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# INTERNATIONAL TAX EVASION AND AVOIDANCE IN JAPAN*

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## *Introduction*

In the past several years, correction of unfairness in the tax system has been one of the important policy objectives of the Japanese government. The social imperative of securing a fair sharing of the tax burden still remains strong among the general public especially in light of the prerequisite of tax increases in the future. Japan's fiscal budgetary deficit has swollen remarkably since the oil crisis in 1973 and continues to rise. In order to reduce dependence on fiscal deficit in compiling the budget, the Japanese government is making great efforts towards cutting expenditures. However, many people implicitly admit the necessity of increasing the tax burden in some form (e.g., VAT) to diminish the gap between government revenues and expenditures in the near future.

Against this background, major concerns are with the existence of unfair income taxation, which should be removed before introducing any new devices for tax increases. Thus, increased attention has been paid to the concepts of tax avoidance and tax evasion as forms of unfair taxation. Since these are presently only descriptive terms, no clear-cut definition is given officially in this area of tax administration.

In general terms, however, tax evasion and tax avoidance are distinguishable concepts. That is to say, tax evasion is relevant to behavior of taxpayers who deliberately violate a tax provision to reduce tax liability by such means as nonreporting of income or concealment of facts giving rise to tax liability. This is really illegal conduct and needs special attention. By contrast, tax avoidance generally covers a broader range of behavior intended to minimize one's tax burden. This conduct is accepted as a wholly legitimate phenomenon, and thus might well apply to all forms of tax minimization other than tax evasion. Thus, tax avoidance may include the generally accepted range of "tax saving." In fact, the Japanese connotation of the term tax avoidance resembles, more or less, the accepted scope of tax saving in the international context. This demonstrates the considerable attention which is paid to international taxation in the promotion of tax equity. For example, in 1978, anti-tax haven measures were first introduced as only one general measure to combat the international avoidance and evasion we are now experiencing in Japan.

Similarly, domestic aspects of taxation have been much criticised in terms of the unfair

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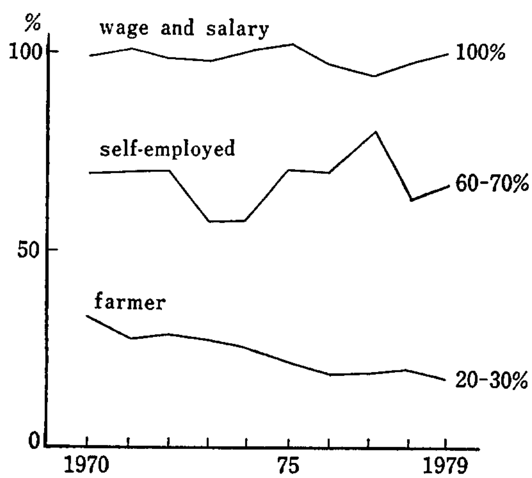
burden caused by tax evasion and avoidance. In particular, it is widely believed, especially among salaried workers, that there are large divergences in the identification of taxable income, depending upon different classes of taxpayers. Since salaried workers are taxed fully at source under the withholding income tax, their income is almost fully (90%) identified by tax authorities.

On the other hand, those self-employed (including practicing doctors and lawyers) and farmers file their income returns by themselves. They are not taxed fully at source and can easily dodge tax liability by cheating on reporting their income. Reputedly, only 60% of the self-employeds' income and 40% of farmers' are caught by the tax office. These percentages (90–60–40%) are used so often in describing the present unfair situation in the Japanese tax system that a special term has been coined; "*Ku-ro-yon*" is a portmanteau word of Japanese numbers—9 (ku), 6 (ro) and 4 (yon).

It is difficult to test statistically the "*Ku-ro-yon*" ratio. One possible method is to compare the scope of aggregate taxable income in tax statistics with the counterpart found in national income statistics, after the necessary adjustment for obtaining the common base to be compared. In Fig. 1, percentages of taxable income derived from tax statistics relative to those for the national income are computed and depicted for 1970–79 by three different classes of income earners. The "*Ku-ro-yon*" ratio does indeed seem to be approximated by these statistical procedures, although the results are far from satisfactory. The gap between these three classes of income earners would probably include factors of both evasion and avoidance. Obviously, it would be impossible to draw borderline distinctions statistically.

Under the current circumstances in Japan, the national climate vis-a-vis tax avoidance and evasion attracts wide attention among the general public. Preventing tax avoidance

FIG. 1 TAX EVASION AND AVOIDANCE IN JAPAN




*Note:* Figures are percentages of taxable income derived from Tax Statistics to counterpart found in National Income Statistics.

and evasion, internal and international, comprises an important target for developing tax policy.

## I. *General Measures to Combat Tax Avoidance and Tax Evasion*

Internal Japanese tax law applies three principles to tax avoidance and tax evasion. These are the principles of substance over form, computation of net income, and special treatment of "family corporations." First, Japan's Income Tax Law (ITL) contains the basic principle of taxation of the actual beneficiary. That is to say, priority is given to economic reality over legal form. This is not specifically a rule for the purpose of preventing tax avoidance and evasion, but rather is a practical rule in view of tax equity.

According to Article 11 of the ITL, taxes are levied on the person to whom income or gains accruing from assets or enterprises are deemed to revert. As a result, income taxes are not applicable to a merely nominal recipient who does not enjoy these gains although he may be specified as the legal recipient in the tax form reported to the authorities. Importance is given to substance over form, but it is not always easy in practice to determine to whom income pertains. For instance, according to an agreement between two persons (Mr. A and Mr. B), Mr. A often presents himself to third parties as the person entitled to receive a certain kind of income. On the other hand, Mr. B actually benefits from all such income because it is channeled to him through Mr. A. In such a case, income taxes are levied on the person (Mr. B) to whom the income finally reverts in economic reality.

Second, under Article 22 of the Corporation Tax Law (CTL), the scope of income is defined according to a general rule for computing the income amount in each accounting period. The income amount is computed on the basis of books and records which are required to be kept by all corporations under the Commercial Code and other laws and regulations. Income for each accounting period is defined as the excess of total receipts over total expenses.

One provision may be worth noting pertinent to the definition of income for the purpose of taxation. When corporations transfer their assets free of charge or at a remarkably low price, the amount of money they would otherwise have received is recognized as part of their receipts. That is to say, an amount equivalent to the difference between the actual price and the current market price or the fair market value is considered as a receipt. This provision can be applied to prevent tax evasion on arbitrary transactions in international operations between associated enterprises.

Third, special treatment is given to "family corporations," which are defined as corporations which have three or fewer shareholders (or three or fewer groups of specially related shareholders) owning 50% or more of the capital. Shareholders can be natural persons or legal entities, so subsidiary corporations owned by parent corporations come within this definition. It is widely acknowledged that the book entries of such corporations are often unnatural and transactions between a family corporation and its shareholders are not always made at arm's length. The same can be said for transactions between parent and subsidiary or between two subsidiaries controlled by one parent company. In view of maintaining fair income taxation, Japanese tax authorities may deny any such transactions or book entries if they are found to unreasonably decrease the tax burden of these corporations. In this case, tax authorities have discretion to recalculate the basis of taxable income within reasonable limits.

Japan has no major measures specifically aimed at international tax evasion and avoidance, except for its anti-tax haven measures. However, several internal provisions, such as those which have been discussed so far, are in general applicable to the international area.

## II. *Specific Measures to Combat Tax Avoidance and Evasion*

Specific measures to combat tax avoidance and evasion are aimed at both the individual and the corporate levels. The withholding tax mechanism works as an effective means to prevent tax avoidance and evasion. As an illustration, non-resident individuals must pay tax at a flat rate of 20% on income derived from personal services, which are defined as follows:

(1) salaries, wages, or similar remuneration paid to an employee for his personal services,
(2) retirement allowances or pension payments for past personal services,
(3) remuneration paid to an individual for professional personal services performed in Japan.

Taxes are collected directly from the payer of income under the withholding system. Even in the case of an artist, athlete or consultant who incorporates a company whose business is the provision of that person's personal services (a "one-person company"), remuneration for such services is taxed at source when paid to the company.

Also, capital gains enjoyed by a non-resident taxpayer, an individual or a corporation, from the sale of shares and other securities are exempt from income taxation in Japan. However, those derived by a non-resident taxpayer from the sale of a substantial portion of the shares of a Japanese company are subject to taxation. This legislation is useful in preventing tax avoidance on income from alienation of business assets or real estate taking the form of the alienation of shares.

It is the principle under Japanese tax law that taxable income of foreign corporations is restricted to that portion of income accrued from sources within Japan. Thus, when a Japanese overseas subsidiary located in a tax-haven country earns interest from foreign investment made through its permanent establishment in Japan, investment income was not taxed in Japan and escaped taxation entirely.

The 1973 tax law amendments provided for closing this tax loophole. Primarily, income accrued from overseas investment through a place of business ("permanent establishment") located in Japan is treated as income from business carried on within Japan if such income is not taxable overseas.

Lastly, as regards business income, a foreign corporation can avoid taxation on business income by doing business in Japan without having its own permanent establishment, such as an office, construction or assembly site, or contract concluding agent.

## III. *Tax Havens*

In 1978, anti-tax haven tax measures were introduced. This reflects the growing internationalization of the Japanese economy as enterprises seek to reduce tax liabilities by establishing subsidiaries in tax havens. The new legislation defines the term "tax haven" as a "country and/or area where tax burdens on all income or on particular types of income of corporations is significantly lower than those on income of domestic corporation in Japan." More particularly, these countries and areas are classified into three categories, as follows:

(1) Countries with low rates of taxation—Bahama, Bermuda, etc.
(2) Countries with low rates of taxation on income from foreign sources—Panama, etc.
(3) Countries with low rates of taxation on income from specific business activities—Liberia (international transportation company income), Luxembourg (holding company income), etc.

The term "low rates of taxation" implies that the effective rates of corporate tax are less than half the rates in Japan and includes no tax at all. The number of subsidiaries and affiliates of Japanese enterprises believed to be located in these low-tax countries is estimated at about 900.

The anti-tax haven law can be outlined in four major points:

(1) *Specific foreign subsidiaries*

"Specific foreign subsidiaries" are defined as corporations in low-tax countries in which Japanese domestic corporations and residents hold directly or indirectly more than 50% of the issued shares. Thus, specific foreign subsidiaries are not necessarily first-tier subsidiaries, but may be foreign corporations at successive layers of control.

Where a vertical chain of ownership is formed between Japanese domestic corporations and specific foreign subsidiaries subject to taxation, the indirectly held part of the shares is computed proportionately by multiplying the successive proportions of shares held in each of the intermediate subsidiaries to arrive at the percentage of total shares issued by the specific foreign subsidiary deemed to be controlled by the Japanese corporations.

(2) *Scope of taxed corporations*

Taxes are levied on (a) domestic corporations which hold directly or indirectly 10% or more of the shares issued by a specific foreign subsidiary, and (b) domestic corporations belonging to a group of individual shareholders from the same family that together hold directly or indirectly 10% or more of the shares of a specific foreign subsidiary. On this point, the criterion of 10% has been adopted from the Japanese Commercial Code, which defines a "major stockholders" with respect to the right of shareholders to examine the company books. The inclusion of (b) is concerned with attempts to avoid the application of the new tax measures by dispersing shareholding of 10% or more among individuals related to one another.

(3) *Retained income subject to taxation*

Retained income of the specific foreign subsidiary in a low-tax country is regarded as earnings of the domestic corporation and thus taxable under the new tax system. Particularly, retained income is computed at the taxpayer's option (a) under the Japanese Corporation Tax Law and the Special Taxation Measures Law, or (b) in accordance with tax laws of the country in which the subsidiary's head office is located, subject to certain modifications under the Japanese tax laws. Losses arising for the past five years are deducted in order to define the scope of taxable income.

(4) *Time point for determination of the specific foreign subsidiary*

It is necessary for the purpose of taxing under the anti-tax haven legislation to fix a point in time for recognition of a specific foreign subsidiary. Judgment is made on the basis of the situation at the end of the foreign corporation's accounting year.

(5) *Exclusion from application*

Of great importance here are the provisions on excluded income. At first sight, it may appear that all retained income of specific foreign subsidiaries should be taxed without exception. There are, however, several important restrictions preventing full application of these tax measures. The basic idea behind these restrictions arises from Japan's special economic position attendant upon its poor endowment of natural resources and the necessity of capital exports. Assuming this basic policy, economically valid and legitimate business activities should not be subject to such tax liability as is levied in the case of specific foreign subsidiaries.

Major conditions or criteria for exclusion from application of anti-tax haven measures are classified into four items. First, holding companies whose principal business activity is merely the holding of stocks and bonds are made subject to the tax measures. The main reason for this is that it is difficult to recognize sufficient economic reason in locating businesses in low-tax countries in view of the nature of the business activity.

Second, there is the criterion of fixed facility in order to judge whether or not taxes are levied. To satisfy this exclusionary provision, the specific foreign subsidiary is required to have an office, shop, factory, or other fixed facility in the country where its head office is located. Needless to say, these facilities must be recognized as necessary to the conduct of its business.

The third criterion is that the company itself should supervise, control and manage its own business affairs. This criterion must be satisfied at the local level of the specific foreign subsidiary.

The fourth criterion is related to the third and is called the "location" or "non-related persons" requirement; that is, the specific foreign subsidiary must conduct its business mainly in the country where its head office is located or must deal principally with persons other than related persons.

Finally, as an overall condition, the exclusion is limited to cases where the maximum amount of dividends received from another specific foreign subsidiary does not exceed 5% of total revenue.

A foreign subsidiary is exempted from application of the anti-tax haven measures only if it satisfies all of the above conditions or criteria.

Obvious from the foregoing discussion, the anti-tax haven measures place emphasis on the aim of preventing tax evasion and avoidance in Japan. While the American and West

German systems specify certain types of retained income ("tainted income") as tax targets, the Japanese system levies taxes on all of the retained income of specific foreign subsidiaries so long as they do not fall within given criteria for exclusion. Such exclusions are made according to whether foreign subsidiaries have proper economic and non-tax reasons to exist in low-tax countries. With these exclusions, it is not necessary under the Japanese system to specify certain tainted income and the income is taxed as a whole. It can be expected, however, that this approach can make tax administration more difficult.

With regard to cooperation with tax haven countries to combat tax evasion, there is at present no mechanism for the mutual exchange of information. Although it is unrealistic to expect future means for exchange of information, such exchange would certainly be helpful, desirable and significant for Japan to prevent tax evasion and avoidance. Furthermore, cooperation with tax authorities of non-tax haven countries is limited to exchange of information under relevant tax treaties. Such treaty provisions should be given full effect through cooperative efforts between the tax administrations of contracting countries.

## IV. *Abuse of Tax Treaties*

Japan's internal law has no special provisions to prevent the abuse of tax treaties. Thus, general domestic measures must be applied to international forms of avoidance and evasion connected with tax treaties.

In Japan, non-resident individuals or corporations are subject to the 20% withholding tax at the source on such income as interest, dividends, royalties, etc. The person required to withhold the tax, generally referred to as the "withholding agent," may be the actual payer of the income in question or one of several agents of the payer, such as banks or other financial intermediaries which have control over or custody of such payment.

Tax treaties between Japan and other countries commonly provide, on a reciprocal basis, for reduced tax rates on various categories of investment income (e.g., interest, dividends, rents and royalties) paid to residents of treaty partner countries. Reduced rates are available by having the payer, as the withholding agent, present to the local tax authorities the prescribed form filled out by the recipient. The payer may even complete the form on behalf of the taxpayer under a power of attorney from the taxpayer. The payer alone is charged with full knowledge of whether the recipient is entitled to treaty relief from Japanese tax and so the arrangements for tax payment center around the payer.

It should be noted that local Japanese tax authorities do not require certificates given by the appropriate revenue officials of the country concerned. The entries in the reduction request form made by the taxpayer or his duly authorized agent suffice. Merely by submitting the form to the local tax offices reduced treaty rates may be applied to the non-resident taxpayer. This demonstrates the Japanese tax authority's reliance on non-resident taxpayers.

Accordingly, under the current method, a recipient of Japan source investment income who has an address in a country with which Japan has a tax treaty will be presumed to be a resident of such country for purposes of obtaining reduced rates under the treaty. This presumption does not apply when the withholding agent has actual knowledge that the recipient is not a in fact resident of the country under whose treaty the reduced rates are claimed. It is impossible, however, for the tax office to identify whether the address is correct or not under the current filing method.

The present system of tax withholding on Japan source investment income is particularly vulnerable to abuse under tax treaties. The system permits tax evasion by persons who are not legitimate treaty beneficiaries but who merely establish post office boxes or nominee accounts in countries with which Japan has a tax treaty in order to obtain reduced rates of tax on interest, dividends, etc.

One possible check on this abuse is to adopt a refund system for the withholding tax. If adopted, the local tax offices would require withholding agents to withhold tax at the statutory 20% on all Japan source income paid to non-residents, regardless of the potential application of a treaty provision. A non-resident recipient of the income in question who claims treaty benefits would be required to file a tax return for the refund. The return would be accompanied by a "Certificate of Residence" from the competent authority of the country whose treaty benefits are being sought.

Obviously, such a refund system would be of great help to check abuse under tax treaties. The potential shortcomings inherent in the adoption of a refund system, however, should not be disregarded. One of such shortcomings is the possible negative effect on the flow of foreign capital into Japan caused by the increased costs to foreign persons of transactions which generate treaty-protected income. The increased costs would derive both from the inevitable time lag between the payment of the withholding tax and receipt of the refund of over-withheld amounts and from the limitations on interest payable by the government with respect to refunds.

Another concern in the control of treaty abuse is the efficient exchange of information with treaty partners. In Japan, the payer of interest, dividends, remuneration, royalties, wages and salaries to non-residents is required by the domestic tax law to submit a detailed statement of payment to the tax authority every year. Information collected by the Japanese tax authority is provided, on a reciprocal basis, to treaty partners in order to prevent the abuse of tax treaties.

## V. *Expected Trends and Developments*

In recent years, special attention has been paid to the issue of "transfer pricing" between Japanese firms and their overseas subsidiaries, especially U.S. subsidiaries. This issue is also pertinent to international tax evasion and avoidance. As a result of tax audits, the U.S. Internal Revenue Service (IRS) sometimes requests Japanese corporations to correct the transaction prices and levies additional taxes on sales income deemed to have been realized. In these cases, Japanese corporations encounter difficulties in proving the validity of the transaction prices due to the special relations between parent companies and subsidiaries.

Basically, the principle of arm's length bargaining is regarded in any country as the dominant rule applicable to international transactions. Under this principle, the transaction price in question is to be compared with the market-determined price among independent enterprises. If there is a significant gap between two levels of prices, the issue of proper transfer pricing is raised.

Needless to say, tax treaties include a stipulation relevant to the issue of proper transfer pricing for the purpose of establishing equitable taxation. At the practical level, however, a number of technical difficulties are involved in determining a case of transfer pricing. There is no way to avoid arbitrary judgments from being made by the relevant tax authority. Owing to the different views and interpretations in the pricing method, many cases have now proceeded to litigation. This is true with some IRS cases involving Japanese enterprises which have subsidiaries in the U.S. Some guideline providing safe habor is required to resolve international disputes on taxation concerning transfer pricing.

## VI. *Conclusion*

The discussion of international tax avoidance and evasion has not yet emerged as an important issue in Japan, although domestic phenomena relevant to tax evasion or avoidance receive much attention. In fact, Japan's tax system has no general measures exclusively to combat tax evasion and avoidance related to international transactions, with one exception, the anti-tax haven measures. Thus, internal measures designed to counteract domestic avoidance or evasion must be applied analogously to operations with international aspects.

In recent years, however, there has been a growing awareness of the need to counteract international evasion and avoidance. This reflects the recent emergence of many cases involving international issues. It is clear that the problem of international tax evasion and avoidance will become more important in the future. It is important, however, that international implications should be fully taken into consideration before one introduces new domestic legislation to combat international tax avoidance and evasion.

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