

Client Alert

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Substantial Changes to Japan's Transfer Pricing Documentation Rules

On March 31, 2010, Japan's parliament passed into law amendments to the rules relating to documentation to be provided to tax authorities for transfer pricing purposes. The amendments incorporate into law the requirement that taxpayers produce specified documentation to back up their transfer pricing position. These changes are of some help to taxpayers as they clarify what had previously been an "implied" rule. However, giving the documentation rule the force of law could present taxpayers with a new legal risk. This client alert provides an explanation of the amended rules.

1. Background

Requirements with respect to transfer pricing documentation in Japan have historically had an implied rather than a legal basis, as Japan's transfer pricing laws had never expressly required contemporaneous documentation. Specifically, taxpayers were not legally required to prepare and produce a detailed statement or in-depth explanation of their transfer pricing position and there were no penalties for failure to provide these. However, not providing relevant documentation when required to do so by the tax authorities could lead to a deemed assessment, with the added risk that secret comparables may be used to arrive at that assessment.

The Special Taxation Measures Law ("STML") is the primary source of Japan's transfer pricing rules. The "implied" Japanese documentation rule was found in Article 66-4(7) (66-4(6) as of April 1, 2010) of the STML, and Enforcement Ordinance¹ 22-10. STML Article 66-4(7) authorized the tax authorities to presume an arm's length price and reassess the taxpayer's taxable income (in terms of a deemed assessment, if necessary) when a taxpayer failed to provide, without delay, the documentation necessary to calculate the arm's length price. However, what constituted the "documentation necessary to calculate the arm's length price" was sometimes unclear as it was not set out in the STML, but was to be found in the Commissioner's Directive (also known as the "TP Guidelines").

¹ An Enforcement Ordinance is an order by the relevant Ministry, and has the same legal effect as the STML.

2. The Change

An amendment to the STML, promulgated on March 31, 2010 with effect from April 1, 2010, has clarified and given legal force to the application of the documentation rule. Amended STML 66-4(6) still authorizes the tax authorities to reassess income where a taxpayer fails to promptly provide the requisite documentation, but now more helpfully directs taxpayers to produce the documentation “listed in the Enforcement Ordinance” to avoid such a reassessment. In this regard, the documents listed below have been added to Enforcement Ordinance 22-10:

- (1) Documents indicating the following, as related to intercompany transactions:
 - The services provided and details of the assets used in the intercompany transaction
 - Functions and risks of each related party
 - Details of the intangible assets used in the intercompany transaction
 - Intercompany contracts
 - Pricing policies/pricing negotiations
 - Profits and losses of each related party with respect to the intercompany transaction
 - Market analysis
 - Business strategies
 - Details of other transactions closely related to the intercompany transaction, if any

- (2) Documents indicating the following, to compute arm’s length price:
 - The selected transfer pricing method and the reason for its selection
 - Comparable transaction selection process and details of selected comparables
 - Calculation of profit attributable to each related party where the profit-split method or TNMM is applied
 - Justification and details of each transaction where multiple transactions are aggregated for computation of the arm’s length price
 - Details of adjustments made to the comparable transaction, if any

3. Obligation to Submit “Schedule 17” to Continue

Prior to the amendment, Enforcement Ordinance 22-10 also included a requirement for taxpayers to submit a Schedule 17(4) (previously 17(3), with respect to fiscal years ending before April 1, 2009) with their Japanese corporate tax returns, which requires disclosure of information regarding transactions with foreign affiliates. This has not changed. The information required by 17(4) includes the following:

- Information about the foreign affiliates
- Name, main address, number of employees, sales, operating income
- Information about transactions with the foreign affiliates
- Amounts and transfer pricing methodologies applied to calculate

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- the sales/purchase amounts, service fees, royalties, and interest paid and/or received
- APA Status

Although there is no penalty for not submitting Schedule 17(4), failure to submit it may trigger an audit. Also, as Schedule 17(4) requires taxpayers to disclose the transfer pricing methodology applied, it would be difficult for taxpayers to complete Schedule 17(4) without preparing documentation. Once an audit has begun, a taxpayer would be asked to submit detailed information on its foreign affiliates and the transfer price of transactions listed in amended Enforcement Ordinance 22-10.

4. Comments

The effect of the documentation rule amendment is both positive and negative. Positively, the specificity of the documents listed in the Enforcement Order may assist taxpayers to more readily identify the most appropriate documentation to produce when required by the authorities. The negative aspect of the change arises because the documentation list was transferred from the TP Guidelines, which are not law *per se*, to the STML (by way of the Enforcement Ordinance), giving the tax authority a firm legal basis on which to conduct deemed assessments more easily when taxpayers cannot provide requested information in a timely manner.