Besides arm's length pricing: the donation rules under Japanese corporate tax law

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In brief

Many Japanese taxpayers have encountered difficulties in corporate tax examinations, when what are generally considered transfer pricing issues have been challenged by the Japanese tax authorities not under the transfer pricing legislation, but under the "donation rules" of the Japanese Corporate Tax Act.

These challenges may arise even where the taxpayer's transfer pricing is at arm's length, or more dramatically, even where the taxpayer's transfer pricing leaves more than arm's length profit in Japan. In such cases, most taxpayers have trouble understanding the basis for the tax authorities' approach.

To provide some clarity in this area, this article will describe the interaction between the Japanese transfer pricing and donation rules, as well as provide some examples of donation challenges that have arisen in relation to intercompany transactions in recent years. Finally, the article will provide recommendations to taxpayers as to how best to mitigate the possibility of a challenge under the donation rules in future examinations.

In detail

1. Japanese transfer pricing legislation

The Japanese transfer pricing legislation is contained in the Act on Special Measures Concerning Taxation ("ASMT") Articles 66-4 and 68-88[1], and their related cabinet orders and ministerial ordinances. Japan is also a member of the OECD, and as such generally supports the theory and practices set out in the OECD's Transfer Pricing Guidelines. While localization of OECD principles has historically left some differences from the OECD's Transfer Pricing Guidelines, Japan's transfer pricing legislation as set out in ASMT Articles 66-4 and 68-88 is consistent with the arm's length principle described in those Guidelines.

Essentially, the Japanese transfer pricing legislation provides that a taxpayer engaged in the sale or purchase of inventory, the provision or receipt of services, or in other transactions with a foreign related party must do so at an arm's length price. Where the Japanese tax authorities determine that an arm's length price has not been applied, the price in a related party transaction can be adjusted to approximate a third party transaction.

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[1] ASMT Articles 66-4 and 66-88 are essentially identical, except that Article 66-88 applies specifically to corporations that are part of a consolidated group.

Overall, the Japanese transfer pricing examiners, who conduct specialist transfer pricing audits, are principled and technical in their analysis of transfer prices. While taxpayers may not always agree with the conclusions they draw, the process undertaken to reach those conclusions would generally be considered consistent with the principles laid out by the OECD.

2. Japanese donation rules

All payments made by a Japanese taxpayer are subject to the rules governing donations under Article 37 of the Corporation Tax Act. Under Article 37, the Japanese tax authorities may re-characterize any payment made by a corporation that is a "gift or gratuitous furnishing" as a donation[2]. Payments re-characterized as donations are deductible by the payor only up to a nominal statutory limitation, and are wholly non-deductible when paid to a foreign related party[3]. Such payments are considered taxable donation income to the receiving party.

Under Article 37(8), where assets or furnishing of economic benefits are transferred and the value received in exchange is less than the value of the assets or economic benefits as of the date of transfer, the difference between the former and the latter is considered to be a donation to the extent that it is "recognized to have been substantially a gift or gratuitous furnishing".

3. Interaction between transfer pricing and donation rules

The Japanese transfer pricing legislation makes it clear that transactions falling under the transfer pricing rules are also subject to the donation rules[4]. In fact, the Commissioner's Directive on the Operation of Transfer Pricing identifies several situations where the tax examiners should specifically consider the applicability of the donation rules (notwithstanding that the transactions are also subject to the transfer pricing rules), such as for retroactive price adjustments as further outlined below.

The result of the application of the donation rules to transactions subject to the transfer pricing rules can be surprising to foreign multinationals not familiar with the donation rules. This is because the donation rules may give rise to challenges where the transfer pricing rules ordinarily would not, due to the differences in the principles underlying each.

An example that illustrates this difference is one of the situations identified in the Commissioner's Directive on the Operation of Transfer Pricing where the tax examiners should specifically consider application of the donation rules. This is the scenario where a Japanese taxpayer has made a payment to a foreign affiliate for purposes of retroactively adjusting transfer prices[5]. The directive instructs examiners to investigate whether the price adjustment was "based on reasonable grounds" and, if it is considered not to be based on reasonable grounds, to examine the applicability of the donation rules. The provision lists several factors relevant to the determination of "reasonable grounds," including:

- the reason for the payment,
- the original arrangement,
- the calculation methods and basis of calculation of the payment, and
- the date of the payment.

Thus, for example, if there is nothing in the intercompany agreement or other documentation indicating that the parties had previously agreed to make retroactive transfer pricing adjustments ("the original arrangement") and the taxpayer cannot show how the adjustment amount was determined ("the calculation methods and basis of calculation of the payment"), the tax examiners might take the position that the payor was not obligated to make the payment, and that the payment was therefore a gift or gratuitous furnishing – i.e., a donation.

What might be surprising to a foreign multinational is that the examiners can raise such a donation challenge giving little, if any, consideration as to whether the transfer prices after the payment are

[2] Corporation Tax Law, Article 37(7).
[3] ASMT Articles 66-4(3) and 66-88(3).
[4] See ASMT Art. 66-4(3) and (4).
[5] See Commissioner's Directive on the Operating of Transfer Pricing, 2-20.

arm's length or not. For example, in the above situation, the examiners might raise a donation challenge to the retroactive price adjustment due to lack of documentation, even if the resulting profitability of the Japanese taxpayer is at arm's length. This is because the donation rules are applied independently of the transfer pricing rules and are concerned with whether the circumstances of the payment are such that they support a conclusion that the payment was a gift or gratuitous furnishing under those rules, not necessarily with whether the payment was "arm's length" under the transfer pricing rules.

4. Audit practice around donation assessments

Although the regular corporate tax examiners can, theoretically, make adjustments under the transfer pricing rules (since the transfer pricing rules are part of the corporate income tax law), unless they have spent time with the specialist transfer pricing group such examiners may not have the required training to perform detailed transfer pricing analyses. As a result, they tend to scrutinize intercompany transactions almost exclusively from a donation perspective, and focus on donation issues much more closely than the transfer pricing specialist examiners.

So, for example, in the scenario described above, the regular corporate tax examiners may be more inclined than the transfer pricing examiners to closely examine the potential for a donation challenge in relation to the payment made to retroactively adjust transfer prices. The transfer pricing examiners, on the other hand, might be more inclined to focus on the taxpayer's compliance with the transfer pricing rules, such as the appropriateness of the transfer pricing method and comparables used to test the related party transactions.

5. Case studies

To further illustrate this difference in results between the Japanese transfer pricing legislation and the donation rules, it is helpful to consider some examples that have arisen in tax audits.

Case 1

The taxpayer's intercompany agreement specified a certain target operating margin as the arm's length return for the taxpayer's distribution of products in Japan. At the same time, and trying to follow best practices by continually monitoring its transfer pricing, the taxpayer conducted comparable company benchmarking analyses from year to year, in order to determine the current arm's length operating margin based on the most up-to-date market data. The taxpayer then applied the arm's length operating margin derived from those benchmarkings rather than the operating margin stated in the intercompany agreement.

During a transfer pricing audit, the tax authorities raised a donation challenge against the taxpayer stating that, regardless of the fact that the actual operating margin may have been at arm's length as determined by a transfer pricing analysis, it was not consistent with the operating margin stated in the intercompany agreement. Consequently, in the years in which the actual operating margin, benchmarked using current transfer pricing analyses, was lower than the operating margin stated in the intercompany agreement, the Japanese taxpayer was deemed to have made a "donation" to its foreign related party in the amount of the difference in operating profit.

Case 2

The taxpayer had entered into an intercompany agreement with a foreign related party ("Party A") for the taxpayer's distribution of products in Japan, for which consideration was an arm's length operating margin. The intercompany agreement also provided that a year-end retrospective transfer price adjustment could be made as necessary to ensure that the Japanese taxpayer achieved that arm's length operating margin. For the particular years under audit, however, year-end adjustments related to the transactions with Party A were made with a different foreign related party ("Party B"). In the years where that adjustment mechanism required an outbound payment to be made by the Japanese taxpayer to Party B, the tax authorities disallowed those payments as donations, on the basis that there were no benefits being provided to the Japanese taxpayer by Party B. Again, the

Japanese taxpayer's actual operating margin was at arm's length, as determined by transfer pricing principles.

Case 3

In a similar case, the Japanese tax authorities challenged under the donation rules a retroactive transfer pricing adjustment on the basis that the calculation process adopted was not clearly described, despite the fact that the taxpayer's operating margin was significantly above the arm's length benchmark from the Japanese perspective.

In all of these cases, the donation challenge was raised notwithstanding that the transfer prices were arguably arm's length (or more favorable than arm's length from the Japanese perspective). These cases are indicative of the potentially surprising results that can occur where the donation rules are applied to transactions that are more typically considered by foreign multinationals to be purely transfer pricing matters.

It should also be noted that, in all of the above cases, the tax examiners ultimately dropped the donation challenge, without raising an assessment, but only after significant back-and-forth between the examiners and the taxpayer. However, the cases illustrate the potential for donation assessments in similar cases, and should therefore serve to forewarn taxpayers of such possibility.

The takeaway

As most corporations are subject to periodic regular corporate tax audits, while relatively few are subject to transfer pricing audits, most corporations are probably more likely to face a donation challenge to their intercompany transactions than a transfer pricing challenge. Therefore, it is important that in reviewing their intercompany transactions, companies consider not only the transfer pricing rules, but also the donation rules and their potential implications.

This should start at the beginning of the year by ensuring that every intercompany transaction has an intercompany agreement (or written evidence that an agreement has been reached). It is also helpful if there is an internal document containing a clear statement of the transfer pricing policy for each intercompany transaction (if not already stated in the agreement).

Following this, as transactions are undertaken between the Japanese taxpayer and its foreign related party or parties during the year, monitoring how those transactions are executed is also important. This will include checking the calculation of any transfer pricing adjustment (including retroactive adjustments), confirming that transfer pricing entries are correctly described in the taxpayer's general ledger, and ensuring that transactions are conducted consistently with intercompany agreements (or that intercompany agreements are modified as necessary).

As taxpayers continue to become more sophisticated in the development of transfer pricing policies and more accurate with their transfer pricing compliance, there is less room for challenge by tax examiners in those areas. As a consequence, tax authorities – not only in Japan but also in other countries – are likely to focus increasingly on the implementation and management of the transfer pricing process in the future.

Let's talk

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

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