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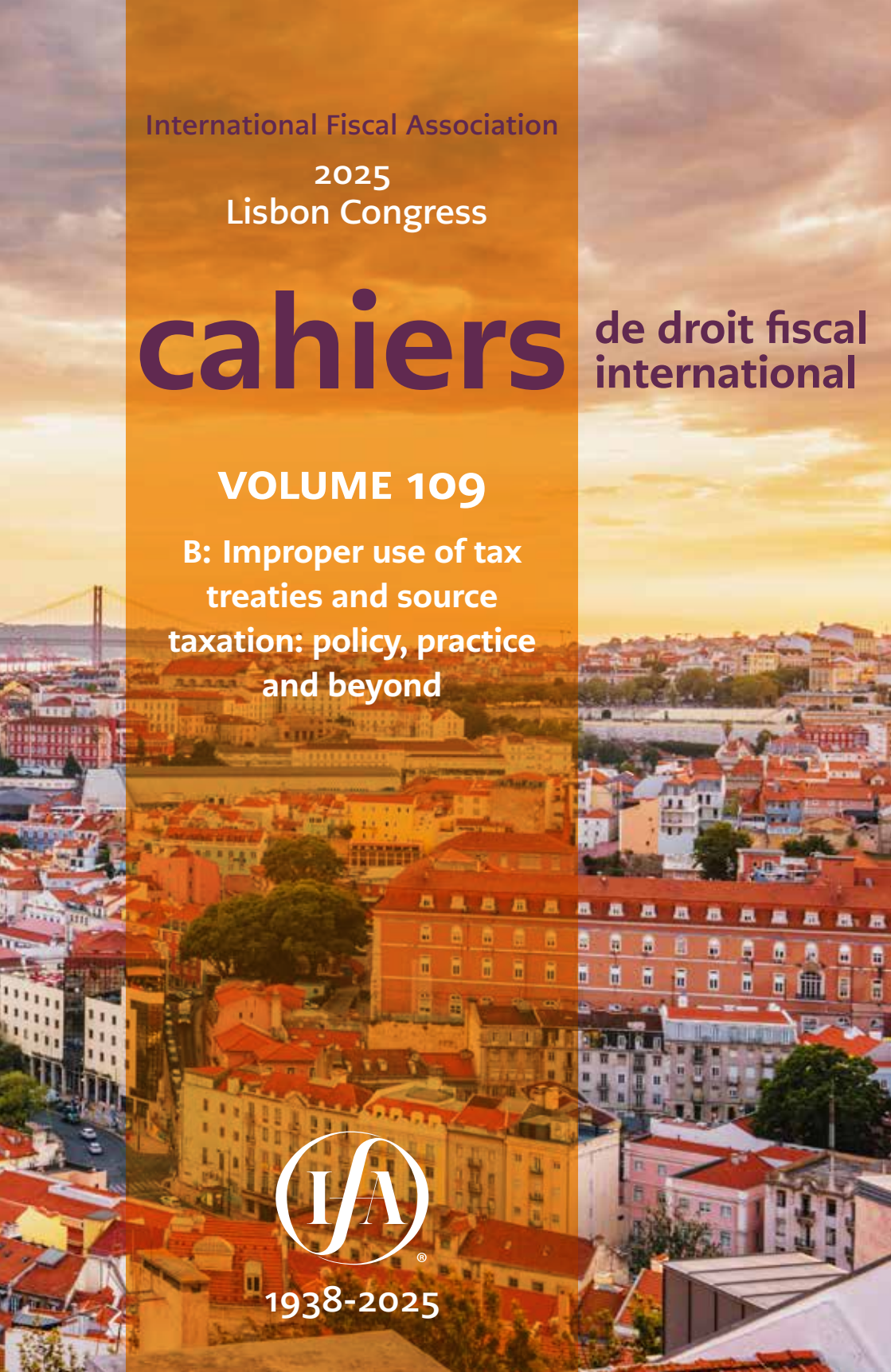
B: Improper use of tax treaties and source taxation: policy, practice and beyond



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Summary and conclusions

This report provides a comprehensive analysis of Japan's approach to counteracting improper use of tax treaties, both through domestic legislation and international frameworks. Below is a summarized breakdown of the key points:

1. *Line between proper and improper tax treaty use:* Japan has no specific judicial or administrative guidelines to define improper use of tax treaties, but case law emphasizes economic substance over subjective intent. Elements such as the unnaturalness of a transaction and absence of reasonable business purposes are critical in identifying abuse.
2. *Domestic anti-avoidance rules (SAARs and GAARs):* Japan employs Specific Anti-Avoidance Rules (SAARs) such as the Controlled Foreign Corporation (CFC) rule, Transfer Pricing (TP) rule, thin capitalization rule, and earnings-stripping rule to mitigate tax avoidance. General Anti-Avoidance Rules (GAARs) address family companies or corporate reorganizations that reduce the tax burden unnaturally, guided by Supreme Court criteria focused on the economic rationale of transactions.
3. *Interaction between domestic rules and tax treaties:* Generally, Japan's Constitution requires that treaties take precedence over domestic law, meaning tax treaties cannot be denied by domestic anti-avoidance rules unless the treaty itself includes an anti-abuse provision. Nonetheless, domestic anti-avoidance rules may indirectly influence treaty application if they reject the basis of a transaction or attribution of income, leading to treaty benefit denial.
4. *Treaty abuse cases:* Although Japan has rarely encountered treaty abuse cases, courts have, in some cases, upheld taxpayer claims that treaty benefits cannot be denied without explicit provisions due to Japan's Principle of Statute-Based Taxation.
5. *Treaty-based anti-avoidance measures:* Most Japanese treaties follow the OECD Model Convention, and Japan's tax treaties often include the simplified Limitation on Benefits (LOB) clause and the Principal Purpose Test (PPT) provision to curb treaty abuse.
6. *Dispute resolution and arbitration:* Japan primarily relies on Mutual Agreement Procedures (MAP) to resolve tax disputes, most of which involve transfer pricing. Arbitration is an available but rarely utilized mechanism so far, despite agreements with several countries.
7. *Japan's role in the BEPS project and future policy directions:* Japan actively supports international tax reforms through the BEPS project, particularly in adopting measures that strengthen source-based taxation. This includes legislative updates in line with the BEPS final reports and a commitment to continue aligning domestic rules with OECD agreements on minimum global tax standards. These initiatives aim to protect Japan's tax base while maintaining international competitiveness for Japanese companies.

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Overall, Japan's tax policy combines domestic anti-avoidance rules with international standards to safeguard against treaty abuse, while steadily integrating OECD agreements into its tax framework.

Part I

1. The line between proper and improper use of tax treaties

1.1. The decisive factors or elements

There are no judicial precedents or administrative guidelines that present any factors or elements for determining whether the situation is a proper or improper use of tax treaties. Having said that, the Supreme Court of Japan has ruled and emphasized the absence of economic rationality in the context of applying general anti-tax avoidance provisions under domestic law (see section 2.3 below). Based on this, it can be said that rather than subjective factors such as the taxpayer's intent to avoid taxes, objective factors like the absence of economic rationality or economic substance could be the decisive elements in evaluating the impropriety of applying a tax treaty.

1.2. Establishment of the elements of abuse

Referring to the criteria used in cases where the application of general anti-tax avoidance provisions under the domestic law was disputed before the Supreme Court, whether an act constitutes abuse would be judged based on elements such as (i) the unnaturalness of the transaction, i.e., whether the transaction was conducted based on steps or methods that are not normally expected, or whether it created a form that deviates from the actual substance, and (ii) the presence of a reasonable cause, i.e., whether there are business purposes or other reasons justifying the transaction beyond merely reducing tax liabilities.

The above is an interpretation of the domestic law provisions that address the "improper" reduction of tax liabilities. Nonetheless, if the essence of the abuse in the context of tax treaties also lies in the "improper" application of tax treaties to reduce taxes, then it can be understood that the fundamental elements to establish the abuse should be the same.

1.3. Guidance from the tax authorities on the line of abuse

There is a view presented by a government official to interpret the applicability of the principal purpose test (PPT) under tax treaties, which suggests a comprehensive assessment of (i) the artificiality of the transaction and (ii) the presence of legitimate business purposes

to draw a line between a proper and an improper application of tax treaties.[2] It can be said that this view is equivalent to the interpretation criteria outlined in section 1.2 above.

1.4. Difference in the evaluation of proper/improper use

It is understood that factors used to identify tax avoidance, such as whether the transaction is unnatural or whether the purpose is reasonable, would not be considered when interpreting the ordinary distributive rules.

1.5. The burden of proof

As a rule, in applying anti-tax avoidance provisions, the burden of proof of impropriety rests with the tax authorities. Although the formal wording of one of the two requirements to apply the PPT, specifically saying "unless it is established", might suggest that the burden of proof is transferred, it should be interpreted that the tax authorities still need to prove that granting the treaty benefit would not be in accordance with the object and purpose of the relevant treaty provisions, since the two requirements should be comprehensively judged.

The threshold for proof is the same as in general civil litigation, requiring the judge to be convinced.

1.6. Time for evaluation

Generally, the evaluation is based on the circumstances at the time of the transaction, but subsequent events may serve as indirect facts that infer the purpose or other factors at the time of the transaction.

1.7. The effect if there is an improper use of the tax treaty

No penalties can be imposed in the absence of explicit provisions, nor can the application of the tax treaty be denied beyond the scope of each provision. Furthermore, even if a transaction is deemed abusive, the tax authorities are not permitted to recharacterize transactions or establish a legal relationship that differs from the parties' agreement without explicit provisions.

[2] Kentaro Ogata, *Debate about Anti-Tax Avoidance Measures under the BEPS Project, etc.*, Financial Review vol. 126, p. 205 (2016).

2. General information about Japan

2.1. The main specific anti-avoidance rules (SAARs) designed to protect source taxation

2.1.1. Overview

The main specific anti-avoidance rules (SAARs) include the controlled foreign corporation (CFC) rule, transfer pricing (TP) rule, thin capitalization rule, and earnings-stripping rule, as described below.

2.1.2. CFC rule[3]

The CFC rule was first introduced in 1978, and before BEPS, the rule's application was mainly based on the trigger tax rate (20%), which tended to result in the fact that entities like paper companies without economic substance were excluded from the scope only if they met the 20% tax rate. Following BEPS Action 3, the rule was revised in 2017 to expand the scope. As a result, the rule applies to paper companies and cash-box companies even if the 20% tax rate is met. In addition, an income-based approach (as opposed to an entity-based approach) has also been introduced. In cases where the 20% tax rate is not met, passive income is broadly subject to the rule, even if there is economic substance.

2.1.3. TP rule[4]

The TP rule was first introduced in 1986, based on other countries' systems and the OECD Transfer Pricing Guidelines. The rule has since been revised to reflect updates to the OECD Transfer Pricing Guidelines. Furthermore, in response to the recommendations of the final BEPS report (Actions 8-10), the 2019 tax reform introduced enhancements to ensure alignment with international standards and more effectively address the risks of income shifting overseas. These enhancements included the addition of the DCF method and the introduction of a system corresponding to the HTVI approach.

2.1.4. Thin capitalization rule[5]

The thin capitalization rule was first introduced in 1992. This rule denies the deduction of interest expenses on debt exceeding a certain ratio of capital to debt (in principle, 1:3) owed to a foreign parent company by a domestic subsidiary. Since this is a formal standard, parent-subsidiary companies can easily adjust the ratio to avoid exceeding the threshold while maximizing debt. Thus, there was a possibility that the thin capitalization rule alone might not sufficiently address tax avoidance (refer to the *Universal Music* case discussed in section

[3] Art. 40-4 (for individual residents) and art. 66-6 (for domestic corporations) of Act on Special Measures Concerning Taxation.

[4] Art. 66-4 of Act on Special Measures Concerning Taxation.

[5] Art. 66-5 of Act on Special Measures Concerning Taxation.

2.3 below). Consequently, the earnings-stripping rule, described below, was introduced in 2012. After BEPS, the thin capitalization rule has not been significantly amended.

2.1.5. *Earnings-stripping rule*[6]

The earnings-stripping rule was first introduced in 2012. Before BEPS, it denied the deductibility of net interest (i.e., the amount of interest paid minus corresponding interest received) paid to related parties in excess of 50% of EBITDA. Following BEPS Action 4, the rule was revised in 2019, lowering the threshold from 50% to 20% and expanding the scope to include interest paid to unrelated third parties.

2.2. Effectiveness, frequency, and litigation

The limitation on interest expense deductions (sections 2.1.4 and 2.1.5 above) has rarely been an issue and is generally considered to function efficiently. On the other hand, the CFC rule (section 2.1.2 above) and the TP rule (section 2.1.3 above) have been often contested in litigation. Among others, issues regarding inefficiency of the CFC rule are frequently pointed out.

In Japan, under the "Principle of Statute-Based Taxation,"[7] tax conditions must be explicitly defined. Therefore, the scope of rule application should not be set based on substantive criteria, but instead, it often relies on formal standards. In this regard, the CFC rule, even before BEPS, sought to capture any potential tax avoidance comprehensively, resulting in a broad scope of application. Moreover, as mentioned earlier, the rule was strengthened after BEPS, further expanding its scope. As a result, a lot of "over-inclusion" problems occur, where entities that should not be subject to the CFC rule are nonetheless included in its scope.

In this way, the CFC rule attempts to capture everything using formal standards, leading to inefficiencies in the taxation system. What is even worse is that tax authorities tend to apply the CFC rule in a formalistic manner, regardless of whether tax avoidance is involved, resulting in disputes with taxpayers.[8]

6 Art. 66-5-2 of Act on Special Measures Concerning Taxation.

7 Art. 84 of the Constitution of Japan. Under this principle, it is understood that literal interpretation of legal provisions is strictly required.

8 See, The Supreme Court Decision 2023-11-06, *Minshu* vol. 77, No. 8, p.1933 [*Mizuho Bank* case] (https://www.courts.go.jp/app/files/hanrei_jp/467/092467_hanrei.pdf);
Tokyo High Court Decision 2021-11-24, *Zeishi* vol. 271, No.13633 [*Sanrio* case] (https://www.nta.go.jp/about/organization/ntc/soshoshiryo/kazei/2021/pdf/13633.pdf);
The Supreme Court 2017-10-24, *Minshu* vol. 71, No. 8, p. 1522 [*Denso* case] (https://www.courts.go.jp/app/files/hanrei_jp/157/087157_hanrei.pdf); and
Tokyo High Court Decision 2015-02-25, *Zeishi* vol. 265, No.12612 [*Citi Group* case] (https://www.nta.go.jp/about/organization/ntc/soshoshiryo/kazei/2015/pdf/12612.pdf).

2.3. Domestic General Anti-Avoidance Rule (GAAR)

Under Japanese domestic law, there are several anti-avoidance provisions generally applicable to tax avoidance cases, although their scope is limited to the situations where the actor is a family company or the transaction involves a corporate reorganization, which includes (i) the provisions for rejecting acts or calculations of family companies[9] and (ii) the provision for rejecting acts and calculations pertaining to organizational restructuring of corporations.[10] A common application requirement for these provisions is the condition that "if such acts or calculations are allowed, it would improperly reduce the tax burden." This is referred to as the "impropriety" requirement. There are many court cases where the impropriety requirement has been contested, but the criteria presented in the recent Supreme Court case[11] are particularly instructive, which will be introduced below.

In this case, a new Japanese corporation was created as part of a group reorganization of the multinational corporation headquartered in France and engaged in the music-related business. The newly created corporation borrowed a large sum of money from an overseas related corporation to acquire the shares of an existing Japanese corporation that was already operating within the group and then merged with it. As a result, the existing corporation incurred a significant amount of debt, and a large amount of interest payments were deducted from its domestic business profits. The capital of the newly created corporation was about 29.5 billion yen, while the loan amounted to approximately 86.6 billion yen. The transaction did not meet the requirements for the application of the thin capitalization rule because it was within the allowable limit, and the earnings-stripping rules did not exist at that time. Therefore, the tax authorities applied the provision for rejecting acts or calculations of family companies, arguing that the reorganization transaction involving borrowing from a related foreign party was improperly reducing the corporate tax burden.

In response, the Supreme Court made the following ruling, setting out the criteria for assessing the impropriety requirement:

"The phrase 'acts or calculations of a corporation that, if allowed, would result in an improper reduction of the corporate tax burden' should be understood to refer to those acts or calculations of family companies that are economically and substantively unnatural or unreasonable, in other words, those that lack economic rationality and would result in a reduction of the corporate tax burden. … In examining whether something lacks economic rationality, it is appropriate to consider [1] whether the series of transactions is unnatural, such as being based on procedures or methods that are not normally expected or creating forms that deviate from the actual substance, and [2] whether there are reasonable business purposes or other reasons for the reorganization besides reducing the tax burden."

Thus, in determining the impropriety requirement, the Supreme Court's stance is to comprehensively consider (i) the unnaturalness of the transaction and (ii) the reasonableness of the purpose to assess the presence or absence of economic rationality. This approach can also be considered relevant when evaluating impropriety in the context of applying tax treaties.

In cases where general anti-avoidance rules are applied, there are no special penalties imposed, but the same penalty taxes as in cases of underreporting are applied. The

9 Art. 157 of Income Tax Act, Article 132 of Corporation Tax Act.

10 Art. 132-2 of Corporation Tax Act.

11 The Supreme Court Decision 2022-04-21, *Minshu* vol. 76, No. 4, p.480 [*Universal Music* case] (https://www.courts.go.jp/app/files/hanrei_jp/112/091112_hanrei.pdf).

requirements for penalty taxes are defined by law, and there is generally no room for discretion, but they may be waived if there is a legitimate reason.

2.4. Application of domestic SAARs and GAAR to treaty abuse

There has been no case so far where the denial of the application of a tax treaty has become an issue under the domestic anti-tax avoidance rules.

2.5. Interaction between domestic anti-avoidance rules and tax treaties

Generally, treaties shall be faithfully observed under Japanese constitutional law.[12] This means that treaties take precedence over domestic law, and such principle is also applicable to tax treaties. Consequently, the applicability of tax treaties should not be denied due to domestic anti-avoidance rules.

Nonetheless, there is a possibility that taxpayer's acts or calculations might be rejected by the tax authorities under the domestic anti-tax avoidance rules, and consequently, the application of tax treaties can be denied. Also, there is another possibility that the "Principle of Taxing the Actual Earner"[13] may apply to recognize the person to whom income is attributable, which functions similarly to the beneficial ownership requirement under tax treaties. In essence, this principle provides that if the recipient of income is merely a nominal holder, the income is attributed to the person who substantially enjoys the income. For example, if a resident of a treaty partner country receives income but is merely a nominee and the actual rights holder is a resident of a third country, the income is attributed to that third-country resident for tax purposes. In such cases, the application of the treaty can be denied.

2.6. Proposals to reform any of the domestic SAARs or domestic GAAR

The general anti-tax avoidance rules mentioned in section 2.3 above are more comprehensive than the specific anti-avoidance rules; however, the scope of the GAARs is limited to cases where the actor is a family company, or the transaction involves a corporate reorganization. For this reason, the need for a broader general anti-tax avoidance rule that is not limited by the type of actor or transaction is sometimes advocated. Nevertheless, there are strong cautious opinions regarding the introduction of such a general rule, as it would grant excessive discretion to the tax authorities and harm the predictability for the taxpayers.

[12] Para. 2 of art. 98 of the Constitution of Japan.

[13] Art. 12 of Income Tax Act, art. 11 of Corporation Tax Act.

3. Typical treaty abuse situations in Japan

3.1. Cases involving treaty shopping

There is a case[14] involving the old Japan-Ireland tax treaty (the "Treaty") that was seen as treaty shopping. In terms of the facts, X Co (a Cayman Islands entity with a branch in Japan), who was the business operator under a silent partnership agreement, made profit distributions to A Co (an Irish entity), a silent partner under the same agreement. Under domestic law, withholding tax would be required on these payments, but the application of the Treaty would exempt them from withholding tax.

The issue was that although A Co had the right to receive the profit distributions as a silent partner, A Co had entered into a swap agreement with B Co, a limited liability partnership formed in Bermuda, a tax haven. A Co was obligated to pay 99% of the profit distributions received to B Co. If B Co were considered the recipient of the distributions, the Treaty would not apply. Furthermore, the money transferred from A Co to B Co, based on the distributions (i.e., 99% of the distributions from X Co), was not taxed in either Ireland or Bermuda, with only the remaining 1% being subject to taxation in Ireland. Moreover, if the treaty had the beneficial ownership requirement, the application of the investment income provisions could have been denied on the grounds that A Co was not the beneficial owner, but at the time of the case, the Treaty did not have the beneficial ownership requirement.

Based on the above circumstances, the tax authorities argued that this case was an abuse of the tax treaty for the purpose of tax avoidance and that the general principle specified in the OECD Commentary would allow the denial of the application of the tax treaty, even in the absence of explicit provision. However, the Tokyo High Court rejected the tax authorities' argument, reasoning that under the Principle of Statute-Based Taxation, explicit provision is required to deny the application of a tax treaty.

3.2. Cases involving indirect transfers

There has been no case of treaty abuse involving indirect transfers in Japan.

3.3. Cases involving surplus stripping

There has been no case of treaty abuse involving surplus stripping in Japan.

3.4. Cases involving other forms of treaty abuse to avoid source-based taxation

There is a case[15] which involved the abuse of the old Japan-Netherlands tax treaty (the "Treaty") in what is referred to as the "TK (*Tokumei Kumiai*) scheme". In an investment through a silent partnership called TK, profit distributions to the silent partner (i.e., the

[14] Tokyo High Court Decision 2014-10-29, *Zeishi* vol. 264, No.12555 [*JP-IE Tax Treaty* case] (https://www.nta.go.jp/about/organization/ntc/soshoshiryo/kazei/2014/pdf/12555.pdf).

[15] Tokyo High Court Decision 2007-06-28, *Hanji* No. 1985, p. 23 [*Guidant* case].

investor) are deductible as expenses for the Japanese corporation (i.e., the TK operator), thereby eroding the tax base of Japan. Under domestic law, such distributions are subject to withholding tax, but if the "Other income" article of the Treaty is applied, the income would be exempt from taxation in Japan. Furthermore, if the income is not taxed in the country of residence either, it would result in double non-taxation.

The tax authorities argued that the Japanese TK operator had a permanent establishment (PE) in Japan, and thus the "Business profits" article should apply. However, the court ruled that the "Other income" article, not the "Business profits" article, was applicable.[16] The tax authorities also argued that the TK scheme, being a tax avoidance scheme, contradicted the purpose of the tax treaty. However, while the court acknowledged that there was a purpose of tax avoidance by the taxpayer, it ruled that there was no legal basis to deny the application of the treaty.

Part II

4. Treaty-based SAARs

4.1. Treaty-based SAARs in Japan's tax treaties

Since the conclusion of the Japan-U.S. tax treaty in 2003, Japan has introduced in treaties with major countries, such provisions that address treaty shopping, combining the simplified LOB clause with conduit transaction prevention provisions or the PPT. For other forms of tax treaty abuse, Japan has generally adopted specific anti-tax avoidance rules (SAARs) that are in line with the OECD Model Convention. Also, Japan has signed and ratified the MLI, whereby Japan has adopted the SAARs except article 8 (Dividend Transfer Transactions) and article 14 (Splitting-up of Contracts).

4.2. The relevance of the UN Model in Japan's tax treaties

Although Japan generally follows the OECD Model Convention, it sometimes incorporates provisions from the UN Model Convention at the request of the other contracting country.

4.3. The beneficial ownership requirement in articles 10, 11 and 12 of the OECD Model

In Japan, the Principle of Taxing the Actual Earner (see section 2.5 above) governs the attribution of income, and the beneficial ownership requirement is regarded as an anti-tax avoidance provision. When the Principle of Taxing the Actual Earner is applied, the application of the tax treaty can be denied without the need to apply the beneficial

[16] Although the tax authorities did not argue the application of the "Interest" article, it is considered that the "Interest" article could have been applied, resulting in the withholding taxation at the reduced treaty rate.

ownership requirement. If the concept of beneficial owner is interpreted more broadly than that of actual earner, there would still be cases where the application of a tax treaty is denied through the beneficial ownership requirement, even when the Principle of Taxing the Actual Earner does not apply.

4.4. Entities considered as transparent from the source state

In general, foreign entities that do not qualify as "corporations" are treated as "partnerships" without legal personality. In this regard, the recent Supreme Court case[17] provides useful judgment criteria, which are introduced below.

In this case, a Japanese investor (an individual) invested in a limited partnership (LPS), a foreign entity established under the laws of the state of Delaware, USA, and offset the losses incurred by the LPS against their other income. The tax authorities, however, argued that the LPS qualifies as a corporation under Japanese tax law, and therefore, the losses should be attributed to the LPS itself, not the individual, making the offsetting of losses with other income impermissible. The key issue was determining the criteria for assessing whether a foreign entity like the LPS qualifies as a corporation.

The Supreme Court set out the following two criteria and determined that the LPS in this case qualifies as a corporation:

i. Whether, based on the wording of the provisions and the structure of the legal system under the law under which the entity was established, it is clear beyond doubt that the entity has been granted a legal status equivalent to that of a corporation under Japanese law.
ii. (If a determination cannot be made under criterion i), whether rights and obligations are attributed to the entity, based on an examination of the provisions and purposes of the law under which the entity was established, and whether the entity can be a party to legal transactions and the legal effects of such transactions are attributed to the entity itself.

Considering this framework, if an entity is found not to qualify as a corporation, then it will be treated as a partnership.[18]

4.5. Hybrid entity and tax planning opportunities

In some tax treaties concluded in 2003 and thereafter, there are specific provisions dealing with hybrid entities that are like those in the OECD Model Convention. In addition, provisions regarding hybrid entities have been adopted by Japan through the MLI.

17 The Supreme Court Decision 2015-07-17, *Minshu* vol. 69, No. 5, p.1253 [*Delaware LPS* case] (https://www.courts.go.jp/app/files/hanrei_jp/219/085219_hanrei.pdf).

18 Even in cases where a foreign entity is seen as a partnership, the Japanese tax authorities may allow such entity to apply the relevant tax treaty. See the website of the National Tax Agency, Japan. (https://www.nta.go.jp/english/tax_information.pdf).

4.6. Limitation on benefits (LOB)

As of 1 November 2024, among the 74 tax treaties currently in effect[19] (including the agreement applicable to Chinese Taipei, the same applies hereinafter), 22 tax treaties have introduced the LOB provision.[20]

4.7. Other SAARs in Japan's tax treaties

In order to address the TK scheme mentioned in section 3.4 above, there are some tax treaties with special provisions approving the taxability of Japan on TK profit distributions under domestic law. For example, paragraph 9 of the Protocol to the Japan-Netherlands tax treaty concluded in 2010 stipulates as follows:

"Nothing in the Convention shall prevent Japan from imposing tax at source, in accordance with its laws, on any income and gains derived by a person pursuant to a sleeping partnership (Tokumei Kumiai) contract or other similar contract".

Additionally, in Japan, there are special types of corporations where dividend payments can be deducted as expenses. To secure Japan's taxing rights, approximately half of all the tax treaties concluded by Japan include special provisions denying the application of the dividend income article to deductible dividends. For example, article 10, paragraph 5 of the Japan-Netherlands tax treaty concluded in 2010 stipulates as follows:

"The provisions of subparagraph a) of paragraph 2 and subparagraph a) of paragraph 3 shall not apply in the case of dividends paid by a company which is entitled to a deduction for dividends paid to its beneficiaries in computing its taxable income in Japan".

5. Treaty GAAR

5.1. Principal Purpose Test (PPT)

As of 1 November 2024, among the 74 tax treaties currently in effect, 61 tax treaties have introduced the PPT,[21] including additions through the MLI.

5.2. The "guiding principle" in OECD Commentary, article 1 paragraph 61

In the case in section 3.1 above, the tax authorities argued, citing the general principle from the OECD Commentary, that tax avoidance could be denied even in the absence of explicit provision. However, the court ruled that the application of a tax treaty cannot be denied based on general principles but only if there is an explicit provision. In Japan, the Principle of Statute-Based Taxation is strictly upheld, and it is generally understood that the application of a tax treaty cannot be denied without an explicit provision.

[19] See the website of the Ministry of Finance, Japan. (https://www.mof.go.jp/tax_policy/summary/international/tax_convention/).

[20] See the author's personal website (https://www.kimuralegal.com/taxtreaties).

[21] Ibid.

5.3. The relationship between domestic GAAR and tax treaty GAAR

Although the substantive factors for determining whether domestic GAARs and the tax treaty GAAR can be applied are considered essentially the same, the scope of their application differs. Specifically, the treaty GAAR is more comprehensive, whereas domestic GAARs are more limited in scope. Furthermore, domestic GAARs apply only to domestic law and are not applicable to tax treaties. In order to deny the application of a tax treaty, an anti-abuse provision within the tax treaty itself is required.

6. Potential conflicts of rules (ordering of rules)

6.1. SAAR or GAAR

While there may be a process where the application of specific provisions is considered first, followed by the consideration of general provisions, these are not necessarily mutually exclusive and are understood to be applied cumulatively. Therefore, the fact that specific provisions do not apply does not mean that the general provisions cannot be applied.

6.2. Case law regarding the interplay between tax treaty SAARs and tax treaty GAAR

There is a domestic case[22] where it was disputed whether a general provision could still be applied if a specific provision did not apply. Specifically, in the case of a company merger, there is a specific provision that prevents the transfer of the dissolved company's carried-forward losses if certain conditions are not met. The issue was whether the general provision related to the acts and calculations in reorganizations could still be applied if the specific provision did not apply. The court ruled that the general provision could indeed be applied.

Additionally, in the previously mentioned *Universal Music* case (see section 2.3 above), it was acknowledged that a general provision could be applied even if the specific provision, namely the thin capitalization rule, did not apply, although the court ultimately found that the conditions for the application of the general provision were not met.

Since there is no significant difference between the domestic law and tax treaties in this regard, inapplicability of specific provisions should not preclude the application of general provisions.

[22] Tokyo High Court Decision 2019-12-11, *Zeishi* vol. 269, No. 13354 [*TPR* case] (https://www.nta.go.jp/about/organization/ntc/soshoshiryo/kazei/2019/pdf/13354.pdf).

7. Examples of treaty abuse

7.1. Scenario 1 – Treaty shopping

Even if an intermediary holding company is interposed to reduce or eliminate withholding tax in Japan as the source country on dividend income, the beneficial ownership requirement would be met. However, it will then be necessary to examine whether the application can be denied under the PPT. Specifically, the establishment of the intermediary holding company will be evaluated based on (i) whether it is unnatural, and (ii) whether there is a reasonable business purpose. For example, if the intermediary holding company is merely a paper company, it would be considered artificial and lacking any reasonable purpose other than tax avoidance, which would lead to the denial of tax treaty benefits under the PPT. On the other hand, if the intermediary holding company is recognized as having economic substance for the management of subsidiaries in its jurisdiction, the application of the PPT would be difficult. The same applies even if the nature of the income is capital gains rather than dividends.

In the case of interest or royalty income, the beneficial ownership requirement should be examined first. If the intermediary holding company is recognized as lacking economic substance for the management of loans or intellectual property and is merely a conduit, the intermediary holding company would not meet the beneficial ownership requirement, and the tax treaty would not apply. Even if the beneficial ownership requirement is met, the question of whether the PPT could still apply would arise. However, since the factors for determining both the beneficial ownership requirement and the PPT overlap, it is assumed that the conclusion would likely be the same.

7.2. Scenario 2 – Thin capitalization

In Japan, when a domestic corporation receives funding from an overseas related company, if the debt-to-equity ratio exceeds 1:3, the deduction of interest expenses corresponding to the excess portion is denied under the thin capitalization rules. Additionally, if the interest payments exceed 20% of EBITDA, the excess interest is treated as non-deductible under the earnings-stripping rules. When both the thin capitalization and earnings-stripping rules apply, the regime denying the largest amount of interest deductions will be applied.

In addition to this, if a series of transactions is recognized as tax avoidance, there is room for the deduction of interest payments to be denied under the general anti-tax avoidance provisions of domestic law. However, this denial only concerns the deductibility of interest payments on the payer's side and does not deny the application of the tax treaty's exemption provisions on the recipient's side.

7.3. Scenario 3 – Fat capitalization

There is no fat capitalization rule in Japan.

7.4. Scenario 4 – Transparent and/or hybrid entities

If a corporation in Country R, whose shareholders are residents of a third country, is not taxed in Country R but is considered a taxable entity in Japan, and if the tax treaty between Country R and Japan contains a provision equivalent to article 1, paragraph 2 of the OECD Model Convention, Japan would not consider the corporation to be a resident of Country R, and the tax treaty would not be applicable. If such a provision does not exist, it would then be necessary to examine whether the application of the tax treaty can be denied under the PPT. Specifically, it would be examined based on (i) whether conducting business through the corporation in Country R is unnatural and (ii) whether there is a reasonable business purpose.

7.5. Scenario 5 – Surplus stripping

In Japan, even if a loan is made up to the limit set by the thin capitalization rule and important intangible assets are licensed, resulting in no taxable income for the paying corporation due to interest and royalty payments, and the receiving corporation is exempt from tax under the relevant tax treaty, the deductibility of such payments would not be denied as long as the payment amounts are appropriate. However, if the payment amounts are deemed excessive, the application of the TP rule would adjust the taxable income accordingly.

When a Japanese corporation makes an interest-free loan to a related company in a third country, the TP rule would apply, and an appropriate interest amount would be taxed.

In cases where shares in a Japanese corporation are sold to another Japanese corporation, resulting in the receipt of tax-exempt capital gains on the share transfer instead of taxable dividends, and post-transfer dividends are not subject to taxation as dividends between domestic parent and subsidiary companies, such outcome of non-taxation cannot be denied even though the originally taxable dividend income becomes untaxed. To deny such transactions, the general anti-avoidance provisions under the domestic law would need to be applied, and the economic rationality of the share transfer to another corporation would be examined based on whether (i) the transaction is unnatural, and (ii) there is a reasonable business purpose. However, it is generally considered difficult to make such a determination.

Part III

8. Dispute resolution mechanism

8.1. Mutual agreement procedure (MAP)

In Japan, mutual agreement procedures are conducted around 200 to 300 times a year, of which approximately 80% are related to advance pricing agreements concerning transfer pricing, with most of the remaining cases also involving transfer pricing taxation.[23] Nevertheless, a small number of cases, ranging from several to about 10 per year, involving issues such as permanent establishments or withholding taxes, are handled through mutual agreement procedures. Although statistical information on the number of mutual agreement cases is publicly available, the specific details of these cases are not disclosed.

8.2. Arbitration

In Japan, implementation arrangements for arbitration procedures with the tax authorities of the counterpart countries have been established with the Netherlands, the Hong Kong S.A.R., Portugal, New Zealand, the UK, Sweden, the US and Singapore.[24] However, there is no publicly available information indicating that any actual arbitration procedure has been carried out.

8.3. Other dispute resolution mechanisms (e.g., mediation) available

There is no other dispute resolution mechanism specifically designated to resolve tax treaty interpretation issues in Japan.

[23] See the website of the National Tax Agency, Japan: (https://www.nta.go.jp/taxes/shiraberu/kokusai/map/jyokyo.htm).

[24] See the website of the National Tax Agency, Japan: (https://www.nta.go.jp/taxes/tetsuzuki/shinsei/annai/sogokyogi/annai/1279_3.htm).

Part IV

9. Policy

9.1. The importance of source-based taxation

Japan has been actively promoting international tax systems as an important fiscal policy from both the perspectives of resident taxation and source taxation, primarily influenced by the United States even prior to the BEPS initiative.

9.2. The OECD BEPS work

Since the launch of the BEPS project in 2013, the Japanese government has consistently led discussions on international tax reform. Following the publication of the BEPS final report, Japan has advanced domestic law revisions and the formulation and ratification of multilateral agreements in line with international agreements. Japan plans to continue working in coordination with other countries moving forward.

9.3. Improper use of tax treaties

In Japan, cases where the abuse of tax treaties becomes a significant issue are quite a few. Nonetheless, the Japanese government has promoted the introduction of anti-tax avoidance provisions in tax treaties as part of a broader effort to align with partner countries in addressing the common issue of tax avoidance.

9.4. MLI

Japan has signed and ratified the MLI.

Part V

10. Beyond – how to counteract improper use of tax treaties in the future

10.1. Initiatives to strengthen anti-abuse measures under domestic law and/or in tax treaties

Following the BEPS final report, Japan has amended its domestic laws, signed and ratified the MLI, and ensured that newly concluded or revised tax treaties are generally aligned with the OECD Model Convention.

10.2. The Subject-To-Tax-Rule (STTR) from Pillar Two in tax treaties

As mentioned in section 4.7 above, provisions limiting the application of tax treaties to deductible dividends were introduced in some tax treaties concluded by Japan even before BEPS. It is not clear whether Japan will participate in multilateral treaties or take actions to conclude or amend individual treaties to further incorporate the subject-to-tax-rule from Pillar Two.

10.3. Protecting source-based taxation by providing a floor for tax competition

Based on the recognition that Pillar Two contributes to maintaining and enhancing the international competitiveness of Japanese companies, legislation related to the Income Inclusion Rule (IIR), including the introduction of corporate tax on the international minimum tax for each relevant fiscal year, was enacted in 2023.[25] Going forward, Japan plans to proceed with legislation in line with international agreements, taking into account any guidance issued by the OECD and the content of international discussions.

[25] See *The explanation of tax reform in 2023*, Ministry of Finance, Japan: (https://www.mof.go.jp/tax_policy/tax_reform/outline/fy2023/explanation/PDF/p0470-0495.pdf).


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