The Inward Investment and International Taxation Review

Seventh Edition

Editor
Tim Sanders

Law Business Research

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CONTENTS

Editor's Preface vii
Tim Sanders

Chapter 1 BASE EROSION AND PROFIT SHIFTING 1
Jennifer Wheater

Chapter 2 AUSTRALIA 10
Adrian O'Shannessy and Tony Frost

Chapter 3 AUSTRIA 25
Niklas JRM Schmidt and Eva Stadler

Chapter 4 BELGIUM 34
Christian Chéruy and Marc Dhaene

Chapter 5 BRAZIL 64
Silvania Tognetti

Chapter 6 CANADA 77
KA Siobhan Monaghan

Chapter 7 CHINA 92
Jon Eichelberger

Chapter 8 CYPRUS 107
Georgia Papa

Chapter 9 DENMARK 122
Jakob Skaadstrup Andersen

Chapter 10 ECUADOR 136
Alejandro Ponce Martínez

Chapter 11 FRANCE 149
Philippe Derouin

Chapter 12 GREECE 174
Aspasia Malliou and Maria Kilatou

Chapter 13 HONG KONG 189
Steven Sieker and Wenwen Chai

Chapter 14 INDONESIA 200
Mulyana, Sumanti Disca Ferli and Bobby Christianto Manurung

Chapter 15 IRELAND 216
Peter Maher

Chapter 16 ISRAEL 236
Meir Linzen

Chapter 17 ITALY 250
Paolo Giacometti and Giuseppe Andrea Giannantonio

Chapter 18 JAPAN 268
Kei Sasaki, Fumiaki Kawazoe and Kohei Kajiwara

Chapter 19 LEBANON 284
Souraya Machnouk, Hachem El Housseini and Ziad Maatouk

Chapter 20 LUXEMBOURG 297
Pieter Stalman and Chiara Bardini

Chapter 21 MALTA 314
Juanita Brockdorff and Michail Tegos

Chapter 22 MEXICO 325
Eduardo Barrón and Carl E Koller Lucio

Chapter 23 NETHERLANDS 348
Paulus Merks and Sebastian Frankenberg

Chapter 24 NIGERIA 363
Theophilus I Emuwa, Chinyerugo Ugoji, Adefolake Adewusi and Mutiat Adeyemo

Chapter 25 NORWAY 374
Thomas E Alnæs and Erik Landa

Chapter 26 PERU 387
César Castro Salinas and Rodrigo Flores Benavides

Chapter 27 POLAND 403
Jarosław Bieroński

Chapter 28 PORTUGAL 433
José Pedroso de Melo

Chapter 29 PUERTO RICO 449
Miguel A Santiago Rivera and Alberto J E Añeses Negrón

Chapter 30 SPAIN 470
Javier Hernández Galante and Ricardo García-Borregón Tenreiro

Chapter 31 SWEDEN 489
Carl-Magnus Uggla

Chapter 32 TAIWAN 502
Michael Wong and Dennis Lee

Chapter 33 THAILAND 512
Panya Sittisakonsin and Sirirasi Gobpradit

Chapter 34 UNITED ARAB EMIRATES 525
Gregory J Mayew and Silvia A Pretorius

Chapter 35 UNITED KINGDOM 541
Tim Sanders

Chapter 36 UNITED STATES... 564
Hal Hicks, Moshe Spinowitz and Robert C Stevenson

Chapter 37 VENEZUELA.. 588
Alberto Benshimol and Humberto Romero-Muci

Chapter 38 VIETNAM... 603
Fred Burke and Nguyen Thanh Vinh

Appendix 1 ABOUT THE AUTHORS.. 617

Appendix 2 CONTRIBUTING LAW FIRMS' CONTACT DETAILS....... 639

EDITOR'S PREFACE

2016 saw dramatic change in the tax landscape in which international business is conducted. Most of this change revolved around the rollout of base erosion and profit shifting (BEPS) following the endorsement of the reports containing the 15-point action plan by the G20 leaders in November 2015, both in terms of its adoption in domestic tax laws and follow-up action by the EU Commission.

As well as the implementation of BEPS, 2016 also saw the European Commission adopting an increasingly aggressive use of state aid laws to attack the application by Member States of their domestic tax laws and the tax rulings they issue to multinational taxpayers operating across international borders. Many observers are concerned that the European Commission has crossed a fine line and is imposing its authority over Member States' sovereign right to determine their own direct taxes. On a more practical level, the European Commission's approach has drawn expressions of concern from the US Treasury on the basis, *inter alia*, that the Commission's approach is inconsistent with international norms, and that it undermines the international tax system and the BEPS initiative. It will be interesting to see where this potential conflict between the US Treasury, supported by certain EU Member States (notably Ireland, which is contesting the findings in the *Apple* case), and the European Commission, goes in 2017.

Despite the uncertainty so much radical change produces, enterprises will continue to trade across borders and establish a presence in jurisdictions beyond the boundaries of their home state. When doing so they will look to the tax adviser for guidance and confirmation of their tax position. While it is beyond any book to provide all the answers, it is hoped that this volume will prove to be a useful starting point for readers. Each chapter aims to provide topical and current insights from leading experts on the tax issues and opportunities in their respective jurisdictions with a chapter on the overarching potential impact of BEPS. While specific tax advice is always essential, it is also necessary to have a broad understanding of the nature of the potential issues and advantages that lie ahead; this book provides a guide to these.

I should like to thank the contributors to this book for their time and efforts, and above all for their expertise. I would also like to thank the publisher and the team for their support and patience. I hope that you find the work useful, and any comments or suggestions for improvement that can be incorporated into any future editions will be gratefully received.

The views expressed in this book are those of the authors, and not those of their firms, the editor or the publishers. Every endeavour has been made to ensure that what you read is the latest available intelligence.

Tim Sanders
London
January 2017

Chapter 18

JAPAN

Kei Sasaki, Fumiaki Kawazoe and Kohei Kajiwara[1]

I INTRODUCTION

Even as preparations for the Tokyo 2020 Olympics and Paralympic Games are underway, Prime Minister Shinzo Abe and the Liberal Democratic Party are continuing the 'Abenomics' economic programme, targeted at increasing inbound investments in Japan and stimulating domestic demand. Japan's entry into the Trans-Pacific Partnership agreement in February 2016 signals the government's resolve to strengthen Japan's economy through, *inter alia*, enhanced international trade and reform of various domestic policy frameworks. An area of significant reform is that of tax. The effective tax rate for corporations in Japan has been on a gradual downslide – it was 34.62 per cent in 2014 and is scheduled to be lowered to 29.74 per cent by 2018 – in line with policy initiatives to encourage more inbound investment in Japan.

On the other hand, Japan has a flat national consumption tax rate of 8 per cent as of November 2016, which is anticipated to rise to 10 per cent (except with respect to selected food and beverage items and daily newspapers) by October 2019. This increase in consumption tax is expected to adversely affect the momentum in Japan's economic recovery. The rapid growth in online purchases of digital content, goods and services, especially from vendors located abroad, has also prompted the introduction of a 'reverse-charge' system that allows consumption tax to be imposed on certain categories of taxpayers for their online transactions. These and other upcoming developments highlight the importance of tax considerations for foreign companies wishing to establish or expand their businesses in Japan.

1 Kei Sasaki is a partner and Fumiaki Kawazoe and Kohei Kajiwara are associates at Anderson Mori & Tomotsune.

II COMMON FORMS OF BUSINESS ORGANISATION AND THEIR TAX TREATMENT

i Corporate

In Japan, with the exception of sole proprietorships, businesses generally adopt a corporate form. Under the Companies Act of Japan (Companies Act), there are four types of companies one can establish:

a stock company (KK);
b general partnership company;
c limited partnership company; and
d limited liability company (GK).

The corporate form chosen will determine whether ownership of a company is separated from the management thereof, and the extent to which shareholders or members are liable to perform the company's obligations. The main differences between these four types of corporations are as follows: a KK is owned by shareholders but managed by its directors. The three other types of companies are, however, owned and managed by their members. The shareholders of a KK and members of a GK are only liable to the extent of their investments in their respective companies. On the other hand, the liability of members in a general partnership company is unlimited. By contrast, a limited partnership company has two types of members: those with limited liability and those with unlimited liability. As their names suggest, limited liability members are only liable to the extent of their investment in the company, while the liability of unlimited liability members is unlimited.

The KK is the most widely used corporate form in Japan. The GK, although not as popular as the KK, is also often used as a vehicle in structured finance. Limited partnership companies and limited liability companies, on the other hand, are not so common.

In addition to corporate forms under the Companies Act, there are also laws in Japan that enable corporations of other forms to be incorporated for special purposes. These include:

a specific purpose companies (TMKs), which are often used in asset securitisation;
b investment corporations, which are commonly used to accumulate funds for investment in securities and real estate;
c mutual companies, which are commonly used in insurance-related transactions; and
d medical corporations, which are commonly used for holding hospitals.

ii Non-corporate

Non-corporate entities (except sole proprietorships) can generally be categorised as (partnerships, silent partnerships (TKs) and trusts.

Most partnerships are general partnerships formed under the Civil Code of Japan (NKs). The partners in such partnerships are subject to unlimited liability. Additionally, there are other types of partnerships such as investment limited partnerships (LPSs) and limited liability partnerships (LLPs) that are derivatives of the NK. These partnerships may be established under special legislation. An LPS has partners with both limited and unlimited liability. LPSs are usually used for forming venture capital firms. An LLP is a partnership in which all partners are liable only to the extent of their investment in the partnership, and is typically used in joint ventures for academic research and development.

A TK is formed by way of a bilateral agreement between a business operator and its silent partners. A silent partner is someone who has contributed capital toward the relevant business operations in return for a share in the profits generated from the business. TKs are often used in structured finance.

Corporations incorporated under the Companies Act (i.e., KKs, general partnership companies, limited partnership companies and GKs) are fiscally opaque. (Sole proprietorships are also fiscally opaque.) On the other hand, partnerships such as NKs, TKs and most forms of trusts are fiscally transparent (i.e., they are pass-through entities). By comparison, TMKs and investment corporations are pay-through entities, such that the amount of profits they distribute (if any) to equity holders will be deducted from their taxable income.

III DIRECT TAXATION OF BUSINESSES

i Determination of taxable profit

Under the Corporation Tax Act of Japan (CTA), taxable income is derived by subtracting deductible expenses from gross profits. Deductible expenses are similar to accounting expenses, but with some important differences, and exclude certain kinds of accounting expenses. Gross profits are similar to accounting incomes, but with some important differences, and exclude certain kinds of accounting income.

There are major differences between deductible expenses and accounting expenses under the CTA, as follows:

a in respect of depreciable or amortisable assets, the amount of depreciation or amortisation permitted to be included in deductible expenses is limited. Specifically, the amount of depreciation or amortisation deductible for each year is calculated based on the useful life of the relevant asset, which in turn is determined based on the category of the relevant asset, and on the method of depreciation or amortisation adopted by the company. It should also be noted that under the Japanese tax system, depreciation and amortisation are required to be recorded first as accounting expenses before they can be registered as expenses deductible from taxable income in the relevant fiscal year;

b the amount of remuneration paid to officers shall not be included in the deductible expenses unless the period of remuneration payment is a constant period of one month or less, and the amount thereof is the same at each time of payment, remuneration is paid based on a provision with registration that ascertains an amount to be paid at a fixed time or remuneration is a certain kind of profit-linked remuneration;

c the amount of contribution or donation exceeding a certain amount shall not be included in the deductible expenses; and

d the amount of entertainment account exceeding a certain amount shall not be included in the deductible expenses.

Practically speaking, taxable income is derived from accounting profits. Once accounting profits have been ascertained, taxable incomes can be calculated by adding to the accounting profits the non-deductible expenses referred to above, and deducting therefrom, exclusive of gross profits, such items as certain portions of dividends distributed from a corporation.

In Japan, profits are taxed on an accrual basis, not receipt basis. Japanese corporations are subject to taxation on their worldwide income. Foreign corporations, on the other hand, are only subject to taxation on Japan-source income for the purposes of Japanese taxation.

A foreign corporation's taxable Japan-source income differs depending on whether the foreign corporation is deemed to have a permanent establishment (PE) in Japan. Further to the FY2014 tax reform, Japan's system of taxable domestically sourced income, which was previously based on the 'entire income principle', now adopts the 'attributable income principle'. The effect of this change is that, in relation to taxation on business profits, even if a foreign corporation has a PE in Japan, only the portion of its business profits that is attributable to such PE will be recognised as Japan-source income and therefore subject to Japanese taxation.

Capital and income

Realisation of and taxation on capital profits are usually deferred to the time of sale of the relevant asset. Where assets are sold at a profit, corporate income and capital profits will be aggregated and subject to corporate income tax at the corporate income tax rate.

Losses

Tax loss carry back

Where a domestic corporation incurs losses in a fiscal year, it may, simultaneously with the filing of its tax return, also file a claim for a corporate income tax refund for a certain amount of corporate income tax for any fiscal year commencing within one year prior to the beginning of the relevant loss-making fiscal year, depending on the amount of the said loss.

Tax loss carry forward

When a domestic corporation files a final tax return that indicates losses in a fiscal year commencing within nine years prior to the first day of each of its fiscal years, an amount equivalent to the said loss will be permitted to be included within the deductible expenses for each relevant fiscal year. In respect of fiscal years beginning on or after 1 April 2018, the losses carryover period, currently nine years, will be increased to 10 years. However, where a corporation is not a small or medium-sized company (i.e., not a corporation with stated capital of ¥100 million or less, but excluding a corporation that is completely controlled by a corporation with stated capital of ¥500 million or more) and the amount of said loss exceeds the maximum deductible amount stated in the following table for the relevant fiscal year, inclusion within the deductible expenses will not apply to the amount of the said excess.

Commencement date of the fiscal year when the relevant loss is included within the deductible expenses	*1 April 2015–31 March 2016*	*1 April 2016–31 March 2017*	*1 April 2017–31 March 2018*	*1 April 2018 onwards*
Maximum deductible amount	65% of the taxable income	60% of the taxable income	55% of the taxable income	50% of the taxable income

In the case of a merger, losses are not usually permitted to be succeeded by the surviving corporation unless certain requirements for exceptional treatment are satisfied.

Under the CTA, taxable income is subject to aggregate taxation and is not taxed on an income category-by-category basis. Accordingly, in cases where losses are incurred by a business, but it receives capital gains from the sale of some assets, then said losses offset the income of the capital gain and reduce the taxable income.

Rates

The corporate income tax rate applicable to small or medium-sized companies is 15 per cent for income up to ¥8 million and 23.4 per cent for the portion of income in excess of ¥8 million. The corporate income tax rate applicable to companies other than small or medium-sized companies is 23.4 per cent. The corporate income tax rates will, however, be amended in the manner set forth below.

Commencement date of the fiscal year		*1 April 2016–31 March 2017*	*1 April 2017–31 March 2018*	*1 April 2018–31 March 2019*
Small or medium-sized companies	Up to ¥8 million	15%	19%	19%
	Portion in excess of ¥8 million	23.4%	23.4%	23.2%
Companies other than small or medium-sized companies	Overall	23.4%	23.4%	23.2%

Other than corporate income tax, companies are also subject to, *inter alia*, the following local taxes, which are proportional with a rate that is flat or progressive, on profits generated:

a special reconstruction corporation tax;
b special local corporation tax;
c inhabitant tax; and
d enterprise tax.

The effective corporate income tax rate of corporations that are subject to size-based business tax (i.e., corporations with stated capital of more than ¥100 million) is as follows: from 1 April 2016 to 31 March 2018, 29.97 per cent; and from 1 April 2018 to 31 March 2019, 29.74 per cent. 'Effective tax rate' means the tax rate taking into account the deductibility of special local corporation tax and enterprise tax payments from taxable income.

Administration

Corporations are required to file their final tax return to the district director of the relevant tax office for corporate income tax (national tax) within two months following the end of each fiscal year (final return). A corporation whose fiscal year exceeds six months is also required to file an interim tax return to the district director of the relevant tax office within two months of the end of the first six months of its fiscal year (interim return).

In some cases, the competent district director may extend the filing deadline for final and interim returns by one month if such extension is requested. Regardless of whether the deadline is postponed, corporations are required to pay corporate income tax by the original tax return filing deadline. Therefore, where the tax return filing deadline is extended, corporations are liable to pay interest on payable corporate income tax for the period of extension.

The primary objectives of the National Tax Agency (NTA) include the enhancement of transparency in tax filing procedures, creating predictability for taxpayers, encouraging taxpayers' cooperation in investigations by the tax authority, improving the efficiency of the self-assessment system and strengthening accountability.

Matters of national tax (excluding internal consumption tax on imported goods, which is under the jurisdiction of the Customs and Tariff Bureau) are within the NTA's purview. The NTA has 11 regional tax bureaux, a national tax office in Okinawa and around 500 tax offices located throughout Japan.

Matters of local tax fall within the jurisdiction of the relevant prefectural tax office or city office of the relevant local government.

Tax offices have the authority to conduct tax audits for corporate income tax. The timing of such audits is not prescribed in the relevant laws and regulations. Notwithstanding this, there is a general understanding that tax audits are conducted once every few years and are typically focused on corporations whose profits swing widely from year to year.

Revised tax returns may be filed to increase tax liability when the declared tax amount is less than the correct amount stated in the new tax return.

On the other hand, if the declared tax amount is more than the correct amount, corporate income tax reassessments may be requested by taxpayers, provided such request are conducted within the permitted time frame (as indicated in the table below).

Type of request for tax reassessment	*Permitted time frame (beginning from the deadline for the filing of the relevant tax return)*
General	Five years
Tax reassessment in relation to transfer pricing	Six years
Tax reassessment in cases of changes to net loss amount	Nine years

The district director of the relevant tax office may conduct reassessments of corporate income tax, provided such reassessments are conducted within the permitted time frame (as indicated in the table below).

Type of tax reassessment	*Permitted time frame (beginning from the deadline for filing of relevant tax return)*
General	Five years
Tax reassessment in relation to transfer pricing	Six years
Tax reassessment in situations where a taxpayer evades tax through fraud or other wrongful means	Seven years
Tax reassessment in cases of changes to the net loss amount	Nine years

Taxpayers wishing to appeal a tax assessment can do so through the following avenues:

a making a request for reinvestigation to the director of the relevant tax office that had performed the original tax assessment (taxpayers have the option (but are not obliged) to request a reinvestigation before requesting for a reexamination under (b));

b making a request to the National Tax Tribunal (NTT) for a reexamination of the original tax assessment; and

c filing a lawsuit. (Lawsuits can only be filed after the results of the NTT's reexamination under item (b) have been released.)

As stated above, item (c) may be conducted only after following the procedure mentioned in item (b). On the other hand, a taxpayer may skip item (a) and go straight to item (b) instead.

Tax grouping

There are two regulatory frameworks in Japan in respect of tax consolidation: the full controlling interest framework and the consolidated return framework.

The full controlling interest framework applies mandatorily to intragroup transactions (including transactions involving transfers of assets, losses, dividends and interest) where all

companies in the group are wholly owned (whether directly or indirectly) by the ultimate parent of the group, regardless of whether the ultimate parent is a foreign or domestic company or individual, provided that the parties to the relevant transaction are domestic companies. Under this regulatory framework, taxation on intragroup profits from transfers of certain kinds of assets, such as fixed assets, securities, monetary claims and deferred assets (qualifying assets), is deferred until those assets are transferred outside the group. Additionally, intragroup contributions, donations and dividends are disregarded. Where the full controlling interest framework applies, certain tax incentives to which corporations with stated capital of ¥100 million or less are normally entitled would no longer be available to a small or medium-sized company that is fully controlled by a large corporation with stated capital of ¥500 million or more.

On the other hand, the consolidated return framework is, where approved by the Commissioner of the NTA, only applicable to groups in which all companies are wholly owned (whether directly or indirectly) by the ultimate parent of the group and the companies consist only of domestic companies. Under this framework, corporate income tax is calculated based on the group's consolidated income and payable by the domestic controlling corporation as the taxpayer. In respect of subsidiaries in such groups, unrealised profits and losses of qualifying assets will be imputed to taxable income or losses for the fiscal year immediately preceding that in which the consolidated return applies to the group. In addition, under the consolidated return framework, taxation on profits from intragroup transfers of qualifying assets is deferred until those assets are transferred outside the group. Intragroup contributions, donations and dividends are also disregarded under the consolidated return framework.

ii Other relevant taxes

In addition to corporate income tax, the taxes that generally apply to businesses are, *inter alia*, inhabitant tax, enterprise tax, fixed property tax, consumption tax, stamp duty, registration tax and real estate acquisition tax.

Inhabitant and enterprise taxes are local taxes that are proportional to a flat rate or progressive with regard to profits, etc. However, only enterprise tax is deducted from taxable income. Fixed property tax is proportional to the book value of the relevant property as indicated in the property register. Consumption tax is imposed on transfers of assets, with the transferor being deemed the taxpayer, although such tax is borne by the transferee in practice. Notwithstanding the above, in certain categories of online transactions, a 'reverse charge' was introduced and the transferee is deemed the taxpayer. Stamp duty is generally imposed on documents such as written contracts. Registration tax is imposed when registration is undertaken with the authorities, such as when real estate is registered on the national real estate register. Real estate acquisition tax, as its name suggests, is imposed on acquirers of real estate.

IV TAX RESIDENCE AND FISCAL DOMICILE

i Corporate residence

An entity becomes a Japanese tax resident (that is, it is deemed a domestic corporation for Japanese tax purposes) if its head office or principal office is located in Japan. Unlike the tax system in the UK, the place where management and control are exercised is irrelevant

for the purposes of determining tax residency in Japan. Accordingly, a foreign-incorporated entity cannot be a Japanese tax resident, even though it exercises its management and control functions in Japan.

ii Branch or PE

A foreign-incorporated entity will be considered to have a fiscal presence for purposes of Japanese tax if it has a PE in Japan, such as a fixed place of business, building or site, or a person is predominantly based in Japan to act on the corporation's behalf. Several factors are relevant in determining whether a PE exists. For example, in determining whether a foreign-incorporated entity has a PE in Japan, relevant factors include, *inter alia*, whether the corporation's business is conducted at such a fixed place. Several steps can be taken to avoid being deemed to have a PE in Japan, including using the fixed place only for the purchase or storing of goods, or for performing supporting functions such as advertising, information collection or dispensation, and conducting of market research and feasibility studies.

Japanese municipal law was amended in 2014. By this amendment, tax principles in Japan were shifted from the entire income principle, under which all of Japan-sourced income is taxed in Japan if the corporation has a PE, to the attributable income principle, under which only the income attributable to the PE is taxable. Consequently, the Authorised OECD Approach was adopted in Japan. As a result, profits calculated by deeming that the PE was a distinct and separate entity from the corporation, was engaged in the same or similar activities under the same or similar conditions with the corporation, and was dealing wholly independently from the enterprise, are attributable to the PE.

Treaty tiebreakers, such as Article 4, Paragraph 3 of the US–Japan tax treaty (or the US–Japan double tax treaties (DTAs)), prescribe the method by which to determine the tax residence of a person who falls within the definition of tax resident in both the US and Japan. There is no concept of branch profit tax in Japan.

V TAX INCENTIVES, SPECIAL REGIMES AND RELIEF THAT MAY ENCOURAGE INWARD INVESTMENT

i Holding company regimes

There is no special tax regime applicable to holding companies in Japan.

ii IP regimes

There is no special tax regime applicable to intellectual property in Japan, although withholding tax on royalty payments is exempt under some tax conventions.

iii State aid

State aid is available in certain sectors, such as the agriculture and manufacturing sectors. State aid comes in various forms, including tax exemptions, tax reductions and tax-free subsidies that encourage investments and the conducting of research and development in Japan. State aid is generally available as long as the relevant taxpayer is a tax resident of Japan, regardless of whether it is controlled by a foreign entity or individual.

iv General

The government provides several tax incentives to foreign business operators to encourage their investment in some sectors in Japan. Certain areas in Tokyo have been designated to fall within the Special Zone for Asian Headquarters, established to induce foreign companies to set up their offices and facilities in Japan. Specifically, a foreign company that establishes its Asian headquarter or its research and development centre in such special areas and also satisfies certain requirements will be entitled to enjoy tax incentives in the form of national and local income tax deductions, special depreciation rates or investment tax credits.

VI WITHHOLDING AND TAXATION OF NON-LOCAL SOURCE INCOME STREAMS

i Withholding outward-bound payments (domestic law)

Dividends and certain forms of profit distribution (such as capital repayment or repurchase of shares) by a domestic corporation to a non-resident or a foreign corporation (dividends) are subject to withholding tax at a rate of 20.42 per cent (or 15.315 per cent in the case of dividends from listed shares).

The Income Tax Act of Japan contains different rules on sources of income in respect of interest income from Japanese government bonds, certain kinds of domestic corporate bonds and deposits with financial institutions' business offices or facilities located in Japan (bond interest), and interest income from loans to business entities that conduct business in Japan (loan interest). Under Japanese law, bond interest is deemed Japan-sourced income, and is generally subject to withholding tax at a rate of 15.315 per cent if paid to a non-resident or a foreign corporation. Loan interest attributable to business conducted in Japan is also deemed Japan-sourced income, but is generally subject to withholding tax at a rate of 20.42 per cent when paid to a non-resident or a foreign corporation.

Royalties paid to non-residents or foreign corporations by entities or residents conducting business in Japan are subject to withholding tax at a rate of 20.42 per cent.

Notwithstanding the above, non-residents or foreign corporations with PEs in Japan may apply for an exemption from withholding tax on loan interest income or royalties attributable to their Japanese PEs with a competent district director of the relevant tax office. Specifically, by obtaining a certificate issued by the competent district director of tax office and by presenting the certificate to the payers, such non-residents and foreign corporations are permitted to pay taxes on loan interest income or royalties attributable to their Japanese PEs in the form of corporate income tax instead of withholding tax.

ii Domestic law exclusions or exemptions from withholding on outward-bound payments

As stated above, bond interest is generally subject to withholding tax. However, non-residents and foreign corporations may apply for an exemption from income tax on interest income from government bonds or corporate bonds received by way of the book-entry system, and interest income from corporate bonds issued outside Japan that is paid to recipients outside Japan. It should be noted, however, that such exemption does not apply to cases where interest income on corporate bonds is attributable to PEs of non-residents and foreign corporations or paid to related parties (such as relatives or controlling shareholders with more than 50 per cent equity interest in the issuer of the relevant corporate bonds).

As stated above, interest income from deposits with financial institutions' business offices or facilities located in Japan is generally subject to withholding tax. Non-residents and foreign corporations may, however, apply for an exemption from income tax on interest income derived from deposits in special international financial transactions accounts maintained with certain financial institutions.

iii Double tax treaties

As of 1 November 2016, Japan is party to 66 tax treaties with 102 countries or regions. These treaties comprise 54 tax treaties on avoidance of double taxation on income with 65 countries or regions (DTAs); 10 tax treaties on exchange of information with 10 countries or regions; a tax convention on mutual administrative assistance in tax matters among 66 countries; and a tax agreement between Japan and Taiwan.

Although Japan does not publish its general policies under the tax treaties it has entered into, most of the 54 DTAs are substantially based on the OECD Model Tax Convention on Income and on Capital (OECD Model Convention). In particular, the 2004 US–Japan DTA, which was based on the OECD Model Convention, serves as a base for many of the subsequent tax treaties entered into by Japan. It should be noted in this connection that even though the US–Japan DTA is based on the OECD Model Convention, it provides for lower tax rates on investment income such as interest, dividends or royalties in the source country to facilitate international investments; and contains anti-treaty abuse clauses, limitation-on-benefit clauses and exchange-of-information clauses to prevent treaty abuse.

The following table indicates the withholding tax rates in Japan, and how such rates are reduced or eliminated based on Japan's DTAs with various developed and developing countries.

Contracting state	*Dividend*		*Interest*		*Royalties*
	General	*Received by shareholders holding certain percentage of shares*	*General*	*Received by banks*	
(Domestic standard in Japan)	20.42%		15.315% or 20.42%		20.42%
US	10%	5% or 0%	10%	0%	0%
UK	10%	0%	0%	0%	0%
France	10%	5% or 0%	10%	0%	0%
Netherlands	10%	5% or 0%	10%	0%	0%
Switzerland	10%	5% or 0%	10%	0%	0%
Australia	10%	5% or 0%	10%	0%	5%
Singapore	15%	5%	10%	10%	10%
Vietnam	10%	10%	10%	10%	10%
China	10%	10%	10%	10%	10%

iv Taxation on receipt

A domestic corporation that receives dividends from a domestic or foreign corporation is required to include dividends in its taxable income, although it is eligible for withholding tax credits or foreign tax credits.

However, a domestic corporation that receives dividends from another domestic corporation may exclude all or part of such dividends from its taxable income, depending on the relationship between the payer and recipient of the dividends. Where a dividend recipient holds 100 per cent of the shares in the dividend payer, received dividends may be entirely excluded from the recipient's taxable income. Where a dividend recipient holds more than one-third but less than 100 per cent of the shares in the dividend payer, 100 per cent of received dividends after deducting the relevant interest cost may be excluded from the recipient's taxable income. Where a dividend recipient holds more than 5 per cent but one-third or less of the shares in the dividend payer, 50 per cent of received dividends may be excluded from the recipient's taxable income. Where a dividend recipient holds 5 per cent or less of the shares in the dividend payer, 20 per cent of received dividends may be excluded from the recipient's taxable income. Further, such dividends are generally subject to withholding tax at a rate of 20.42 per cent (or 15.315 per cent for dividends received in respect of listed shares). A dividend recipient is eligible for withholding tax credits.

On the other hand, dividends received by a domestic corporation from a foreign corporation are generally required to be included in the domestic corporation's taxable income. Where the dividend recipient holds 25 per cent or more of the shares in the foreign dividend payer, then 95 per cent of the dividend may be excluded from the recipient's taxable income.

If a foreign country withholds tax on dividends, interest or royalties paid to a Japanese corporation recipient, the recipient will be eligible for foreign tax credits up to a certain amount in general. However, certain types of foreign tax, including but not limited to withholding tax on dividends received by a domestic corporation holding 25 per cent or more of the shares in the foreign dividend payer, are ineligible for the foreign tax credit.

VII TAXATION OF FUNDING STRUCTURES

Entities in Japan are commonly funded through equity or debt, or both. In situations involving foreign parent companies and Japanese subsidiaries, foreign parent companies will typically provide loans to their Japanese subsidiaries until the latter achieve operational stability and necessary critical mass.

i Thin capitalisation

Japanese tax law includes thin capitalisation rules. Under these rules, if interest is paid to a foreign controlling shareholder by a domestic corporation (i.e., a Japanese corporation) when the payer's average interest-bearing debt to the foreign controlling shareholder in the fiscal year exceeds three times the value of the foreign controlling shareholder's equity interest in the payer in the said fiscal year, and the payer's average aggregate interest-bearing debt in the said fiscal year exceeds three times the value of the aggregate equity interest in the payer, the interest income related to the excess debt will not be deductible from the payer's taxable income. A domestic corporation may, however, apply a different debt-to-equity ratio (instead of three times) if it can prove that a different ratio is appropriate in light of the debt-to-equity ratio of similar corporations.

ii Deduction of finance costs

Finance costs such as interest or bank arrangement fees are generally considered deductible expenses. However, because Japanese tax law includes earnings stripping rules, transfer pricing rules and thin capitalisation rules, the inclusion of finance costs in deductible expenses is restricted.

Under the earnings stripping rules, when interest payments to related foreign corporations (such as a foreign parent company or subsidiary) exceed 50 per cent of the statutory income of the payer, the portion of interest payments exceeding 50 per cent of the statutory income of the payer is not deductible in the fiscal year. However, such excess portion is carried forward for seven fiscal years and can be used as deductible expenses until the total amount of deductible expenses reaches a 50 per cent threshold in each of the following seven fiscal years.

Under the transfer pricing rules, the portion of finance costs exceeding arm's-length prices will not be tax-deductible if the transaction giving rise to the relevant finance costs (including interest payments) is not conducted at arm's-length.

The thin capitalisation rules also place restrictions on the amount of deductible expenses claimable as stated above.

iii Restrictions on payments

Under the Companies Act, a KK's distributable profits, which are subject to statutory limits, are calculated based on surplus funds available. A GK's distributable profits are also limited to a certain amount. By contrast, the profits distributable by a general partnership company and limited partnership company are unlimited, unless restrictions on profit distribution are contained in their articles of incorporation.

iv Return of capital

A KK is permitted under the Companies Act to repay its capital to shareholders in the form of dividends through the reduction of its capital or statutory reserves. This involves approval for the capital or statutory reduction being obtained from the KK's shareholders at a shareholders' meeting; and the notification of the KK's creditors about the reduction in capital or statutory reserves and, in the event of any objection to such reduction by any creditor, the taking of the required statutory procedures to protect the interests of the objecting creditor. Upon the implementation of the reduction, the KK will be generally deemed to have returned capital to its shareholders of an amount equivalent to the capital of reserves reduced.

However, if there is any portion as a result of a calculation subtracting the value of capital attributable to the shares held by the shareholder from the amount of such capital return, such portion is deemed to be a dividend instead of a capital return for tax purposes. Accordingly, if the shareholders of a KK are domestic corporations, a certain amount of deemed dividends may be excluded from the recipient's taxable income depending on the relationship between the payer and recipient of the dividends, as stated above.

Further, if the shareholder of a KK is a domestic corporation, then the shareholder may include the capital gain or loss in its taxable income or loss. Such capital gain or loss is calculated by subtracting the acquisition cost basis of the share held by the shareholder from the capital return amount attributable to the share.

Overall, dividends distributed by a KK through the reduction of its capital or statutory reserves are viewed and taxed differently depending on which portion of the dividends is deemed to be a capital return or a dividend. Such a tax regime is not considered to be tax-neutral.

VIII ACQUISITION STRUCTURES, RESTRUCTURING AND EXIT CHARGES

i Acquisition

Foreign corporations often acquire businesses in Japan by acquiring the shares or assets (including employees) of the target entity in Japan. Doing so obviates the need to establish a new entity in Japan. Based on the prevailing interpretation of the Companies Act, however, a Japanese corporation cannot engage in a merger or demerger with a foreign corporation. Accordingly, if a foreign acquirer wishes to merge with or demerge from a Japanese target entity, it has to establish a new wholly-owned subsidiary in Japan (if it does not already have a Japanese subsidiary) through which to merge with or demerge from the target entity indirectly. In transactions where foreign corporations adopt such a structure, the new wholly-owned Japanese subsidiary is typically financed by capital or debt, or both. The debt-to-equity ratio of such subsidiary is also determined in light of the thin capitalisation rules, or the earnings stripping rules, or both.

Consideration for the acquisition of shares or assets is typically paid in cash. It should be noted, however, that consideration in forms other than cash (such as shares (including shares issued by parent company of the acquirer), corporate bonds and other assets) is also permissible.

ii Reorganisation

Under Japanese tax law, mergers and demergers may be classified as tax-qualified mergers or demergers if certain conditions prescribed by the CTA are satisfied. One requirement is that the consideration in tax-qualified mergers or demergers has to consist solely of shares in the acquirer or the 100 per cent parent company of the acquirer.

Assets and liabilities in normal mergers or demergers are transferred at fair market value. In tax-qualified mergers or demergers, however, assets and liabilities are transferred at book value. This means that capital gains or losses arising from transfers in tax-qualified mergers or demergers may be deferred at both the merged corporation level and the level of its shareholders. Notwithstanding this, tax-qualified mergers or demergers may not always offer the most favourable tax treatment to taxpayers where unrealised losses are deferred. However, taxpayers wishing to avoid requirements in respect of tax-qualified mergers or demergers can easily do so by paying consideration in forms other than shares. In this sense, Japanese tax law does not prevent consolidation between an acquired business and an existing local business, although mergers and demergers between Japanese corporations and foreign corporations are not permitted under the Companies Act, as stated above. Ultimately, the most suitable type of merger or demerger depends on the relevant situation.

iii Exit

Foreign corporations wishing to exit the Japanese market commonly do so by selling the shares in their Japanese subsidiaries. Capital gains arising from such sales are taxable under the CTA. As a result, foreign corporations are required to file tax returns with the applicable tax office within two months following the end of their fiscal year.

IX ANTI-AVOIDANCE AND OTHER RELEVANT LEGISLATION

i General anti-avoidance

Japanese tax laws contain general avoidance rules such as:

a the disallowance of acts or calculations by family-owned corporations;

b the disallowance of acts or calculations in relation to organisational restructuring;

c the disallowance of acts or calculations by consolidated corporate groups; and

d the disallowance of acts or calculations regarding foreign entity profits that are attributable to a PE.

In respect of low-tax jurisdictions, the Japanese tax authorities apply controlled foreign corporation (CFC) rules (CFC rules) in addition to other rules such as transfer pricing rules, thin capitalisation rules and earnings stripping rules.

ii CFCs

When more than 50 per cent of shares in a foreign corporation are held directly or indirectly by one or more Japanese residents (domestic corporations or individual residents in Japan), and when the amount of taxes on a foreign corporation's income that is earned in a foreign country where the head office or principal office of the foreign corporation is located is less than 20 per cent of the foreign corporation's income, CFC rules apply. When CFC rules apply, a Japanese resident who owns 10 per cent or more of the shares in such foreign corporation is taxable on the retained profits of the foreign corporation in proportion to the ratio of the resident's stock ownership in that corporation.

The CFC rules are, however, not applicable to a foreign corporation that conducts businesses in a certain manner in said foreign country, as the CFC rules are focused on preventing international tax avoidance. Generally speaking, the CFC rules do not apply when the foreign corporation satisfies the following requirements:

a the main businesses of the foreign corporation are not certain types of business, such as holding shares or bonds (business purpose test);

b the foreign corporation has the business offices necessary for its main business in said foreign country (substance test);

c the foreign corporation has management and control functions (management and control function test); and

d the foreign corporation conducts business mainly with unrelated parties (unrelated parties test) or mainly in said foreign country (location test). Whether the unrelated parties test or location test will apply depends on the segments of the foreign corporation's business that are involved.

It should be noted, however, that Japanese residents are still taxable on the tainted income (such as dividends or interest income) they receive from foreign corporations that are exempt from Japanese CFC rules.

iii Transfer pricing

Under Japanese transfer pricing rules, a domestic corporation that transacts with related foreign entities (such as a foreign parent corporation) will, if the transaction involves non-arm's-length consideration, be liable for tax calculated based on an arm's-length consideration imputed on the transaction. In calculating the appropriate arm's-length consideration, the tax authority will apply the most suitable statutory method of calculation available.

Typically, the tax authority will request further information from the taxpayer that will aid the authority to calculate an appropriate arm's-length consideration. Where a taxpayer fails to adequately respond to such requests, or does not promptly provide such information, the tax authority will have the right to determine such arm's-length consideration as it deems fit based on reasonable assumptions applicable to the relevant statutory method of calculation.

iv Tax clearances and rulings

It is possible to obtain advance rulings from the NTA in respect of actual (as opposed to hypothetical) situations. Trade associations also frequently consult the NTA in advance of the kinds of transaction that are commonly conducted by such trade associations. In addition, advance pricing arrangements are also applicable under the transfer pricing rules. As a general matter, no tax clearances or rulings are required in transactions involving the acquisition of a local business.

X YEAR IN REVIEW

i Reduction of corporate income tax

Corporate income and effective tax rates in Japan have been lowered in recent years. The following table sets forth recent changes in the tax rates.

	1 April 2015–31 March 2016	*1 April 2016–31 March 2018*	*1 April 2018–31 March 2019*
Corporate income tax rate	23.9%	23.4%	23.2%
Effective tax rate for corporations	32.11%	29.97%	29.74%

The gradual lowering of corporate income tax rates in Japan is in line with the government's plan to make Japan more competitive in the global economy, considering that Japanese corporate income tax rates are among the highest in the world. This is also consistent with the worldwide trend of lower corporate income tax rates.

ii Consumption tax

Japan's national and local consumption tax rates had originally been slated to rise from 8 to 10 per cent in October 2015. However, the date of implementation of this increase has been postponed to October 2019. When the increased tax rate comes into force, reduced

tax rates will at the same time be introduced in respect of certain kinds of food, beverages and daily newspapers, which will for the first time see non-flat consumption tax rates being implemented in Japan.

iii Court cases

In February 2016, the Supreme Court of Japan ruled on two cases involving different anti-avoidance rules. The first case (commonly known as the *Yahoo!-IDCF* case), which involved a domestic corporate restructuring (merger) conducted by Yahoo! Japan (the taxpayer), the Supreme Court ruled that the taxpayer had artificially and unreasonably decreased its taxable income by imputing accumulated losses incurred by one of the merging companies to the merged company, and that the anti-avoidance rule that allows tax authority to recalculate the tax amount is applicable. Accordingly, the Court ruled that tax amounting to ¥17.8 billion, which was imposed by the tax authority, was justified.

In the second case, the taxpayer (IBM Japan) won, with the Supreme Court ruling that tax amounting to ¥120 billion imposed by the tax authority on IBM Japan was illegal. The tax authority had argued in this case that IBM Japan's global restructuring was subject to certain anti-avoidance rules that are applicable to certain corporate groups, but this position was not supported by the Court.

These cases have resulted in increased focus on tax issues in M&A transactions and have highlighted the importance of careful tax planning. Additionally, they have made it clear that tax-driven corporate transactions involve an inevitable risk.

XI OUTLOOK AND CONCLUSIONS

Generally, we expect the tax authorities in Japan to continue keeping pace with developments in international tax laws, and to harmonise Japanese tax principles with such developments through legislative amendments and tax treaties. With regard to more specific issues, the upcoming reduction in corporate income tax and increase in consumption tax may lead to tax-driven business restructuring, especially in the supply chain and logistics sectors. Additionally, base erosion and profit shifting action plans are expected to be localised over the next few years. These tax reforms are expected to affect business activities in Japan in a way that we hope is conducive to overall economic growth.

Appendix 1

ABOUT THE AUTHORS

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Kei Sasaki advises on a wide range of areas, including international and domestic tax; banking, structured finance and project finance; financial regulation; energy and resources; and customs duties. Mr Sasaki has also successfully represented a client at the Supreme Court of Japan in a landmark case regarding an investment scheme using the Cayman exempted limited partnership structure.

He gained a bachelor of laws from the University of Tokyo (2004), attended the Legal Training and Research Institute of the Supreme Court of Japan (2004–2005) and gained in LLM in international taxation from the New York University School of Law (2012)

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