

Legal Form vs. Substance

In November 1999, the Tokyo Upper Court reversed the judgment of the Tokyo District Court (entered on May 13, 1998) holding that the income tax assessment by the tax authorities based on the substance over the form approach was not appropriate. On June 13, 2003, the Supreme Court decided not to accept the appeal by the tax authorities and hence, the case was closed by the judgment of the Tokyo Upper Court. Considering the recent tendency of tax corrections by the tax authorities based on the substance over the form approach, this case will establish certain rules when such approach is adopted by the tax authorities.

I. Outline of the facts

The plaintiff X (hereinafter referred to as “X”) acquired the land from Y, a corporation, in exchange for its own land. The parties (X and Y) agreed to conclude purchase and sales contracts prescribed under Article 560 of the Civil Code for each transaction of the land, in lieu of the exchange contract prescribed under Article 586 of the Civil Code. Since the fair value of the land owned by X was higher than that of the land acquired from Y, such shortfall was paid in cash by Y. X intended to sell the land for 850 million JPY but could not due to the administrative ruling and X was forced to reduce its selling price to 730 million JPY. Accordingly, Y also reduced the selling price of the land to 430 million JPY while the land was acquired for 640 million JPY. X received the land and 300 million JPY (i.e., a difference of the land price) for transferring its own land pursuant to the purchase and selling contract. As specified in the contract, the selling price of the land from X to Y was 730 million JPY and the purchase price of the land transferred from Y was 430 million JPY.

The tax authorities argued the fair market value (“FMV”) of the X’s land for the purpose of the capital gain taxation of the land should be 1.08 billion JPY rather than 730 million JPY based on the analysis as follows:

“Two separate transactions (i.e., selling of X’s land and acquiring of A’ land) should be treated as a single exchange of the land for the other land plus cash. Therefore, the FMV of the transferred land by X should be measured as the FMV of the assets acquired in exchange for the transfer. Since the FMV of the non-monetary asset is determined (pursuant to Article 36, Paragraph 1 of Income Tax Law) regardless of the contracted price, the FMV of the land transferred from Y is 640 million JPY and the aggregate amount of assets received by X in exchange for transferring land is 1.08 billion JPY (640 million JPY for the land, 140 million JPY for the leasehold and 300 million JPY in cash) rather than 730 million JPY as specified in the contract.”

X counter-argued that the two transactions (purchase and sale of the land) should not be commingled, but should be treated as separately, and accordingly, the selling price of the land as specified in the contract should be treated as income (i.e., consideration received for the transferred land) for the purpose of the capital gain taxation of the land.

II. Summary of the judgments

1. Judgment by the Tokyo District Court (in favour of tax authorities)

With regard to the tax treatment of the contract entered by the taxpayer, the District Court stated that although the content of the contract may be determined at discretion of both parties concerned, the tax treatment of the transaction pursuant to the contract should be based on the factual transaction rather than the contract by taking into account the intention

of the parties, purpose of the transaction and etc. Further it stated since the purpose of the transaction was to exchange the land, and the purchase and selling contracts were sham in order to achieve the purpose of the transaction, two separate transactions were, in substance, deemed as a single exchange transaction as prescribed under Article 586 of the Civil Code. Based on this fact finding, the District Court held that the selling price of the land by X as specified in the contract could not constitute income for the purpose of the capital gain taxation of the land, rather, the selling price of the land should be measured by the FMV of the assets acquired in exchange (pursuant to Article 36, Paragraph 1 of Income Tax Law) as insisted by the tax authorities. Thus, the argument by the plaintiff was disregarded by the District Court.

2. Judgment by the Tokyo Upper Court (in favour of the taxpayer, reversing the judgment of the Tokyo District Court)

In the appeal by X, the Tokyo Upper Court entered for the taxpayer, X, reversing the judgment of the Tokyo District Court and concluded the assessment by the tax authorities was illegal.

For the “substance over the form approach”, the judgment held that an election of legal form would be up to the will of taxpayers, and the tax authorities would be allowed to disregard the legal form when the underlying transactions involves fraud and the contract was entered only for sham. In the case at hand, the purpose of the contracts may be to avoid the tax payable resulting from exchange transaction, however, it is rather difficult to recognize fraud in the underlying transactions.

The judgement further refers to the circumstances where the legal form is disregarded to make income assessment. “Under the principle of no taxation without law, the tax authorities are not authorized to disregard the legal form elected by taxpayers unless otherwise provided such provision in the tax law. Since the Income Tax Law does not have any provision that authorize the tax authorities to disregard the legal form for the assessment purpose, the income assessment by the tax authorities by reclassifying the purchase and selling transactions into a single exchange transaction was illegal.

III. Issues in the judgment

The most important issue of the present case is whether or not the tax authorities is able to make assessment disregarding the legal form adopted by taxpayers. According to the Tokyo District Court, a series of transactions of the present case are regarded as an exchange transaction from perspective of economic purposes and significance of sales transaction of acquired asset. It further admits the income amount of the transaction as the fair market value of the acquired asset (780 million JPY) plus the difference (300 million JPY) as the total income.

Under Income Tax Law, capital gain arising from the transfer transaction is calculated by deducting acquisition cost of asset from the gross revenue. The gross revenue means the total of the consideration of the transfer transaction. Thus, unless the transaction is regarded as “deemed transfer” or exchange, the revenue should be the amount of the consideration of the transfer transaction even if the transfer is made lower than the market value. Thus, tax burden may be different whether the transaction is regarded as an exchange transaction or a transfer.

If the transaction of the present case is treated as transfer and purchase as the plaintiff argued, the consideration of the transfer transaction would be 430 million JPY. Since this amount is not significantly low price, the rule of deemed transfer under Article 59, Paragraph 1, No. 2 of Income Tax Law would not apply. In such a case, the tax may be

imposed only when the tax authorities disregard the legal form of the transaction and recognizes that the substance is the exchange transaction.

While the Tokyo District Court admits the tax authorities' reclassification of the transaction into an exchange, the Tokyo Upper Court examines in detail and laid down some guidelines when the legal form may be disregarded for income tax purposes.

According to the Tokyo Upper Court, the legal form originally adopted by parties concerned may be disregarded when the contract deviates from the realities of transaction. If disregarded, the tax may be imposed on the real status of the transaction. The Tokyo Upper Court explains that under the principle of no taxation without law, it is not allowed for the tax authorities to disregard the legal form originally adopted by parties concerned to the normal legal form and treat that the requirement for tax imposition is satisfied according to the amendment.

The underlying theories are:

If the transaction in question that is doubted as intentional transaction for tax avoidance purposes is a false transaction and does not exist in the course of examining the true legal relationship, no legal effect would be generated so that there would be no tax reduction at all. This theory is used in the decision with regard to film lease transaction using the partnership.

The second theory relates to the principle of no taxation without law and disregard of legal form. This is frequently referred to in the argument of tax avoidance deed. Generally, tax avoidance deed is defined as "Under principle of private autonomy and principle of freedom of contract, there are some extent of selection for the parties concerned in order to realize certain economic purpose or economic effect. By utilizing selectability under the private law, an election of legal form that is not generally elected may lead to reduction or elimination of tax liability free from taxation requirement although there is no justifiable reason for such election. Such deed is referred to as tax avoidance deed". As to whether disregard of legal form under the grounds of the tax avoidance deed requires any legal grounds such as laws or regulation, there is no uniform or agreed conclusion appeared in past decisions. In the present case, the Tokyo District Court did not mention that the present transaction is tax avoidance deed. However, in order to admit the tax authorities' decision to disregard the legal form, theoretical grounds should have been presented. The Tokyo District Court lacked such grounds. It should be also noted that while tax avoidance deed is "the deed to reduce the tax liability by using extraordinary legal form that the laws and regulations do not expect", the tax saving deed is "to reduce the tax liability according to expectations under laws and regulations", and that tax avoidance deed and tax saving deed should be separately treated. As referred by the Tokyo Upper Court, the present case should be treated as tax saving deed under expectation of Article 59, Article 1, No. 2 of the Income Tax Law, and thus may not be disregarded.

A borderline between tax avoidance and tax saving is not clear enough in most of transactions. In case where the law is enacted with the purpose of activating companies by utilizing tax loss by way of corporate reorganization, if the tax authorities opt to assess income tax by substance over the rule approach, the purpose of the legislation would not be achieved. The judgment by the Upper Court may give some shelter for taxpayers from the assessment by the tax authorities via substance over the form approach.