Common Misunderstandings about Transfer Pricing Regulations in Japan — Inbound Companies

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In brief

It is common that during corporate tax audits, which covers both transfer pricing and general tax matters, for inbound companies in Japan (Japanese subsidiaries of multinational corporations headquartered outside of Japan), the examiner requests the company to submit its transfer pricing documentation (Local File). However, some inbound companies may mistakenly believe that they do not need to prepare a Local File if the amount of transactions (total receipts and payments) with foreign related parties are less than the threshold amount that exempts them from the preparation of contemporaneous documentation. In this newsletter, we will explain the points where inbound companies are likely to be misled with respect to Japanese transfer pricing taxation rules.

In detail

1. Recent Tax Audit Trends

During the COVID-19 Pandemic, the number of tax assessment cases based on transfer pricing regulations decreased significantly. According to data released by the National Tax Agency, the number of tax assessment cases, which exceeded 200 cases in the fiscal year 2018 (from July 2018 to June 2019)[1] and the fiscal year 2019 (from July 2019 to June 2020), decreased to 134 cases, 154 cases, and 149 cases in the last three fiscal years, respectively. However, since the start of the fiscal year 2023 (from July 2023), corporate tax audits have been very active, and the number of inbound companies undergoing corporate tax audits focusing on transactions with foreign related parties have been increasing.

Table 1: Number and Amount of Tax Assessments Based on Transfer Pricing Regulations

	Fiscal Year 2018 (Fiscal year ended June 2019)	Fiscal Year 2019 (Fiscal year ended June 2020)	Fiscal Year 2020 (Fiscal year ended June 2021)	Fiscal Year 2021 (Fiscal year ended June 2022)	Fiscal Year 2022 (Fiscal year ended June 2023)
Number of Cases	257 cases	212 cases	134 cases	154 cases	149 cases
Assessment Amount	36.5 billion yen	53.4 billion yen	50.2 billion yen	33.3 billion yen	39.2 billion yen
Average Assessment Amount	140 million yen	250 million yen	380 million yen	220 million yen	260 million yen

Source: Prepared by PwC Tax Japan based on "Summary of Corporate Tax Investigations" published by the National Tax Agency

[1] In Japan, the fiscal year of the tax authorities starts on July 1 and ends on June 30.

Considering the increased cases of corporate tax audits, this newsletter discusses common misunderstandings amongst inbound companies detailed in sections 2 to 6 below.

2. Obligation to Prepare a Local File

(1) Common misunderstanding
Since the amount of transactions with foreign related parties is less than 5 billion yen, the company is not required to prepare a Local File. Therefore, the company is not required to submit a Local File during a tax audit.

(2) Correct Understanding
Even if the amount of transactions with foreign related parties is less than 5 billion yen, it does not mean that a Local File is exempted, only the contemporaneous documentation requirement (see below). In addition, tax examiners will generally request inbound companies to submit Local Files at the initial stage of a corporate tax audit.

(3) Explanation
Japanese transfer pricing regulations provide for a contemporaneous documentation requirement. The contemporaneous documentation requirement means that a corporation that has transactions with its foreign related parties is required to prepare, obtain, and preserve a Local File by the due date of filing a tax return.

However, a corporation is exempted from the preparation of contemporaneous documentation with respect to the transactions with a single foreign related party for the relevant fiscal year, only when the below conditions are met:

(i) The amount of transactions (total of receipts and payments) with one foreign related party[2] in the previous fiscal year (or the fiscal year in question if there is no previous fiscal year) is less than 5 billion yen, <u>and</u>
(ii) The amount of intangible asset transactions (total of receipts and payments) with one foreign related party in the previous fiscal year (or the fiscal year in question if there was no previous fiscal year) is less than 300 million yen.

Many inbound companies assume that they are not required to prepare a Local File because the transaction amounts are less than 5 billion yen and 300 million yen, respectively. However, this is only an exemption provision for contemporaneous documentation, and does not mean that the Local File obligation itself is exempted. Even if the transactions are not subject to the contemporaneous documentation requirement ('transactions exempt from contemporaneous documentation'), a Local File is still required to be submitted at the time of a tax audit under transfer pricing regulations.

3. Local File Submission Deadlines

(1) Common misunderstanding
Since there is a 45 or 60-day grace period from the time the corporate tax audit is commenced to the due date of Local File submission, we have sufficient time to prepare the Local File after receiving a notice of the corporate tax audit.

(2) Correct understanding
There is not necessarily a 45 or 60-day grace period. The deadline for submission of Local File is determined at the discretion of the examiner.

(3) Explanation
The deadline for submitting the Local File is a certain date from the date the tax examiner requests the company to present or submit the Local File during the tax audit. If the Local File is not presented or submitted by the due date set by the examiner, the tax authorities are allowed to make a presumptive tax assessment, or question and inspect other companies who are engaged in the same type of business as the taxpayer and make an assessment. For transactions subject to contemporaneous documentation, the Local

[2] The amount of transactions with one foreign related party is used to determine the amounts of the transaction, not the sum of the amounts of transactions with all foreign related parties.

File must be submitted by the date specified by the examiner within 45 days, and for other transactions, by the date specified by the examiner within 60 days.

Some inbound companies with transactions with foreign related parties of less than 5 billion yen may believe they can prepare the Local File (or update it from previous years) promptly after they are notified that a tax audit is being conducted, since they assume there is a 60-day grace period before the submission of the Local File. However, in practice it is common for the tax examiner to request the company to submit their Local File on the first day of a tax audit or within a short period of time (e.g., within two weeks).

4. Selection of Comparable Companies

(1) Common misunderstanding
To test the profit margin of our Japanese subsidiary, there is no issue in using selected comparable companies from the Asian region, as the comparable set includes Japanese companies.

(2) Correct understanding
When the examiners analyse the reasonableness of the profit margin of a Japanese company as a tested party, in principle, they use the profit margin of comparables selected only from Japanese companies.

(3) Explanation
It is common for inbound companies to perform a benchmark analysis to analyse the profit margin of the Japanese subsidiary as a tested party to be verified. For example, the operating profit margin of a Japanese company might be analysed based on the Transactional Net Margin Method (TNMM). The overseas headquarters of inbound companies often centrally perform benchmark analysis for their subsidiaries located in Asia. In such cases, the benchmark analysis in the Local File of the Japanese subsidiary often include comparable companies selected from the Asian region. Under Japanese transfer pricing regulations, there is no provision that require that only Japanese corporations must be selected as comparable companies when a Japanese corporation is a tested party. Therefore, it is possible to present to the examiner the results of a regional benchmark analysis which includes comparable companies located outside Japan. However, the Japanese tax authorities place importance on market differences when reviewing the reasonableness of comparable companies, and hence, in a tax audit, the examiners analyse the profit margin of the Japanese corporation by comparing with the profit margin of the Japanese comparable companies only. Therefore, it is advisable to select only Japanese corporations as comparable companies in a Local File for the Japanese subsidiary.

5. Maintenance of an Intercompany Agreement

(1) Common misunderstanding
Since the company maintains an intercompany agreement with the overseas headquarters, payments to the overseas headquarters based on such agreement are deductible.

(2) Correct understanding
Simply having an agreement in place is not sufficient. It is also necessary to have documentation detailing the basis of how the amount of payments to the overseas headquarters are calculated.

(3) Explanation
Payments of royalties and service fees to overseas headquarters are made based on inter-company agreements such as license agreements and service agreements, respectively. However, when it comes to the payment, it is often the case where the Japanese subsidiary simply pays the amount indicated on the invoice to the headquarters by the due date without checking what is being charged as consideration. In Japan, it is common that the tax examiners review not only the agreements and invoices, but also the basis for the calculation of the invoiced amount. The Japanese company should obtain a spreadsheet or other documentation prepared by the headquarters as the basis for calculation and confirm in advance that the calculations have been made accurately. If the taxpayer is not able to provide such information, the examiner can determine that the payment is made for a transaction that has no value, and therefore determine it to be a non-deductible expense.

In addition, since explanations and submission of the deliverables that substantiate these services are requested even in general tax audits, which does not cover transfer pricing matters, it is also necessary to prepare this information in advance.

6. Local Files Prepared at the Initiative of the Headquarters

(1) Common misunderstanding
When an examiner requests a Local File to be submitted, a Japanese subsidiary can submit a Local File prepared by the overseas headquarters. Since the Local File was prepared by the overseas headquarters, which has a good understanding of the Japanese subsidiary's business, the Japanese subsidiary does not have to check the contents of the local file.

(2) Correct understanding
Even if the Local File was created by the overseas headquarters, the Japanese subsidiary should always check and confirm the contents from a Japanese local perspective before submitting the Local File to the examiner.

(3) Explanation
The Local Files for inbound companies are often centrally prepared by the overseas headquarters. In some cases, since the Japanese subsidiary does not have a tax specialist, the Local File is finalized without any detailed review by the Japanese subsidiary. In such cases, through discussion with the tax examiners, it may turn out during a tax audit that the descriptions related to the Japanese subsidiary in a Local File are unclear or inaccurate. Even if the Local File is prepared by the headquarters, the Japanese subsidiary should have a good understanding and review the contents of the functional and risk analysis, the characterization of the Japanese subsidiary under Japanese transfer pricing regulations, and the arm’s length range to be earned by the Japanese subsidiary stated in the Local File.

The takeaway

The common misunderstandings by inbound companies listed above are all fundamental, but they are the minimum points to keep in mind when dealing with Japanese transfer pricing regulations. In particular, it is important to have a correct understanding of local file preparation obligations and submission deadlines.

Let’s talk

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

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E-learning

PwC Tax Japan launched a new e-learning program called Tax Academy in October 2022, to support those wishing to develop their skills in the international tax field. For tax professionals outside Japan, the ‘Introduction to Japanese taxes’ series within Tax Academy provides a basic outline of the Japanese tax system, including corporate tax and consumption tax, and covers key points of international tax practice in English.

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