The Transfer Pricing Law Review

Fifth Edition

Editors
Steve Edge and Dominic Robertson

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THE TRANSFER PRICING LAW REVIEW

FIFTH EDITION

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Steve Edge and Dominic Robertson

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CONTENTS

PREFACE..................v
Steve Edge and Dominic Robertson

Chapter 1 BRAZIL..................1
Luciana Rosanova Galhardo and Felipe Cerrutti Balsimelli

Chapter 2 CANADA..................11
Jeffrey Shafer

Chapter 3 CYPRUS..................22
Kyriacos Scordis and Costas Michail

Chapter 4 DENMARK..................34
Martin Bay and Henrik Stig Lauritsen

Chapter 5 GERMANY..................42
Sven-Eric Bärsch and Vassil Tcherveniachki

Chapter 6 INDIA..................58
Mukesh Butani and Seema Kejriwal

Chapter 7 INDONESIA..................76
Romi Irawan and Yusuf Wangko Ngantung

Chapter 8 IRELAND..................88
Joe Duffy and Catherine O'Meara

Chapter 9 ISRAEL..................100
Eyal Bar-Zvi

Chapter 10 ITALY..................118
Franco Pozzi, Lisa Vascellari Dal Fiol, Stefano Grossi and Luca Consalter

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Chapter 11 JAPAN 132
Shigeki Minami

Chapter 12 LUXEMBOURG 144
Alain Goebel and Danny Beeton

Chapter 13 NETHERLANDS 156
Taco Wiertsema and Anne Verhagen

Chapter 14 NIGERIA 171
Lolade Ososami, Joseph Eimunjeze and Mojisola Jawando

Chapter 15 PORTUGAL 184
Susana Estêvão Gonçalves

Chapter 16 SPAIN 200
Raúl Salas Lúcia, Elena Ferrer-Sama Server and Pilar Vacas Barreda

Chapter 17 SWITZERLAND 216
Jean-Blaise Eckert and Jenny Benoit-Gonin

Chapter 18 UNITED KINGDOM 226
Steve Edge, Dominic Robertson and Tom Gilliver

Appendix 1 ABOUT THE AUTHORS 241
Appendix 2 CONTRIBUTORS' CONTACT DETAILS 253

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PREFACE

It has been a great pleasure to edit this fifth edition of *The Transfer Pricing Law Review*. This publication aims to give readers a high-level overview of the principal transfer pricing rules in each country covered in the *Review*. Each chapter summarises the country's substantive transfer pricing rules, explains how a transfer pricing dispute is handled, from initial scrutiny through to litigation or settlement, and discusses the interaction between transfer pricing and other parts of the tax code (such as withholding taxes, customs duties, and attempts to prevent double taxation).

Other than Brazil, all the countries covered in this *Review* apply an arm's-length standard and adhere, at least to some extent, to the Organisation for Economic Co-operation and Development Transfer Pricing Guidelines (the OECD Guidelines); and Brazil itself is considering aligning its TP rules with the OECD norm. However, as the chapters make clear, there remains significant divergence, both in countries' interpretation of the arm's-length standard (e.g., the transactions it applies to, the pricing methods preferred and whether secondary adjustments are imposed) and in the administration of the rules (e.g., the documentation requirements imposed, and the availability of APAs). Transfer pricing practitioners, therefore, cannot simply assume that the OECD Guidelines contain all the answers but must in fact engage with their detailed application within each country.

Given their economic importance, transfer pricing rules will be high on the corporate tax agenda (and the broader political agenda) for many years to come, and they are continuing to evolve at a rapid pace. Over the next few years, we expect the following to be among the main areas of focus.

First, the transfer pricing impact of the covid-19 pandemic still needs to be worked out by many countries, though the OECD should be commended for publishing clear guidance on this within a few months of the start of the pandemic. At this time last year, many advisers were arguing (in our view, rather optimistically) that companies that were rewarded on cost-plus or the transactional net margin method bases as routine service providers should, as a result of the pandemic, bear a share of the 'system losses' in groups that had been pushed into heavy loss-making positions by lockdowns or travel restrictions. The OECD guidance has largely rejected that approach, arguing that the existing arm's-length principle and the OECD guidelines remain fit for purpose during the pandemic. In particular, the guidance warns tax authorities to be sceptical of claims that a routine service provider should bear a share of residual losses, and notes (rightly, in our view) that this argument – if accepted – would likely require that entity to share in residual profits in happier times. Looking further forward, the experience from the 2008 financial crisis suggests that, in the medium term, the need for tax revenues is likely to push tax authorities towards a more assertive approach in transfer pricing cases.

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Second, a number of countries may see disputes over the extent to which transfer pricing can be used to recharacterise transactions, rather than merely to adjust the pricing of transactions. For example, the German courts have recently held that transfer pricing rules are not limited to pricing adjustments alone; and Ireland has introduced rules that enable the Irish Revenue to impose a 'substance over form' principle. In contrast, the Canadian courts ruled, in the *Cameco* case last year, that TP recharacterisation was permitted only where the underlying transactions were 'commercially irrational'.

Third, many countries are strengthening the requirements for contemporaneous transfer pricing documentation, either aligning with the OECD master file or local file model (as in Israel), or potentially going beyond this (as the UK has proposed).

Finally, the OECD/G20 project to address the tax consequences of digitalisation continues to work towards agreeing a solution in 2021, which has become more likely following the arrival of the Biden administration in January 2021. Immediately before this preface was written, the G7 finance ministers confirmed that they have agreed to a global minimum tax rate of at least 15 per cent; and, more significantly for transfer pricing purposes, a pivot away from the arm's-length standard for large and highly profitable multinationals, under which a portion of their profits (above a 10 per cent hurdle rate) would automatically be reallocated to market jurisdictions. This is, of course, a radical shift away from the traditional arm's-length standard, but it is worth emphasising that the arm's-length principle will continue to play a crucial role for large businesses and tax authorities. This is, first, because it will take several years for the reallocation rule to become embedded in national laws and double tax treaties; and, more enduringly, because the arm's-length standard will continue to apply (1) to the vast majority of businesses that fall outside the reallocation rule, either because of size or profit margins; and (2) to the majority of the profits of those businesses that are subject to the reallocation rule. Clearly, there is much more detail to come on these changes, and we look forward to seeing this discussed in depth in the next edition of the *Review*.

We would like to thank the authors of all the country chapters for their comprehensive and illuminating analysis of each country's transfer pricing rules; and the publishing team at Law Business Research for their diligence and enthusiasm in commissioning, coordinating and compiling this *Review*.

Steve Edge and Dominic Robertson
Slaughter and May
London
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Chapter 11

JAPAN

Shigeki Minami[1]

I OVERVIEW

i General

The principal Japanese transfer pricing legislation is Article 66-4 of the Special Taxation Measures Law (the Law) and Article 39-12 of the Enforcement Order thereof (the Order). For a taxpayer who files a consolidated tax return, Article 68-88 of the Law and Article 39-112 of the Order are applicable. While they are not legislation, the National Tax Agency of Japan (NTA) published detailed interpretations in respect of these statutory provisions in Chapter 12 of the Basic Circular of the Law (the Circular) and in the Commissioner's Directive on the Operation of Transfer Pricing (the Directive), under which the transfer pricing legislation is enforced.

The Japanese transfer pricing rules only cover income tax on corporations (under the Corporation Tax Law), and do not cover individuals or trusts (with certain limited exceptions).[2] The rules are applicable to transactions between a Japanese corporation (or a foreign corporation subject to the Japanese corporation income tax) and its 'foreign related corporation' (as defined by the Law). A foreign related corporation is defined, in essence, as a foreign corporation, controlling, controlled by or under common control of a Japanese corporation (i.e., a parent–subsidiary or brother–sister relationship), as measured by 50 per cent or more direct or indirect ownership, or by effective control through officers, business dependency or finance.

ii Conformity with OECD Guidelines

The Law and the Order spell out a set of transfer pricing methodologies that effectively follow the Organisation for Economic Co-operation and Development Transfer Pricing Guidelines (the OECD Guidelines). Specifically, the Japanese transfer pricing rules were overhauled in 2011 in response to the amendments to the OECD Guidelines in 2010, confirming the prevalence of the transactional net margin method (TNMM) as well as introducing the 'most appropriate method' rule and the 'range' concept. The 2013 amendment to the Order adopted the Berry ratio as another net profit indicator, in line with the OECD Guidelines. In 2016, in line with Action 13 of the OECD Base Erosion and Profit Shifting (BEPS) project, the Japanese government introduced new legislation adopting the three-tiered documentation approach, consisting of a master file, a country-by-country report (CbCR)

1 Shigeki Minami is a partner at Nagashima Ohno & Tsunematsu.

2 The Japanese transfer pricing rules cover individuals who are trustees for a trust treated as a corporation, or non-resident individuals doing business in Japan through their permanent establishments in Japan.

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and a local file. In 2019, in line with the OECD Guidelines as revised in 2017, the Japanese government introduced new legislation adopting the discounted cash flow method as another transfer pricing method, and price adjustment measures for hard-to-value intangible assets (see Section III.i below). The 2017 edition of the OECD Guidelines is used in practice, and the Japanese tax authority and courts can refer to paragraphs in that edition to help them determine whether transactions predating such Guidelines were at arm's length, as long as a specific paragraph in that edition is understood to clarify the rules and principles that were adopted in prior editions, rather than creating a new rule in the 2017 edition.

iii Covered transactions

The Japanese transfer pricing rules cover 'foreign related transactions' conducted between a Japanese corporation and its foreign related corporation; the rules cover any types of transactions that include, among others, purchases or sales of inventory or other property, leases, provision of services, sales or licensing of intangible assets, and borrowing or lending of money.

While the Japanese transfer pricing rules cover any income transactions, they are unlikely to be applied to capital contributions, even if it is theoretically possible. For example, when a Japanese parent company was deemed to have received shares in its Thai subsidiary in excess of the value of the new capital money that the Japanese parent contributed, the NTA invoked the rules for 'gift', not resorting to the Japanese transfer pricing rules, which was affirmed by the Tokyo High Court judgment, dated 24 March 2016.

II FILING REQUIREMENTS

In 2016, the new documentation rules introduced in line with Action 13 of the BEPS project adopted the contemporaneous documentation requirement, under which taxpayers have to prepare a local file by the filing date of a final corporation income tax return, which is within two months of a fiscal year end (or later if an extension is granted).

The legislation adopted the three-tiered documentation approach, under which separate master and local files, as well as a CbCR, are required. Any Japanese corporations and foreign corporations with permanent establishments in Japan that are a constituent entity of a multinational enterprise (MNE) group with total consolidated revenues of ¥100 billion or more in the previous fiscal year (specified MNE group) are subject to the foregoing documentation rules.

Such corporations must file (1) a notification for their ultimate parent entity, (2) a CbCR and (3) a master file with the Japanese tax authority online (e-tax). A local file is mandated for transactions with a foreign related corporation where the sum of the payments and receipts is ¥5 billion or more; or where the sum of the payments and receipts for intangible transactions is ¥300 million or more, in the previous fiscal year. Therefore, relevant companies must prepare a transfer pricing file every year (as long as the foregoing conditions are met) even if there is no change in circumstances (including the functions and risks of the relevant parties).

In a master file, a taxpayer is required to report, among other things, a description of the MNE's businesses, intangible assets, inter-company financial activities, and financial and tax positions.

In a CbCR, a taxpayer is required to report, among other things, an overview of income, taxes and business activities by tax jurisdiction, and a list of all the constituent entities of the MNE group per tax jurisdiction.

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In a local file, a taxpayer is required to report, among other things, a description of the local entity, a description of foreign related transactions (controlled transactions) and relevant financial information. The key component is the description of the taxpayer's foreign related transactions, in which functions regarding the material foreign related transactions must be provided (such as procurement of manufacturing services, purchase of goods, provision of services, loans, financial and performance guarantees, and licensing of intangible assets), accompanied by a detailed comparability and functional analysis and an indication of the most appropriate transfer pricing method with regard to the transactions and the reasons for selecting the applicable transfer pricing method.

As for the acceptable language, a master file can be prepared either in English or Japanese, and a CbCR must be prepared in English, while a local file must be prepared in Japanese.

Although the Japanese government will provide the CbCRs to tax authorities in other jurisdictions in accordance with the conditions and limitations under the relevant tax treaties, the law does not allow, nor is it expected to be amended to allow, disclosure of CbCRs to the public, as called for by some advocates.

III PRESENTING THE CASE

i Pricing methods

Current rules

The following methods are applicable to tangible property transactions, including the sale of inventories:

a the comparable uncontrolled price (CUP) method;
b the resale price method;
c the cost-plus method;
d the transactional net margin method (TNMM);
e the quasi-CUP, quasi-resale price and quasi-cost-plus methods, and quasi-TNMM; and
f the profit split method.

Methods equivalent to those methods listed above are applicable to transactions other than tangible property transactions, namely, intangible property transactions, services transactions and loans or advances.

The most-appropriate-method rule, which is equivalent to the best-method rule, has been employed in Japan. Japanese transfer pricing rules identify the following factors as relevant in selecting the most appropriate method in line with the OECD Guidelines:

a the respective strengths and weaknesses of the transfer pricing methods codified in the rules;
b the appropriateness of each potential transfer pricing method considered in view of the nature of the controlled transaction at issue, determined in particular through a functional analysis;
c the availability of the information needed to apply each potential transfer pricing method; and
d the degree of comparability between the controlled transaction at issue and comparable transactions (including the reliability of the comparability adjustments).

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In recent years, the TNMM has been the most prevalent method in practice, and accounts for 60 per cent of the mutual agreement procedure (MAP) cases, including advance pricing agreement (APA) cases, completed by the Japanese tax authority in 2019. For service transactions, the cost-plus method is often used if no significant intangible asset is involved. For loans or advances, the quasi-CUP method is often applicable by referring to the terms and conditions of similar transactions under similar conditions. For transactions involving intangible assets, see Section IV below.

Introduction of the discounted cash flow method in 2019

Under the 2019 Tax Reform, the discounted cash flow method (the DCF method) was introduced as another transfer pricing method for producing arm's-length prices. The DCF method will be the most appropriate method when a transaction involves intangible assets and comparable transactions cannot be identified, as would be the case with most intangible-asset transactions. A typical example would be the transfer of a valuable patent from a Japanese company to its foreign related corporation, where comparable technologies are not traded in the open market. Although the DCF method has been prevalent in the business community, the OECD Guidelines indicated concerns over its practical applications in the context of transfer pricing, citing its considerable volatility subject to even small changes in the underlying assumptions or the valuation parameters. Specifically, the Guidelines point out, 'Under this approach, valuation requires, among other things, defining realistic and reliable financial projections, growth rates, discount rates, the useful life of intangible assets and the tax effects of the transaction', which would be closely examined by the Japanese tax authority if the DCF method were to be adopted by the taxpayer.

As symmetrical treatment, the DCF method may be adopted by the Japanese tax authority when presumptive taxation is triggered (see Section III.ii below).

Introduction of price adjustment measures for hard-to-value intangible assets in 2019

In line with the OECD Guidelines as revised in 2017, Japan adopted price adjustment measures for hard-to-value intangible assets under the 2019 Tax Reform. The new rules are typically applicable when unique intangible assets are transferred from a taxpayer to its foreign related corporation in consideration for a price calculated by the DCF method. The adjustment will be triggered when the actual results are different from the *ex ante* projections used for the calculation of the arm's-length price, in which case the Japanese tax authority will be allowed to make assessments by presuming the amount calculated using the transfer pricing method the tax authority deems the most appropriate after considering the actual results of the subject transaction and the likelihood of the events that caused the difference; however, if the difference between the adopted price and the price (not revenue) calculated by the foregoing method is within 20 per cent, the adjustment will not be triggered.

The foregoing price adjustment measures are not triggered if the following documents are filed by the taxpayer within a certain fixed period:

a documents that describe details of projections used for calculating the arm's-length price, and documents that demonstrate that the events that caused the difference between the projections and the actual results were extremely difficult to foresee (such as natural disasters or other similar events) or that the arm's-length price was calculated after appropriately considering the likelihood of the foregoing causal events at the time of the transaction; or

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b documents that demonstrate that there is a difference of less than 20 per cent between (x) the projected revenues (not price) and (y) the actual results for the five-year period after the subject intangible assets begin to generate revenues from third parties.

Adjustments under an interquartile range

Until 2019, the Japanese transfer pricing rules did not adopt an interquartile range concept, except in the context of APAs. The 2019 Tax Reform introduced an interquartile range for the purpose of documentations and assessments. Under the new rules, an interquartile range can be used to adjust the differences between the tested party and the comparable companies, which are difficult to gauge in a 'quantitative manner' as long as the differences are immaterial. The differences in capacity utilisation and asset intensity are examples of those that can be gauged in a quantitative manner. Conversely, the differences in the nature of a business model and geographical markets are those that are difficult to gauge in a quantitative manner. Such differences, if immaterial, would be adjusted using an interquartile range, where a range of the net profit indicator is recognised with the numbers that are above the lowest 25 per cent and below the top 25 per cent for comparable companies.

ii Authority scrutiny and evidence gathering

The Japanese tax authority does not necessarily ask to have discussions with witnesses within or outside the taxpayer group, including the taxpayer's customers. However, the taxpayer definitely requires the assistance of experts or professionals within or outside the taxpayer group in preparing the transfer pricing documentation or during audits by the tax authority, as the demonstration of an appropriate transfer pricing methodology involves highly sophisticated economic analysis and extremely technical legal arguments.

The Japanese tax authority does not use dawn raids for transfer pricing audits in general, as transfer pricing audits concern evaluation or judgement on pricing, not factual issues involving hiding or disguising assets or documents.

The Japanese tax authority is allowed to resort to 'presumptive taxation' and may inquire about and inspect third parties operating similar businesses ('secret comparables'), if a taxpayer fails:

a for non-exempt transactions (see below), to submit a local file by the day designated by the tax examiner that falls within 45 days of the tax authority's request, or to submit documents 'important for calculating the arm's-length price' by the day designated by the tax examiner that comes within 60 days of the tax authority's request; or

b for exempt transactions (see below), to submit documents important for calculating the arm's-length price by the day designated by the tax examiner that falls within 60 days of the tax authority's request.

For this purpose:

a non-exempt transactions (subject to the local-file obligations) are transactions with a certain foreign related corporation with which:
- the sum of payments and receipts is ¥5 billion or more; or
- the sum of payments and receipts for intangible transactions is ¥300 million or more, in the previous fiscal year; and

b exempt transactions are transactions with a certain foreign related corporation with which:
- the sum of payments and receipts is less than ¥5 billion; and

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- the sum of payments and receipts for intangible transactions is less than ¥300 million, in the previous fiscal year.

CbCRs changed the transfer pricing landscape. The first CbCRs were due on or after 31 March 2018, and show potential imbalances of taxable income per jurisdiction, and more effectively help the Japanese tax authority claim revenue losses due to inappropriate transfer pricing and initiate transfer pricing audits. In 2018, the Japanese tax authority received 2,100 CbCRs from the tax authorities of 42 jurisdictions and provided 831 CbCRs to tax authorities in 51 jurisdictions. The Japanese tax authority is expected to examine these CbCRs and to discover unprofitable Japanese companies with highly profitable foreign affiliated companies.

IV INTANGIBLE ASSETS

i Definition of intangible assets

Under the 2019 Tax Reform, intangible assets are defined as 'assets other than tangible assets and financial assets that are owned by companies, for which consideration would be paid in the event they were transferred or lent out in accordance with ordinary terms entered into between independent parties' for the purposes of Japanese transfer pricing rules. This definition is in line with the amended OECD Guidelines.[3] This clarification is intended to distinguish intangible assets from market conditions or local market circumstances. For example, if a non-Japanese company asserts that its Japanese affiliate earns excess profit in Japan on account of the intangible assets owned by the non-Japanese company (for which the non-Japanese company should be compensated), the Japanese tax authority may take the position that the excess profit is due to the market conditions proper to Japan, and not attributable to the intangible assets owned by the non-Japanese company (for which the non-Japanese company should not be paid). Under the 2017 edition of the OECD Guidelines, the latter position is no longer sustained unless such market conditions are reflected in profitability of comparable companies.

ii Licensing of intangible assets

Under Japanese transfer pricing rules, for transactions involving intangible assets, the following methodologies can be applied.

Quasi-CUP method

For a licensing transaction, the quasi-CUP method is likely to be the most appropriate method as long as a comparable transaction can be identified. However, since each intangible asset has its own unique character and varies from others, it would be rare for it to be the most appropriate method, except where the internal comparable transactions are identified.

TNMM

In the context of licensing transactions, when only one party contributes to the development, enhancement, maintenance, protection and exploitation[4] of the subject intangible asset, and the other party's functions are simple, such as only manufacture or sale, the TNMM is likely

3 OECD Guidelines as revised in 2017, Chapter VI, Paragraph 6.6.

4 Known as DEMPE functions.

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to be the most appropriate method. In such cases, the party not involved with the intangible asset will be examined, and it is necessary to identify companies comparable to the examined party, whose operating profits relative to sales or full costs, or Berry ratio (i.e., the ratio of gross profit to operating expenses), will be the net profit indicator (benchmark) for the examined party.

Residual profit split method

When both parties subject to a transaction perform 'unique functions' by engaging in the 'creation, maintenance or development' of the intangible asset, the NTA has a tendency to apply the two-stage residual profit split method (RPSM), which is presumably the most appropriate method. The OECD Guidelines[5] state:

> *The functional analysis should identify the relevant intangibles at issue, the manner in which they contribute to the creation of value in the transactions under review, the important functions performed and specific risks assumed in connection with the development, enhancement, maintenance, protection and exploitation of the intangibles and the manner in which they interact with other intangibles, with tangible assets and with business operations to create value.*

The Japanese transfer pricing rules adopted similar rules before the OECD Guidelines were revised in 2017. Specifically, Section 3-12 of the Directive indicates how an intangible asset is recognised in the context of the transfer pricing, stating that the degree of contribution by the parties to the 'creation, maintenance or development' of the intangible asset needs to be examined.

For example, if a certain party has made a decision with substantial discretion in conducting the research and development (R&D) services, and takes risks associated with the R&D activities, then that party will be found to have significantly contributed to the creation of an intangible asset. If both parties are found to be involved in the creation, maintenance or development of the intangible asset, the RPSM is likely to be the most appropriate method. Under the two-stage RPSM, the combined profits from the subject transaction are identified, from which 'routine profits' are assigned to each party based on the benchmark analysis (using companies comparable to each party). The 'residual profits', which are produced by subtracting the foregoing routine profits from the combined profits, will be assigned to each of the relevant parties in proportion to the 'degree of contribution', which can be presumed based on the value of the intangible assets owned by the relevant parties, or the expenses paid for the development of the intangible assets. However, in practice, the Japanese tax authority usually adopts the relevant expenses (such as those paid by the respective parties for R&D) as the parameters and the 'value' of the intangible asset is rarely used.

iii Sales of intangible assets

For sales of intangible assets, the Circular lists the quasi-CUP and quasi-cost-plus methods as candidate transfer pricing methods. However, it is extremely difficult and practically impossible to identify comparable transactions for the sale of intangible assets given the uniqueness inherent in each intangible asset. Therefore, if the arm's-length price of an intangible asset is at issue during a tax audit, the audit tends to become more controversial

5 OECD Guidelines as revised in 2017, Chapter VI, Paragraph 6.12.

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than normal. In line with the revised OECD Guidelines, suggesting the viability of the DCF method, the Japanese tax authority has adopted this method as being applicable to sales of intangible assets (see Section III.i above). Apparently, however, the Japanese tax authority is reluctant to apply the DCF method to license of intangible assets.

V SETTLEMENTS

Under Japanese tax law, the prevailing view is that the Japanese tax authority is not supposed to enter into a settlement with taxpayers, not only for transfer pricing cases, but also for any tax disputes; this is based on the idea that tax law should be applied impartially, without the tax authority exercising any discretion. However, in practice, the Japanese tax authority may suggest during a tax audit that the taxpayer voluntarily amend the original tax return to the tax amount that the tax authority indicates. After discussions, if the taxpayer and the tax authority agree on a middle ground, and the taxpayer makes a corrective filing in accordance with their mutual agreement, it will effectively close the case. Although this is not a 'settlement' in a legal sense, the end result is similar.

Even if a settlement is reached for a certain fiscal year, it will not automatically be incorporated into an advance pricing agreement (APA). Therefore, if the settlement is acceptable, even if not desirable, to a taxpayer, an APA could be a recommended course of action to ensure that the tax authority will not take a more disadvantageous position to the taxpayer in the future.

VI INVESTIGATIONS

The Japanese tax authority's assessments based on the Japanese transfer pricing rules must be made within six years (or seven years for fiscal years beginning on or after 1 April 2020) of the deadline for the filing of the relevant corporation income tax return. Within this period, the tax authority may review a transfer pricing filing without any other time limitations. Generally, a transfer pricing audit takes a significant amount of time, and may take one year, or even two or three years in some cases.

When the Japanese tax authority makes an assessment by issuing a correction notice, the taxpayer has two options. The first is to seek administrative remedies, followed by judicial review (which can be initiated before the final resolution of the administrative remedies under certain conditions). The second is to seek competent authority relief from double taxation if a relevant tax treaty so provides.

Generally speaking, with respect to a transaction involving a country where competent authority relief is effective, taxpayers tend to seek it. The Japanese tax authority has received a number of requests for competent authority relief (including APAs) with OECD member countries. Particularly with Australia, Germany, Korea, the United Kingdom and the United States, most of the requests have been successfully resolved by agreements between both relevant governments. In addition, the Japanese government has had APAs with non-OECD member countries, including China, Hong Kong, India, Indonesia, Singapore, Taiwan, Thailand, Malaysia and Vietnam; however, with respect to competent authority relief with non-OECD member countries, precedents are relatively few.

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With respect to a transaction involving a country where competent authority relief is ineffective (even if a relevant treaty allows such relief) or not available in the first place, administrative remedies and judicial review will be the only practical option that the taxpayer may seek.

VII LITIGATION

i Procedure

In response to a transfer pricing assessment, when a taxpayer does not or is not able to seek competent authority relief, the taxpayer may resort to the administrative appeals process to dispute the assessment. The taxpayer is required to exhaust the administrative appeals process before seeking judicial review. In general, the administrative appeal consists of two steps: a request for re-examination, and an appeal to the National Tax Tribunal (the Tribunal). The taxpayer is able to choose to proceed with the entire process, namely a request for re-examination, followed by an appeal to the Tribunal if the re-examination decision is unsatisfactory. Alternatively, the taxpayer is able to unconditionally skip the request for re-examination and file an appeal with the Tribunal directly. For a request for an initial administrative appeal, the filing period (either for a request for re-examination or for direct appeal with the Tribunal) is three months from the date of delivery of a correction notice.

In the litigation, expert witnesses are rarely called to testify, although taxpayers (commonly), and the tax authority (less frequently), submit analytical evidence prepared by economists or other transfer pricing experts. The courts review all of the evidence and decide to adopt that which the courts hold is persuasive.

ii Recent cases

During the 2000s, the Japanese tax authority tended to apply the RPSM to cases involving valuable intangible assets, resulting in assessments being made for significantly large amounts of income. However, the courts have taken a stringent position in finding comparability between an examined party and comparable companies for the purpose of calculating routine profits under the RPSM, which was shown in the Tokyo High Court judgment dated 13 May 2015, where Honda Motor Company Limited, a major Japanese automobile manufacturer, obtained a cancellation of an assessment of ¥25.4 billion in taxable income. In the judgment, the Court held that the tax authority's selection of companies allegedly comparable to the examined party (the taxpayer's foreign subsidiary) was illegal, based on the finding that the examined party was doing business where tax incentives had been offered – specifically, in the Manaus Free Trade Zone in Brazil – whereas the alleged comparable companies identified by the Japanese tax authority had been located outside the Zone. The judgment is significant since it indicated that market conditions (including governmental regulations and interventions) are material in a comparability analysis.

In contrast, in support of the continued use of the RPSM by the Japanese tax authority, the Tokyo District Court judgment dated 24 November 2017 affirmed the assessment made by the Japanese tax authority applying the RPSM to licensing and sales transactions between a Japanese manufacturer, C Uyemura & Co, Ltd, and its Taiwanese, Malaysian and Singaporean subsidiaries. The Court recognised that the Japanese parent had intangible assets created by its research and development activities and its technical support provided to its foreign subsidiaries and customers. The Court also recognised that the Taiwanese, Malaysian and Singaporean subsidiaries had created intangible assets by penetrating the regional markets

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and cultivating and maintaining customers. This is the first case in which a Japanese court has affirmed the application of the RPSM adopted by the Japanese tax authority following the tax authority's losses in high-profile cases such as the *Honda* case (discussed above) and the *Takeda Pharmaceutical Company Limited* case (where the National Tax Tribunal cancelled a transfer pricing assessment based on the RPSM in the amount of ¥24.6 billion).

Following the initial court approval of the RPSM in the foregoing case, the court declined again to approve the Japanese tax authority's application of the RPSM in a case involving NGK Insulators Ltd (a leading ceramic manufacturer). On 26 November 2020, the Tokyo District Court ordered the cancellation of an approximately ¥5.8 billion assessment that had been based on the application of the RPSM to the licence transaction with its Polish subsidiary.

Another noteworthy case was a taxpayer's successful challenge of a transfer pricing assessment involving very significant intangible assets, namely Disney characters. The Tokyo District Court judgment dated 11 April 2016 cancelled the assessment based on the resale price method, in which the Japanese tax authority had found the gross margin obtained by the Japanese reseller (named 'Disney World of English') to be below the benchmark that the tax authority calculated by averaging the gross margin earned by the other resellers that the authority identified as comparable. The Court disagreed with the Japanese tax authority and held that the use of Disney characters by the Japanese taxpayer reseller was idiosyncratic and distinguished the taxpayer from the other resellers since the Disney characters were far more widely recognised and had an even stronger customer appeal than any intangible assets used by the other allegedly 'comparable' companies. Therefore, the Court held that the 'comparable' transactions the Japanese tax authority had identified were not in fact comparable and thus no arm's-length price had been demonstrated by the tax authority. This exemplifies the significance of intangible assets in measuring the profitability of taxpayers and determining comparability of potential 'comparable' transactions.

VIII SECONDARY ADJUSTMENT AND PENALTIES

Under Japanese transfer pricing rules, if a cross-border payment of interest or royalties is recalculated and decreased as a result of a transfer pricing assessment, the transfer pricing assessment has no effect on the underlying substantive transactions. Therefore, for example, even if a royalty payment from a Japanese licensee to its foreign related corporation as a licensor is decreased for Japanese transfer pricing purposes, it will not oblige the Japanese licensee to receive the difference back from its foreign related licensor, and the Japanese licensee is not eligible for a refund of any part of the withholding tax that was paid based on the original royalty amount notwithstanding the decreased amount of the royalty for transfer pricing purposes. In addition, a reduced rate under a relevant tax treaty may not be available with respect to the amount in excess of the arm's-length price, which will result in additional withholding tax. However, if the Japanese licensee does choose to receive back the difference, under a certain clause in the Circular, provided that a certain report is filed with the relevant tax office, the amount that the Japanese licensee receives back will not be subject to the Japanese corporation income tax, while the analysis for the withholding tax set out above will not change.

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IX BROADER TAXATION ISSUES

i Diverted profits tax, digital sales taxes and other supplementary measures

There are no diverted profits taxes or similar taxes under Japanese law and no immediate proposals have been made for such taxes. Furthermore, the Japanese government has not made any immediate proposals for digital sales taxes. There is no multinational anti-avoidance law or anything similar to the US BEAT/GILTI regime.

ii Tax challenges arising from digitalisation

The Japanese government has been proactively participating in and leading discussions regarding the Inclusive Framework Pillar One and Global Anti-Base Erosion (GloBE) proposals. Nevertheless, considering the potential impacts on Japanese companies operating internationally, the Japanese government argues that companies that allocate profits appropriately in market countries should not be materially affected by the reforms, representing the voices of Japanese multinational companies.

For Pillar Two, the Japanese government appears to support the global minimum tax regime currently proposed by the OECD, although Japanese multinational companies are particularly nervous about the minimum taxes being applicable to subsidiaries operating in emerging markets that have manufacturing or distribution functions. While such subsidiaries in emerging countries are exempt from the Japanese controlled foreign corporation (CFC) regime due to their substantive activities in the emerging countries, they may not be exempt due to their engagement in active businesses and would be subject to the new minimum taxes under Pillar Two because it is expected not to exclude low-taxed subsidiaries owing to their substance.

iii Transfer pricing implications of covid-19

After the World Health Organization recognised covid-19 as a potential pandemic on 11 March 2020, governments around the world, including the Japanese government, took emergency action. Lockdowns and other preventive measures worldwide have restricted economic activity with an enormous impact on global and Japanese economies. Companies will certainly suffer tremendous losses, raising the question of which parties will assume such losses, or, if both parties are to assume such losses, how the losses will be allocated between the parties for transfer pricing purposes. It is likely that parties will have to deal with possible disagreements with the respective governments in relation to transfer pricing calculations determined after the crisis impacted the economy. In accordance with the transactional net margin method (TNMM), which is the prevailing transfer pricing method in Japan, a party that performs simple or routine functions is deemed to be a contractor that does not assume any business risks and could supposedly be compensated based on fixed fees regardless of any economic losses from an overall transaction. If some governments take such a position, the taxpayer will be required to pay corporate income tax despite its financial losses. Even if a taxpayer tries to defend itself by benchmarking based on comparable companies, identifying comparable transactions may not be easy given the extraordinary nature of the crisis. Taxpayers are encouraged to delineate specifically how covid-19 caused their sales to drop and to identify justifiable reasons as to why the taxpayer, as opposed to the other party, is suffering losses.

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The OECD published the 'Guidance on the Transfer Pricing Implications of the COVID-19 Pandemic' on 18 December 2020, which was approved by the 137 members of the Inclusive Framework. Because Japan has joined the Inclusive Framework, the Japanese government is expected to follow the Guidance and taxpayers are advised to adopt the appropriate strategies suggested in the Guidance to cope with the irregular incidences of 2020.

iv Double taxation

Japan has an APA programme, which may be effective depending upon the counter-party countries (see Section VI above). Bilateral as well as unilateral APAs are available; in practice, multilateral APAs are rare.

In general, any transaction types or issues with foreign related corporations can be covered by APAs. A taxpayer must submit to the relevant regional tax bureau of the NTA a proposed method to calculate the arm's-length price and the relevant materials to support the proposed method, for review by the relevant section of the regional tax bureau. The taxpayer needs to pay no user fees for an APA application.

Roughly speaking, it often takes approximately two to three years to obtain a bilateral APA. According to the NTA, it took 34.1 months on average for a bilateral APA or MAP in 2018. In practice, APAs often cover five years. Rollback is also available. The key advantage of obtaining an APA with the tax authority is the avoidance of transfer pricing disputes in the future; the key disadvantages are that it is time-consuming and costly.

v Consequential impact for other taxes

In practice, transfer pricing assessments do not affect value added tax ('consumption tax' under Japanese tax law), or import or customs duties.

X OUTLOOK AND CONCLUSIONS

In 2018, there were 257 enforcements, assessments or amendments in respect of transfer pricing imposed or suggested by the Japanese tax authority, amounting to ¥36.5 billion, which represented a significant increase in number but a decline in monetary amount compared to 2005, in which there were 178 enforcements, assessments or amendments, amounting to ¥43.5 billion. This shows that investigations are now being directed at a wider range of companies, encompassing not only large companies, but also small to medium-sized companies, while the amount involved in each case has become smaller, possibly because of the tax authority's more prudent approach.

The BEPS initiative could significantly change transfer pricing in Japan. Before the introduction of CbCRs, the Japanese tax authority had no effective measures to obtain information regarding the taxpayer's global tax position, which is necessary to assess the profit share per jurisdiction in respect of Japanese taxpayers. However, as the first CbCRs were due on or after 31 March 2018, depending on the taxpayer's fiscal year, the Japanese tax authority is expected to be keen to examine the CbCRs to find potential imbalances of taxable income per jurisdiction and identify revenue losses due to inappropriate transfer pricing so that it can pursue transfer pricing audits more effectively.

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Appendix 1

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Shigeki Minami is a lawyer licensed in Japan and a partner at Nagashima Ohno & Tsunematsu, Tokyo. He served as the chair of the International Fiscal Association (IFA), Asia-Pacific Region until 2018, and is an active member of the Practice Council of the International Tax Program at New York University School of Law. His practice focuses on tax law matters, including transfer pricing, international reorganisations, anti-tax haven (CFC) rules, withholding tax issues, and other international and corporate tax issues, and, with respect to such matters, he has acted as counsel in various tax disputes on behalf of major Japanese and foreign companies. His recent achievements include the successful representation of a Japanese multinational company in a transfer pricing dispute before the National Tax Tribunal, which resulted in the cancellation of an assessment of more than US$100 million, and the successful representation of a US-based multinational company in a tax dispute involving an international reorganisation before the Japanese court, which resulted in the cancellation of an assessment of more than US$1 billion.

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