

Japan Inbound Tax & Legal Newsletter

New release of the Transfer Pricing Administrative Guidelines by the National Tax Agency

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Overview

Japan's National Tax Agency (the "NTA") recently released a revised version of the Commissioner's Directive on the Operation of Transfer Pricing (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 transfer pricing rules in Japan. A discussion draft of the amended Administrative Guidelines was released on November 10, 2017 with comments submitted to the NTA until December 10, 2017 and the final Administrative Guidelines subsequently released on February 23, 2018.

The key changes for foreign multinationals operating in Japan can be grouped into: 1. Changes to the Advance Pricing Arrangement ("APA") landscape in Japan; and 2. Revisions concerning intra-group service provision. This article summarizes the most important aspects of each group, as well as possible challenges for taxpayers resulting from the changes.

1. Changes to the APA Landscape in Japan

(1) Clarification on the Relationship between Audit and APA

Historically, there was 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 amongst 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 (i.e. an APA roll-back).

The amendment to the Administrative Guidelines clarify that:

- Even where a taxpayer requests a roll-back in an APA application, a tax examiner is not barred from carrying out an audit for the roll-back years.
- When an APA is being discussed or agreed, 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 given by the Japanese tax authorities, the amendments are intended to confirm that APA roll-back years are still able to be audited, even after filing an APA request, 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 roll-back years, as follows:

- If APA roll-back years are subject to an audit that has commenced, the audit will continue covering the roll-back 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 roll-back years after the filing of an APA application, the audit for APA roll-back 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 roll-

back years are being audited, or subject to possible future audits.

(2) Introduction of Deadlines for Responses to Information Document Requests

Another important change is the introduction of a deadline for responses to information document requests (“IDRs”) from the Japanese tax authorities during their review of 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 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 45 days is seen by the tax authorities as a reasonable amount of time for taxpayers, and seemingly encouraging taxpayers to be well prepared for an APA application.

If the timing condition is not met, 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 APA application by the Japanese tax authorities. The Japanese tax authorities’ APA review process generally involves significant scrutiny of the APA application, including a substantial number of IDRs being issued and the new timing requirement may pose a compliance challenge for multinationals applying for Japanese APAs.

(3) Importance of Pre-Filing meeting

The revised Administrative Guidelines suggest that the Japanese authorities place even greater importance on the pre-filing 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 pre-filing meeting prior to filing of APA applications. Although pre-filing meetings are not mandatory under law, pre-filing meetings are becoming more important in Japan. A pre-filing 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 placed on the pre-filing meeting by the authorities.

While it is within a taxpayer’s right not to hold a pre-filing meeting, and there may be reasons a taxpayer chooses not to, careful consideration of this issue would be warranted, given the risk of prejudicing the APA negotiation process.

(4) Special Conditions for Suspension of APA Review

Finally, changes were made allowing for suspension of a review of bilateral APA applications involving mutual agreement procedures. Recently, the Japanese tax authorities has seen an increasing number of bilateral APA applications involving countries whose competent authorities have limited APA experience (e.g., non-OECD countries) leading to significant delays in concluding APAs or accepting APA applications. This amendment assists the Japanese authorities in clearing their APA inventory of cases where 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.

2. Revisions Concerning Intra-Group Service Provision

(1) 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 which provides a simplified approach for pricing low value-adding 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 core business activities of the group.
- 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 re-insurance, or (iv) mining, exploration, or formulation.
- No identical service is provided to or by third parties.
- Where 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 which 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 each approach, and when either is considered appropriate.

(2) Elaboration on shareholder activities

Finally, the amended Administrative Guidelines provide comments on shareholder activities which 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 clarifies 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), while the OECD Transfer Pricing Guidelines only state that costs relating to compliance of the parent company with relevant tax laws are examples of costs associated with shareholder activities.

Deloitte's View

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 and, in this context, changes to the guidelines are significant.

For taxpayers considering an APA, it would be prudent to consider the changes described in this newsletter 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 importance of the decision whether to hold a pre-filing meeting.

Taxpayers providing or receiving certain low value adding intra-group 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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