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## Japan Advance Pricing Agreements in View of Covid-19 Disruptions

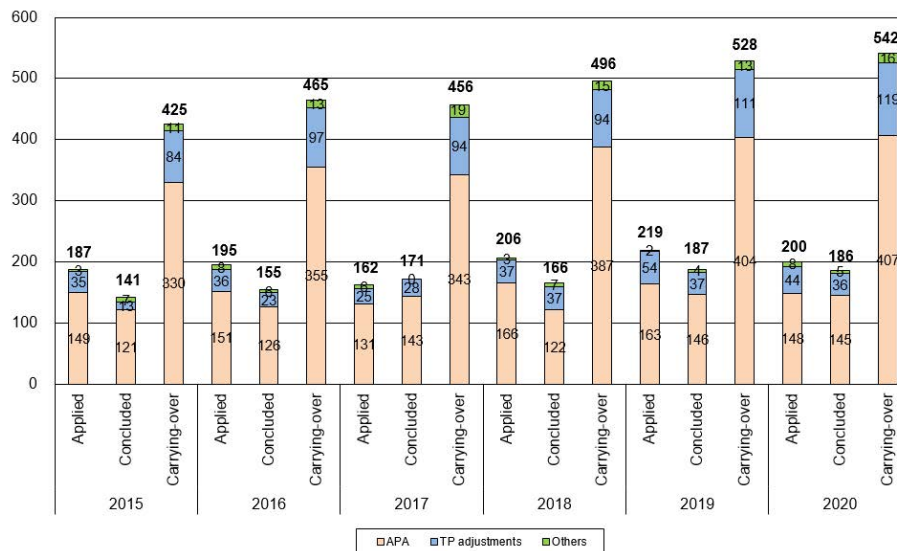


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### APA CLIMATE IN JAPAN

Japan first introduced APA programs in 1987, and it can be called an APA-friendly country. In the past, the National Tax Agency (NTA) has recommended bilateral APAs, but there have been many unilateral APAs in recent years as well.

The following chart shows the number of MAPs over the past six years, including bilateral APAs. The number of bilateral APAs in Japan is by far the highest compared to other Asian countries. The 148 cases in 2020 include the numbers from March to June 2020, when the impact of Covid-19 was manifested. Nonetheless, the number of concluded APAs has not been affected by the Covid-19 disruptions and has remained at a record high level as in the previous year.



In Japan, guidance on transfer pricing treatment during the Covid-19 pandemic has not been issued, but the tax authorities are taking a flexible approach. In addition, the NTA has always respected the OECD Transfer Pricing Guidelines, and the OECD's Guidance on the transfer pricing implications of the Covid-19 pandemic (OECD's Covid guidance), released on Dec. 18, 2020, would be respected as well.

## **Japanese Tax Authorities' Operations in the Current Situation**

Presently, the Regional Tax Bureau and the NTA are alternating between working from home and going to their offices. Although this may make it inconvenient and time-consuming to hold discussions with them, they have consented to holding teleconferences with taxpayers (but not video conference yet), which sometimes is more beneficial than in-person meetings for foreign multinational entities (MNEs), as it makes it easier for people outside of Japan to attend. The conferences are held in Japanese, but interpreters can also participate by phone.

### **Evidence to Support the Taxpayer's Position**

The Japanese tax authorities tend to place great emphasis on evidence, both at audits and APA negotiations, to confirm if the facts that the taxpayers provided are correct and if their claims are reasonable. In this regard, they may issue many information documents requests (IDRs) seeking not only financial data, but also copies of emails and minutes to verify in detail the assertions of taxpayers. Preparing and providing evidence of Covid-19's impact would be very important when negotiating APA amendments, new APAs, a renewal, or even a cancellation. For instance, a taxpayer should be aware that copies of emails regarding discussions on allocation of loss derived from Covid-19 among the related parties may be requested by the tax authority in order to confirm that their communication and decision-making are in line with the arm's-length principle, as well as their transfer pricing policy.

Like in many other countries, the impact of Covid-19 differs, depending on each industry's and company's situation in Japan. Taxpayers should be aware that there are companies making record-high profits in this new situation and it is necessary to explain precisely what the case was like for itself. If it becomes necessary for taxpayers to claim that a Japanese related party's arm's-length profitability should be lower than the APA's agreed range due to the negative impact to the covered transaction, they must first prove that the transaction was actually affected by Covid-19. In some cases, the impact of Covid-19 may be more indirect, which makes it difficult for tax authorities to understand. In such case, elaborate preparations and detailed explanations are required.

### **Impact of the OECD's Guidance on Covid-19**

While not all of the recommendations in the OECD's Covid-19 guidance are necessarily applicable in Japan, it can be said that these are taxpayer-friendly and supportive of companies that are suffering due to Covid-19. Also, as previously mentioned, the Japanese tax authority respects the OECD's guidelines, and it is plausible that the new guidance would be a helpful tool for taxpayers. Taxpayers should carefully examine if they can leverage any statement in the guidance as support for their negotiations with the tax authorities.

## **EXISTING APAS**

Whether these are unilateral or bilateral, Japanese APAs generally include a critical assumption, which may enable taxpayers to renegotiate APAs if their businesses are significantly impacted by Covid-19 and the assumptions were breached.

When a Japanese entity who is a tested party for TNMM analysis under the APA wants to negotiate with the Japan tax authority for a lower return than what would be at arm's-length without the impact of Covid-19, it would be necessary to prove that a loss brought about by Covid-19 has actually occurred with respect to the tested transaction to begin with. In addition, it would be necessary to convince them that it is reasonable for the Japanese tested party to bear the loss (or the decrease in profit) under the circumstance, and that the share of the burden proposed by the taxpayer is reasonable. In order to do so, information must be submitted not only by the Japanese tested party, but also by the foreign affiliate.

Usually, in the case of unilateral APAs, related overseas parties tend to submit less information in the process of APA examination than is done as regards bilateral APAs, and this sometimes can be the reason some MNEs choose unilateral APAs. However, taxpayers should be aware that when renegotiating APAs on the impacts of Covid-19, they may be required to submit information that they did not submit at the time of the original examination for obtaining the APA. Particularly, taxpayers should be prepared to submit financial information of the entities involved in the tested transaction.

In addition, even if the tax authority accepts that a Japanese entity will incur a loss or gain lower profits than agreed in the APA for the year affected by Covid-19, it may assert that such entity should earn a higher profit in later years, as it is not a limited risk entity. In this regard, taxpayers should carefully consider the pros and cons of the Japan entity bearing the loss caused by Covid-19 in the long run before negotiating with the Japanese tax authority.

Taxpayers are generally encouraged to consult the tax authority as soon as they learn that they may not be able to comply with the APA. However, a taxpayer should also know that they need to have a strategy, not only for Covid-19-impacted years, but also for future years, before commencing such discussions.

### **APA Application Under Review and New APAs**

With regard to new APAs, in view of the fact that the Covid-19 crisis is still unresolved at present, it is important to conclude a flexible APA that takes into account future uncertainties, such as ex-post verification, as stated in OECD's Covid-19 guidance.

Also, although there are some limitations compared to bilateral APAs, such as the inability to roll back (i.e., apply the unilateral APA retroactively to prior years), in some cases, a unilateral APA may give more flexibility to the negotiation, as the taxpayer is required to negotiate with the Japanese tax authority only.

Pre-filing conferences should be fully utilized as an opportunity to gather information, hear the NTA's thoughts and make a final decision on what kind of

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APA the taxpayer should apply for. Taxpayers should be fully aware that unlike tax audits, where discussions tend to be led by the auditors, the starting point of the APA examination is what the taxpayer claims in its application. The final decision as regards the choice between bilateral or unilateral APAs can also be made after having a pre-filing conference with the NTA. In fact, it is recommended that the pros and cons between these two options be carefully considered prior to making a final decision.

Finally, it can be said that having APAs can be advantageous—particularly during uncertain situations like today when the full impact of Covid-19 is still to unravel—to explain a taxpayer’s business and situation and to claim how the arm’s-length return should be considered, in order to avoid lengthy and burdensome audits as well as the costs related to them.

*This column does not necessarily reflect the opinion of The Bureau of National Affairs, Inc. or its owners.*

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