

Japan

Kiyokazu Iida,
Grant Thornton Japan, Tokyo

As a member state of the OECD, Japan's transfer pricing rules are consistent with the OECD transfer pricing Guidelines, and Japan's rules direct tax examiners to consider consistency with the OECD guidelines during audits and assessments.

The Special Taxation Measures Law (STML), enacted in 1986, remains the central transfer pricing legislation in Japan. Under STML 66-4, a transaction between a domestic or foreign corporation and a foreign related person not priced in accordance with the arm's length principle will be deemed to occur at an arm's length price for corporate tax purposes.

Other key transfer pricing regulations include the STML Enforcement Order 39-12 and the STML Enforcement Regulations 22-10, respectively laying out detailed rules on foreign related persons and transfer pricing methods, and the transfer pricing information that corporations are required to report annually on schedule 17(4) of the corporate tax return.

The STML Circular provides further guidance on control relationships, comparables, and transfer pricing methods. The NTA (Japan's National Tax Agency) Commissioner's Directive on the Establishment of Instructions for the Administration of Transfer Pricing Matters (the "Administrative Guidelines") outlines the various transfer pricing administrative procedures.

I. Scope

All transactions between foreign related parties, whether transactions of tangible or intangible assets, financial transactions, lease transactions, provision of services, etc. fall within the scope of Japan's transfer pricing regulations.

"Foreign related person" includes any corporation related to the taxpayer directly or indirectly through 50 percent or more shareholdings (including non-voting shares).

Where no shareholding relationship exists, two or more corporations may still be considered to be foreign related parties for the purpose of the transfer pricing rules if a substantial control relationship is found due to business, financial, or any other kind of dependence. Such a relationship may be found if any of the following conditions exist:

- An officer with representative authority of one corporation is concurrently employed as an officer or employee of the other corporation.
- 50 percent or more of the officers of one corporation are concurrently employed as officers or employees of the other corporation.

- A substantial portion of the business activities of one corporation are conducted in reliance upon transactions with the other corporation.
- One corporation provides loans or guarantees to the other corporation which constitute or are used to obtain a substantial portion of the funds necessary for the latter corporation's business activities.
- One corporation conducts its business activities in reliance upon intangible property provided by the other corporation.
- 50 percent or more of the executive officers of a corporation or the executive officers with representative authority are in effect designated by the other corporation.

II. Documentation

Japan has no explicit contemporaneous documentation requirement. However, taxpayers are required to disclose information about foreign affiliates and related party transactions on schedule 17-4 as part of the annual corporate tax filing. Schedule 17(4) requires taxpayers to disclose the following items:

- name of foreign affiliated persons
- main business line
- investment ratio
- fiscal year
- the number of employees of the foreign related party
- recent profit and loss summary
- related party transactions summary (value of the transaction, transfer pricing method)
- presence or absence of any APA.

In addition to this annual filing requirement, taxpayers are in practice required to provide transfer pricing documentation in response to a request from NTA in the case of a transfer pricing or corporate tax audit. (See further discussion below under "Audits and assessments").

III. Methodology and 2011 reforms

Japan's regulations currently specify the following permitted methods for determining an appropriate arm's length price:

- Traditional methods
 - the comparable uncontrolled price (CUP) method;
 - the resale price (RP) method;
 - the cost plus method.
- Transactional profit methods
 - the profit split (PS) method;

- the transactional net margin method (TNMM).

In response to the 2010 revisions to the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, Japan is set to adopt a ‘most appropriate method’ rule. This will be effective for fiscal years starting on or after October 1, 2011. To date, the three traditional transaction-based methods – CUP, RP, and CP – have been the preferred methods of the NTA and have had preference in Japan’s transfer pricing regulations.

The reforms which took effect in 2011 will also expressly allow for the application of three types of profit split method – comparable, residual, and a contribution approach whereby the arm’s length price is determined according to the value of the contribution made by each taxpayer to the combined operating profit or loss. To date this has been included in STML Circular, but the proposal is to clarify the rules in an enforcement order with legal force.

In addition, Japan is considering including the following reforms. First, a price would be acceptable if it falls within an otherwise appropriate arm’s length range. Current rules do not expressly allow for a range of arm’s length prices. Also, the NTA would only be able to use secret comparables if a taxpayer does not promptly provide information requested by NTA and if it provided (while maintaining the confidentiality of other taxpayers) a rationale for the transfer pricing adjustments.

IV. Audits and assessments

The Administrative Guidelines require that NTA examiners carrying out transfer pricing audits consider documents describing the relationship between the taxpayer and the foreign related person, the specifics of the transaction in question, and the selection methodology of comparables and transfer pricing method. For assessments, examiners are directed to consider operating and gross profit margins against internal or external comparables and in light of the functions performed and risks borne by each entity. It is not unusual for transfer pricing audits to span a year or longer.

Transfer pricing audits can begin through questions asked directly by a transfer pricing examiner or can result from questions that arise during a general corporate tax audit. Before formally undertaking a transfer pricing audit, an examiner will typically undertake an informal inquiry to determine whether a taxpayer is an appropriate target, and if so, the examiner will follow up more formally with a meeting or information request. Taxpayers failing to supply requested information in a timely manner are exposed to Japan’s *presumptive taxation* rules. These rules can be disadvantageous to the taxpayer as they afford examiners broad discretion to make assessments, including the ability to apply secret comparables, and to make income adjustments or apply a transfer pricing method without consultation or input from the taxpayer.

NTA guidance lists the following as information that taxpayers are required to produce in a timely manner in response to an NTA examiner’s request:

- details of assets or services that are the subject of the transaction;

- function and risk analysis for the taxpayer and the related party;
- details of the intangible property involved, if any;
- relevant contracts;
- relevant transfer pricing policies, details of the price negotiations;
- segmented income statement of the taxpayer and of the related party with respect to transactions with Japan;
- relevant market analysis;
- description of business strategy of the taxpayer and the related party;
- details of any connected transactions;
- details of the selection of the transfer pricing method and the pricing calculation;
- details of comparables and the selection process;
- details of the income apportionment calculation (for taxpayers using a profit split method);
- for price calculations on combined transactions, details of each component transaction; and
- details of any adjustments made to account for differences between the tested and comparable transactions.

To avoid exposure to assessments made under Japan’s presumptive taxation rules and corresponding penalties and interest charges, prudent taxpayers will want to assess their transfer pricing exposure and take appropriate steps to ensure compliance.

For taxpayers who wish to dispute a transfer pricing assessment, there are three basic responses. First, a request for re-examination may be made to the tax office that issued the assessment. If this is unsuccessful, which is typically the case, the taxpayer can then request reconsideration of the matter by the National Tax Tribunal, which operates as a quasi-judicial organisation within the NTA. If an appeal to the National Tax Tribunal is unsuccessful, the taxpayer may then bring a suit to challenge the assessment in a district court.

V. Burden of proof

The burden of proof in tax matters generally rests with the Government. In practice, however, the burden of proof threshold is often easily met by the tax authority and taxpayers that do not comply with reasonable information requests or who fail to provide reasonable rebuttals of evidence risk being subject to tax assessments and penalties.

VI. Statute of limitations

A transfer pricing assessment may go back to six years, one year longer than the time allowed for corporate tax assessments.

VII. Penalties and interest

Corporate tax penalties and interest are applicable to transfer pricing assessments. For tax underpayment, a flat 10 percent is payable on the first ¥500,000 of unpaid amount and 15 percent on any additional unpaid amount thereafter. This increases to 35 percent in cases of fraud. Penalties for underpayment are non-deductible for corporation tax purposes.

In addition, there is a delinquency interest charge. For the first year of delinquency, and for two months

immediately following the payment due date given in an assessment, the applicable delinquency interest rate as of the time of this writing is 4.3 percent. For tax that remains unpaid beyond two months from the payment date fixed in an assessment, the applicable penalty interest rate is 14.6 percent

There are no additional transfer pricing-specific penalties, but as discussed above under “Audits and assessments”, taxpayers failing to submit documents requested by the NTA in a timely manner may be subject to presumptive taxation or be disadvantaged by the use of secret comparables.

VIII. Mutual Agreement Procedures (MAP)

All of Japan’s double taxation agreements contain provisions for competent authority negotiations, allowing a taxpayer who disputes a tax treatment on the basis of an existing double taxation agreement to present the case to the relevant competent authority. According to NTA published information, as of June 30, 2010, the NTA was involved in 363 ongoing cases under competent authority negotiation, including APA cases. This number has been increasing in recent years and is expected to continue to increase. Since 2001, the number of countries negotiating with Japan in competent authority negotiations has increased from 10 to 25.

IX. Court cases

It is rare that transfer pricing disputes reach litigation before Japan’s courts. Only four transfer pricing cases

have been brought before the courts in Japan, and only one of these cases was won by the taxpayer. In 2008, software maker Adobe Systems won on an appeal to the Tokyo High Court. The NTA had made an assessment using secret comparables and characterising Adobe’s Japan subsidiary as a fully-fledged software distributor. Adobe took the position that the proper risk profile, for transfer pricing purposes, was a marketing service provider. The NTA’s assessment was upheld by the Tokyo District Court, but was overturned by the Tokyo High Court. Japan’s tax authority did not appeal.

X. Advanced Pricing Agreement (APA)

Japan’s APA system was instituted in April 1987. The APA guidelines are set out in section 5 of the Administrative Guidelines. Since 2008, the NTA has required that APA applications be submitted before the start of the fiscal year for which the APA is to apply. It is common for taxpayers to have several informal consultations with NTA examiners before submitting an APA application. According to NTA reports, bilateral APA applications have an average processing time of between two and three years. Obtaining a multilateral APA can take longer. The filing of an APA application by the taxpayer does not stop a transfer pricing audit if already underway.

While the APA process can be long, obtaining a high degree of transfer pricing certainty covering three or five fiscal years may provide an effective solution to transfer pricing risk for certain taxpayers.

www.gtjapan.jp