TRANSFER PRICING NEWS (Japan)
The Importance of Intercompany Agreements

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Intercompany agreements between Japanese entities and overseas group companies are frequently absent or inadequately drafted. Although not legally required by the Japanese tax law, well-constructed intercompany agreements are critical for substantiating the arm's length nature of intercompany transactions during tax audits and for mitigating transfer pricing risks.

This article outlines the significance and effectiveness of maintaining robust intercompany agreements, highlights the essential elements that should be included, and provides practical considerations for preparing such agreements.

The importance of intercompany agreements

Japanese transfer pricing regulations require that prices for intercompany transactions adhere to the arm's length principle—that is, prices must reflect those that would be agreed upon between independent parties under comparable circumstances. The regulations also require that pricing accurately reflects the functions performed and risks assumed by each party.

During tax audits, authorities do not focus solely on transaction amounts. Instead, they review the underlying business context, the nature of the transaction, and the allocation of functions and risks between the parent company and its subsidiaries. Therefore, a thorough understanding and identification of the actual facts surrounding related-party transactions are essential when evaluating the appropriateness of transfer pricing.

Intercompany agreements serve as the starting point for this fact-finding process. These agreements typically define the purpose and scope of the transaction, the functions and risks assumed by each party, the pricing methodology, and any conditions for retroactive transfer price adjustments. In practice, tax officers often begin by reviewing the contents of these agreements before assessing the appropriateness of transaction prices.

The OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations also recognize intercompany agreements as the foundation for understanding the actual conditions of related-party transactions. The Guidelines emphasize that consistency between the terms of the agreement and the parties' actual conduct is a key factor[1] in determining whether the transfer price is at arm's length. Furthermore, since tax authorities almost always request these agreements during audits, having them properly prepared in advance can streamline the audit process and enable taxpayers to take a more proactive role in discussions.

Conversely, the absence of such agreements—or deficiencies in their content—may allow tax authorities to interpret the facts at their own discretion, potentially resulting in unfavorable outcomes for taxpayers. In other words, failing to prepare appropriate intercompany agreements poses a significant risk of increased corporate tax liabilities.

To mitigate these risks, it is essential to prepare agreements that incorporate the "Key Elements and Considerations in Drafting Intercompany Agreements" discussed later in this article. Doing so can help shorten audit timelines and reduce the likelihood of tax adjustments. These benefits extend beyond Japan and are equally applicable when dealing with tax authorities in other jurisdictions. Well-prepared

[1] OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations - Chapter 1, D.1., 1.42 ([OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2022 (EN)])

intercompany agreements are, therefore, an effective tool for managing global transfer pricing risks.

Key Elements and Considerations in Drafting Intercompany Agreements

When drafting intercompany agreements, it is insufficient to merely have a document for the sake of formality. The agreement must accurately reflect the true nature of the transaction, clearly define the rights and obligations of the parties, and include all tax-relevant information.

For example, in the case of tangible transactions (i.e. inventory sales) between related parties, the agreement should not only define the parties' rights but also include provisions regarding the pricing methodology and any retroactive transfer pricing adjustments. Under Japanese administrative guidelines on operational transfer pricing, if a retroactive price adjustment results in a payment from a Japanese entity to an overseas affiliate, detailed supporting documentation—such as the rationale for the payment, pre-agreed terms, and calculation basis—is required[2]. If such documentation cannot be provided, there is a risk that payments to an overseas affiliate may be treated as a donation, resulting in the denial of all or part of the deduction for the price adjustment payment. Similarly, when a Japanese entity receives a price adjustment from an overseas affiliate, it is important to be able to explain the rationale, pre-agreed terms, and calculation basis. To mitigate these risks, intercompany agreements should clearly set out the pricing policy and the conditions for implementing retroactive price adjustments.

For service transactions, the agreement should accurately describe the nature of the services rendered and the method for determining the service fee.

For agreements involving the licensing or transfer of intangibles, it is essential to specify the facts related to the nature and ownership of the intangible assets, the scope of the license, and the method for calculating license fees (or royalties).

For financial transactions, the agreement should include key terms such as interest rates, payment conditions, and whether collateral is required.

While agreements should address these critical points, it is also important to maintain a degree of flexibility to accommodate future changes in the parties' actual conduct. To ensure that an agreement is both practical and compliant from a transfer pricing perspective, it is advisable to seek guidance from transfer pricing experts.

Ensuring Consistency Between Intercompany Transactions and Agreements

Finalizing intercompany agreements is not the end of the process. Business environments are dynamic, and the nature of related-party transactions may change over time. In practice, agreements are often prepared at the outset of a transaction but left unchanged for years, even as circumstances evolve. During tax audits, such situations may lead to scrutiny if the agreement no longer reflects the parties' actual conduct.

This risk is particularly pronounced when agreements are established in overly rigid terms, which can result in discrepancies between the contract and actual practice. To prevent such issues, it is essential to monitor whether the terms of the agreements remain aligned with actual facts and circumstances as part of day-to-day operations. If discrepancies arise, companies should carefully consider whether to review and revise the agreements to ensure they remain accurate and appropriate.

Maintaining intercompany agreements that reflect actual conditions is critical for mitigating transfer pricing risks and ensuring smooth tax audit processes.

[2] 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). Please also refer to TRANSFER PRICING NEWS (Japan) Release #1 for more details.

Summary

As outlined above, intercompany agreements are not merely formal documents—they serve as essential evidence in tax audits to substantiate the appropriateness of transfer pricing policies. Well-prepared agreements enable taxpayers to lead discussions regarding transfer pricing policies and strengthen their ability to justify the chosen policy, thereby reducing the risk of transfer pricing adjustments.

Since tax authorities typically request intercompany agreements during audits, preparing these documents only after such a request can be challenging within the required timeframe. It is strongly recommended that companies assess whether appropriate intercompany agreements are in place for all relevant transactions. If agreements are missing or outdated, steps should be taken to prepare or update them in advance.

Contact

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