Case

A Case in which foreign taxes paid by a subsidiary in the Guernsey Islands which was established by a company in Japan were judged to be equivalent to a foreign corporation tax, as prescribed by the Corporation Tax Act, Section 69, Subsection 1 and Cabinet Order, Section 141, Subsection 1. The foreign taxes were charged at a rate of 26% based on a system in the Guernsey Islands under which a company was allowed to decide the tax rate in the range of 0% to 30%.

(Supreme Court, P. B. 1; December 3, 2009; *Hanrei-jihō,* No. 2070, p. 45)

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[Facts]

The Guernsey Islands consist of a number of islands in the English Channel located to the west of the Normandy peninsula in France. They are a Crown Possession and have an independent legislature, executive and judiciary. According to the system of income tax in the Guernsey Islands at the time when the tax liability was incurred, insurance companies there were allowed to choose one taxation system from the following four systems:

① Applying the standard rate of income tax (20%)
② Claiming an exemption from taxes by application
③ Applying progressive taxation to the prescribed income
④ Applying a tax rate which is chosen by the company in the range of 0% to 30%

It was possible for the subsidiary in the Guernsey Islands which was established by Company X to choose any of these, and the subsidiary chose the forth option. A 26% tax rate was applied and the foreign taxes were paid.

However, the Superintendent of the taxation office, Mr. Y, decided that the foreign taxes the subsidiary paid were not equivalent to a foreign corporation tax as provided for by the Corporation Tax Act, Section 69, Subsection 1; therefore the rate of imposed income tax was 25% or less, and the Anti-Tax Haven Rule was applied to Company X. For these reasons, he decided to reassess Company X's taxes and levied a penalty for underpayment.

The Tokyo District Court and the Tokyo High Court concluded that the taxation system of the Guernsey Islands was unusual in the point of giving the taxpayer room for selection. They also concluded that the foreign taxes the subsidiary of Company X had paid and the concept of taxation developed countries adopt were mutually exclusive. They dismissed X's appeal. Company X appealed this decision to the Supreme Court.

[Judgment]

The Supreme Court overruled the Tokyo High Court's judgment and accepted X's claim for the following reasons:

"Indeed, the subsidiary can select from a wide range of taxation systems when foreign taxes are imposed. However, as a result of the selection, the taxation office of the Guernsey Islands imposes foreign taxes according to the Income Tax Act of the Guernsey Islands. Clearly, the fact that the foreign taxes that Guernsey imposes on all companies which fulfill the relevant requirements are imposed in monetary form cannot be denied, and it is clear that the foreign taxes do not result from any special services from the government of the Guernsey Islands. So it cannot be said that the foreign taxes are not tax.

The Corporation Tax Act, Section 69, Subsection 1 provides that a foreign corporation tax is a tax equivalent to corporation tax imposed in accordance with foreign laws and ordinances, as prescribed by Cabinet Order. Cabinet Order, Section 141, Subsection 1, provides the definition of foreign corporation tax; Subsection 2 provides examples of the type of taxes which are regarded as a foreign corporation tax; and Subsection 3 provides examples of the type of taxes which are not regarded as a foreign corporation tax. According to this prescribed method, the formal definition of a foreign corporation tax is provided by Subsection 1, and Subsections 2 and 3 prescribe concrete examples. In other words, Subsection 2 and 3 can be read as the rules to clarify the range of the foreign corporation tax.

In this case, Cabinet Order, Section 141, Subsection 3, Paragraph 1 and 2 is the applicable regulation, and assuming the abovementioned understanding, it can be read that not only tax falling under Paragraph 1 or 2 but also tax which is similar to these cannot be included in the definition of a foreign corporation tax. However, in view of the principle of tax law, any judgment in this regard must be cautious, so such issues cannot be allowed to be judged with an abstract standard.

The foreign taxes which are paid by the subsidiary of Company X are a tax corresponding to corporation tax imposed in accordance with foreign laws and ordinances and formally fall under the definition of a foreign corporation tax. Therefore, examining whether these foreign taxes substantially fall under Paragraph 1 and 2 or not, the foreign taxes which are paid by "international companies" under the Guernsey law cannot be exempted from taxes by application after the taxes have been paid. So the foreign taxes do not fall under Paragraph 1. Next, the subsidiary of Company X cannot decide the period of extension for paying the taxes optionally, so the foreign taxes do not fall under Paragraph 2.

In addition, the decision of the tax rate concerning the foreign tax requires the approval of the taxation office in the Guernsey Islands, and the taxation office does not always approve applications by companies that fulfill the prescribed requirements. So it cannot be said that the subsidiary of Company X chooses the taxation system based on its international taxation status instead of taking an exemption from tax optionally. The subsidiary of Company X

actually pays the foreign tax equivalent to corporation tax, the tax rate is 26%, and the subsidiary does not have any option to avoid paying the foreign tax. Because of the reasons mentioned above, the foreign tax is not a tax similar to the tax excluded from the definition of a foreign corporation tax as prescribed by Paragraph 1 and 2. In other words, because it is unreasonable to conclude that the foreign tax does not fall under the definition of a tax equivalent to corporation tax, the foreign tax falls under the definition of a tax equivalent to corporation tax prescribed by the Corporation Tax Act, Section 69, Subsection 1. The validity cannot be denied."

[Comment]

The issue in this case was as follows: Does the foreign tax fall under the definition of a foreign corporation tax? In this case the Supreme Court divided the issue into two elements as follows:

・Precisely, can it be said that the foreign tax is a tax?

・Does the foreign tax fall under the definition of a foreign corporation tax prescribed by the Corporation Tax Act, Section 69, Subsection 1 and Cabinet Order, Section 141, Subsection 1?

The Supreme Court finally concluded that it cannot be said that the foreign tax does not fall under the definition of a foreign corporation tax.

In the tax code, there is no definition of what constitutes a tax, but in this Case the Supreme Court defined a tax as a monetary charge a country or a public organization imposes, according to law, on all taxpayers who fulfill the prescribed requirements to obtain funds to allot them to expenditures. So the conclusions of the Tokyo District Court and the Tokyo High Court have been criticized as follows: Even if the taxation systems of the Guernsey Islands are unusual compared with the systems of developed countries, it cannot be said that the foreign taxes imposed are not a tax.

In addition, this case is significant in the point of understanding the definition of a foreign corporation tax prescribed by the Corporation Tax Act, Section 69, Subsection 1 and Cabinet Order, Section 141, Subsection 1, and understanding the types of taxes excluded from the definition of a foreign corporation tax prescribed by Cabinet Order, Section 141, Subsection 3, Paragraph 1 and 2.

Especially regarding Cabinet Order, Section 141, two different theories are advocated. One is that the examples prescribed by Subsection 2 and 3 are limited enumerations, and the other is that the examples are illustrational enumerations. In this Case, it was concluded that the examples are illustrational enumerations. The reasons for this conclusion are that the prescriptions of Cabinet Order, Section 141, Subsection 2 and 3 have the purpose of substantially demonstrating the content of a foreign corporation tax, and that not only the prescription of Subsection 1 but also the prescription of Subsection 2 and 3 define the substance of a foreign corporation tax.

Moreover, in this Case the Supreme Court concluded that even if the examples are

illustrational enumerations, the judgment, in view of the principle of tax law, must be cautious, and it cannot be allowed to judge with an abstract standard. This understanding is a reasonable conclusion. Incidentally, regarding the judgment of whether foreign taxes fall under the definition of a foreign corporation tax or not, the Supreme Court concluded that foreign taxes are equivalent to Japanese corporation tax. This understanding is the same as accepted theory.

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