



Japan releases revised transfer pricing administrative guidelines

Global Transfer Pricing Alert 2018-006

Japan's National Tax Agency (NTA) recently released a revised version of the Commissioner's Directive on the Operation of Transfer Pricing, known as the Administrative Guidelines.

The Administrative Guidelines do not have the force of law in Japan and are not binding on Japanese taxpayers. They are intended to encourage a consistent application of Japan's transfer pricing rules at the various levels of the tax authorities. Therefore, the Administrative Guidelines are an important source of guidance for how the Japanese authorities are likely to interpret Japan's transfer pricing rules. A discussion draft of the amended Administrative Guidelines was released on November 10, 2017, with comments submitted to the NTA until December 10, 2017. The final Administrative Guidelines were released on February 23, 2018.

The key changes for foreign multinationals operating in Japan can be grouped into two categories: (1) changes to the advance pricing arrangement (APA) landscape in Japan; and (2) revisions concerning intragroup service provision. This article summarizes the most important aspects of each group of changes, as well as possible challenges for taxpayers resulting from the changes.

Changes to the APA landscape in Japan

Clarification on the relationship between audit and APA

Historically, Japan has had no clear guidance on the relationship between tax audits and APAs, other than a statement that an APA application does not preclude the tax authorities from conducting an audit, and that information

provided during APA procedures cannot be used in tax audits without approval from the taxpayer.

In practice, however, there was an understanding among taxpayers and practitioners that, when a taxpayer requests an APA, the APA covered years would not be subject to tax audits, and that this would include any years covered by a retroactive application of the APA (an APA rollback).

The amendments to the Administrative Guidelines clarify that:

- Even when a taxpayer requests a rollback in an APA application, a tax examiner is not barred from carrying out an audit of the rollback years.
- When an APA is being discussed or agreed to, tax filings (limited to those relating to transfer prices covered by the APA), will not be subject to tax audits for the APA years.

Based on the explanation provided by the Japanese tax authorities, the amendments are intended to confirm that APA rollback years may still be audited, even after an APA request has been filed, and the tax authorities' view that this has always been the case. Based on this, it would be prudent to consider possible consequences of the changes for APA rollback years, as follows:

- If APA rollback years are subject to an audit that has commenced, the audit will continue covering the rollback years, and the APA review may be deferred. Once the audit is completed, the APA review for the covered years would recommence.
- If an audit is commenced on APA rollback years after the filing of an APA application, the audit for APA rollback years will commence and the APA review for the covered years may be deferred. Once the audit is completed, the APA review for the covered years would recommence.

As a general comment, we would expect it to take more time to complete the APA process when APA rollback years are being audited, or subject to possible future audits.

Deadlines for responding to information document requests

Another important change is the introduction of a deadline for responding to information document requests (IDRs) from the Japanese tax authorities during their review of an APA application. New Article 6-11-(3) of the Administrative Guidelines provides that an IDR must be answered before the deadline set by the APA review officer, which shall not exceed 45 days from the IDR date.

Previously, no specific deadline was provided for responding to such requests, and the timing of a response was at the discretion of the tax officer requesting the information. The new deadline is consistent with the timing for large companies to submit their local file after a request, indicating that the tax authorities view 45 days as a reasonable amount of time for taxpayers to respond to a request for information, and

seemingly encouraging taxpayers to be well prepared for an APA application.

If the taxpayer does not respond to an IDR within the prescribed time frame, the tax authorities would classify the application as a case where concluding an APA or commencing review of the APA application is not appropriate, resulting in either a withdrawal of the APA application by the taxpayer, or a denial of the APA application by the Japanese tax authorities. The Japanese tax authorities' APA review process generally involves significant scrutiny of the APA application, including issuing a substantial number of IDRs, and the new timing requirement may pose a compliance challenge for multinationals applying for Japanese APAs.

Importance of prefiling meeting

The revised Administrative Guidelines suggest that the Japanese authorities place even greater importance on the prefiling meeting prior to filing an APA application. The newly added Article 6-2-(1) states that the Japanese tax authorities should direct taxpayers to hold a prefiling meeting prior to filing of APA applications. Although prefiling meetings are not mandatory under law, prefiling meetings are becoming more important in Japan. A prefiling meeting presents an opportunity for the Japanese tax authorities to state their comments and guidance to taxpayers as to what they would prefer to see in the APA application.

The changes to the Administrative Guidelines are consistent with comments in the NTA's Transfer Pricing Guide Book for Taxpayers issued in 2017, further demonstrating the importance the tax authorities place on the prefiling meeting.

While it is within a taxpayer's right not to hold a prefiling meeting, and there may be reasons why a taxpayer chooses not to do so, careful consideration of this issue would be warranted, given the risk of prejudicing the APA negotiation process.

Special conditions for suspension of APA review

The Administrative Guidelines were amended to allow the suspension of a review of bilateral APA applications involving mutual agreement procedures. Recently, the Japanese tax authorities have seen an increasing number of bilateral APA applications involving countries whose competent authorities have limited APA experience (for example, non-OECD countries) leading to significant delays in concluding APAs or accepting APA applications. This amendment allows the Japanese authorities to clear their APA inventory of cases when there is a long delay. Based on the changes, if the bilateral APA application is not received/accepted, or is unlikely to be received/accepted, by the counterparty competent authorities three years from the day after the filing deadline, the APA must be withdrawn or converted to a unilateral APA application. For APAs filed before the amended Administrative Guidelines were published, the three-year period begins on the date of the amended Administrative Guidelines, rather than the standard timing.

Revisions regarding intragroup service provision

Low-value-adding services

Revisions were also made to the calculation approach for low-value-adding services in the Administrative Guidelines. These revisions are consistent with the 2015 BEPS final report on low-value-adding services, which provides a simplified approach for pricing such intragroup services. Under the new provision, certain intragroup service transactions will be deemed to be at arm's length if the service is priced on a cost-plus five percent basis. This may be selected as an alternative to the conventional calculation methodology.

In order to apply the simplified calculation method, all of the following requirements must be met:

- The provision of the service must be supportive in nature, and have no direct relationship to the group's core business activities.
- Intangible assets must not be used in the provision of the service. This includes intangibles owned by the taxpayer, foreign related parties, or licensed from third parties.
- The service-providing entity must not assume, manage, or create material risks in relation to the service.
- The contents of the service do not fall under any of the following functions: (i) research and development, (ii) manufacturing, distribution, purchase of raw materials, logistics, or marketing, (iii) finance, insurance or reinsurance, or (iv) mining, exploration, or formulation.
- No identical service is provided to or by third parties.
- When all requirements above are met, a service fee is calculated based on the total cost incurred by the service provider (both direct and indirect) relating to the particular service recipient. A reasonable allocation methodology should be used. After calculating the costs, a five percent markup is added.
- Documentation on the service transaction must be prepared/obtained and maintained.

The previous version of the Administrative Guidelines stated that the service cost itself (i.e., cost-based pricing without markups) could be used in the determination of an arm's length price for certain services that are auxiliary to a taxpayer's core business. These provisions remain in the amended Administrative Guidelines, alongside the simplified approach described above. The Administrative Guidelines simply provide that tax examiners should "consider" either the five percent markup on cost approach or the cost-based approach for certain service provisions. Additional clarification is required on the interaction between the two approaches, and when either one is considered appropriate.

Elaboration on shareholder activities

The amended Administrative Guidelines provide comments on shareholder activities that would not be considered services to foreign related parties (and thus would not justify a charge to

the foreign related parties). The guidance is generally consistent with the OECD transfer pricing guidelines. However, there are minor differences. For example, the Administrative Guidelines further clarify that the cost of preparation of records relating to the CbC report by a parent company falls into shareholder activities costs (as well as costs of other activities relating to compliance of the parent company with relevant tax laws), whereas the OECD transfer pricing guidelines only state that costs relating to compliance by the parent company with relevant tax laws are examples of costs associated with shareholder activities.

Comments

The Transfer Pricing Administrative Guidelines are an important source of guidance for how the Japanese authorities are likely to interpret the transfer pricing rules in Japan; in that context, changes to the guidelines are significant.

For taxpayers considering an APA, it would be prudent to consider the changes described in this article at an early stage. This includes considering any potential impact on rollback years, timing of the APA process, being in a position to respond to information requests in a timely manner, and the importance of the decision whether to hold a pre-filing meeting.

Taxpayers providing or receiving certain low-value-adding intragroup services now have an additional, simplified method of calculating service fees. While the method is generally consistent with the OECD view, if the new method is to be used, taxpayers would be well advised to consider the consequences in the counterparty jurisdiction. For affected taxpayers, it would also be prudent to monitor additional guidance from the authorities clarifying the interaction of the simplified approach with the existing cost-based pricing method.

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