

Transfer Pricing News

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PwC Japan Tax Newsletter

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Key Amendments to the Commissioner's Directive on the Operation of Transfer Pricing (Administrative Guidelines)

As outlined earlier this year, the following two points were addressed in the 2010 Tax Reform.

1. Clarification of the factors that should be taken into account when examining the negotiation of transfer prices between related parties.
2. Clarification of the scope of documents that may be requested to be presented or submitted during a transfer pricing examination.

Amendments to the Japanese transfer pricing law¹ to reflect the above provisions of the 2010 Tax Reform were enacted on March 31, 2010. On June 22, 2010, further guidance on these issues was also published by the National Tax Agency by way of amendment to the Commissioner's Directive on the Operation of Transfer Pricing (Administrative Guidelines), originally issued June 1, 2001 ("June 2001 Directive"). This update summarizes the contents of this additional guidance.

1. Clarification of the factors that should be taken into account when examining the negotiation of transfer prices between related parties

(1) Contents of the Amendment

The current amendment to paragraph 2-2(3) of the June 2001 Directive lists the following factors that should be taken into account during a tax examination, in order to determine whether there exist any problems regarding transfer pricing.

- (a) Taxpayers may in fact use arm's length principles to determine their transfer prices, in order to properly assess both their own financial performance for the business relating to the intercompany transactions, and that of their related party.
- (b) In some cases, such as joint ventures, third parties (i.e. shareholders of a joint venture) may be involved in the negotiation of transfer prices between two related parties.

¹ Special Taxation Measures Law Ministerial Order Article 22-10.

Moreover, those negotiations may also be conducted taking arm's length principles into account. [Of course, the mere fact that transfer prices are determined through negotiation, or that third parties (i.e. shareholders to a joint venture) are parties to the agreement covering the intercompany transaction, does not by itself provide sufficient evidence of arm's length pricing.]

(2) Impact of the Amendment

The current amendment to the June 2001 Directive specifies that the tax authorities should consider not only the profitability of the two related parties engaged in any intercompany transaction, but also the negotiation procedures conducted in deriving the transfer price for that intercompany transaction.

That is, where a transaction is conducted between a taxpayer, and a joint venture owned equally by that taxpayer and a third party, the transaction is subject to the Japanese transfer pricing legislation; however, if the transfer price for that transaction is determined by negotiation with the third party investor taking into account arm's length principles, the transfer price may well be accepted as being at arm's length. Although this approach has been widely accepted in other countries for some time, until now it was not clearly applicable in Japan.

Going forward therefore, when preparing for a transfer pricing examination in Japan, it will be important for taxpayers to prepare and store records and documents that demonstrate the negotiation of the terms and conditions of intercompany transactions, rather than only preparing documents that demonstrate the profitability of those intercompany transactions is appropriate.

In addition, at this stage it is still unclear as to the manner in which the tax authorities will apply the above provisions, and in particular on what factual basis they will reach a conclusion as to whether a transaction was or was not negotiated taking into account arm's length principles. Consequently, it will be necessary to monitor the tax authorities' implementation of these provisions for further guidance.

2. Clarification of the documents that may be requested to be presented or submitted during a transfer pricing audit

(1) Contents of the Amendment

The list of documents that may be requested to be presented or submitted during a transfer pricing audit was outlined in an earlier newsletter² and was incorporated into the Japanese transfer pricing legislation as part of the March 31, 2010 enactment. However, the current amendment to the June 2001 Directive provides more guidance as to the process of making such requests and of complying with them, as set out below.

- (a) No specific time period for complying with a request to present or submit such documents is stated. Instead, the time period shall be determined bearing in mind the "usual" period required for such presentation or submission, and taking into account the taxpayer's opinion.
- (b) In compliance with such a request, if the taxpayer presents or submits documents that demonstrate how the taxpayer calculated its transfer price, the tax authorities should look at whether an arm's length price can actually be calculated based on those documents. If the tax authorities do not consider an arm's length price can be so calculated, other documents may be requested to be presented or submitted.
- (c) If a taxpayer presents or submits documents that have been prepared based on inaccurate information, the presentation or submission of those documents will not be considered compliance with the request.

(2) Impact of the Amendment

In relation to the timing of presentation or submission, this will obviously depend on the type of documents that have been requested. However, it would appear that one month is the typical period that will be allowed in most cases.

² *Transfer Pricing News - Clarification of documents required to be presented or submitted pursuant to paragraph 6 of Article 66-4 (Estimated Taxation Clause)*, April 2010.

As readers will be aware, the list of documents that was enacted into the Japanese transfer pricing law on March 31, 2010 identifies documents that may not be necessary for calculation of the arm's length price, depending on the methodology that has been selected. However, as noted above at (b), the current revision gives the tax authorities the power to request presentation or submission of other documents if they consider that an arm's length price cannot be calculated from the documents already provided by the taxpayer.

For example, therefore, if the taxpayer calculates its transfer price using the transactional net margin method ("TNMM"), but the tax authorities consider that it is not possible to calculate an arm's length price under the TNMM, it would appear that the tax authorities have the power to request documents that they consider are necessary to calculate an arm's length price using a transfer pricing method other than the TNMM, after explaining to the taxpayer the rationale for their position.

In summary, the amendment to the June 2001 Directive in relation to documentation makes it clear that the tax authorities will firstly focus on documents prepared by taxpayers themselves. However, in relation to both (b) and (c) above, it is not yet clear on what basis the tax authorities will make their determinations. Thus, it will be necessary to monitor the tax authorities' implementation of this provision for further guidance.

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

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