27, 1947 (as amended 1950) (Japan).

107. *Id.*

108. RINJI ZEISEI CHŌSAKAI [TAX SYSTEM SPECIAL INVESTIGATIVE COUNCIL], RINJI ZEISEI CHŌSAKAI TŌSHIN [REPORT OF THE TAX SYSTEM SPECIAL INVESTIGATIVE COUNCIL] 49 (1956).

109. See KIYONAGA, *supra* note 38, at 89; see also Judgment of Mar. 24, 1985, Saikōsai [Supreme Court], 39:2 Minshū 247, 257-61 (Japan); KANEKO, *supra* note 38, at 182-83.

110. Professor Oshima filed this suit in 1965, but lost both in the Kyoto District Court, see Judgment of May 30, 1974, Kyoto Chisai [District Court], 25:5 Gyōshū 548 (Japan), and in the

that his deduction was only 7.9% of his salary, and therefore far less than the actual business expenses that he paid. The issue was whether the denial of business expense deductions was discriminatory in violation of Article 14 of the Japanese Constitution.¹¹¹

In 1985, the Supreme Court decided against Professor Oshima, finding the system constitutional.¹¹² The Court held that the standard employment income deduction is a substitute for the business expense deduction for employment income and that Oshima failed to prove that his business expenses exceeded the standard business deduction.¹¹³ The Court also said that applying the standard deduction instead of allowing the wage earner to deduct the actual business expense was constitutional, because the scope of the business expense is unclear. Thus, the Court said it would be too burdensome to permit the deduction of actual business expenses given the huge number of salary earners.¹¹⁴

This litigation did not go unnoticed by political parties.¹¹⁵ While the case was still pending the government of the conservative party (the Liberal Democratic Party), which refused to allow business deductions, considerably increased the amount of the standard deduction as a political compromise.¹¹⁶ The amount of the deduction is now almost one third of gross revenue¹¹⁷ of the average income level.¹¹⁸

In 1987, following the Supreme Court's *Oshima* case,¹¹⁹ the Diet enacted the Specified Payment Deduction Rule.¹²⁰ Under this rule the excess amount of the following limited categories of expenses over the standard employment income deduction are deductible:

Osaka High Court, *see* Judgment of Nov. 7, 1979, Osaka Kōsai [High Court], 30:11 Gyōshū 1827 (Japan).

111. KENPŌ [Constitution] art. XIV, ¶ 1.

112. *See* Judgment of Mar. 24, 1985, 39:2 Minshū 247.

113. *Id.* at 261.

114. *Id.* at 259-60.

115. *See* HIROHISA KITANO, SARARĪMAN ZEIKIN SOSHŌ [THE SALARY EARNER TAX LITIGATION] 55 (rev. ed. 1990).

116. *See* 2 DHC KOMMENTAR SHOTOKU ZEIHŌ 3060-65; *see also* Tax System Report, *supra* note 95, at 37.

117. It is often argued by non-corporate independent entrepreneurs that for those employees whose job-related expenses are relatively small, the amount of the standard employment income deduction is too large to justify. In response to this argument the system called "deemed corporate taxation" to the business of non-corporate independent entrepreneurs was introduced. Under this system, the individual entrepreneur is deemed to be an employee of the deemed business entity, and the individual entrepreneur can get the standard employment income deduction. *See* Sozei Tokubetsu Sochihō [Special Taxation Measures Act], art. 25-2. This resembles the system under repealed subchapter R of the I.R.C.

118. Conversely, since these reforms were initiated, business income earners have begun to complain that the treatment of employment income is too favorable compared to the treatment of business income.

119. Judgment of Mar. 24, 1985, Saikōsai [Supreme Court], 39:2 Minshū 247, 257-61 (Japan).

120. Shotoku Zeihō [Income Tax Act], art. 57-2.

- (1) reasonable commuting expenses from the taxpayer's residence to her workplace;
- (2) necessary and ordinary moving expenses;
- (3) educational expenses which are directly necessary to perform the employee's services;
- (4) a payment for acquiring a qualification which is directly necessary for the employee to perform her services; and
- (5) ordinary and necessary travel expenses between the employee's residence and the residence of the spouse, if the employee has to live in a separate residence to perform the services.¹²¹

Although only the excess amount of specified payments above the standard employment income deduction are deductible, the standard employment income deduction is always permitted. If the aggregate amount of specified payments is greater than the amount of the standard employment income deduction, then the taxpayer can choose to deduct the aggregate specified payments. Otherwise, the taxpayer may only take the standard employment income deduction.¹²² Thus, the relationship between the standard employment income deduction and the aggregate amount of the specified payments (not the deductible portion) is similar to the relationship between a standard deduction and itemized deductions in the United States.

Finally, employment income is subject to the withholding of income at the time of each payment. This means that wage earners have to pay taxes earlier than business income earners, who pay taxes three times a year (twice as prepayments).¹²³ Considering the time value of money, business income is taxed more favorably than employment income.

E. Analysis of the Oshima Case in Light of the Four Reasons for Deductions

As was demonstrated above, the Supreme Court in *Oshima* held that it was appropriate to regard the standard employment income deduction as a proxy for the business deduction of actual expenses. The Court thought that this was the only reason for the standard employment income deduction. However, the scope of the deductible items is a problem. Whether the necessary business expenses of employment income can be determined using the same criteria as in business income, or whether there are special kinds of necessary expenses inherent in earning employment income, is also a question.

In the *Oshima* case, membership dues to academic associations and the subscription costs of technical journals were among the items at issue.¹²⁴ These expenses had both business and personal aspects, because they not only

121. *Id.*

122. *Id.*

123. *Id.* art. 104.

124. Judgment of Mar. 24, 1985, 39:2 Minshū at 301-02.

contributed to Oshima's research and teaching, but also enriched his personal education. Because he could theoretically teach without these items, these expenses were voluntary rather than required by his job. In contrast, if an attorney subscribes to law journals or attends academic conferences, these expenses are deductible without regard to their effect on income.¹²⁵ Thus, the criteria for deductibility of these dual-purpose expenses differ according to the taxpayer's employment.

The government's explanation for this inconsistency was based on the dependency of employees.¹²⁶ The government believed that because employees are subject to their employer's management, the employer should pay for its employees' business expenses or reimburse them (such reimbursement is not included in the employee's income).¹²⁷ In the extreme case, if the employer did not reimburse the employee's expenses, the government considered such expenses unnecessary. This view discounts the possibility that necessary business expenses exist that are not paid for or reimbursed by the employer.¹²⁸

The other expenses at issue in the *Oshima* case were the expenses for clothing (depreciation of formal suits and cleaning costs) and haircuts.¹²⁹ The statute provides that if an expense falls under living expenses, it is not deductible.¹³⁰ Though formal clothing is all but required for teachers in Japan, it is also a living requirement. In the case of business income, these expenses would be non-deductible. Therefore, if we apply the same criteria of deductibility as in business income to employment income, these expenses should be non-deductible.

In the *Oshima* case, although clothing and haircuts can also be considered living expenses, they were essential to earning income. In other words, these expenses were additional to the basic living cost, or living cost differential, caused by Oshima's work as a professor. Had he not been living on employment income but on interest or dividend income, he could have stayed at home and would not have had to wear formal clothing. The same could be

125. Business income earners can deduct expenses for acquiring knowledge or skills directly necessary to their performance of business functions. Kokuzeichō Shotokuzei Kihon Tsūtatsu [National Tax Agency Income Tax Basic Circular] No. 37-4 (1970) (Japan). Though this circular further states that these expenses must be ordinary and necessary to acquire the knowledge or skill, it does not require the expenses to be ordinary and necessary in order to earn the income.

126. Judgment of Mar. 24, 1985, 39:2 Minshū at 291.

127. Shotoku Zeihō [Income Tax Act], art. 9, ¶ 1-6.

128. The Osaka High Court decision in the *Oshima* case basically followed this theory and did not recognize necessary expenses for employees. However, the court held that some expenses of salary earners have the character of "appropriate business expenses" and that the standard employment income deduction should not be less than that amount. Judgment of Nov. 7, 1979, Osaka Kōsai [High Court], 30:11 Gyōshū 1827 (Japan).

129. Judgment of Mar. 24, 1985, 39:2 Minshū at 299-301.

130. Shotoku Zeihō [Income Tax Act], art. 45. However, if a part of the expense related to living is necessary to conduct the business, and the taxpayer clearly demonstrates that necessary part, the taxpayer can deduct that part in the computation of income from immovables, business income, and miscellaneous income, but not employment income. Shotoku Zeihō Shikōrei [Income Tax Act Enforcement Order], art. 96, Cabinet Ordinance No. 96, 1965 (Japan).

said of the additional expenses for food and shelter. Were he not a professor, he would not have had to eat at restaurants or live near the university where the rent is very high.

These additional living expenses are incurred in the income earning activities of business income as well as employment income, thus deductibility should be discussed in the more broad context of earned income—not merely employment income. The policy denying deductions of these expenses both for business and employment income in general may be justified by the regressive result of the deduction.

Because of the progressive tax rates, high income taxpayers can save more tax than low income taxpayers when they incur the same expenses and get the same amount of deductions. Take the case of two handicapped persons, one earns a high income, the other earns a moderate income, and both subscribe to the same care services in order to work. If these expenses are deductible, although both pay the same amount, the former can save more tax. This outcome justifies the policy that these expenses should be taken care of not by deductions but by a tax credit or welfare benefit.

In the *Oshima* case, the government rejected the deductibility of this type of expense.¹³¹ It concluded that employees only had to pay business expenses under exceptional circumstances, so that the amount would be small compared to the amount of gross revenue. It argued further that permitting itemized deductions for employees would increase administrative costs and might jeopardize the administrative process because the scope of business expenses for employees would be unclear and the number of employees claiming such deductions would be large.¹³² The government's reading of the *Oshima* decision was that even though some business expenses are necessary, those expenses are covered by the standard employment income deduction. Because the scope of necessary business expenses for employees is very narrow, the Court considered the existing amount of the standard employment income deduction adequate and not discriminatory.¹³³

The Diet reaffirmed this position when it enacted the very limited "Specified Payment Deductions"¹³⁴ after the *Oshima* case. Under that provision, employees can deduct the excess amount of the specified payments over the standard employment income deduction. Because this additional deduction is allowed only when actual expenses exceed the amount of the standard deduction, the policy behind this provision must be that the content of the standard employment income deduction was a substitute for the necessary business expenses of employees.

131. Judgment of Mar. 24, 1985, 39:2 Minshū at 291-95.

132. *Id.* at 291-92.

133. Naomi Miyazaki, an official of the Ministry of Justice, has expressed this view. See Hiroshi Kaneko, Keiji Kiyonaga & Naomi Miyazaki, *Sarariman Zeisei to Saikōsai Hanketsu* [The Decision of The Supreme Court and The Tax System for Salary Earners], 837 JURISUTO 6, 11-12 (1985).

134. Shotoku Zeihō [Income Tax Act], art. 57-2.

Despite the "Specified Payment Deductions," some taxpayers continue to try to establish the concept of business expenses. Most commentators agree that there exist business expenses inherent in providing services as an employee.¹³⁵ Some argue further that the standard used to determine the scope of the necessary business expense for employment income should be different from the standard used to determine business income, because the latter depends heavily on financial accounting, which has nothing to do with the expenses of employees.¹³⁶ These commentators are trying to establish the concept of business expenses for employees.

Many commentators mention the vulnerability of a wage earner's ability to pay tax based on employment income, or more precisely, earned income, as compared to income from capital.¹³⁷ The government's response to the Shoup Mission pointed out this vulnerability using the term "the depreciation of human capital."¹³⁸ For example, if a wage earner becomes sick, she cannot earn income, though she can get interest or dividend income. In contrast, the earners of interest income or dividend income can sell their bonds or stocks if they need money because of some casualty or disease. The problem is how to value this vulnerability of the earned income in terms of money. Inevitably, this evaluation will be unclear, and results in a subjective judgment or becomes political by nature.

The *Oshima* case also noted the difference in the capture ratio in salary earners. Many commentators and even lay persons say that there is a magic ratio, 9:6:4:1, which means 90% of salaries, 60% of business income, 40% of agricultural income, and just 10% of the income of politicians are subject to tax.¹³⁹ The problem is that even if we can prove these figures, it does not automatically mean that the standard employment income deduction is required to compensate for this difference. Indeed, the Supreme Court, while recognizing the difference among the various capture ratios, decided that in order to solve the problem of the capture ratio difference, the tax authority has to make every effort to collect 100% of the tax on all kinds of income.¹⁴⁰ At the same time, the Court warned that if the difference is so remarkable that it is inconsistent with the concept of justice and equity, and if the difference exists over a long period of time, then the tax system itself may be unconstitutional.¹⁴¹

135. See, e.g., Keiji Kiyonaga, *Oshima Soshō Kōsoshin Hanketsu ni tsuite [Regarding the Decision in the Oshima Appeal]* 709 JURISUTO 114 (1980).

136. See, e.g., KITANO, *supra* note 115, at 107-14.

137. The lower courts in the *Oshima* case noted this vulnerability. See cases cited *supra* note 110; see also Judgment of Dec. 6, 1982, Tokyo Kōsai [High Court], 1062 HANJII 25 (Japan); Judgment of March 26, 1980, Tokyo Chisai [District Court], 962 HANJII 27 (Japan); KIYONAGA, *supra* note 38, at 89; KANEKO, *supra* note 38, at 182-83.

138. See *supra* text accompanying note 111.

139. See KANEKO, *supra* note 38, at 18-20.

140. Judgment of Mar. 24, 1985, Saikōsai [Supreme Court], 39:2 Minshū 247, 257-61, 261-62 (Japan).

141. *Id.*

There is also a more fundamental argument that it is senseless to compare one group of taxpayers with another when discussing equity. Accordingly, each individual must be compared to the general treatment accorded the rest of society. The right to equal treatment under the law is vested in each individual, rather than in the group.¹⁴²

F. International Comparison of Employment Income Deductions

Before the 1986 Tax Reform Act (TRA), salary earners in the United States were able to deduct four types of business expenses as well as limited moving expenses above-the-line, that is, in the computation of the adjusted gross income (AGI).¹⁴³ Other employee business expenses were deducted below-the-line as itemized deductions.¹⁴⁴

After the 1986 TRA, only the employee business expenses reimbursed by the employer and business expenses incurred by performing artists can be deducted above-the-line.¹⁴⁵ Though other business expenses can be deducted below-the-line, if a taxpayer chooses to itemize the business expenses and deduct them from AGI, she will lose her standard deduction.¹⁴⁶ The House Ways and Means Committee explains as follows:

[T]he distinction under present law between employee business expenses (other than reimbursements) that are allowable above-the-line, and such expenses that are allowable only as itemized deductions, was not supportable in most instances. The reason for allowing these expenses as deductions (i.e., the fact that they may constitute cost of earning income) app[lies] equally to both types of expenses.¹⁴⁷

This indicates that the argument in Japan relating to employment business expenses exists in the United States and that Congress is cognizant of the fact that employee business expenses inevitably have a more personal or mixed nature than other business expenses. Even so, Congress does not deny their deductibility entirely, but permits it below-the-line. The system that requires taxpayers to choose either the standard deduction or itemized deductions indicates that in most cases the standard deduction should cover most of an employee's business expenses. On the other hand, because of this approximation of business expenses in the standard deduction, American employees are treated less favorably than non-employees, because non-employees receive the standard deduction without incurring business expenses. This differs from the Japanese system in which the standard employment income deduction serves only as an approximation or substitution for actual business expenses.

142. See KLAUS TIPKE, *STEUGERECHTIGKEIT* 66-67 (1981).

143. I.R.C. § 62(a) (1982).

144. I.R.C. § 63(b)(1)(A), (c), (f) (1982).

145. I.R.C. § 62(a)(2) (1988).

146. I.R.C. § 63 (1988).

147. HOUSE WAYS AND MEANS COMM., *GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1986* 79 (1986) [hereinafter *GENERAL EXPLANATION*].

The 1986 TRA further introduced a 2% AGI floor, under which the deduction of the miscellaneous itemized deductions including employee business expenses is allowed only to the extent that the aggregate of such deductions exceeds 2% of AGI.¹⁴⁸ Selection of this 2% floor by the House Ways and Means Committee was based on the I.R.S.'s enforcement problems: "This floor will relieve taxpayers of the burden of record-keeping unless they expect to incur expenditures in excess of the percentage floor. Also, the floor will relieve the Internal Revenue Service of the burden of auditing deductions for such expenditures when not significant in aggregate amount."¹⁴⁹

From this explanation, the reason for the change is clear but not necessarily convincing. If the employee's business expenses are a necessary cost to earning income, then more than net income is subject to tax by virtue of the 2% floor only in the case of employment income. If Japan introduces this kind of floor with respect to the business expenses of employees, the government can expect that suits will be brought challenging the constitutionality of this rationale.

On the other hand, the United States allows employment-related expense credits under which the applicable percentage of the expenses for household services and the care of a qualifying individual are credited, subject to some limitations.¹⁵⁰ This credit system can avoid the regressiveness of the deduction system because the taxpayer can save the same amount of tax without regard to the amount of income. However, to treat these kinds of expenses not as deductions but as credits means that they are not considered necessary expenses of earning employment income. Allowing these credits may indicate the weakness of the taxpayer's ability to pay the employment income tax, and allowing a credit is suitable to adjust for that weakness.

As for the ability to pay, the United States allows the earned income credit¹⁵¹ which is more reasonable than the Japanese standard employment income deduction in two ways. First, in the United States, the credit system reduces the tax of the poor and that of the rich by the same amount. Second, the credit is for employees and earners of other kinds of income.¹⁵² A problem which is not as openly discussed in the United States as in Japan is the difference in capture ratios. This may be because there are fewer serious problems of this nature in the United States.

148. I.R.C. § 67 (1988).

149. See GENERAL EXPLANATION, *supra* note 147, at 78. The Joint Committee also noted that, under prior law, I.R.S. enforcement problems "were exacerbated by the fact that taxpayers frequently make errors of law regarding what types of expenditures are properly allowable as miscellaneous itemized deductions." *Id.*

150. I.R.C. § 21 (1988).

151. I.R.C. § 32 (1988).

152. I.R.C. § 32(c)(2)(A) (1988).

V.
CONCLUSION

This paper has discussed three main topics in Japanese taxation from the viewpoint of how tax law and the Constitution govern tax administration. First, by circular taxation the tax authority tries to avoid Diet-made rules by resorting to self-made rules. This allows the tax authority to manipulate or evade the rule of law. Second, in terms of the denial of tax avoidance, the tax authority ignores the actual legal formulation chosen by the taxpayer and replaces it with a hypothetical one. This manipulation of the facts amounts to the tax authority making a new taxing condition. Finally, in employment income taxation, the tax authority, though it prevailed in the Supreme Court *Oshima* case, could not successfully eliminate the widespread suspicion among taxpayers that the flat denial of business expense deductions to employees violates Article 14 of the Constitution. Although the Diet was later forced to enact the Specified Payment Deduction provision, employment income is still subject to unfavorable treatment compared to business income, mainly due to considerations of enforcement. These tensions between taxpayers and the tax administration have been the source of the development of legal studies in tax law in Japan.