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Japan Inbound Tax & Legal Newsletter

COVID-19's impact on transfer pricing in Japan

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In Brief

The topic dominating conversations globally is the COVID-19 (novel coronavirus) pandemic. In addition to the serious health impact of the virus, it also is impacting vital components of the global economy, such as production, the supply chain, consumption, and financial markets. Industries such as airlines, hospitality and tourism, electronics, consumer goods, pharmaceuticals, and medical equipment are experiencing this impact, and global markets are volatile.

It is still early in the timeline of the virus to have a clear view of the extent of the economic impact. One point of reference may be the SARS outbreak in 2002-03. As of the date of writing, the COVID-19 outbreak is more far-reaching than the SARS outbreak (both in terms of countries with infections and the number of infections). Using this as a benchmark, it is reasonable to expect that the impact of the COVID-19 outbreak may be significantly greater than the SARS outbreak.

It is in this context that global multinationals are beginning to consider how a potential downturn may impact their tax and transfer pricing positions, particularly for industries seriously affected by the outbreak.

In Japan, the government has taken measures relating to tax compliance in response to the outbreak, such as extending the due dates for filing individual income tax returns, consumption tax returns, and gift tax returns. For companies, the corporate income tax and consumption tax payment deadline may be extended under existing disaster relief measures with the approval of the tax authorities.

At the date of writing, no public announcement has been made with respect to measures specifically relating to transfer pricing.

Impact on taxpayers

While the reach of the coronavirus outbreak is global in nature, certain industries and businesses are likely to be more sensitive to a resulting economic downturn. For example, businesses that typically involve a higher ratio of fixed costs may be expected to be more affected than those with a greater proportion of variable costs.

Industries with large fixed costs, such as manufacturing, are likely to experience a significant effect. Distributors also are likely to be affected, to the extent that they need to sell a certain volume to cover fixed costs. In Japan, given the extremely robust labor laws leading to a less flexible workforce scale, employees' labor costs may be considered akin to a long-term fixed cost for a business. Depending on the length of the outbreak, businesses with large permanent employee workforces, and businesses with large capital or labor costs may be substantially impacted.

Impact on "limited risk" transfer pricing models

Many foreign multinationals operating in Japan use "limited-risk" models based on the transactional net margin method (TNMM) of pricing. Such a model may be used for contract manufacturers, contract R&D service providers, and limited-risk distributors. Limited-risk pricing models often are considered to give taxpayers a "guaranteed return" for their activities, benchmarked against the profit margins of comparable companies in the Japanese market. However, foreign tax authorities and taxpayers may question the outcome of such pricing models in the event of a significant market downturn, which may result from the COVID-19 outbreak.

At a high level, the impact of such a market downturn may likely depend on the risk profile of the Japanese subsidiary. For example, a typical limited-risk distributor may be exposed to certain market risks that may result in a loss of revenue streams. If the Japanese distributor is responsible for managing and controlling its fixed costs, it may be exposed to such risk to the extent of those fixed costs.

In order to form a view on the impact of the coronavirus outbreak on a particular Japanese subsidiary, the taxpayer would need to consider its analysis of the risk profile of the subsidiary. Any analysis of risk should start with the terms of the intercompany contract. Taxpayers should review their intercompany contracts as part of their analysis of the risk profile of the Japanese subsidiary. For companies that do not have intercompany contracts, taxpayers may wish to look at their course of dealings over the past few years.

Practical considerations

From a practical perspective, Japanese taxpayers typically approach compliance and risk management through the use of an advance pricing agreement (APA) or a "document-and-defend" strategy (that is, preparing annual transfer pricing documentation to use as a basis for defense in the event of a potential future audit). The practical considerations of the above issues for both strategies are described below.

Transfer pricing documentation

For taxpayers following a document-and-defend strategy, the documentation should be consistent with the outcomes of the risk analysis described above. To the extent that the local entity experiences a significant reduction in profit margin or is in a loss position, an additional explanation and support for this outcome should be provided. Further, the industry analysis typically included in transfer pricing documentation may become a more central aspect of the analysis and documentation strategy in the coming years.

In terms of economic analysis, taxpayers may need to consider the need for adjustments to support the results of their subsidiaries, such as an adjustment for fixed costs to determine the impact of decrease in volume for the selected comparable companies. From a Japanese perspective, the tax authorities often challenge the use of complex adjustments. The authorities typically argue that the Japanese market is broad and deep enough to identify sufficiently comparable companies, and that if the benchmarked companies are truly comparable from a function, asset, and risk perspective, complex comparability adjustments should not be needed. In these circumstances, taxpayers may wish to review the robustness of their existing Japanese benchmarking studies and consider refining their benchmarking strategy if needed.

Finally, depending on the taxpayer's transfer pricing policy, significant year-end adjustments may be necessary during a major market downturn. It is important that the mechanism for such adjustments are contained in an intercompany contract and supported in the transfer pricing documentation.

Taxpayers with APAs

In principle, taxpayers that have APAs should continue to follow the agreed upon outcome under the APA and generally would be expected to be shielded from the impact of the issues described above.

However, APAs generally include a set of "critical assumptions," the conditions on which the agreement is based. Critical assumptions often contain items such as significant changes to economic conditions and fundamental changes in the conditions of a particular industry. When a critical assumption is not met, the taxpayer and the revenue authority may agree to continue to honor the APA, revise the APA, or cancel the APA.

In this context, taxpayers that have an APA should review the terms included as critical assumptions and assess whether the COVID-19 outbreak could trigger a discussion with the revenue authority to revise or cancel the APA. In the event that a critical assumption has been triggered, taxpayers should consider working with their advisors to initiate contact with the relevant revenue authorities.

Deloitte's View

Alongside the concerning health aspects of the coronavirus pandemic are real economic issues. As part of planning for a market downturn resulting from the outbreak, multinationals should proactively consider their tax and transfer pricing positions. Taxpayers with an APA may wish to consider reviewing the critical assumptions and working with their advisors to contact the tax authorities as appropriate. Other taxpayers may wish to consider the risk analysis for their Japanese subsidiary and form a view on whether reduced profitability during an economic downturn would be appropriate. Taxpayers also should review their intercompany contracts, benchmarking, and transfer pricing documentation, and prepare additional support for lower profitability or losses as appropriate.

Finally, a modification to a taxpayer's transfer pricing position may affect existing contractual and regulatory obligations with third parties or local governments and tax authorities, in respect of customs duties, consumption tax, value added tax, goods and services tax, excise duties and other taxes. Taxpayers should evaluate all of these issues before implementation of any modifications.

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