TRANSFER PRICING NEWS (Japan) Managing the Tax Audits Related to Transfer Pricing

Forvis Mazars Tax Corporation

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Managing the Tax Audits Related to Transfer Pricing

Tax audits have been increasing since the end of the COVID-19 pandemic. Numerous tax audits targeting inbound companies (Japanese subsidiaries or branches of multinational companies headquartered outside Japan) have occurred regardless of the company size.

This article presents the common points of dispute with the tax authority and explains the best practices for managing the tax audits related to transfer pricing.

Recent Tax Audit Trends

As shown in Table 1, statistics published by the National Tax Agency (the "NTA") show that while the number of correction cases and corrected amounts were low through FY2022 due to the impact of COVID-19, tax auditing has become more active since FY2023. In fact, our tax team has been assisting many audit cases lately. Over the past few years, the tax administration has been restructuring their internal organization to strengthen the enforcement of international taxation. Today, tax examiners who have experience in transfer pricing are assigned not only at regional taxation bureaus (Kokuzeikyoku) but also at major local tax offices (Zeimusho), and it has become common for companies under the jurisdiction of the local tax offices to receive information requests on transfer pricing regardless of the amount of intercompany transactions. In particular, transfer pricing often becomes a point of dispute for inbound companies that conduct transactions mainly with related parties from overseas. To avoid the risk of tax corrections, it is important to be prepared in advance for requests and questions from the tax authority in relation to transfer pricing.

Table 1[1]：Statistics on Transfer Pricing Audits

（JPY100M）	FY2019	FY2020	FY2021	FY2022
Number of Cases	212	134	154	149
Corrected Amount (taxable income basis)	534	502	333	392

※Fiscal year of the tax administration is from July 1st to June 30th. For instance, FY2022 starts from July 1st, 2022 to June 30th, 2023.

This article presents some of the common points of dispute with the tax authority and explains the best practices for managing the tax audits.

[1] "Overview of Tax Audits related to Corporate Income Tax, etc." published by the National Tax Agency 報道発表 (nta.go.jp). The report is published in November every year and the report for FY2023 is expected to be published in November 2024.

Information Requests and Points of Dispute

The tax authority now requests transfer pricing-related information regardless of the volume of intercompany transactions. If a company is unable to provide sufficient explanation and information, the tax authority either solicits the taxpayer for self-correction or issues a tax assessment notice.

1. Local File and Transfer Pricing Documentation

It is now common for the tax officers to request Local Files or equivalent transfer pricing documents in their initial information and data request. Under the Japanese transfer pricing regulations, the Local File is required to be prepared contemporaneously[2] if the total amount of intercompany transactions exceeds JPY5.0 billion, or the amount of intangible transaction (payment of royalty/license fee for the use of trademarks, technical know-how, etc.) by itself exceeds JPY300 million. However, companies are exempt for such contemporaneous requirement if the volume of intercompany transactions are below the above thresholds. However, it must be noted that this exemption merely means that contemporaneous documentation is not necessary and does not mean an exemption from the TP documentation itself. In principle, multinational companies engaged in cross-border transactions are required to prepare the documents that explain the appropriateness of their transfer prices. Nowadays, tax officers even ask for Local Files and transfer pricing studies in the case of lower volume intercompany transactions.

2. Intercompany Agreements and Transfer Pricing Policy

The tax authority inspects the intercompany agreements between related parties to obtain an overview of the intercompany transactions, the roles and responsibilities assumed by the involved parties, and the related transfer pricing policies. Tax officers will then often evaluate whether there are any discrepancies between contractual pricing policies and actual transaction prices, and any discrepancies will need to be justified. Therefore, taxpayers are advised to periodically monitor whether the results during and after the end of the period conform with the transfer pricing policies, and whether there are reasonable explanations in case of any discrepancies.

3. Evidence for TP Adjustments

Many inbound companies use TP adjustments to revise transaction prices retroactively at year end. The tax officers ask taxpayers to provide evidence for TP adjustments and to explain the calculation methodology. Various factors can lead to tax corrections. Examples include simple mathematical errors or differences due to the use of different accounting standards (TP adjustments need to be calculated based on local GAAP), insufficient evidence of the calculation process, or differences in the target margin. It is vital for the Japanese taxpayers to understand the mechanism of why TP adjustments happen already during their everyday operations, so that they will be able to provide swift and coherent answers during a tax audit.

For an internal retroactive TP adjustment leading to an additional payment from a Japanese taxpayer to its foreign related party, Japanese transfer pricing guidelines require thorough evidence including the reason of the payment, the existence of an adjustment mechanism in the pre-agreed contract, supporting documentation for the calculation, etc.[3]. If the taxpayer fails to submit these documents, the tax authority would consider the application of a donation taxation denying the payment (Kifukin Kazei to the foreign related party) [3]. For the aforementioned reasons, it is crucial to well prepare the supporting materials when a TP adjustment occurred.

[2] Requirement to prepare the Local File by the due date of the tax return.

[3] Commissioner's Directive on the Operation of Transfer Pricing (Administrative Guidelines) **3-21: Points to Consider for the TP Adjustment** （**https://www.nta.go.jp/law/jimu-unei/hojin/010601/02.htm**）

When a company changed the amount of consideration that was paid to the foreign related party in the foreign-related transaction retroactively as a TP Adjustment, the tax officer will consider whether such change in the amount of consideration can be treated as a revision of transaction price which is based on reasonable grounds.

If the change in consideration was made through the payment of money to the foreign related party or the record of costs, etc. (hereafter, referred to as “Payment, etc.”), the tax officer will examine in a wholistic manner the reason for payment, the contents of the pre-agreed contract, the calculation methodology and the calculation basis, the date of the Payment, etc. The tax officer will treat the transaction price as revised if the Payment, etc. is considered to be made on reasonable grounds.

If the Payment, etc. is not considered to be made on reasonable grounds, the tax officer will consider the applicability of the provisions of Article 66-4 (3) of ASMT (i.e. donation taxation).

Best Practices

As noted above, it has become a standard for the tax authority to demand information on transfer pricing regardless of the size of the company and the volume of intercompany transactions. To reduce the risk of being scrutinized and to avoid time-consuming investigations, self-corrections, or tax assessments, it is important to be in the position to provide swift and cohesive explanations to inquiries from the tax officers. The key for doing so is to build the defensive line in advance by deepening the understanding of the group transfer pricing policies (including the TP adjustment mechanism) based on regular communication with the parent company and by maintaining the Local Files to explain the appropriateness of the transfer pricing results.

Since building such a defensive line requires not only a specialized knowledge of transfer pricing but also a smooth exchange of information with the parent company, regular consultation and information-sharing with the company's internal or external tax advisors is an important part for managing tax audits properly.

Every year in July, the tax administration completes its personnel reassignments and begin the new administrative year under its new staffing structure. With the start of the new tax audit cycle, we expect the tax audits to continue to increase. This newsletter will provide timely and periodical updates on tax audit trends.

Contact

Leveraging off the global network of more than 100 countries, Forvis Mazars Tax Corporation provides various domestic and international tax services to Japanese and foreign clients.

Please feel free to reach out to our Partners below for more information on this news release or on our service offerings.

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