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Tax Connect

Transfer pricing: managing documentation requirements in 30 countries

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Introduction

The determination and verification of a transfer pricing policy involves the consideration of a range of information not necessarily contained in the documents that must be submitted to a tax authority (such as a company's tax returns or contracts). This specificity of transfer pricing, together with the fact that, generally, the tax authorities bear the burden of proof for making adjustments, has led various States to introduce specific documentation obligations in this context.

These obligations are recent (they are mostly less than ten years old) and undoubtedly reflect the increasing attention that the tax authorities are paying to transfer pricing. The first State to impose such requirements on its taxpayers was the United States in the mid-1990s. It was not until the mid-2000s that the phenomenon became widespread, with the introduction of documentary requirements in States such as Germany (2003), China (2008), Spain (2009), France (2010) or Russia (2012). According to the UN manual described below, the number of countries having specific transfer pricing documentation requirements rose from approximately 15 in 2001 to almost 60 in 2012.

Alongside these national initiatives, several multilateral groups have also turned their attention to the matter. Firstly of course there is the OECD, whose 1995 guidelines provided directions that have been used in practice by taxpayers and authorities without change to national laws. More recently (October 2012), the UN issued the "Practical transfer pricing manual for developing countries" which includes developments on transfer pricing documentation.

Standardised approaches have also been proposed by other multilateral groups in order to reduce the cost to businesses of producing such documentation. In 2003, the Pacific Association of Tax Administrators (comprising Australia, Canada, Japan and the U.S.) published the final version of its standard multilateral documentation and, more recently, the European Union Joint Transfer Pricing Forum produced a code of conduct which was adopted by the Council of Ministers of the EU in 2006. The application of this Code of Conduct is becoming widespread in Europe, even though Member States are not strictly obliged to incorporate it into their national law, either by the introduction of laws (like the obligations introduced in Spain and France) or by administrative practice. In Europe, it is becoming increasingly advisable for companies to retain the type of documentation proposed by this Code of Conduct.

As shown in this CMS Tax Connect, the provisions of national laws are far from being harmonised (either in respect of the range of companies to which such requirements apply, the content of the documentation required, or the penalties resulting from the absence of such documentation). However, in relation to the content of the documentation, a consensus is emerging based on the following four main points:

— A description of the group and the industry in which it operates;
— A functional analysis – a description of the business functions, risks and assets – of entities involved in intra-group transactions;
— A description and justification of the method(s) utilised for setting transfer prices for the various intra-group transactions;
— One or more economic/benchmark studies, intended to justify the parameter(s) of the methods applied.

These documentary requirements impose constraints and additional costs on businesses. However, they also provide legal certainty to taxpayers, as they specify what information is expected by the government, thereby avoiding certain discussions having to take place during assessments.

Keeping such documentation also enables companies to better identify the potential risks they face in this context and enables them, if necessary, to change their transfer pricing policy to limit such risks.

Finally, the documentation also acts as a precise statement of the company's position on transfer pricing. It should therefore not be seen as a compilation of information, but rather as the primary tool enabling businesses to persuade tax authorities that their transfer pricing policies are consistent with the arm's length principle.

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Japan

1. In your jurisdiction, are taxpayers obliged to maintain transfer pricing documentation? Does this obligation apply to all taxpayers, or only to certain categories (e.g. taxpayers with turnover or assets exceeding a particular threshold)?

New documentation requirement: Up until 2010, Japanese transfer pricing regulations did not require detailed documentation on the taxpayer's transfer pricing policy. However, the 2010 annual tax reform, which took effect on 1 April 2010, introduced certain documentation requirements. Before the amendment, it was only required that the taxpayer should produce "books and records that are necessary to compute the arm's length price". In the practical context of transfer pricing audits, it was often pointed out that it was unclear what specific documents that wording covered. That is, if the taxpayer fails to produce certain transfer pricing documentation to the Japanese tax authority without delay, upon being so requested in the course of a transfer pricing audit, the Japanese tax authority is entitled to issue a transfer pricing assessment using a presumed arm's length price determined according to certain prescribed methodologies, including so-called "secret comparables".

This means that, if the taxpayer wishes to avoid a transfer pricing assessment on the basis of presumption by the tax authority – or the use of secret comparables (which should be the case for all transfer pricing audits), the taxpayer must have the required documentation prepared and in good order, and be ready to submit it to the tax authority without delay upon a request made in the course of a transfer pricing audit. There is no threshold determining which taxpayers are subject to the requirements on the basis of turnover, corporate size, etc.

Disclosure by tax returns: In addition to the documentation requirement discussed above, all corporate taxpayers who engage in controlled transactions with foreign affiliates must attach to their corporate tax return a statement concerning foreign affiliates, referred to as Schedule 17(4). The statement requires disclosure of certain facts relating to the foreign affiliates and the controlled transactions, including the following:

— Corporate details:
  - Corporate name;
  - Headquarters;
  - Principal business;
  - Number of employees;
  - Amount of stated capital;
  - Classification/type of affiliated relationship;
  - Shareholding ratio;

— Profit/loss status of the foreign affiliates for the latest fiscal year:
  - Gross sales or turnover;
  - Operating expenses (costs of goods sold, and sales, general and administrative expenses);
  - Operating profits;
  - Earnings before taxes;
  - Retained earnings;

— Status of controlled transactions with foreign affiliates:
  - Type of controlled transactions (sale and purchase of inventory, provision of services, royalties for use of tangible property, royalties for use of intangible property, interest on loans, or other transactions);
  - Total amount received from or paid to the foreign affiliate, with respect to each type of the controlled transactions;
  - Transfer pricing methodology adopted by the taxpayer, with respect to each type of the controlled transactions;
  - Whether or not the taxpayer obtained an advance pricing arrangement (APA) with respect to the foreign affiliates.

The information to be disclosed on Schedule 17(4) is mere facts or numbers, and may not be very onerous to fill in. However, taxpayers should bear in mind that the information disclosed in Schedule 17(4) will be the basis for the Japanese tax authority to conduct a transfer pricing audit on the taxpayer. If there is any inconsistency between the information provided in Schedule 17(4) and the taxpayer's position on transfer pricing in a tax audit (especially in relation to the transfer pricing methodology) this would be a problem. As such, taxpayers must be cautious in preparing Schedule 17(4) and must bear in mind the possibility of a future transfer pricing audit.

2. What is the content of the documentation that must be prepared?

The regulations provide that the required transfer pricing documentation will include the following items:

— Terms and substance of controlled transactions with foreign affiliates, including:
  - Details of assets and services pertaining to the controlled transaction;
  - Functions performed and risks assumed by the taxpayer and the foreign affiliate in the controlled transaction;
  - Details of intangibles used by the taxpayer and the foreign affiliate in the controlled transaction;
  - Contractual documents pertaining to the controlled transaction;
  - Details of the amounts paid or received by the taxpayer to or from the foreign affiliate, as well as details of the negotiation of such amounts;
  - Details of the respective profits and losses of the taxpayer and the foreign affiliate pertaining to the controlled transaction (i.e., segmented P&Ls);
  - Market analysis and other market information pertaining to the controlled transaction;
  - Business policies of the taxpayer and the foreign affiliate; and
  - Details of other transactions closely related to the controlled transaction, if any;

— Calculation of the arm's length price of the controlled transaction, including:
  - The transfer pricing methodology adopted by the taxpayer for the controlled transaction, as well as the reasons for its adoption;
  - The process of selection of comparables for the controlled transaction and the details of the selected comparables;
  - If the taxpayer adopted the profit split method as the transfer pricing methodology, computation of respective profits of the taxpayer and the foreign affiliate, such as the factors used for the profit split;
  - If the taxpayer computed the arm's length price by treating several controlled transactions as one integrated transaction, the reasons for such computation and details of each of such controlled transactions; and
  - If the taxpayer made an adjustment of differences with respect to the comparables, the reasons for and the method of such adjustment.

With respect to the above-listed items, the subsequent 2011 annual tax reform has created the following important ramifications: first, with respect to the transfer pricing methodology adopted by the taxpayer, the 2011 annual tax reform has employed the so-called "best method rule," which, consistently with the OECD Guidelines, provides that the most appropriate transfer pricing methodology for the transaction(s) at issue must be applied. In this regard, it has become more important to describe in the documentation why the adopted transfer pricing methodology should be regarded as the "best method" among other methodologies. Second, with respect to the selected comparables, it must be noted that the 2011 annual tax reform has approved the concept of a "range" of arm's length price; so it would be important to describe in the documentation sufficient comparability of the comparables forming the arm's length range to be claimed by the taxpayer.

3. What is the deadline or timescale for providing transfer pricing documentation to the tax authorities (is it to be provided for example upon filing of the tax returns, at the beginning of a tax audit, or on the specific request of the tax authorities)?

This new documentation requirement will apply to transfer pricing assessments with respect to taxpayers' fiscal years beginning on or after 1 April 2010.

The taxpayer must be able to produce the required documentation, without delay, if audited for any of these fiscal years. Without exception, all Japanese corporate taxpayers who are subject to Japanese transfer pricing regulations (including of course Japanese subsidiaries of European companies, and Japanese parent companies having European subsidiaries) are required to comply. While the documentation must be provided "without delay" in a transfer pricing audit, there is no express requirement that the documentation must be contemporaneous, i.e., no specific deadline for its preparation. There is also no limitation on applicable foreign jurisdictions.

4. In the event that the documentation is not provided within the applicable timescale, or is incomplete, do documentation-related penalties apply in your jurisdiction? If so, please detail the penalties and the circumstances in which they do and do not apply.

Failure to comply with the documentation requirement could result in a transfer pricing assessment on the basis of a presumption by the Japanese tax authority as mentioned above, as well as associated deficiency penalty tax (as normally imposed); however, there is no special penalty directly linked to noncompliance with the documentation requirement per se. Even if the taxpayer complies with the documentation requirement, while it is able to avoid the presumption or use of "secret comparables", it will not follow that the taxpayer's transfer pricing methodology and the price computed thereunder will bind the Japanese tax authority and will be respected as the arm's length price. In other words, the taxpayer could still be subject to normal transfer pricing assessment and deficiency penalty tax as a result of the audit. It would be wrong to interpret the introduction of the new documentation requirement as effectively shifting the burden of proof from the Japanese tax authority to the taxpayer in a transfer pricing dispute; in other words, the amendment should have no adverse effect upon the burden of proof issues in a transfer pricing dispute.

As is obvious from the items that are required to be provided in the documentation as set out above, it could be very onerous to comply with the requirement. The documentation is not a matter of mere facts or numbers or mere retention of books and records, but requires quantitative and qualitative analysis and evaluation of transfer pricing, especially from an economic viewpoint. These exercises may be difficult to perform especially for small size corporate taxpayers who do not have sufficient internal resources for transfer pricing compliance. In addition, the language of the regulations suggests that the documentation should be prepared with respect to each of the controlled transactions that the taxpayer engages in (provided that some controlled transactions can be treated as one integrated transaction as mentioned above). This would entail not only an administrative burden, but also require the taxpayer to maintain consistency in its overall transfer pricing policy applicable throughout all controlled transactions. Taxpayers should be reminded of the necessity to establish a consistent global transfer pricing policy that could survive scrutiny in a transfer pricing audit.

5. Does the absence or incompleteness of documentation reverse the burden of the proof as regards the arm's length character of the transactions?

As it is relatively new, it is not yet established what the actual enforcement practice of the Japanese tax authority in relation to this documentation requirement would be like, including how complete and detailed the documentation must be with respect to each required item, and how vigorously the tax authority will try to pursue the presumption or use of "secret comparables" by alleging incompleteness of the documentation. For example, if the taxpayer fails to present the segmented P&Ls of the subject controlled transaction without delay, as it takes substantial time to produce the information, will the tax authority immediately proceed with the presumption, or are they, in practice, willing to wait? In this regard, the Japanese tax authority has clarified the practical enforcement policy, in conjunction with the 2011 annual tax reform, as follows: (i) if there is a reasonable cause for the taxpayer's failure to submit, another audit session should be set in a future date, (ii) if some audit sessions are held and a considerable time period has passed from the first request for submission, the tax authority should explain that the requirements for the presumption and use of "secret comparables" will be satisfied unless there is a prospect for the taxpayer to be able to submit the requested information, and, (iii) if "secret comparables" are to be used eventually, the tax authority should give the taxpayer sufficient explanation as to the selection, substance, etc. of such "secret comparables". It would be fair to say that, according to that policy, the Japanese tax authority would not unreasonably "abuse" the presumption and "secret comparables" but rather is willing to allow some reasonable time depending upon the taxpayers' circumstances. The practical enforcement policy also provides that, if the documentation prepared and submitted by the taxpayer is based upon inaccurate information, that will not constitute lawful submission of the required documentation, and the tax authority shall order re-submission based upon the accurate information. While the scope of application of this rule is not clear, the better view would be that the tax authority should not treat the taxpayer's documentation as inaccurate merely because the tax authority has a different view from the taxpayer's in terms of economic or other evaluation of the subject controlled transaction.

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