

Tax Reform Proposal Issued on December 22, 2009,
by the Japan Cabinet (1)

On December 22, 2009, the Japanese cabinet issued the first annual tax reform proposal (*Zeisei Kaisei Taiko*) since the Democratic Party of Japan (DPJ) took power. As there are a number of controversial changes under the Manifesto of the DPJ, the release of the proposal was significantly delayed when compared with previous years. Accordingly, it is possible there may be further changes to the tax reform proposal before it is finally codified and made law in 2010. Fortunately, however, several important changes in the area of international taxation are not politically controversial, and are expected to be made into law without significant changes. While the details of the changes that will be made in the process of the codification have not been made public, in this memorandum we outline the changes proposed in the international tax area.

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Administration of transfer price taxation

In the last couple of years, the Japanese tax authorities have been more active in enforcing transfer price taxation against major Japanese companies. However, major Japanese companies have expressed some concern and frustration over the transfer price enforcement. Some of these concerns have been resolved or addressed in the proposal, not in the form of changes to the law, but in the form of changes to the operation manuals (*jimu un-ei you-ryou*) and basic circular (*Kihon Tsutatsu*).

(1) Transaction with a Joint Venture company

The tax authority enforces transfer price taxation in respect of transactions between a Japanese party and its foreign affiliate, even where the foreign affiliate is a joint venture company held equally by a Japanese parent company and a foreign partner. In such case, often the Japanese parent company does not have effective control over the management of the joint venture company. Accordingly, the transaction terms between the Japanese parent and the joint venture company are not necessarily controlled by the Japanese parent company, rather they are often determined through an arm's length negotiation between the two companies.

According to the tax reform proposal, the operation manual for transfer price taxation (*jimu un-ei you-ryou*) will be amended so that where a Japanese party and its joint venture affiliate negotiate the terms of transactions between them with reference to the appropriate market price and through a similar negotiation process to that between unrelated parties, due consideration should be given to the fact that the transaction terms agreed are likely to be similar to the terms agreed upon between unrelated parties.

(2) Regulation by foreign governments

If the government of a foreign country where the foreign affiliate is located regulates the price and other terms and conditions of transactions between the Japanese party and its foreign affiliate, the terms and conditions of the transaction would be different from the terms and conditions that would exist without such governmental regulation. Further, it is often the case that the foreign government enforces its policy on the terms and conditions of international transactions not only by written law or regulations but also by informal oral instructions.

The tax reform proposal recognizes this situation, and it is expected the chapter on transfer pricing in the basic circular for the Tax Special Measures Act (*Kihon Tsutatsu*) will be amended so that when selecting the comparable transaction terms, consideration must be given to the existence of such governmental regulations, including those given orally.

(3) Documentation Requirement

The current transfer price taxation law (Tax Special Measures Act, Article 66-4, paragraph 7) provides that when the tax authority requires a taxpayer to present its books and records necessary for calculation of the transfer price, and the taxpayer fails to comply with such requirement, the tax authority may make an assessment based on comparable transaction information the tax authority obtains from a third party, rather than information on a comparable transaction to which the subject taxpayer is a party. The tax reform proposal includes a clarification on this requirement - there will be a list of documentation that the taxpayer must be ready to present in a reasonable time when required by the tax authority, and a failure to present such documents when required may trigger assessment based on third party transaction information.

Although the list of required documentation is not included in the tax reform proposal, we anticipate that the following list of documentation, (which is taken from the operation manual), will be included in the list of required documentation:

- (i) Documents recording the information that is used by the taxpayer in determining the price between independent parties, including:
 - (a) The process to select the comparable transactions, and the specifications of the selected comparable transactions.
 - (b) If several transactions are aggregated as comparable transactions, the reason for such aggregation.
 - (c) The reason the party selected a particular calculation method and did not select other calculation methods.
 - (d) If the party makes an adjustment to the terms of the comparable transaction based on different circumstances, the specifications of the adjustment and reason for adjustment.

- (ii) Documents describing the transaction subject to the transfer price regulation ("Target Transaction")
 - (a) Written contract or other documents recording the terms and conditions of the Target Transaction.
 - (b) Pricing method and process of pricing and other negotiation
 - (c) Business strategy of the taxpayer and/or the foreign affiliate relevant to the Target Transaction
 - (d) Profit and loss of the taxpayer and the foreign affiliate from the Target Transaction
 - (e) Function and risks of the taxpayer and the foreign affiliate in connection with the Target Transaction
 - (f) Description of intangible assets used in connection with the Target Transaction
 - (g) Analysis of the market of the products or services relevant to the Target Transaction (if any)
 - (h) Description of the products or services subject to the Target Transaction
 - (i) Description of other transactions closely related to the Target Transaction (if any)

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Contact Information:

Should you wish to receive further information or advice regarding the above-mentioned matters, please contact Eiichiro Nakatani, Koji Fujita, Kotaro Okamoto or Yoshinori Aoyagi.

Eiichiro Nakatani
Partner
Email: eiichiro.nakatani@amt-law.com
Telephone: 03-6888-1039

Koji Fujita
Partner
Email: koji.fujita@amt-law.com
Telephone: 03-6888-1041

Kotaro Okamoto
Associate
Email: kotaro.okamoto@amt-law.com
Telephone: 03-6888-1090

Yoshinori Aoyagi
Associate
Email: yoshinori.aoyagi@amt-law.com
Telephone: 03-6888-1109

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