

# Transfer Pricing News

April 2010

## PwC Japan Tax Newsletter

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## Clarification of the documents required to be presented or submitted pursuant to paragraph 6 of Article 66-4 (estimation taxation clause)

### 1. Explanation of change to law

As outlined in various articles published by Zeirishi-Hojin PricewaterhouseCoopers earlier this year, the 2010 tax reform proposed certain clarifications to the requirements for documentation under the Japanese transfer pricing legislation, Special Taxation Measures Law Article 66-4 ("Article 66-4"). As anticipated by the proposals, the 2010 tax reform was enacted into law on March 31, 2010 by way of a revision to paragraph 6 (formerly paragraph 7) of Article 66-4, and a new paragraph 1 of Special Taxation Measures Law Ministerial Order Article 22-10 ("Article 22-10"), an ordinance of the Ministry of Finance<sup>1</sup>. The latter now outlines two categories of documents required to be presented or submitted during a transfer pricing examination. These are:

1. Documents providing details of the taxpayer's foreign-related transactions; and
2. Documents used by the taxpayer for the calculation of arm's length prices.

Prior to this amendment, there was no explanation of what documents were "required to be presented or submitted" during an audit under Article 66-4 or any of its associated Enforcement Orders.

Article 22-10 provides a detailed list of the documents falling within each of the above two categories. In substance, these documents reflect paragraphs 2-4(2) and 2-4(3) of the Commissioner's Directive on the Operation of Transfer Pricing issued June 1, 2001 ("Commissioner's Directive")<sup>2</sup>. However, the list contained in Article 22-10, paragraph 1 is set out in full below for ease of reference.

### (1) Documents providing details of the taxpayer's foreign-related transactions

- (i) Documents providing details of the assets and services related to the foreign-related transactions

<sup>1</sup> Similar revisions have been made to Special Taxation Measures Law Article 68-88, the transfer pricing legislation for consolidated tax filings.

<sup>2</sup> Paragraph 2-4 of the Commissioner's Directive provides a list of documents that may be requested by the examiners in the event of an audit. This is intended as guidance to the tax examiners in the case of an audit, and is not legally binding on taxpayers in Japan.

- (ii) Documents outlining the functions performed or risks assumed (i.e. the possibility of an increase in or decrease to the profit or loss arising from the foreign-related transactions derived from fluctuations in exchange rates, market interest rates, changes in economic conditions, etc.) assumed by the taxpayer and the foreign-related person
- (iii) Documents providing details of any intangible properties used by the taxpayer or the foreign-related person for the foreign-related transactions
- (iv) Contracts, or documents outlining the contents of contracts, related to the foreign-related transactions
- (v) Documents explaining the pricing policy for the amounts paid by or paid to the foreign-related person, and details of price negotiations between the taxpayer and its foreign-related person
- (vi) Documents providing the statement of profits and losses of the taxpayer and the foreign-related person with regard to the foreign-related transactions
- (vii) Documents providing a description (including analysis) of the market related to the sale or purchase of assets, provision of services, etc. with respect to the foreign-related transactions
- (viii) Documents explaining the business policies of the taxpayer and the foreign-related person
- (ix) If there are any other transactions closely connected with the foreign-related transactions, documents providing details of such transactions

## **(2) Documents used by the taxpayer for the calculation of arm's length prices**

- (i) Documents explaining the reasons for selection of the calculation method of the arm's length prices, and any other documents prepared by the taxpayer for calculating the arm's length prices
- (ii) Documents explaining the selection of comparable transactions adopted by the taxpayer and details of the comparable transactions
- (iii) Documents used to calculate the income which should belong to the taxpayer and the foreign-related person if the taxpayer has selected the profit split method
- (iv) In cases where the taxpayer calculates arm's length prices by combining more than one foreign-related transaction as a single transaction, documents explaining the reason for adopting such an approach, and details of each single transaction
- (v) Documents containing the reasons for adjustments and the adjustment method, if adjustments are made to reflect differences with the comparable transactions

There have always been two key powers at the disposal of the tax examiners in cases where a taxpayer fails to provide documents "required to be presented or submitted" during an audit. These are (i) the power to make an assessment to taxable income using taxation by estimation pursuant to paragraph 6<sup>3</sup>, and (ii) the authority to inquire and inspect third parties engaged in the same kind of business as the foreign-related transaction pursuant to paragraph 8 (former paragraph 9), i.e., the use of so-called "secret comparables". These powers have not changed as a result of the new provisions. Instead, however, taxpayers now have a clearer understanding of what documents are covered by the phrase "documents required to be submitted".

Finally, it should be clearly understood that there is no change in the following areas as a result of the introduction of the new law.

- Penalty protection – notwithstanding a taxpayer's compliance with paragraph 6 during an audit, if an assessment is made by the tax examiners penalties will continue to be applied automatically.
- Deadline for presentation or submission of required information – the wording of paragraph 6, which requires a taxpayer to comply with a request for information during an audit "without delay", has not changed. Accordingly, there is no requirement to submit the listed documentation with the filing of the annual tax return as in other countries with contemporaneous transfer pricing documentation requirements. In practice, the tax examiners have usually accepted a one month period in which to provide requested information as being "without delay".

The new law is effective from April 1, 2010.

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<sup>3</sup> Under this approach, the tax examiners may estimate transfer prices (including based on transactions between related parties, so not at arm's length) without reference to the taxpayer's own transfer pricing method, and without providing as many details of how that price was calculated as in the typical assessment.

## 2. Practical impact of change to law

On the face of it, therefore, the new law would seem to provide taxpayers with a way to mitigate the risk that the tax examiners may make an assessment based on taxation by estimation or by using secret comparables. However, when considering the impact of the amendment, two potential issues should be borne in mind.

### (1) Submission of financial information of foreign-related parties

In relation to category 1 of the documents “required to be presented and submitted”, subparagraph (vi) refers to the profit and loss information of not only the taxpayer, but also its foreign-related party. Accordingly, simply based on the wording of the law, a taxpayer will not have complied with the law, and thus will not be able to benefit from any restriction on the exercise of the tax examiners’ powers, unless the taxpayer has submitted all the listed documentation, including the profit and loss information of its foreign-related party (notwithstanding that the selected transfer pricing methodology may not require analysis of that information). However, as can be imagined, submission of financial data of foreign-related parties is often a sensitive issue for many foreign-owned taxpayers in Japan.

Moreover, it is probable that many taxpayers, even those with the best intention in the world to comply, will be unable to provide all of the information listed by paragraph 1, Article 22-10. Bearing this in mind, it would seem unlikely the tax examiners will automatically exercise their power of taxation by estimation or their power to use secret comparables across all non-compliant taxpayers.

### (2) Quality of documentation

Although category 1 of the documents “required to be presented and submitted” are purely factual documents, category 2 covers the kinds of documents produced from a transfer pricing analysis, and thus are by definition subjective in nature.

It is not yet clear whether some kind of “reasonableness test” will be applied when the tax examiners review documents presented or submitted under category 2, in a similar manner to section 1.6662-6(d) of the US documentation regulations.

## 3. Conclusion

In conclusion, although substantially the same as the documents listed in paragraphs 2-4(2) and 2-4(3) of the Commissioner’s Directive, the new law has introduced a clear explanation as to what documents are “required to be presented or submitted” during a transfer pricing audit. On the other hand, introduction of this explanation by Ministerial Order makes it clear also that where a taxpayer fails to provide these documents during an audit, the tax examiners are entitled to excise (i) the power to make an assessment to taxable income using taxation by estimation, and (ii) the authority to inquire and inspect third parties engaged in the same kind of business as the foreign-related transaction, i.e., the use of so-called “secret comparables”.

However, given the two issues described above (i.e. submission of financial information of foreign-related parties and quality of documentation), a strict enforcement of the new law would be overly burdensome to many taxpayers. Instead, it could be anticipated that the information requested by the examiners from the list defined in paragraph 1, Article 22-10 might differ from taxpayer to taxpayer, depending on the transfer pricing methodology selected, the relevant industry, the type of transaction, etc.

The National Tax Agency is now preparing amendments to the Commissioner’s Directive, to provide guidance to its examiners on interpretation and application of these new documentation provisions. It is hoped that these amendments will provide some clarification around the areas outlined in this article. Until that time, however, it would appear to be premature to guess what, if any, practical impact the new law will have on current Japanese transfer pricing practice.

For more information, please consult your international tax representative or contact any of the following members listed below:

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