

Transfer Pricing in Japan

Regulatory framework

The Special Taxation Measures Law (STML), enacted in 1986, remains the central transfer pricing legislation in Japan. Under STML 66-4, a transaction between a domestic or foreign corporation and a foreign related person not priced in accordance with the arms-length principle will be deemed to occur at an arms-length price for corporate tax purposes. Foreign related person includes any corporation related to the taxpayer directly or indirectly through 50% or more shareholdings, or through a substantial control relationship due to business, financial, or other dependence.

Other key transfer pricing regulations include the STML Enforcement Order 39-12 and the STML Enforcement Regulations 22-10, respectively laying out detailed rules on foreign related persons and transfer pricing methods, and items to be reported on schedule 17(3). The STML Circular provides further guidance on control relationships, comparables, and transfer pricing methods. The Administrative Guidelines outline the various transfer pricing administrative procedures. The NTA has also published 28 hypotheticals illustrating the application of Japan's transfer pricing rules.

Generally Japan's transfer pricing rules adhere to the OECD transfer pricing guidelines. The Administrative Guidelines expressly direct tax examiners to consider OECD guidelines during audits and assessments.

Filing Requirements

Schedule 17(3) must be filed by corporate taxpayers annually with the corporate income tax return. The schedule requires the taxpayer to report:

- Name, address, industry, main business activity, and shareholding relationship for each foreign related person;
- Sales, COGS, expenses, pre-tax profits, and retained earnings for each foreign related person;
- Each amount received or paid in a related party transaction and a description of the transaction; and
- Transfer pricing method(s) used.

There is no minimum reporting threshold – all transactions with foreign related parties must be disclosed.

Japan's current regulations do not expressly require taxpayers to maintain contemporaneous documentation, but the reporting requirements of 17(3) implicitly demand that taxpayers have Japan-specific transfer pricing policies and documentation in place to support the disclosures.

Transfer Pricing Methods

The 3 traditional transaction-based transfer pricing methods – CUP, RP, and CP – continue to be the preferred methods of the NTA. Transactional profit methods are also increasingly used. The profit-split method has been recognized since the initial 1986 transfer pricing legislation. TNMM was introduced in 2004. The NTA accepts these methods only when the traditional methods are inapplicable.

Transfer Pricing Audits

The NTA typically undertakes an informal inquiry to determine whether a taxpayer is an appropriate target for a transfer pricing audit. Information available to NTA examiners from 17(3) and considered during this target selection process includes (i) transactions with a related

party in a tax haven or low-tax jurisdiction; (ii) shrinking profits or persistent losses in Japan; (iii) intangible transactions or intra-group services; and (iv) changes in transfer pricing method.

The Administrative Guidelines require that NTA examiners carrying out transfer pricing audits consider documents describing the relationship between the taxpayer and the foreign related person, the specifics of the transaction in question, and the selection methodology of comparables and transfer pricing method. For assessments, examiners are directed to consider operating and gross profit margins against internal or external comparables and in light of the functions performed and risks borne by each entity. Japan's tax authority puts less emphasis on assets employed than other jurisdictions. A transfer pricing assessment may go back 6 years – double the period allowed for general corporate tax assessments.

To achieve a favorable audit result, it is critical that taxpayers have a Japan-specific transfer pricing policy and supporting documentation in place. Furthermore, having a transfer pricing policy and supporting documentation in place during the NTA's audit target selection phase can significantly reduce the risk of being selected for a full-scale audit.

Penalties and interest

Corporate tax penalties and interest are applicable to transfer pricing assessments. There are no additional transfer pricing-specific penalties, but taxpayers failing to submit documents requested by the NTA in a timely manner may be subject to 'presumptive tax' or disadvantaged by the use of 'secret comparables'. Perhaps due to increased availability of published comparable data and complaints about lack of transparency, NTA use of secret comparables in recent years is less frequent.

Advance Pricing Arrangements

Under an APA, the tax authority agrees to not adjust or audit a specified transfer pricing method for specified transactions for a fixed period (typically from 3 to 5 years). For some taxpayers, obtaining an APA may provide an effective solution to transfer pricing audit risk. APA applications have increased steadily, with the number of applications submitted in 2007 more than double the number submitted in 2002.

From 2008 forward, APA applications must be submitted before the start of the fiscal year to which the APA is to apply. Several informal pre-consultation meetings with NTA examiners are typically required before an application will be formally accepted. According to NTA reports, bilateral APA applications have an average processing time of between 2 and 3 years. Obtaining a multilateral APA takes significantly longer, possibly up to 5 years. The filing of an APA application by the taxpayer does not stop a transfer pricing audit if already underway.

Recent developments and trends

The NTA has increasingly focused on intangible transactions and intra-group services in its transfer pricing assessments. Between 2004 and 2008, almost half of the NTA's 30 largest transfer pricing assessments involved intangibles, and a significant number both intangibles and intra-group services. Rules on intra-group services reflecting OECD guidelines were introduced in 2002, and detailed rules on intangibles were introduced in 2006. Since the 2006 reforms, NTA examiners look beyond cost contributions and consider all intangible producing activities in determining economic ownership.

As the Japan subsidiaries of most large foreign firms were targeted throughout the 1990s and currently have APAs in place, the largest assessments since 2004 have generally been against Japanese parent corporations with foreign subsidiaries. The NTA is also increasingly targeting Japan subsidiaries of small and medium sized foreign firms.

How can Grant Thornton help you?

Grant Thornton Japan's transfer pricing advisory team can assist you with all aspects of implementing and managing a Japan-compliant transfer pricing policy, including:

Documentation – prepare transfer pricing documentation or review existing documentation to ensure Japan compliance;

Risk analysis – identify transfer pricing risks through an economic analysis of your business;

Benchmarking – provide industry-specific benchmark analysis;

Audit support – plan or review audit counter-measures, attend on-site audits, and assist in negotiations with NTA examiners;

APA applications – facilitate and assist the APA application process from initial planning and document preparation through final settlement;

MAP applications – facilitate the MAP application process from preliminary meetings through mutual consultation requests, negotiation, and settlement.

For further information, please contact Grant Thornton Japan.

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