

Japan Inbound Tax & Legal Newsletter

NTA Updates Transfer Pricing Documentation Guidance

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Introduction

In June 2020, Japan's National Tax Agency (NTA) updated its transfer pricing documentation guides "Documents Recognized as Necessary for Calculating Arm's Length Prices" (local file guidance) and "Transfer Pricing Documentation Frequently Asked Questions" (TP documentation FAQs).

The guides were originally published in 2016, following Japan's implementation of the OECD's three tiered approach to transfer pricing documentation. The local file guidance sets out illustrative examples of the documents the authorities consider relevant to preparing a local file, while the TP documentation FAQs provide a comprehensive list of questions and answers covering local files, master files, and CbC reports on issues such as thresholds, preparation, filing, etc. Both guides are intended to assist taxpayers in interpreting the documentation rules in a way that is consistent with the view of the NTA.

This article briefly presents the main changes to the guides.

Local file guidance

The updates to the local file guidance introduce additional considerations for taxpayers preparing local files and primarily cover the changes to the transfer pricing law coming out of the 2019 tax reform package, including guidance on documenting the discounted cash flow (DCF) method, the use of financial forecasts, and clarifications relating to use of the interquartile range.

The 2019 tax reform package, among other things, implemented the OECD's approach to hard to value intangibles (HTVI approach) in Japan. In introducing the HTVI approach, the tax reform package also formally allowed the use of the DCF method as the method of last resort. While the DCF method is commonly used by taxpayers in valuing intangible assets and would be used in an application of the HTVI approach, the Ministry of Finance has clarified that the application of the DCF method is not limited to intangible assets, and is not limited to the application of the HTVI approach.

The updates to the local file guidance provide the NTA's view on the level and type of documentation that should be maintained to support the application of the DCF method. Examples of documents include:

- Workpapers showing the calculation of projected profit on a year by year basis, the taxpayer's reasons for the use of terminal value and the calculation of the terminal value (as appropriate), support for the reasonableness of assumptions (such as growth rate, corporate taxes, etc.), and support for routine returns used in the calculation (e.g., benchmarking);
- Documents supporting the reasonableness and calculation of the discount rate used; and
- Documents supporting the reasonableness of the forecast period during which profit is expected.

The updates also provide the NTA's view on documents necessary to support the use of financial forecasts for transfer pricing purposes. Forecasts are used in the application of the DCF method; however, the examples provided in the guidance are not limited to the DCF method.

Examples of documents necessary to support financial forecasts include:

- Documents that support the reliability of business plans, including third party reports and historical financial data where appropriate; and
- An explanation of the calculation method, including the purpose for which the forecast was prepared (e.g., management decisions, investment decisions, transfer pricing specific forecasts) and to whom the forecasts were reported (e.g., board of directors, shareholders).

Finally, the 2019 tax reform package also formally allowed the use of the interquartile range (also referred to as the “statistical method”) under Japanese law. The updated local file guidance provides additional information on calculating the interquartile range, including:

- The interquartile range can be applied where there are four or more comparable transactions/observations.
- The calculation of the interquartile range from the 25th to the 75th percentile is based on either an excel formula or the method prescribed by the US Internal Revenue Service (IRS).
- The IRS method would generally be used in bilateral APAs.

Other guidance, such as guidance on documents necessary to support intangible assets, also is provided.

TP documentation FAQs

In addition to the local file guidance, the NTA has updated the TP Documentation FAQs for certain clarifications relating to “intangible property transactions” and country-by-country reporting.

The updated FAQs clarify the transactions that are considered to be intangible property transactions for purposes of the contemporaneous documentation threshold, specifically whether intangible property transactions include payments of management fees or service fees and payments under a cost contribution arrangement. The FAQs clarify the NTA’s view that the definition includes transactions involving the transfer or license of intangible assets, establishment of rights to these intangibles, or similar transactions, and that these transactions will fall within the definition irrespective of how they are described (e.g., as management fees, etc.). While not specifically stated, the NTA presumably is instructing taxpayers to assess whether transactions of the types listed (e.g., cost contribution arrangement payments) satisfy this definition, without regard to how the transaction is classified internally by the taxpayer.

The updated FAQs also include the following clarifications relating to CbC reporting:

- Confirmation that annual ultimate parent entity notifications (also referred to as CbCR notifications) are required;
- Confirmation that dividend income from group entities does not need to be included in the CbC report;
- Clarification of scenarios where CbC reports are required to be filed in Japan by Japanese subsidiaries of foreign multinationals; and
- Clarification that the Japanese tax authorities will not contact a Japanese subsidiary of a multinational where errors or other issues are identified within the CbC report obtained from a foreign tax authority.



Deloitte’s View

The NTA’s local file guidance and TP Documentation FAQs provide interpretative information for taxpayers preparing Japanese transfer pricing documentation, from the perspective of the NTA. The June 2020 updates to these guides are useful for taxpayers whose transfer pricing policies reflect the 2019 tax reform, such as pricing based on the DCF method, and provide additional clarification on how the Japanese authorities expect financial forecasts to be supported. For taxpayers assessing whether they meet contemporaneous documentation thresholds, the NTA provides additional clarification on the definition of intangible property transactions for purposes of the lower threshold applicable to such transactions.

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Jun Sawada, Inbound Client Services Leader	
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Tax Controversy	Yutaka Kitamura, Partner
Legal	Kaori Oka, Partner
Immigration	Yoshito Kijima, Partner
Payroll and Social Benefits Processing	John Dorff, Partner
email to japan_taxlegal_inbound@tohmatu.co.jp	

Issued by

Deloitte Tohmatsu Tax Co.

Marunouchi-Nijubashi Building, 3-2-3 Marunouchi, Chiyoda-ku, Tokyo 100-8362, Japan

Tel: +81 3 6213 3800

email: tax.cs@tohmatu.co.jp

Corporate Info: www.deloitte.com/jp/en/tax

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