

Client Alert

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Changes to Japan's Transfer Pricing Guidelines

Three significant amendments have been made to Japan's "Administrative Guidelines" for Transfer Pricing as of June 22, 2010. One amendment requires that tax auditors give consideration to the price negotiation process when analyzing pricing decisions in a JV or other multi-party situation. Two further changes modify Japan's new transfer pricing documentation rules, as adopted in April 2010,¹ adding rules regarding (1) consideration by tax auditors of preparation time when setting deadlines for submission of financial data, and (2) a requirement for the tax authorities to provide sufficient reasons for application of the so-called "presumptive taxation" rule under which taxpayers can be subject to transfer pricing adjustments based on "secret comparables". Awareness of these changes will be useful in developing or maintaining a comprehensive transfer pricing strategy involving Japanese interests.

1. Consideration of Pricing Negotiations Between Related Parties

Administrative Guidelines 2-2 ("Points to Consider when Conducting an Examination") requires the Japanese tax authorities to (1) take into account a reasonable price "range", and (2) apply a "multiple-year" methodology when conducting a transfer pricing audit. An additional paragraph has been added to Administrative Guidelines 2-2 which obligates transfer pricing examiners to also consider, when surveying pricing negotiations between related parties, the following:

- (a) The relationship between the transfer price and the "evaluation" of relevant companies within the group. For example, a subsidiary that acts as a reseller may resist an upwards change to a transfer price when its (and its management personnel's) performance evaluation within the group is based on gross profit; and
- (b) The impact on transfer pricing negotiations when the Japanese party has more than one investor, given that joint investors who do not participate in the related party transaction may take part in the pricing negotiations.

¹ See http://www.taalo-bakernet.com/e/newsletters/pdf/2010/ClientAlert_20100528_Tokyo_Tax_Group_E.pdf "Substantial Changes to Japan's Transfer Pricing Documentation Rules" for documentation rules introduced in Japan's 2010 tax reform.

The points above represent situations commonly seen in transfer pricing negotiations of multinational enterprises, and taxpayers have often asked examiners to consider these issues at transfer pricing audits. Taxpayers with multiple shareholders often claim during transfer pricing audits that they do not have full control of the transfer price, with negotiations under such conditions essentially amounting to unrelated party negotiations.

Having these points explicitly provided in the Administrative Guidelines is designed to provide some comfort to taxpayers in the situations described above. Importantly, however, the Notes to Administrative Guidelines 2-2(3) provide that the mere existence of heated transfer pricing negotiations between related parties does not mean that the price arrived at is at arm's length. Although such facts may be considered to some extent, taxpayers should nevertheless prepare appropriate supporting documentation.

2. Deadlines for Submission of Documentation (Including Foreign Related Parties' Financial Data)

Notes added to Administrative Guidelines 2-5 ("Points to Note in Applying the Estimation Clause or the Rules of Inquiry and Inspection of Third Parties in the Same Trade") state that any deadline for submission of transfer pricing documentation should be set by auditors considering the time reasonably necessary for preparation. Failure to submit documentation by the prescribed date triggers the "presumptive taxation" provisions under the Special Taxation Measures Law ("STML") 66-4(6),² pursuant to which the tax authorities can determine taxable income based on their own assessment of a taxpayer's financial data and income, including use of so-called "secret comparables".

The addition of these notes is designed—in theory at least—to have auditors consider taxpayers' input with respect to how long the relevant transfer pricing documentation will take to prepare and submit. However, auditors are not compelled to extend submission deadlines on the basis of a taxpayer's request and continue to have discretion when setting submission deadlines as well as the power to invoke the STML's presumptive taxation provisions when a deadline is missed. The Administrative Guidelines do not define what factors might be considered "reasonably necessary for preparation" when setting a submission deadline, and it is uncertain what weight (if any) will be given to taxpayers' requests in each case. Consequently, we would caution taxpayers against relying on the ability to request long lead times for submission of transfer pricing documentation.

² STML66-4(6) authorizes the tax authorities to presume an arm's length price and reassess the taxpayer's taxable income (by means of a deemed assessment, if necessary) when a taxpayer fails to provide, without delay, documentation necessary to calculate arm's length prices.

A potentially problematic issue caused by short submission deadlines arises when Japanese subsidiaries are required to provide parent or other foreign related-party financial data. The documentation required to be provided on audit was listed in Enforcement Ordinance 22-10 following amendments to the STML in April 2010, and includes documents evidencing the “profits and losses of each related party with respect to the intercompany transaction”. Japanese subsidiaries often have difficulty obtaining and submitting such information in a timely manner as foreign parent companies (or other foreign related parties) often resist providing it as they consider it unnecessary, particularly when they are applying the transactional net margin method (“TNMM”) with a Japanese subsidiary as the tested party. However, Japanese tax authorities tend to ask for this data no matter what transfer pricing methodology (“TPM”) is applied, insisting that they need such information to determine whether it is appropriate to apply that particular TPM.

A foreign parent may make a strategic decision not to disclose foreign affiliate data because it does not want to be exposed to the profit split TPM, which is generally considered the preferred method of the Japanese tax authorities. However, taxpayers (including their foreign parents and foreign affiliates) should be aware, and take into account in developing audit strategy, that a request by Japanese tax auditors for foreign related parties' financial data with respect to related party transactions is a routine part of audit procedure, and does not necessarily mean that tax auditors will seek to apply the profit split method. Taxpayers should bear in mind that resisting submission of foreign party data may trigger a “presumptive taxation” assessment without any opportunity to discuss the TPM that should be applied.

Cooperating with the authorities in a timely manner is always looked on favorably in Japan. Avoiding delays caused by the reluctance of one or more foreign parties to provide relevant information in a transfer pricing audit, where this is not a conscious strategic decision, is likely to help the audit run smoothly and result in a more flexible approach from the authorities. Accordingly, it would be prudent for multinational enterprises with Japanese subsidiaries to have a system in place to provide all relevant data as soon as practicable when requested unless it is determined as a matter of audit strategy not to produce it.

3. Provision of “Reasons” for Deemed Assessment and Possibility of Re-submission

In addition to the changes to Administrative Guidelines 2-5 noted above, a new paragraph (2) has been added requiring transfer pricing auditors to provide taxpayers with reasons for a deemed assessment when they carry out a “presumptive taxation” assessment based on a determination that documentation provided by a taxpayer is insufficient to calculate the arm’s length price. This new requirement is designed to avoid deemed assessments without reasonable cause.

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Additionally, the notes to Administrative Guideline 2-5(2) have been amended to provide that, when documentation submitted by a taxpayer is “inaccurate”, the auditor may ask the taxpayer to re-submit accurate documentation. However, such a “second-chance” to re-submit documentation is not guaranteed: The Administrative Guidelines leave it to tax auditors’ discretion whether or not and under what circumstances to allow resubmission of documentation.

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