

# Japanese tax audits focus on transfer pricing compliance

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## In brief

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Due to the COVID-19 pandemic, Japan's large metro areas – such as Tokyo, Osaka, and Nagoya – have been under government-imposed states of emergency on and off for the past year and a half. The most recent (fourth) state of emergency has been in effect since July and expanded several times.

This has correspondingly slowed the Japanese tax authorities' audit activity, as they have needed to cut back on in-person meetings with taxpayers, and taxpayers' ability to gather information to respond to requests have been hampered. In particular, transfer pricing audits, which tend to be time consuming even under normal circumstances, are taking much longer to complete. As a result, the number of new transfer pricing audits being initiated by the Japanese transfer pricing examiners has declined.

Although slowed, regular corporation tax audits continue to be initiated and, perhaps related to the slowdown in transfer pricing audit activity, we have noticed that the regular corporate tax examiners have, over the past several months, increased and expanded their requests for transfer pricing related documentation and information. As such audits are conducted regularly, and potentially on short notice, this development increases the importance of both advance preparation of transfer pricing documentation and support for any extraordinary results caused by the pandemic.

This newsletter summarizes the Japanese tax authorities' audit activity under the COVID-19 pandemic and suggested actions that should be taken in preparation for an audit.

Please access to [this video](#) for further details.

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## In detail

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### 1. Requests for transfer pricing local file

Requests made by the regular corporate tax examiners typically include the transfer pricing local file (LF). In fact, where the taxpayer is subject to the LF contemporaneous preparation requirement, the tax examiners' first information and document request (IDR) always includes the LF. Where the contemporaneous preparation requirement applies, the LF must be submitted within the time set by the tax examiners, not to exceed 45 days. Taxpayers not required to prepare a LF contemporaneously are nonetheless still required to submit a LF upon request within the time set by the tax examiners, not to exceed 60 days. The examiners have discretion in setting the due date, and we are aware of cases where they have set the due date much sooner than the maximum time allowed.

The failure to provide the LF by the due date allows the tax examiners to use the so-called "presumed" method and/or secret comparables to raise a transfer pricing assessment, both of which

make it easier to do so. We understand that the tax examiners have threatened to use these measures in recent cases.

It is quite difficult to prepare a LF within the maximum 60-day period permitted for submitting one, and given that the examiners may set a due date for submission that is much shorter than that, taxpayer's that do not already have a LF prepared and ready for submission prior to commencement of an audit risk failing to submit it timely and, correspondingly, have an increased risk of a transfer pricing challenge. Therefore, it is prudent for taxpayers to have a LF prepared and ready for submission in advance of any audit.

## **2. Other requests related to intercompany transactions**

In addition to the LF, requests by the regular corporate tax examiners related to intercompany transactions also include copies of intercompany agreements, documents describing the groups' transfer pricing policies, support for intercompany service charges (such as the economic benefit to the local entity for such services and the method of allocating the service costs) and any other documentation supporting the company's transfer pricing.

For the last few years, local tax offices (Zeimusho) – as opposed to the Regional Taxation Bureaus (RTBs) (e.g., Tokyo, Osaka and Nagoya RTBs) – have been scrutinizing intercompany transactions very aggressively in regular corporate tax audits. This has been facilitated by the fact that a number of former RTB examiners with extensive transfer pricing audit experience have been assigned to local tax offices as international tax examiners.

Thus, in regular corporate tax audits, besides being prepared for the LF request, taxpayers should also be prepared for scrutiny of their intercompany transactions in general.

## **3. Impact of COVID-19**

COVID-19 may cause reduced profits or losses for Japanese affiliates of foreign MNCs, and the Japanese tax authorities are likely to scrutinize reduced profits or losses for limited-risk entities (LREs). Therefore, in such cases, the Japan LF should support the reduced profitability of the LRE by documenting the quantitative impact of COVID-19 on the business (such as sales decline, pandemic-specific expenses, etc.) and presenting a rationale for why the LRE should share in the impact (the terms of the intercompany agreement and allocation of risk would be important here).

Also, taxpayers required to e-file a master file (MF) with the Japanese tax authorities should ensure that it is consistent with the local entity's LF. For example, if the local entity has incurred reduced profits for a particular reason, such as the COVID-19 pandemic, besides the LF supporting the result, as mentioned above, the MF should also be consistent with this result (and the LF). For example, the MF should not give the impression that the group was unaffected by the pandemic, so as not to undermine the support provided in the LF.

Typical benchmarking analyses, which rely on historical data, may not be appropriate, so alternative approaches may need to be considered. These may include, for example, a benchmarking study based on only pandemic-period data (to the extent available), an analysis of the effects of previous recessionary periods on profitability, testing the LRE's cumulative results over several years, etc.

An approach that the Japanese tax authorities seem to be considering is testing the profitability of the tested party excluding the effects of the COVID-19 pandemic against the profitability of comparable companies for the period not affected by the pandemic. Such an approach would seem to depend on how easily pandemic-related P&L items of the tested party can be identified and isolated.

We anticipate that the Japanese tax authorities will generally follow the guidance in the OECD's Guidance on the transfer pricing implications of the COVID-19 pandemic, issued 18 December 2020, so taxpayers should look to this for guidance in how to support results impacted by the pandemic.

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## The takeaway

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Transfer pricing related documentation and information is increasingly being requested in regular corporate tax audits (i.e., non-transfer pricing specific audits). Where the LF contemporaneous preparation requirement applies, the LF is always requested at the outset of an audit. Furthermore, the local tax offices have recently been scrutinizing intercompany transactions very aggressively in regular corporate tax audits. Because such audits are generally conducted on a periodic basis, and can be scheduled on short notice, taxpayers are advised to ensure they are always prepared for transfer pricing related inquiries and, in particular, to have their LF prepared and available for submission upon request. For entities negatively impacted by the COVID-19 pandemic, it is important that the LF, as well as the MF, provide support for the results.

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## Let's talk

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For a deeper discussion of how this issue might affect your business, please contact:

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