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Japan's Approach to BEPS Issues

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One of the main topics Japanese taxpayers are currently interested in is the Organization for Economic Cooperation and Development's (OECD's) base erosion and profit shifting (BEPS) initiative. Broadly speaking, the BEPS initiative looks at whether existing international tax principles and rules allow for the allocation of taxable profits to jurisdictions other than those where the actual business activity takes place (through tax planning strategies) and if so, what can be done to change those rules. The BEPS initiative is comprised of a set of 14 Actions the OECD is scheduled to finalize in early October. It will then be up to individual countries to implement the BEPS guidance in their domestic legislation. This article considers the current status of the Japanese implementation of BEPS, with a focus on transfer pricing.

The Japanese government generally supports the BEPS initiative and, of the countries in the Asia Pacific region, may be considered a first mover in adopting BEPS-related changes. Japanese tax law already contains some BEPS-related measures, such as controlled foreign company (CFC) rules, thin capitalization and earnings stripping rules, and other anti-avoidance and anti-treaty shopping provisions. Moreover, Japan's 2015 tax reform package included changes related to BEPS issues, including a modification in the way Japanese consumption tax (JCT) applies to digital transactions and neutralizing benefits from hybrid mismatches (more specifically, an exclusion of "deductible" dividends paid by foreign subsidiaries from the Japanese dividend exemption rule).

From a transfer pricing perspective, the Japanese government is expected to introduce BEPS-related documentation changes in response to BEPS Action 13 (Reexamine transfer pricing documentation). The date for those changes has not been announced, but it is expected that the new rules will be included in the 2016 tax reform package, to be released in December 2015 at the earliest. The rules are expected to be generally consistent with the OECD's deliverable on this action, introducing a three-tiered approach to reporting and documentation – a country-by-country report (CbC), a master file, and a local file. Japan currently does not have CbC reporting or master file rules, so the new rules may follow the OECD report on these aspects of documentation closely. However, local file rules would need to take into account Japan's existing transfer pricing documentation rules, so the actual implementation may differ from the OECD report, and those rules may take longer to implement.

The Japanese government has not announced how new documentation rules would operate from a timing perspective.

> THE JAPANESE GOVERNMENT GENERALLY SUPPORTS THE BEPS INITIATIVE AND, IN ASIA PACIFIC REGION, MAY BE CONSIDERED A FIRST MOVER IN ADOPTING BEPS-RELATED CHANGES

Current Japanese documentation rules do not impose a contemporaneous requirement. If the new rules are in line with the OECD report:

- The CbC report would likely be due one year after the end of the first fiscal year to which the rules apply;
- The master file would likely need to be prepared by the filing date of the Japanese income tax return; and
- The local file would likely need to be prepared by the filing date of the Japanese income tax return.

In comparison to other major economies, Japanese income tax returns are due relatively soon after year end (generally within two months). Preparing documentation within the time frame noted above would clearly impose a heavy burden on taxpayers. The Japanese government has yet to express its views on this issue.

It is not clear when (or to what extent) the Japanese government may update the Japanese transfer pricing rules – the Act on Special Measures Concerning Taxation (ASMT) 66-4, Commissioner's Directive on the Operation of Transfer Pricing (Administrative Guidelines), and the ASMT Directives -- to incorporate other transfer pricing-focused BEPS actions (for example, those relating to intangibles, risk, and capital). Assuming the OECD will update its *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* to incorporate these actions, the Japanese regulations may become inconsistent with the OECD guidelines for a time. In those circumstances, local examiners might be expected to apply the Japanese transfer pricing regulations, but may also refer to the OECD transfer pricing guidelines to the extent they believe the new rules clarify the existing rules. At the competent authority level, more attention may be paid to the OECD guidelines, for example, in discussions with the counterparty competent authority.

There has been a recent trend of Japanese tax reform bringing the Japanese transfer pricing rules into line with the OECD guidelines. Two recent examples include the removal of the hierarchy of transfer pricing methods and the formal introduction of the Berry ratio as an accepted profit level indicator. We may see a similar trend for any inconsistencies resulting from the BEPS initiative. The fact that Japanese Ministry of Finance official Masatsugu Asakawa chairs the OECD's Committee on Fiscal Affairs (responsible for

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the OECD transfer pricing guidelines), may result in the Japanese government placing additional importance on making the Japanese transfer pricing rules consistent with the OECD guidelines.

The Japanese tax authorities may begin to change their approach to interpreting the existing rules even before they formally amend those rules. Two areas where this may be particularly evident is during the advance pricing agreement (APA) process and in a transfer pricing audit. For example, the Japanese tax authorities often request foreign financial data as a matter of course during the APA process. Previously, it was often possible to proceed with an APA without submitting that information (if a reasonable explanation could be given for not providing the information). In the context of BEPS Action 13, the Japanese authorities may now use BEPS as a reason to insist that taxpayers provide that information, and APA negotiations may stall if the taxpayer refuses to provide the data.

Tax authorities also may begin to accumulate more detailed information about the Japanese taxpayer and its multinational group. Having access to that information may lead to an overall shift toward profit splits as the preferred transfer pricing method. In Japan, this trend may be particularly evident, because the Japanese tax authorities have a history of applying profit splits, and significant internal expertise in doing so. In fact, the Japanese authorities may be at the forefront of a [GLOBAL?] shift to profit splits.