
Outline of 2016 Tax Reform pertaining to Japanese Transfer Pricing Documentation

January 2016

In brief

On 24 December 2015, the Japanese Cabinet approved the 2016 tax reform proposal (“2016 Tax Reform”), which includes revised Japanese transfer pricing (“TP”) documentation requirements. The revisions are based on recommendations contained in the “Transfer Pricing Documentation and Country-by-Country Reporting, Action 13 2015 Final Report” (“Action 13 Report”) published on 5 October 2015 as part of the BEPS Project carried out by OECD and G20.

Under the reform, the preparation and filing of a “Master File” and a “Country-by-Country Report” (“CbC Report”) will principally be required of the ultimate parent company of a multinational enterprise (“MNE”). Additionally, the new rules will require the contemporaneous preparation of a “Local File” by all taxpayers who meet a transaction threshold. The contents of the Local File are those set out in Article 22-10 (1) of the Ordinance for Enforcement of the Act on Special Measures Concerning Taxation of Japan (the “ASMT Ministerial Order”), which will be changed slightly for some clarifications and the addition of some reportable items by the reform.

This newsletter provides an outline of the revised TP documentation requirements in Japan, with reference to the relevant recommendations in the Action 13 Report, and highlights some of the potential implications for taxpayers in Japan.

In detail

1. TP documentation requirements

The 2016 Tax Reform includes new TP documentation requirements for the preparation of a Master File, Local File and CbC Report in Japan, and the filing of the Master File and CbC Report. The required documentation is consistent with the three-tiered approach to TP documentation set out in the Action 13 Report. The Master File and CbC Report are newly required, while the Local File is largely equivalent to the documentation currently required to be prepared under the ASMT Ministerial Order. More specific details of each of the requirements are provided below, although there are still areas of uncertainty that should be clarified at a later date by Order or Directive.

1.1 Master File

The Master File provides an overview of the MNE for the relevant tax administrations to evaluate the presence of significant TP risks. Thus, the Action 13 Report explains that the Master File should include the nature of the MNE’s global business operations, its overall transfer pricing policies, and its global allocation of income and economic activity. However, the Master File is only intended to provide a high-level overview of the MNE’s TP pricing practices, and detailed information is not intended to be provided.

The submission and filing of the same general information as set out in the Action 13 Report will be required in Japan for taxpayers belonging to an MNE that meets a threshold test of group consolidated revenues of over JPY100 billion (in the preceding fiscal year). Submission will thus be required for both (a) Japanese headquartered MNEs, and (b) subsidiaries or branches of foreign headquartered MNEs, where the MNE to which they belong meet this test. In the latter case, submission will be required without recourse by the Japanese government to the exchange of information provision of tax treaties (unlike for the CbC Report).

The Master File can be prepared in either Japanese or English. The law will be effective for taxpayers' fiscal years beginning on or after 1 April 2016, with the submission deadline one year following the close of the ultimate parent company's fiscal year to which the Master File relates. The submission must be made electronically.

1.2 Local File

The Action 13 Report provides that the Local File should contain more detailed information relating to specific intercompany transactions, in compliance with the applicable tax laws of each local jurisdiction. According to the Action 13 Report, the information required in the Local File supplements the Master File and helps to meet the objective of assuring that the taxpayer has complied with the arm's length principle.

As the contents specified in the Action 13 Report are largely equivalent to the documentation already listed in the ASMT Ministerial Order, law changes to be made to adopt the Local File requirement in Japan will be limited to some clarifications and the addition of some reportable items.

Both Japanese parent companies of MNEs and Japanese subsidiaries (of both Japanese parent companies and foreign parent companies) will be required to prepare Local Files covering their own related party transactions, effective for fiscal years beginning on or after 1 April 2017. The reason for the one year delay in implementation versus the Master File and CbC Report is that a contemporaneous preparation requirement is also being introduced for the Local File. It will apply to taxpayers having transactions with a related party that exceeded a total transaction amount in the preceding tax year of JPY5 billion or with intangible property transactions with a related party that exceed a total transaction amount in the preceding tax year of JPY300 million. For taxpayers with such transactions, the Local File must be prepared at the time the taxpayer's corporate tax return for the relevant year is filed (the contemporaneous requirement); the corporate tax return is generally due three months after the fiscal year end. Given the short time frame within which the Local File must be prepared following year end, the reform provides an additional one year for taxpayers to prepare.

The requirement for submission of the Local File will continue to be without delay upon request in an audit. Moreover, for those taxpayers that do not meet the transaction threshold described above, the contemporaneous preparation deadline will not apply.

The reform also adds a provision that specifically defines "without delay" for purposes of submission of TP documentation. For taxpayers that meet the transaction threshold described above (i.e., those that are required to prepare documentation contemporaneously), the deadline is 45 days. For taxpayers that do not meet the transaction threshold (i.e., those that are not required to prepare documentation contemporaneously), the deadline is 60 days.

1.3 CbC Report

Per the Action 13 Report, the CbC Report provides aggregate tax information for each jurisdiction in which the MNE operates, including information relating to the global allocation of income, the taxes paid, and certain indicators of the locations of economic activity. The report includes a listing of all the MNE entities, specifying the nature of the main business activities carried out by each entity. The Japan CbC Report will be in the same format as Annex III of the Action 13 Report, and must be prepared in English only.

As with the Master File, filing of the CbC Report will be required in Japan for taxpayers belonging to an MNE that meets the threshold test of group consolidated revenues of over JPY100 billion (in the preceding fiscal year). Submission will thus be required for both (a) Japanese parent companies of

MNEs, and (b) Japanese subsidiaries or branches of foreign headquartered MNEs, if they meet this test. In the latter case, Japan will use the exchange of information provisions of its tax treaties in order to obtain a copy of the CbC Report. If, however, the treaty partner does not provide a copy of the CbC Report (or if the jurisdiction of the Japanese subsidiary's or branch's ultimate parent company has no treaty with Japan), the subsidiary or branch in Japan will be required to submit the CbC Report itself.

The CbC Report will be required for taxpayers' fiscal years beginning on or after 1 April 2016, with the submission deadline one year following the close of the ultimate parent company's fiscal year to which CbC Report relates. The submission must be made electronically.

2. Penalties

The reform implements penalties for a failure to file the Master File and/or CbC Report by the due date. The exact nature of these penalties and to whom they apply will be clarified in a later Order or Directive.

The reform does not implement any monetary penalty for failure to prepare the Local File contemporaneously, or for failure to submit the Local File upon request in an audit within the 45 or 60 day period. However, the reform does reemphasize the current law, which provides that where TP documentation is not provided "without delay" when requested in an audit, the tax examiners may raise an assessment by using the so-called "presumed method" or by using secret comparables. The presumed method allows the tax examiners to raise an assessment using a relaxed standard of comparability (which presumably would result in a large assessment). The examiners' ability to use the presumed method or secret comparables is thus the effective "penalty" for failure to provide the requested documentation.

3. Recommended Taxpayer Actions

The objectives of the new TP documentation rules are, in line with the recommendations of the Action 13 Report, to ensure (i) that taxpayers give appropriate consideration to TP requirements when establishing prices for transactions between related companies, and (ii) to provide tax authorities with the information necessary to conduct an informal TP risk assessment before conducting a TP examination. Therefore, the TP documents are designed to demonstrate the appropriateness of the taxpayer's TP policies and procedures, and, where properly prepared, they may well reduce the risk of a TP audit (and potential assessment).

As has been described above, however, the new TP documentation rules require more information to be provided by taxpayers that belong to MNEs that meet the group consolidated revenue threshold than previously, and must be prepared and/or submitted within certain deadlines not contained in the existing rules. In view of this, it is recommended that companies commence preparation earlier than in the past, in order to allow sufficient time to collect and analyse the necessary information, and to prepare their TP documentation, appropriately. This is particularly the case for Japanese headquartered MNEs, given the significant new requirements of the Master File and CbC Report.

The new preparation and submission deadlines for the Local File should also be noted, as these are a departure from the current TP documentation rules, which do not have specified due dates. If the Local File is not submitted within 45 (or 60) days upon request by the tax authorities, it may result in the application of the presumed method (or the use of secret comparables). It should be noted that, because the current law does not define "without delay", it is not clear where the tax authorities' ability to use the presumed method or secret comparables applies, which may have caused tax examiners to be reluctant to use them until now. The clarification in the 2016 Tax Reform of the time within which documentation must be submitted may make the tax examiners less reluctant to use the presumed method or secret comparables where documentation is not timely submitted. Also, although the 45 or 60 day period may seem a comfortable amount of time to prepare documentation "when requested in an audit", the fact is that the resources required to manage other audit requests make it difficult to do so. Moreover, these time frames do not allow much time for appropriately dealing with unusual or unexpected transactions or results that may arise in the documentation. Thus, the addition of these deadlines to the law, along with the increasing number of requests for submission of TP documentation in audits, leads to a strong recommendation that all taxpayers prepare their transfer pricing documentation well in advance of any audit commencing.

Let's talk

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

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