

Japan Tax Newsletter

Tax Reform Proposal Issued on December 16, 2010 by the Japanese Cabinet [Part 2]

Effects on the Transfer Pricing Taxation Regime of Japan

* * * * *

Introduction

The transfer pricing taxation regime in Japan will be significantly impacted by (a) the proposed 2011 tax reform bill of Japan which amends the Special Measures Law on Taxation (the "SMLT"), and (b) the proposed amendments to the Transfer Pricing Guidelines which are published by the tax authority of Japan. The proposed 2011 tax reform bill has been drafted in accordance with the tax reform proposal (*Zeisei Kaisei Taiko*) (the "**Proposal**"), and the proposed amendments to the Transfer Pricing Guidelines are set out in the Proposal. The amendment to the SMLT, with regard to transfer pricing methodology ("TPM"), abolishes the "priority" of the traditional transaction methods and adopts the principle whereby the most appropriate TPM must be used. The amendments to the Transfer Pricing Guidelines will, respectively, (i) adopt the concept of a transfer price range, and (ii) establish certain rules regarding the use of secret comparables.

(A) Amendment to the SMLT

The Most Appropriate Method Principle

Under the current Japanese transfer pricing taxation regime, traditional transaction methods of calculating an arm's length price (i.e., the comparable uncontrolled method, the cost plus method and the resale price method) must be applied when possible, and the application of transactional profit methods (such as the profit split methods and the transactional net margin method) may occur only in the circumstances where traditional transaction methods cannot be applied. Therefore, it can be said that such traditional transaction methods have "priority" over the transactional profit methods.

The proposed 2011 tax reform bill will amend the SMLT in a way that will abolish the priority application of traditional transaction methods and adopt the principle that requires the taxpayer and the tax authority to apply the most appropriate method in relation to the circumstances. Additionally, such amendment explicitly adopts the residual profit split method (the "RPSM"). The RPSM is a variation of the profit split method, and due to it not previously being explicitly included in the Japanese tax code, it has sometimes sparked debate regarding its legitimacy.

As the transactional profit method is already widely applied in practice in Japan, the introduction of the most appropriate method principle merely modifies the Japanese tax code to correspond with such practical conduct. The traditional transaction methods, however, are often more beneficial to taxpayers than the transactional profit methods in that a more sophisticated arm's length price can generally be obtained from the traditional transaction methods. Therefore, some practitioners are concerned that the tax authority of Japan may arbitrarily apply the transactional profit methods even where the application of traditional transaction methods would be more appropriate. In order to challenge any such arbitrary application of the transactional profit methods, preparation of appropriate documentation and rationale for the application of the taxpayer's chosen TPM would be advisable.

Another concern is that, after this amendment takes effect, a taxpayer subject to a tax assessment by the tax authority applying one of the transactional profit methods may no longer challenge such assessment by arguing that the application of such transactional profit method is not in conformity with the tax code where one of the traditional transaction methods is applicable to the case. Rather, once the tax authority demonstrates that the TPM of its choice is the most appropriate method, the assessed taxpayer would bear the burden of proof to show that the TPM of the taxpayer's choice better reflects the arm's length price.

It should be noted that this amendment, scheduled to take effect on October 1, 2011, is most likely intended to correspond to the revisions of Chapters I to III of the Transfer Pricing Guidelines published by the OECD on July 22, 2010, which also abolished the priority application of traditional transaction methods.

(B) Amendments to the Transfer Pricing Guidelines

(1) Introduction of the Transfer Price Range Concept

Conceptually, if two comparables are both considered reliable, they will create a range of an appropriate arm's length price. In one forthcoming amendment to the Transfer Pricing Guidelines in Japan, such transfer price range concept will be established.

To date, the transfer price range concept has been utilized only in the context of an advance pricing arrangement and has not been openly accepted in the context of an audit or calculation of an arm's length price. Upon the enactment of this amendment, the transfer price range concept will act as a safe harbor for taxpayers whereby if an agreed price between associated enterprises is within the transfer price range, such price must be allowed, and no additional tax assessment may be made. If, however, the price between associated enterprises is outside of the range, a tax assessment may be made using (i) the average of the comparables, (ii) or a reasonably determined price in light of the distribution of the comparables. In the event that the average of the comparables is used for the assessment, it is anticipated that the inter-quartile range might be used, which should also generate a reasonable averaged price for the calculation of the arm's length price.

(2) Clarification of the Application of Secret Comparables

"Secret comparables" refer to data collected by the tax authorities from unrelated third parties that the tax authority uses for determining the arm's length price without identifying such third parties. The identity of the third parties is not disclosed to the assessed taxpayer because the tax authorities are subject to a confidentiality obligation under relevant law. The obvious negative aspect of the use of secret comparables is that it is almost impossible for the taxpayer to challenge the efficacy of the comparables, e.g., whether the unrelated third party transactions are sufficiently similar to the taxpayer's transactions to make it a reliable comparable.

To address this concern, two changes are introduced to the Transfer Pricing Guidelines: (a) in order to assist the taxpayers in predicting when secret comparables will be used, the Transfer Pricing Guidelines will illustrate certain relevant situations where the tax authorities anticipate using secret comparables; and (b) the Transfer Pricing Guidelines will require that when the tax authority uses secret comparables, the tax authority will disclose and explain the secret comparables to the taxpayer to the extent permissible under the confidentiality obligation. It is expected that these changes will result in the taxpayers in better preparing themselves thereby avoiding situations under which secret comparables are likely to be used. Moreover, even if secret comparables are used in the assessment, the assessed taxpayer would have a way to challenge the use of secret comparables based on the explanation to be provided by the tax authorities.

Practically speaking, however, the impact of these changes will most likely be minimal due to the fact that the use of secret comparables by the tax authority of Japan has steadily decreased during the last few years in light of the worldwide attitude against use of secret comparables.

Summary

The transfer pricing taxation regime will undergo many changes this year with the anticipated passing of the tax reform bill of 2011 which will amend the SMLT, followed by the amendments to the Transfer Pricing Guidelines. Amongst the modifications to the taxation regime are (i) the abolishment of the priority of the traditional transaction methods, (ii) adoption of the most appropriate transfer pricing method and the transfer price range concept, respectively, and (iii) the establishment of rules with respect to the use of secret comparables. The effects of such changes are wide-ranging and should allow the taxpayer (a) more accuracy in establishing an appropriate transfer price, and (b) to better anticipate certain actions of the tax authorities and to more sufficiently prepare itself accordingly.

The tax reform bill has been recently submitted by the Cabinet to the National Diet and is now being discussed therein. Ordinarily, a tax reform bill would be enacted by March 31 in the year in which it was introduced. In light of the current unstable political circumstances, however, the amendments described above may be modified and/or the enactment of such bill may be delayed. Further, as the amendments to the Transfer Pricing

Guidelines will generally occur only after the enactment of the tax reform bill, it is anticipated that any delay to such bill will cause a delay in the implementation of the amendments to the Transfer Pricing Guidelines.

* * * * *

This newsletter is published as a general service to clients and friends and does not constitute legal advice. This newsletter is co-authored by Takashi Tezuka and Jeffrey A. Eagan of Anderson Mori and Tomotsune.

* * * * *

Contact Information:

Should you wish to receive further information or advice regarding the above-mentioned matters, please contact Takashi Tezuka or Jeffrey A. Eagan.

Takashi Tezuka
Associate
Email: takashi.tezuka@amt-law.com
Telephone: 03-6888-1166

Jeffrey A. Eagan
Foreign Legal Associate
Email: jeffrey.eagan@amt-law.com
Telephone: 03-6888-1208

*This law bulletin is published as a general service to clients and friends and does not constitute legal advice.

Copyrights reserved by Anderson Mori & Tomotsune.