Recent Trends in Tax Management in Japan

Planning and Compliance – From a Governance Perspective

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I. Introduction

As the world economy and companies increasingly operate across borders, business models are undergoing rapid, structural changes typified by cross-border supply chains and e-commerce, which the German government has promoted as the fourth industrial revolution. It has long been pointed out that, due to constant changes in the business environment, routine international decisions related to taxation at both the national level, in terms of each country's tax laws, and the international level, in the form of tax treaties, cannot adapt

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fast enough. In light of this issue, "legal" tax avoidance in the form of BEPS (Base Erosion and Profit Shifting) – a practice employed by some multinational firms by taking advantage of grey zones in the space between the tax laws of individual countries – has emerged, garnering attention in the media.

In order to address this problem, the OECD Committee on Fiscal Affairs began the BEPS Project and released its final report on 5 October 2015. Domestic reforms that draw inspiration from these reports have been pursued in Japan as well.

Additionally, confidential documents from a Panamanian legal office, widely known as the Panama Papers, shocked the world in April 2016 when they revealed the lack of transparency in terms of how large firms and the wealthy elite handle their money. Their excessive tax avoidance, carefully conducted to flirt with but not cross the line of illegal tax evasion, as well as the environment that enabled it, was met with harsh criticism around the world on both taxation and moral grounds.

In this article, in addition to giving an explanation of recent trends in tax management, also known as tax governance, in Japan, I will address what sort of tax governance structure Japanese companies should adopt and how they should adapt to the changing tax environment. I will do so through a comparison with their North American and European peers.

II. The Need for Tax Governance

To start off, why is tax governance gaining attention now? And why is this important? To answer these questions, we must first understand the circumstances that led us here.

Companies face a dilemma in which they must conduct their businesses while balancing the interests of various stakeholders, sometimes cooperating with them and sometimes disagreeing with them. For example, some investors want stock prices to increase in a short period of time and wish for management to adopt policies that increase dividends. Workers, by contrast, are primarily interested in wage increases, guaranteed long-term employment, and labour reform. As for customers, they expect better services for lower prices, delivered in a timely manner.

Although the priorities of the various stakeholders are very different, companies must be able to respond to the fierce competition and rapid changes happening around them on a global level and maximize after-tax profit and after-tax free cash flow as a way of providing an appropriate return on investment. This is because only through generating profit can the largest number of stakeholders be satisfied. As such, it is in a way self-evident that companies will tend to attempt to reduce their tax burden as much as possible within the limits of the law.

The nature of multinational companies' business activities – until recently shrouded in mystery – has been brought to light by newly introduced international taxation rules meant to deal with BEPS issues that arose under this paradigm. Going forward, information will be shared between countries' tax authorities, and if it is determined that there is a distortion in how a company allocates its profits, that company will be suspected of profit shifting and could be subject to a tax audit. Moreover, since each country may argue for the unique interpretation of the taxation scheme that is most beneficial to them, these companies risk being exposed to double taxation, a serious concern.

Through all of this, tax governance at Japanese companies has reached a turning point. For example, if it seems a Chinese subsidiary of a company reports plenty of profits and there are no transfer pricing issues in China, but the Japanese parent, which presumably holds important intangible assets, is nevertheless incurring a loss, this will be detailed clearly in the Country-by-Country (CbC) Report generated in accord with the BEPS Action 13 Report. In this way, if profit distributions and tax payment statuses become more visible on a global level, overseas subsidiaries will in the future be less able to resist pressure from a country's tax authority in the absence of the support of their headquarters. Our current view is that, going forward, Japanese companies will strengthen headquarters-led tax governance and will need to set about doing so in earnest to reduce global tax risks.

What tax issues and concerns arise in the changing status quo? What policies will countries and the OECD adopt in response? These are only a few of the important issues at hand.

One pressing issue is the treatment of *paper companies.* Also called *mail box companies* or *shell companies,* these are registered companies with no actual substance that are set up in tax havens to store profits. Additionally, they have been used in tax avoidance schemes in connection with hybrid business entities and finance instruments that use business entities and lending techniques that create mismatched treatment for tax purposes, depending on the country. This has created instances where the tax burden of a company is incredibly small compared to its size and the scale of its activities, something increasingly viewed as problematic.

American companies provide a striking example of this. Before the tax reform that took effect this year, the federal corporate tax rate in the US was 35%. Including the state tax rate, there were places where the total tax burden was 40% or more. Despite these statutory rates, it was not uncommon to find American multinational firms with particularly effective tax planning that reduced their effective tax rates to the single digits. To a different degree, this type of behaviour can also be seen in European multinational firms.

Further, critics have alleged that the circumstances that limited tax authorities' access to companies' tax information made it easy for companies to conduct this excessive but otherwise legal tax planning. In an ongoing process, various tax reforms have been adopted in order to address these problems – at the OECD level in the BEPS Action Plan and at the national level with the expansion of taxation powers – thereby shaping the global context in which multinational firms find themselves.

III. Public Perception of Japanese Companies Before BEPS and How They Have Traditionally Differed from Western Companies

Conversely, what did the tax structures of Japanese multinational firms look like, particularly before the introduction of the BEPS Action Plan? While this will of course differ from company to company, simply put, there was no meticulous, aggressive tax planning to avoid taxes. Instead, Japanese companies were compliance-focused, working to ensure proper tax filing and proper transfer pricing documentation. In other words, they were blind to risks and opportunities, and their strategies related to taxation were lacking.

So why have Japanese companies traditionally found themselves in this situation? By comparing them with typical American and European companies, we can identify the reasons for these issues to a certain extent. While this analysis considers cases from both extremes, as certainly not all Japanese companies and not all American and European companies act in such a prototypical manner, this type of comparison allows us to make a general comparison between these two groups.

First, I would like to address our understanding related to who owns a company. In Europe and America, it is generally understood that companies are owned by shareholders and the purpose of business activity is to maximize shareholder value, essentially maximizing profits. On the other hand, in Japan, you cannot necessarily say that a company belongs solely to its shareholders. It has been generally understood – as is evidenced by *Ohmi Akindo's* (merchants) philosophy of the *three-way benefit* whereby the buyer, seller, and society benefit from business – that companies traditionally have a certain obligation to society. This difference in understanding related to who a company belongs to may be the fundamental difference between Western and Japanese companies in how tax issues are handled. We can see an example of this in terms of where emphasis is placed for performance indicators. As described here, in America and Europe, there is a focus on after-tax profit, while in Japan there is a general tendency to focus on operating profits.

Upon further reflection, another difference stems from how taxes are perceived. In the West, taxes are considered costs to be managed, so companies actively try to reduce their taxes within the limits of the law and proactively use their remaining profits to make investments for the future.

These views regarding taxes and tax payment formed the context in which BEPS (tax base erosion and profit shifting) arose. In Japan, taxes have generally been considered as something inevitable that must be paid as a result of producing profits on a business venture. While tax strategy is positioned as a necessary component of a company's overall strategy in the West, with Japanese companies it is more often the case that they simply do not have a tax strategy.

In other words, in America and Europe, the formulation of a tax strategy is an important part of a CEO or CFO's management agenda, while at Japanese companies, tax strategy is not usually something thought to directly involve management.

What about conducting tax management from a global perspective? There are many instances of American and European firms managing tax globally from both a conservative approach of risk management and also an aggressive approach in the form of seeking new tax-planning opportunities. The CTO (chief tax officer) or the tax director reports directly to the CFO and takes responsibility for these matters. Most Japanese companies conduct global management of transfer pricing from a risk management standpoint that mainly considers monetary importance, but for other tax issues they tend to hold a view that is not optimal overall.

What about tax management at the national level as opposed to the global level? At American and European companies, it is often the case that the CTO takes responsibility for tax management and planning and correspondingly formulates and executes a top-down policy from headquarters. At Japanese overseas subsidiaries, the local staff responsible for taxes, finance, or accounting take charge, but the strategy is not necessarily consistent with the company's overall strategy. Additionally, since they handle local affairs from start to finish, information frequently does not reach the tax manager at headquarters. In other words, at American and European companies, information on the tax position of overseas subsidiaries is available to the CTO at headquarters, while in Japan, not only is this information not readily available, it is often the case that tax risks and planning opportunities are not even identified.

How this topic is addressed is the same at the business division level. As opposed to American and European companies, where transfer pricing policies and other tax policies are formulated with the aim to optimize the companies' businesses overall while managing the inherent issues of a certain division's business, in many Japanese companies that level of consideration for tax issues is not undertaken.

IV. Predicted Structure of Japanese Companies After Introduction of BEPS

In the light of this environment, I have tried to imagine how Japanese companies' post-BEPS tax management structure would be viewed and have come up with the following.

- If BEPS action plans are introduced, company activities will become more transparent on a global level and more exposed to tax authorities.
- In other words, this means that if you are not a CTO from headquarters who understands business activities and tax positions on a global level, it will become less feasible to attend to the tax audits of overseas subsidiaries. Thus, for local management staff that does not possess all the necessary knowledge, it will, for example, prove difficult to attend to tax audits while simultaneously maintaining overall consistency as to where business-critical functions and intangible assets are located within the company group and also mapping the tax positions of a country's subsidiary based on the relevant transfer pricing policy.
- Furthermore, if they do not adopt strategic policies, such staff may be at a loss when responding to questions from securities analysts and institutional investors, possibly leading to a loss of confidence in the company.

We have concerns that Japanese companies, who until now have been focused on compliance or risk management, may be relatively less apt for compliance due to the rise in asymmetry in information between them and the tax authorities.

In other words, the risk of double taxation without relief that is based on individual interpretations and logic increases dramatically not only from OECD member countries' tax authorities, who to a certain degree have a mutual understanding based on a shared international tax perspective, but also from OECD non-member countries' tax authorities that use BEPS as an opportunity to assert their "fair share". This is exactly the crisis that exists here.

V. The Ten Issues Japanese Companies Face

In order to address this situation, I have compiled a list of ten issues that Japanese companies must grapple with, called "*10 Things To Do (10TTD)*". The 10TTD can be further broken down into three parts: *Tax Departments, Tax Infrastructure,* and *Environment and Decision-making Reform.*

Ten Things to Do for Japanese Companies

Tax Departments	1	Create functional teams and situate them in business divisions	Tax Infrastructure	6	Understand tax positions (utilization of process management tools and D&A)
	2	Incorporate tax indicators into KPIs and review ratings system for tax departments		7	Maintain a knowledge base that includes the results of tax audits and questionnaires sent to accounting offices
	3	Early involvement in business planning and decision-making	Environment, Decision-making Reform	8	Break down the walls between divisions to allow for "top-down" decision making
	4	Update handling of each country's tax system and tax activity		9	Recognize tax strategy as part of operations (business)
	5	Review services (shared services and outsourcing) and optimize research tools		10	Create broadly tasked tax department

First, let us start with *Tax Departments,* which can be understood in five steps.

1. Create Functional Teams and Situate them in Business Divisions

What points do we need to consider first when establishing a tax management structure? One key element would be the need to divide teams based on "region" and "function." For region, roles should be split into "domestic tax" and "national tax." For function, that would include creating a tax planning team in addition to the already established compliance team. This is how adept American and European companies approach tax planning, by combining these elements when necessary and reorganizing teams. Above all, Japanese companies face a lack of tax personnel with expertise in international taxes and tax planning, so meeting that clear need, including through the use of third parties, is one identifiable challenge.

By situating a tax manager with expertise in local tax law in overseas subsidiaries and regional headquarters, companies can ease the workload of the tax department at headquarters and also help prevent tax issues from arising locally.

2. *Incorporate Tax Indicators into KPIs (Key Performance Indicators) and Re-evaluate Ratings System for Tax Departments*

At a majority of Japanese companies, it is rare for tax-related indicators to be incorporated into KPIs, and most companies do not see management actively involved in tax issues. In addition, even at companies that incorporate tax indicators into KPIs, the number that actually include tax risk management and tax planning in their KPIs is even fewer.

When incorporating tax indicators into KPIs, one method is to set a goal, such as "decrease effective tax rate by X%", whereby business objectives are referenced while including a specific tax rate in the KPIs. Another method might include aiming to reduce unnecessary tax payments or double taxation payments by focusing on improving "cash tax" (the amount of taxes actually paid) or cash flow and by making "indirect tax payment position" a KPIs.

What is important is ensuring that KPIs decided in this way are tied to performance evaluations of tax departments and pay grades. I will discuss this further at a later point.

However, in light of BEPS issues, it is worth bearing in mind that the purpose of reducing one's effective tax rate is ultimately not "aggressive tax avoidance", but rather "optimization of tax payments".

3. *Early Involvement in Business Planning and Decision-making*

Situating a tax manager in business divisions and sharing functions with headquarters is important in building a tax infrastructure. While many Japanese companies pay special attention to the effectiveness of the legal, HR and IT departments, and to the profitability of projects themselves, instances are quite apparent in which business plans are formulated erratically without sufficient tax department involvement, thereby resulting in companies taking on excessive tax risks. From there, it will be important to create an environment in which tax optimization can be promoted easily by establishing a point of contact for tax matters in business divisions and by these divisions communicating closely with the tax departments from headquarters that undertake the company's overall tax risk management and tax planning.

4. *Update Handling of Compliance and Tax Management in Each Country*

One major point to consider when building a platform is how to handle country-specific tax risks and local practical knowledge. Yet if companies do not have an abundance of expertise in tax matters, it is probably true that they will not be able to identify potential tax risks. Accordingly, when reporting to headquarters, it is best to receive assistance from specialists with expertise in local tax matters.

On the other hand, since it will be costly and take a large amount of time to recruit expert talent and build a data platform in-house, I believe that one potentially effective option would be to utilize necessary resources from outside the company.

5. Re-evaluate Activities (Shared Services and Outsourcing) and Enhance Training Programmes

Shared tax services help concentrate tax specialists in regional hubs within the company group and seek to improve business efficiency and reduce costs. Naturally, the best option would be to spread tax specialists out over all locations, but considering the exorbitant costs required, this option is not very realistic.

That is why it would be better to designate regional headquarters as the main hub in each region, concentrate tax specialists there, and entrust the local subsidiaries' tax management in the region to them. So to speak, this method would consist of a tax department that would be set up as a branch office of the headquarters' tax department and undertake the tax risk management and tax planning of all the subsidiaries in that region (commonly known as a Centre of Excellence).

Alternatively, tax outsourcing is a method where a portion of the necessary tax services is contracted out to a third party in order to relieve internal personnel shortages. However, in order to make effective use of outsourcing, it is important to identify exactly what services will be contracted out to third parties. In order to do that, companies must adopt a policy making clear which tax services they will pursue in-house, a decision which for its own part can be made only after identifying what services are lacking and how these shortcomings can be best compensated.

Tax services outsourcing generally falls into two overarching categories: situations in which tax planning services requiring high-level expertise are outsourced and those in which labour-intensive services, such as tax return preparation, are outsourced.

In general, if a company lacks tax specialists, the former situation is often the case. On the other hand, if the latter situation is chosen, you can often see companies that shift company resources to difficult tax planning services.

Additionally, you can also see instances in which all subsidiaries across the globe have their tax return preparation outsourced to accounting firms and employ tax process management tools that are provided as an ancillary service.

In order to make high-level global tax management a reality, information infrastructure that takes advantage of IT tools and personnel that specialize in tax are indispensable. American and European firms that were quick to adopt in this area have made great strides in data collection capacities by proactively utilizing outside personnel and services.

Building a tax data platform that is low-cost and simple while taking advantage of outside resources: to Japanese companies striving to increase their company's value, such a step may prove a crucial choice in supporting future growth.

Next, I would like to propose two solutions on *Tax Infrastructure*

6. Understand Tax Positions (Utilization of Process Management Tools and Data and Analytics (D&A))

If global business structure becomes more transparent due to the new transfer pricing regime, then each country's tax authority will be able to more easily compare the parent company's profits and taxes with those of each of its subsidiaries. Not only that, countries will be able to interpret rules in a way that benefits them, strengthening their abilities to assert taxation authority so as to secure their fair share.

As the shortage of tax professionals becomes the new normal, it will remain difficult to collect information essential for tax planning by relying on human capabilities. In order to collect data from each country and manage affairs with a limited number of qualified personnel in a timely manner, it would arguably be best to simply use IT tools to aggregate company data.

This need for a type of in-house data infrastructure is continually increasing following the introduction of new international taxation rules. Electronic tax filing has just started becoming common in Japan, but overseas, where this field is much more developed, tax authorities conduct analyses of tax returns using big data and are able to narrow down likely candidates for tax audits.

It goes without saying that, in this environment, if Japanese companies continue to process tax returns without incorporating such technology, they will not stand a chance against other countries' tax authorities outfitted with information technology tools at their disposal. It is likely a manifestation of the Japanese tax authority's drive to increase the efficiency of tax collection that the legal compulsion for electronic tax filing was reaffirmed in the 2018 tax reform. Electronic tax filing will eventually become the norm in Japan, so it is easy to imagine that the tax authorities will right the ship and start incorporating this data to improve taxation capabilities.

In order to respond to such necessary changes, companies must comply with the digital transformation of tax filing and hasten the adoption of tax infrastructures that incorporate new technologies.

7. *Maintain a Knowledge Base that Includes the Results of Tax Audits and Questionnaires Sent to Accounting Offices*

In terms of tax infrastructure, another important point is maintaining a knowledge base.

Just building a foundation for tax planning is not the same as building a tax infrastructure. From a compliance standpoint, such as in the handling of tax filings and tax audits, tax infrastructure is becoming a paramount issue.

Firm management is conducted with a certain sense of continuity, so in the context of a tax audit, there are many instances in which a company is questioned on the same areas repeatedly. Consequently, if the timeline of events from previous tax audits were known, companies could work out how to complete their tax returns in a way that prevents additional taxation.

However, at Japanese companies, tax managers frequently change positions due to job rotation, meaning that the knowledge base an employee may have built is often lost as a result of such rotation. Consequently, there is an innumerable number of companies that, upon being audited in regard to the same points as in earlier years, find themselves unable to draw upon past experience and ultimately subject to (repeatedly) paying additional taxes.

The creation of a structure in which a company's knowledge base is cultivated from past experience and shared among the entire tax department in order to pass it down over generations is something that is currently sought. Here again, building databases using IT tools is the key to success.

Finally, I would like to bring up three points related to *Environment and Decision-making Reform.*

8. *Overcoming the Walls between Business Divisions (Lack of Top-down Decision-making)*

Companies that currently employ a business division system face the largest hurdles in respect of tax optimization. In such companies, since business divisions have sole authority and responsibility, they are afforded a great deal of autonomy, creating a tendency for business divisions to enjoy a larger say. As a result, it is often the case that when implementing company-wide projects, the opinions of the business divisions are favoured, making it difficult to introduce top-down reforms from a tax perspective.

In addition, there are many Japanese companies that entrust all the local tax affairs of an overseas hub to local subsidiaries. This is another reason why tax governance that circumvents organizational hurdles is often hard to realize. Namely, performance evaluation systems encompassing changes in the organization's functions and risk burden are not being introduced.

In order to prevent such a scenario, companies must update the new division of roles of all subsidiaries and business divisions in the event of a reorganization, and they must update the criteria for performance evaluation that correspond to contributions made globally. Here, a possible example would be a structure where the benefits of a reduction in tax costs could be returned to subsidiaries or business divisions that contributed to tax savings.

9. Tax Strategy as Part of Business Operations

Many Japanese companies simply do not appreciate that tax matters are a part of their business operations. For example, if an overseas subsidiary is established, the amount of taxes payable locally will differ greatly based on the company's capital structure, its supply chain design, and the company's form.

Since after-tax profits decrease as taxes increase, in principle, one cannot think of tax as being separate from the business.

Going forward, it will become increasingly important to lay a framework for the entire business that takes tax into account.

10. Create Broadly Tasked Tax Departments

Accordingly, in order to promote an understanding that tax departments are not cost centres but rather profit centres that generate money for the company and in order to promote such mind-sets, top management must first have a sufficient understanding of this dynamic and alter how the company views the tax department.

At the same time, the tax department must proactively promote the role that they play and help other departments understand it.

In addition, companies must make tax strategy an important part of company strategy and elevate the position of the tax department in the company. Japanese firms are generally stratified in such a way that the accounting department is often under the CFO, then under it is the budget department, and then finally under this department is the tax section.

In order to change this situation, it may prove particularly effective to raise the position of the tax department to reach parity with those in America and Europe and introduce a compensation scheme tied to tax KPIs, along with putting the tax department under the direct control of the CFO. Career paths could be revised such that the position of the tax director is raised to the same level of the HR, accounting, and legal directors; further, the possibility of becoming a board member could be open to those who embark on a career in the tax department.

VI. An Opportunity to Reassess Tax Divisions and the Future Role of Tax Experts

What could be the impetus for reforming tax departments? Generally, in addition to external factors – such as public opinion about changes in the law, the market environment, changes in the taxation powers of tax authorities, and the tax payment status of businesses – internal causes such as changes in business strategy, changes in upper-management, and the promotion of business structural reforms, including mergers and other reorganizations, could provide a good opportunity to re-evaluate the structure of tax departments.

The present era – with its increasingly apparent geopolitical risks, as evidenced by the emergence of conservative forces such as nationalism and by trade disputes, and with even greater changes expected in an already turbulent business environment – may provide the perfect opportunity to re-evaluate the concept of tax governance. As Japanese companies forge an effective tax governance structure that can be used to comply with the post-BEPS world, the importance of our roles as tax professionals – and what is expected of us – can be expected to increase in the future.

Summary

In recent years, the BEPS (Base Erosion and Profit Shifting) discussions to address controversially aggressive tax planning and saving schemes by certain multinational corporate groups have been heating up globally, particularly among G20 countries. During this period, the need to introduce a robust tax management or governance framework has become more and more critical for Japanese-based companies (which, unlike certain US or European multinationals, have traditionally been relatively humble or inattentive in their tax planning) in order to avoid unnecessary disputes with or challenges from tax authorities in various countries. We have started to observe the trend that Japanese taxpayer companies often end up with unrelieved double taxation as a result of scrutiny from tax authorities, and their traditional conservative approaches no longer seem to help as much as they did in the pre-BEPS era. In this article, I provide a general overview of the types of challenges most Japanese multinationals are facing in the post-BEPS regulatory environment, together with possible measures. Specifically, I offer "10 Things to Do", which are measures that Japanese multinationals could adopt to increase their competitive advantages in terms of optimizing their overall tax positions.

ZUSAMMENFASSUNG

In den letzten Jahren waren weltweit, und insbesondere in den G-20 Ländern, zunehmend kontroverse Diskussionen über das BEPS-Projekt zur Bekämpfung umstrittener aggressiver Steuerplanungs- und Steuersparmaßnahmen bestimmter multinationaler Konzerne zu beobachten. Für japanische Unternehmen, die im Gegensatz zu bestimmten US-amerikanischen oder europäischen multinationalen Unternehmen traditionell relativ bescheiden oder weniger aufmerksam bei der Steuerplanung waren, ist in dieser Zeit die Notwendigkeit der Einführung eines soliden Steuermanagements und tax governance immer wichtiger geworden, um unnötige Streitigkeiten mit den Anforderungen der Steuerbehörden in verschiedenen Ländern zu vermeiden. Hier ist zunehmend der Trend zu erkennen, dass japanische Unternehmen als Steuerzahler aufgrund der Kontrolle durch die Steuerbehörden oft mit einer Doppelbesteuerung ohne einen Ausgleich enden, und ihre traditionellen konservativen Ansätze scheinen nicht mehr so hilfreich zu sein wie in der Zeit vor dem BEPS. Der Beitrag gibt einen allgemeinen Überblick, vor welchen Herausforderungen die meisten japanischen multinationalen Unternehmen derzeit im regulatorischen Umfeld nach dem BEPS stehen, und welche Maßnahmen dagegen möglich sind. Konkret schlägt der Beitrag „10 Things to Do“ vor, d.h., Maßnahmen, die japanische Unternehmen ergreifen könnten, um die Wettbewerbsvorteile im Hinblick auf die Optimierung ihrer gesamten Steuerpositionen zu erhöhen.

(Die Redaktion)