Japan TP update: Tax authority undergoes major reorganization; increased importance of Local File

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In brief

In July, the Japanese tax authority underwent a significant reorganization that combined responsibility for examinations relating to international tax and examinations relating to transfer pricing, which previously had been separate. This change may result in increased scrutiny of transfer pricing for certain taxpayers.

The Local File is increasing in importance in Japan, as the Japanese tax authorities rely more heavily on it for audit selection and seem to be aggressively enforcing deadlines for its submission.

In light of the economic downturn caused by COVID-19, Japanese taxpayers may need to support their transfer pricing in the face of reduced profit or a loss. Such taxpayers, especially those with foreign-owned limited-risk entities in Japan, should determine and document the quantitative impact of COVID-19 on the business. It may be difficult to support the results with benchmarking since comparable data will not yet reflect the impact of COVID-19. However, it may be possible to take some alternative benchmarking approaches in such cases that may be deemed reasonable.

Although the Japanese tax authorities in principle will expect taxpayers to abide by the terms of APAs despite COVID-19, they may be willing to discuss with treaty partners in bilateral APAs a result that more appropriately reflects the impact of COVID-19 on the business. For pending APAs, it may be possible to have included in the APA a critical assumption that allows for future consideration of the impact of COVID-19.

In detail

Reorganization of Tax Authority Divisions

As in previous years, regular personnel changes took place in the National Tax Agency in Japan on July 10. This time, the Tokyo, Osaka, Nagoya, and Kanto-Shinetsu Regional Taxation Bureaus (city bureaus) each underwent a significant reorganization of their Large Enterprise Examination Departments' international taxation divisions. The previous examination structure that separated transfer pricing examination and other international tax examination practices was reorganized into the following new divisions specializing in the examination of international transactions, including transfer pricing:

- International Management Division (Kokusai Chosa Kanri Ka) — Responsible for planning, enforcement, and administration of international taxation in general, taking over the administrative functions of the former International Examination of Large Enterprise Division and the former Transfer Pricing Division;
- International Examination Division (Kokusai Chosa Ka) — Responsible for examining individual international taxation cases, taking over the examination units of the former International Examination of Large Enterprise Division and the former Transfer Pricing Division;
- Advance Pricing Arrangement Review Division (Jizen Kakunin Shinsa Ka) — Responsible for conducting APA reviews, taking over the review function of the Advance Pricing Arrangement Division.

Observation: Local tax offices (as opposed to the city bureaus) have been scrutinizing intercompany transactions, such as intragroup services transactions, as part of their regular corporate income tax audits for several years now. However, this restructuring of the city bureaus, integrating the international tax and transfer pricing examination teams, may mean that taxpayers that previously were not subject to close or frequent scrutiny of their transfer pricing will see, going forward, increased attention on their transfer pricing as part of the city bureaus' corporate income tax audit cycle.

Increasing importance of the Local File

Selection of audit targets

As discussed below, it appears that, due to the COVID-19 pandemic, the Japanese tax authorities have postponed contacting taxpayers for new transfer pricing audits, and currently seem to be examining information collected from taxpayers to select companies to be audited upon recommencement of audits.

More specifically, such information includes not only that collected from Schedule 17(4), "Detailed Statement Regarding Foreign Affiliated Companies," attached to the corporate income tax return, but also information collected through other means. In particular, "documents considered necessary to calculate arm's length prices" as prescribed in the law (i.e., Local Files) presumably are being reviewed.

Observation: Since the 2016 tax reform, the Japanese tax authorities have published a number of reference materials regarding the Local File in various forms, such as FAQs, case studies, and guidebooks. This is probably because the tax authorities are focusing on the importance of the Local File as a source of information about foreign related parties, and as a tool for audit selection.

Presumptive tax or use of secret comparables

A taxpayer must submit the Local File upon the request of the Japanese tax examiners, within the time set by them, which is not to exceed 45 days (where the contemporaneous preparation requirement applies) or 60 days (where the contemporaneous preparation exemption is met) following the request.

Under prior law, taxpayers, upon request in an audit, were required to "endeavor to obtain" books and records maintained by their foreign related parties, or copies thereof (the 'requirement-to-endeavor' provision). Failure to do so allowed the tax examiners to use presumptive taxation or secret comparables to calculate and raise a transfer pricing assessment.

As a result of the 2016 tax reform, the requirement-to-endeavor provision was removed in order to facilitate consistency with the requirement that Local Files be prepared, obtained, or maintained, and to clarify that presumptive tax assessments and the use of secret comparables do not have a prerequisite that the taxpayer failed to make a prescribed effort to obtain the documentation (Commentary on the 2016 Tax Reform, prepared by the Japan Ministry of Finance). Also, the Commissioner's Directive on the Operation of Transfer Pricing 3-5(5) states that the tax authorities may impose a presumptive tax assessment or use secret comparables against a taxpayer if there are any errors, deficiencies, or omissions in its Local File.

Observation: Perhaps partly because of this, there apparently have been cases where presumptive assessments or the use of secret comparables may be triggered in relation to deficiencies in the Local File and its supporting information in transfer pricing audits. This situation does not appear related to whether the contemporaneous preparation exemption (see below) applies — in other words, it applies to all taxpayers with cross-border intercompany transactions. Therefore, for the preparation, and submission upon request, of the Local File, taxpayers need to establish a system that allows for good communication with the departments involved in transactions requiring documentation. This can assist in preparing a Local File with the appropriate content and submitting in a timely manner to the tax examiners when requested.

Impact of COVID-19

Impact on Local File contemporaneous preparation requirement

In Japan, contemporaneous preparation (i.e., preparation by the due date of the tax return) of a Local File is required for transactions with a foreign affiliate, unless the exemption is met. The exemption applies to transactions with a foreign affiliate during a given year where total transactions with that affiliate in the preceding fiscal year were equal to or less than (i) 5 billion yen, and (ii) in the case of intangibles transactions, 300 million yen.

This means that a Japanese corporation with a December 31 fiscal year-end, and with transactions with a foreign affiliate in FY2019 that do not meet the exemption, needed to prepare a Local File for those transactions by March 31, 2020, the due date of its tax return (assuming a normal one-month filing extension is obtained). However, the Japanese tax authorities have announced that an extension of the normal corporation tax return due date will be granted where the taxpayer has a compelling reason related to the coronavirus for being unable to file by the normal due date. The extension is, in effect, granted up to the actual filing date, but no later than two months following the coronavirus-related event causing the inability to file the tax return on time.

Observation: Where such an extension applies, it also should apply to the deadline for preparation of a Local File subject to the contemporaneous preparation requirement. However, taxpayers should be conscious of the fact that the extension limitation described above also would apply to the Local File preparation.

Postponement of audit activity

Normally, the Japanese tax authorities would begin contacting corporate taxpayers to initiate new audits, including transfer pricing audits, immediately following their regular personnel changes in July. However, due to the impact of COVID-19, the Japanese tax authorities have postponed initiating new tax and transfer pricing audits at this time, putting their focus instead on desktop reviews of taxpayer information for the purposes of selecting future audit targets, as mentioned above. Recommencement of new audits does not seem to be imminent at this time, and it is not clear when that will happen. Previously commenced transfer pricing audits, however, are continuing, although involving mainly the exchange of documents.

The tax authorities have, as usual, commenced reviews of taxpayers' APA applications following the personnel changes, although commencement of reviews for individual cases may be delayed due to a backlog of cases, which has been exacerbated by the pandemic.

Importance of quantifying and documenting COVID-19 impact

Typically, foreign-owned Japanese corporations have a fiscal year-end of December 31. For such corporations, a tax audit commenced in 2020 would cover the fiscal year ending December 31, 2019, before the pandemic hit. As such, the impact of COVID-19 may not be an issue in such audits.

However, foreign-based MNCs with Japanese affiliates characterized as limited-risk entities — e.g., limited-risk distributors — should be aware that the Japanese tax authorities would have the view that such limited-risk entities should always earn a routine, stable profit, which they would consider to be consistent with such entities' limited-risk characterization.

As such, regardless of the impact of COVID-19 on MNCs' businesses in Japan, if such limited-risk entities incur losses or very low profitability for FY2020 (and even beyond) due to the impact of COVID-19, such results likely will be scrutinized by the Japanese tax authorities when FY2020 is audited.

Therefore, where it is anticipated that a foreign MNC's limited-risk Japanese entity's results will reflect an impact from COVID-19 through reduced profit or a loss, it is recommended that such operating results be supported by calculating and documenting the quantitative impact of COVID-19 on the Japan business. Attention should be paid to the impact of particular line items in the P&L, such as inventory write-downs or unusual operating expenses, which may have an impact on the Japanese taxpayer's operating results.

Benchmarking support also would be helpful, but there are likely to be practical challenges in obtaining benchmarking data for FY2020 to support a reduced profitability due to COVID-19, because comparable company data available at the time documentation is prepared will not reflect the impact of the pandemic and therefore will lack comparability with the tested party's situation in FY2020.

Observation: Historical comparable company data (or the taxpayer's data) may need to be adjusted to reflect the effect of COVID-19 and support the tested party's results. For example, in the absence of actual post COVID-19 comparable company data, inferring the impact of COVID-19 from the impact on comparable company data of past economic crises (such as the global financial crisis of 2008/2009) may be deemed reasonable. Other potential approaches could be to include loss-making companies in the comparable company set or to test the tested party's results on a multi-year basis, and/or both or all of these approaches combined.

APAs: Likely consideration of COVID-19 impact on case-by-case basis

The Japanese tax authorities have not made any formal announcements regarding how they plan to deal with the impact of COVID-19 in APAs, and we do not anticipate they will. Instead, it seems that they will consider the impact of COVID-19 on APAs on a case-by-case basis. Thus, where the impact is significant and detrimental to a taxpayer's Japanese operations, the taxpayer should discuss with their advisors how best to address the situation. Where some type of relief from the APA terms due to the impact of COVID-19 seems appropriate, the taxpayer should be prepared to present a logical and quantifiable explanation supporting the detrimental impact of COVID-19 on the business.

Observation: We anticipate that for existing APAs in which a Japanese tested party is characterized as a limited-risk entity, the Japanese tax authorities generally would take the position that the terms of the APA should be enforced despite any COVID-19 impact.

At the same time, for existing bilateral APAs, the NTA may be open to discussing the impact of COVID-19 with the relevant treaty partner where the taxpayer has the appropriate support, as discussed under 'Importance of quantifying and documenting COVID-19 impact,' above. For pending bilateral APAs, the NTA may be open to discussing with the treaty partner including a critical assumption in the APA dealing specifically with the potential impact of COVID-19 on the taxpayer's business (we can expect to see such cases soon).

Therefore, even for difficult economic periods, such as that brought on by the COVID-19 pandemic, a bilateral APA can be an effective way to secure tax certainty and avoid double taxation, as it allows taxpayers to proactively engage with the tax authorities on both sides of the intercompany transaction and advocate for the negotiation of a result that reflects the difficult economic environment. The alternative can be a potentially contentious and unilateral transfer pricing audit after the fact, where an assessment could be significant, could potentially result in double taxation, and could be accompanied by penalties.

The takeaway

Due to the integration of the International Tax and Transfer Pricing Divisions in charge of audits of the Regional Tax Bureaus in Japan, taxpayers that previously avoided close or frequent scrutiny of their transfer pricing may see increased attention put on their transfer pricing as part of the corporate income tax audit cycle.

It is increasingly important in Japan to have a timely and well-prepared Local File. The Japanese tax authorities are reviewing Local Files provided by taxpayers as a tool for assessing transfer pricing risk and, consequently, transfer pricing audit targets. Perhaps related to this, the Japanese tax authorities also seem to be aggressively enforcing deadlines for submission of Local Files requested in audits, with the possibility of presumptive taxation or use of secret comparables to raise a transfer pricing assessment if such deadlines are not met. This appears to be the case whether or not the Local File must be prepared contemporaneously.

Due to the economic downturn caused by COVID-19, Japanese taxpayers may be in the position of needing to support their transfer pricing in the face of reduced profit or a loss. Such taxpayers, especially foreign-owned limited-risk entities, should support operating results by calculating and documenting the quantitative impact of COVID-19 on the business. For benchmarking intended to support such results, reasonable adjustments may need to be made to either or both of the comparable company data and tested party's results, such as by looking at comparable company data from past economic crises, including loss-making companies in the comparable company set or testing the tested party's results on a multi-year basis. Such supporting evidence will be necessary, whether taxpayers intend to request some type of relief from the terms of an APA, or simply need to be prepared for a future transfer pricing audit.

Let's talk

For a deeper discussion of how this issue might affect your business, please contact:

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