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Japan Tax & Legal Inbound Newsletter

COVID-19 and Transfer Pricing in Japan – One Year On

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As we enter a second year impacted by COVID-19, this article revisits some of the implications of the pandemic from a Japanese transfer pricing perspective.

COVID-19 and transfer pricing in Japan

Japan has experienced a full year of impact from the COVID-19 pandemic. As the economic effects of the pandemic became apparent, some of the key Japanese transfer pricing considerations included potential loss-making positions of limited risk operating entities, practical issues of benchmarking and documentation during 2020, and the impact of the pandemic on existing or new advance pricing agreements (APAs).

From an APA perspective, the Japanese tax authorities grappled with changing work conditions and responding to state of emergency declarations. Limits on the number of personnel allowed to be physically present in the office has impacted the tax authorities' ability to process cases. APAs continue to be submitted and reviews have generally continued; however, the impact of changing work conditions is obvious. Although some APA cases appear to have been minimally impacted (e.g., pace of review similar to prior years but with a greater reliance on virtual rather than in-person meetings), other cases are not progressing as quickly or have experienced a long delay for the review to begin after submission. This suggests that the authorities are potentially reducing the number of cases they are reviewing at any given time.

In addition, regional tax bureaus appear to be requesting COVID-19-related information as a matter of course in an APA review. This includes questions on how COVID-19 has impacted the taxpayer from a quantitative perspective (e.g., comparison of forecasts against actual financial results), as well as qualitative questions (e.g., site closures and government assistance). The questions and information requests align with OECD guidance on transfer pricing implications of the COVID-19 pandemic, and are likely aimed at understanding the impact of COVID-19 on the individual taxpayers in addition to building up data on how COVID-19 is impacting taxpayers in various industries in Japan.

From a tax audit perspective, there was a pause in audit activity for several months in 2020 and a reduction in the number of taxpayers being selected for audit. The tax authorities still operate in a largely paper-based system due to strict information security and privacy rules, which limit what can be done while not physically present in the office. Nevertheless, the tax authorities are continuing to conduct audits in the current environment. For the time being, the tax authorities will likely take a more strategic approach in selecting taxpayers for audit (including initial risk assessments) in order to deploy their resources more efficiently. This is consistent with the internal restructuring that took place in 2020, which resulted in the centralization of international tax and transfer pricing specialists in the international examination division (conducting risk reviews) and a new strategic planning team (modernizing the use of technology for audit strategy).

OECD guidance

On 18 December 2020, the OECD released guidance on the transfer pricing implications of the COVID-19 pandemic. The guidance focuses on how the arm's length principle and OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations apply to issues that may arise or be exacerbated by the COVID-19 pandemic. The guidance focuses on four priority issues: comparability analysis including practical benchmarking considerations, losses and the allocation of COVID-19 specific costs, the impact of government assistance programs on transfer pricing, and guidance on both existing APAs and those under negotiation.

From a Japanese perspective, while no formal guidance has been issued, the tax authorities have broadly signaled agreement with the OECD guidance. From a comparability analysis and benchmarking perspective, the authorities note the importance of looking at the most recent actual data (even if not full year data), rather than relying on data from prior downturns (e.g., the global financial crisis) or more complex approaches such as predictive modelling. The tax authorities also have acknowledged the potential for inclusion of loss makers in comparable sets.

Any assessment of whether a limited risk subsidiary can return losses should be based on a detailed analysis of the facts of the taxpayer. However, where relevant risk management is typically undertaken at the parent level, the tax authorities have noted they would expect losses to flow to the parent level, rather than limited risk subsidiaries in the group. In this context, the authorities have noted that government subsidies and assistance are an economic factor to be taken into account; however, they do not impact the level at which risk management is undertaken or risk allocation within the group.

Finally, from an APA perspective, the tax authorities expect that critical assumptions are likely to be triggered. However, this should be assessed on a case-by-case basis for the assumptions in an individual APA.

Practical examples

Practical examples of COVID-19 issues faced by inbound taxpayers are set forth below.

Taxpayers with revenue negatively impacted by the pandemic (e.g., luxury goods, travel) assessed temporary changes to their transfer pricing policy throughout the year (e.g., suspending intercompany transactions, such as those involving royalty payments, to maintain local operating margins). In doing so, it was necessary to consider the appropriateness of the Japanese subsidiary bearing part of the financial impact of COVID-19 through an accurate delineation of functions performed, risks assumed, and assets employed by the subsidiary. In addition, taxpayers had to determine whether existing intercompany agreements allowed for such changes or whether a stand-alone agreement, such as a memorandum of understanding, was required. The benefits of any change to transfer pricing policies also had to be considered in the context of potential scrutiny by the tax authorities and supporting arguments for the arm's length nature of the changes. Going forward, taxpayers may wish to consider including mechanisms within intercompany agreements that would allow for pricing changes based on certain events.

The COVID-19 pandemic also resulted in better than expected profit margins for some taxpayers. For example, travel expenses may have significantly decreased for businesses with large workforces that had traveled regularly. As year ends approached, inbound taxpayers with profit margins higher than their benchmarked target considered whether downward transfer pricing adjustments were possible. Taxpayers wishing to make such an adjustment were required to assess whether their intercompany agreements contained an appropriate adjustment mechanism. This is particularly important for Japanese tax purposes, as the tax authorities can deny a deduction for the adjustment if it is not made pursuant to an agreement (i.e., by applying Japan's "donation" rules). As travel restrictions are likely to continue during 2021, companies may wish to amend their intercompany agreements if such adjustments are not possible based on their existing agreements.

Deloitte's View

Inbound taxpayers entering their second fiscal year during the COVID-19 pandemic should consider proactively managing their transfer pricing based on lessons learned from 2020. For example, taxpayers may want to monitor performance during the fiscal year with a view to minimizing the need for large year-end adjustments.

Any changes to transfer pricing policy should be assessed based on an accurate delineation of functions performed, risks assumed, and assets employed by the Japanese taxpayer in the context of guidance from the OECD and the Japanese tax authorities. For example, the Japanese taxpayer should consider whether it should bear some of the financial impact from the COVID-19 pandemic where it manages and controls risks related to the pandemic.

To the extent that adjustments or temporary changes to transfer pricing policies are considered necessary and appropriate, intercompany agreements should be reviewed to ensure consistency with such adjustments or changes.

Tax audit activity has slowed during the pandemic, largely as a result of temporary changes to the tax authorities' work environment. As the statute of limitations for transfer pricing matters in Japan is seven years, COVID-19-impacted years may still be selected for audit even after the pandemic. With the tax authorities undertaking a more strategic approach to audits, if a taxpayer is subject to a transfer pricing audit, the likelihood of an adjustment may increase.

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