

**“APA Program Report 2005”
Released by the National Tax Agency and
the Recent Transfer Pricing Environment in Japan**

Introduction

According to the National Tax Agency’s (“NTA”) announcement relating to transfer pricing, the number of transfer pricing cases assessed for additional taxation in the administrative year 2004 (July 1, 2004 through June 30, 2005) was 82 (up 132.3% year-on-year) and the additionally assessed income totaled 216.8 billion yen (up 286.2% year-on-year), resulting in a significant year-on-year rise both in terms of the number of cases and the additional income assessed. In particular, additionally assessed income per assessment case for the administrative year was more than twice as much as that for the previous administrative year and indicates the increased transfer pricing risk on the taxpayers’ side.

Meanwhile, as the Japanese tax authority improves the advance pricing arrangement (“APA”) program, the program is indeed evolving into a more accessible system to taxpayers. In this article, after a brief overview of the APA system and transfer pricing risk in Japan (by reference to the statistics on the number of transfer pricing cases assessed for additional taxation and the additionally assessed income), we explain the efficacy of the APA system for taxpayers with reference to the contents of the “APA Program Report 2005” issued by the Office of Mutual Agreement Procedures (“OMAP”) of the NTA on September 15, 2005.

What is the APA program?

An APA is a framework under which the tax authority gives their administrative commitment to refrain from auditing a taxpayer’s transfer prices during the agreed years. Such commitment will only be given after the tax authority has reviewed and confirmed the transfer pricing methodology proposed by the taxpayer to be applied to its specific foreign-related transactions of assets, services and others. As long as the actual results of applying the transfer pricing method do not significantly deviate from critical assumptions prescribed by the agreement, assessment for additional tax will not be made during the agreed years.

Increased transfer pricing risk in Japan

Based on the NTA’s statistics for the administrative year 2004, the number of transfer pricing cases assessed for additional taxation was 82, and the total additionally assessed income was 216.8 billion yen, as shown in Table 1. The number of transfer pricing cases assessed for additional taxation and the amount of additionally assessed income in recent years were as follows:

Table 1: Number of transfer pricing cases assessed for additional taxation and amount of additionally assessed income

Administrative year	1999 and Before	2000	2001	2002	2003	2004
Number of transfer pricing cases assessed for additional taxation	368	39	43	62	62	82
Amount of additionally assessed income (in billion yen)	306.5	38.1	85.7	72.5	75.8	216.8

(Source: NTA website)

Newspaper reports say that not only Japanese affiliates of foreign multinationals but also Japanese multinationals are subject to substantial transfer pricing adjustments by the Japanese tax authority. In general, Japanese affiliates of foreign multinationals have tighter controls over their transfer pricing risk; Japanese multinationals should pay more attention to their transfer pricing risk. If, after analysis, Japanese multinationals find that income has been transferred to foreign affiliates and retained there for several years, it will be necessary for those Japanese multinationals to take measures to improve their tax positions as soon as possible.

Contents of “APA Program Report 2005”

The APA Program Report is issued by OMAP every fall, and discloses the status of the Japanese APA program for the year.

As shown in Table 2, in the administrative year 2004, the number of APA cases received declined to 63 from 80 the previous year, while cases disposed of rose to 49 from 39 the previous year. In discussing the fact that the number of APA cases disposed of reached a record high, the NTA commented “this is as a result of our efforts towards appropriate and prompt processing¹” based on consideration of the current situation, where transactions between corporations are becoming more complicated and extending worldwide.

Table 2: Changes in number of APA cases received, disposed of, and carried over

Administrative year	1999 and before	2000	2001	2002	2003	2004
Cases received	121	48	42	47	80	63
Cases disposed	69	29	25	47	39	49
Cases carried over	52	71	88	88	129	143

(Source: APA Program Report 2005 (extract))

Furthermore, due to reorganization in July 2005, the “Second Transfer Pricing Division” was established within the Tokyo Regional Taxation Bureau, with sole responsibility for reviews of APA

¹ *Junkan Sokuho Zeiri* dated Oct. 11, 2005, page 11.

requests. As a result, the number of personnel involved in APA procedures has increased from 18 to 26. In the past, a number of taxpayers were reluctant to file bilateral APA requests, as it would take a long time before the APA was finalized. However, owing to the tax authority's efforts to speed up the APA review processes, the time required for an APA request to be concluded has been reduced to less than two years on average. As such, more and more corporations are expected to file APA requests.

Efficacy of APAs

While taxpayer's transfer pricing risk is substantially increasing as stated above, the Japanese tax authority's moves to promote APAs has been remarkable. The following illustrate the accomplishments made by the Japanese tax authority recently in relation to APA procedures.

- The NTA partly revised the Commissioner's Directive on the Operation of Transfer Pricing ("Commissioner's Directive dated June 1, 2001") as well as issuing the new "Commissioner's Directive on the Operation of Transfer Pricing for Consolidated Corporations" on April 28, 2005 to clarify APA procedures
- The Second Transfer Pricing Division was established within the First Examination Department of the Tokyo Regional Taxation Bureau, effective administrative year 2005, dedicated to conducting APA reviews
- The first bilateral APA was reached between the competent authorities of China and Japan in the spring of 2005

In conclusion, as can be seen from the increase in the number of transfer pricing cases assessed for additional taxation and the amount of additionally assessed income in the administrative year 2004, taxpayers' transfer pricing risk is escalating in Japan. However, due to the Japanese tax authority's efforts to improve the Japanese APA scheme, the time required between filing an APA request and obtaining confirmation of that request is expected to be shortened. Considering these circumstances, it is now time that taxpayers who hesitated to use APAs in Japan in the past reconsidered their misgivings, and proactively review the applicability of the APA program.

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For further information, please contact Yasuko Takahashi or Mayumi Nakamura at:

E-mail: pwcjapan.taxpr@jp.pwc.com Tel:03-5251-2400