

Transfer Pricing News

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A Japanese Perspective on the OECD Proposed Revision to Chapters I-III of the Transfer Pricing Guidelines

On September 9, 2009 the OECD released a proposed revision to Chapters I-III of the Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations ("Transfer Pricing Guidelines"). The proposed changes represent the final step in implementing the OECD projects on comparability and transactional profit methods, two areas considered to be a priority by the OECD Committee on Fiscal Affairs. In particular, the proposed revision reflects the outcome of extensive consultation by the OECD with the business community around:

- The May 2006 discussion draft on the theoretical foundations of comparability analysis; and
- The January 2008 discussion draft on the transactional profit methods.

Given the existing guidance on these aspects is dated 1995, the proposed update represents an effort by the OECD to better align the principles laid out in the Transfer Pricing Guidelines with practical considerations of tax administrations and the business community.

Key aspects of the proposed revision are set out below, together with comment on some potential implications specifically from the Japanese transfer pricing perspective.

1. Hierarchy of transfer pricing methods

One of the main characteristics of the existing guidance is the hierarchy between the traditional transaction methods, which are considered preferred methods under the existing 1995 guidance, and the transactional profit methods, which are considered methods of last resort. According to the proposed revision, all the methods should be on the same footing and the method selection process should be made on the basis of the "most appropriate method to the circumstances of the case". This is an important development since from a pragmatic point of view there is rarely data available to perform an analysis using a traditional transaction method.

Implications for Japan

The hierarchy of methods described in the 1995 Transfer Pricing Guidelines is codified in the Japanese transfer pricing legislation at paragraph 2, Special Taxation Measures Law Articles 66-4 and 68-88 ("STML Art. 66-4 and 68-88"). Thus, to follow the proposed revision in Japan and eliminate this hierarchy would require legislative amendment. At this stage there has been no indication from the Japanese government when, or even if, such amendment might occur.

Moreover, although in practice many taxpayers use transactional profit methods to drive their transfer pricing (due to the lack of data available to conduct a transactional analysis, as described above), the focus on traditional transaction methods in the Japanese legislation continues to drive the Japanese transfer pricing audit process. Accordingly, implementation of this section of the proposed revision into STML Art. 66-4 and 68-88 might well require a fundamental shift in the transfer pricing audit processes of the Japanese tax authorities. For this reason, such change is likely to be carefully considered before being adopted in Japan.

2. Comparability analysis

The existing guidance on comparability contained in Part C, Chapter I, has been updated and supplemented with a new Chapter III on comparability. Amongst other changes, the proposed guidance lays out a 10-step process for performing a comparability analysis, which is recommended as “good practice”, although at the end of the day the reliability of the outcome is more important than the process. The 10-steps, which should not be considered either linear or compulsory, are:

- Broad-based analysis of the taxpayer’s circumstances.
- Determination of years to be covered.
- Understanding the controlled transaction(s) under examination, based in particular on a functional analysis, in order to choose the tested party (where needed), the most appropriate transfer pricing method to the circumstances of the case, the financial indicator that will be tested, and to identify the significant comparability factors that should be taken into account.
- Review of existing internal comparables, if any.
- Determination of available sources of information on external comparables where such external comparables are needed and of the sources’ reliability.
- Selection of the most appropriate transfer pricing method and, depending on the method, definition of the relevant financial indicator.
- Identification of potential comparables.
- Determination of and making comparability adjustments where appropriate.
- Interpretation and use of data collected, determination of the arm’s length remuneration.
- Implementing supporting processes. Installing review processes to ensure adjustment for material changes and documenting these processes.

Further, the guidance specifically provides that internal comparables “may have a more direct and closer relationship to the transaction under review than external ones”, but also recognizes that internal comparables “are not always more reliable”.

When considering the use of commercial databases, the proposed revision notes that care should be taken as such databases often compare the results of companies rather than the results of transactions (because the latter information is rarely available). In addition, the proposed revision states that “Use of commercial databases should not encourage quantity over quality”, and further indicates that non-domestic comparables might be acceptable; however, the systematic use of regional searches for comparables is not specifically endorsed.

Finally, in relation to the use of secret comparables, the proposed revision states explicitly that it would be unfair to apply a transfer pricing method on the basis of a tax administration’s examination of other taxpayers “unless the tax administration was able, within the limits of its domestic confidentiality requirements, to disclose such data to the taxpayer so there would be an adequate opportunity for the taxpayer to defend its own position and to safeguard effective judicial control by the courts”.

Implications for Japan

Much of the discussion on comparability in the new Chapter III of the proposed revision is consistent with existing Japanese transfer pricing audit practice. Accordingly, there is unlikely to be any legislative or regulatory amendment required in order to adopt these provisions in Japan.

Where the proposed Chapter III does potentially conflict with the existing Japanese legislation and practice is in its explicit rejection of the use of secret comparables. Although the use of secret comparables in Japan has decreased in recent years, there is still legislative provision for the same under paragraph 9 of STML Art. 66-4 and paragraph 8 of SMTL Art. 68-88. Moreover, a decision of the Tokyo District Court dated December 7, 2007 explicitly upheld the Japanese tax authorities’ use of secret comparables in making an assessment

against a taxpayer¹. Thus, there is still a very real possibility of secret comparables being used in an audit against a taxpayer in Japan.

Again, there has been no indication from the Japanese government about how, or even whether, the prohibition contained in proposed Chapter III in relation to secret comparables will be adopted in Japan.

3. Application of the transactional profit methods

Chapter II now includes a new Part III with additional guidance on the application of transactional profit methods, including additional guidance on the comparability standard to be applied to the transactional net margin method and on the application of the profit split method.

In applying the profit split method, the proposed revision highlights the need for a common basis regarding accounting practices and currency when determining the profit to be split amongst the parties to a transaction; and recognizes that several allocation keys for splitting the combined profit are applicable, including asset-based, capital-based and cost-based allocation keys (including the Berry ratio), emphasizing that the choice of allocation key depends on the facts and circumstances of the case and should be “reasonably independent of transfer pricing policy formulation”² and be “supported by reasonably reliable comparable data”; and specifies that the splitting factors should be applied “consistently over the life-time of the arrangement, including during loss years”.

When considering a two-sided methodology, the proposed revision notes that taxpayers are expected to provide tax administrations with all the information necessary to conduct the analysis, including financial information, of both the taxpayer and the foreign related party to the transaction. However, if a one-sided transfer pricing method is considered most appropriate, and the tested party is the domestic taxpayer, the proposed guidance states that “the tax administration generally has no reason to further ask for financial data of the foreign related party” (new paragraph 3.22).

Implications for Japan

The general discussion on application of profit-based methods contained in the proposed revision is consistent with Japanese transfer pricing practice to date. However, where the proposed revision differs is in its explicit reference to allocation keys that might be asset-based or capital-based (as well as cost-based, etc.). Currently, certain Administrative Guidelines for Japanese tax examiners, which were issued by the National Tax Agency on May 10, 2004³, clearly state (at Question 10) that asset-based keys may not be used, and that introduction of such keys would in fact require the amendment of the legislation.

In addition, the statement in the proposed revision that one-sided transfer pricing methods do not require financial data of the foreign related party is inconsistent with provisions of both the Japanese administrative directives on transfer pricing audits and APAs (paragraphs 2-4(1)(c) and 5-3(1)(g) of the Commissioner’s Directive on the Operation of Transfer Pricing issued June 1, 2001, respectively), and with the information required to be submitted with a taxpayer’s annual tax return under Schedule 17(4). All three of these regulatory requirements request financial information of a taxpayer’s foreign related parties regardless of the methodology chosen. Moreover, failure to comply with such requirements may lead the tax authorities to invoke the provisions of paragraph 7 of STML Art. 66-4 and paragraph 6 of STML Art. 68-88 in an audit – and thereby apply the imputed method – or to deny confirmation of an APA under paragraph 5-14(1)(b) of the June 2001 Directive.

As described above, there has been no comment yet from the Japanese government on how the proposed revision might be reflected in existing Japanese transfer pricing legislation and practice. However, in relation to the use of financial data of foreign related parties, it seems likely that no amendment will be required to bring the Japanese position into line with the draft guidelines. This is because of (i) the use of the word “generally” in the proposed paragraph 3.22 (as quoted above), and (ii) that the Japanese tax authorities already have considerable discretion whether or not to penalise a taxpayer who fails to provide requested information of foreign related parties.

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¹ Although the decision of the Tokyo District Court was successfully appealed, the Tokyo High Court found for the taxpayer on other grounds and made no comment on the issue of secret comparables.

² That is, allocation keys should be based on objective data, such as sales to unrelated parties, rather than on data relating to controlled transactions, such as sales to related parties.

³ Obtained through a request under the Official Information Act.

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