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Global Tax Alert

Japanese tax authorities reorganize tax audit teams into single unit to cover domestic, international and transfer pricing issues

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Executive summary

The Japanese tax authorities have reorganized the international tax audit teams, effective July 2020. This reorganization allows a single audit team to examine both domestic and international tax issues (including transfer pricing and permanent establishments) simultaneously.

Taxpayers should be aware of this change and adapt their response to tax audits accordingly. In particular, taxpayers should ensure that their personnel managing a tax audit are aware of the potential for transfer pricing or international tax questions to arise from the start of a tax audit and be prepared to obtain the necessary support to respond.

Transfer pricing has been a prominent focus for the tax authorities, and there has been a rising number of transfer pricing assessments in recent years. Specifically, cases have increased from 169 in 2016 to 257 in 2018. As a result, this may be a key issue during a tax audit.

Detailed discussion

Change in tax authority structure

On 20 December 2019, Japan's National Tax Agency (NTA) released a document showing the reorganization planned for the administrative year beginning July 2020.

Building a better working world

Under the heading "Responding to internationalization," the document sets out the divisions/audit teams within the regional tax bureaus (RTBs) which deal with international taxation.

Transfer Pricing Divisions in regional tax bureaus have been replaced by International Examination Management Divisions (a provisional title referred to as IEMD herein). IEMDs are located in the larger RTBs of Tokyo, Osaka and Nagoya, and have a much broader audit scope than just transfer pricing.

Another outcome of this restructuring is that domestic corporate tax audit teams are also now able to audit transfer pricing issues, whereas previously only transfer pricing divisions were able to audit such issues.

Effect on audit approach

The IEMD and domestic corporate tax audit teams will be able to audit a wide range of issues, including transfer pricing and international tax matters such as permanent establishments or application of the principal purpose test concurrently (a "simultaneous audit").

Previously, an examiner would have had to bring in different teams to address each issue separately.

This new approach reflects the NTA's desire to respond effectively to complicated tax issues (TP taxation or PE taxation, tax avoidance schemes, etc.), by concentrating audit authority in the hands of a single team.

Implications for taxpayers

Previously, as transfer pricing issues were examined separately from domestic tax issues, it was easier for the local tax or finance team to know when questions should be addressed to colleagues in international tax or transfer pricing departments, who are usually located overseas.

Now, under simultaneous audits, local corporate tax personnel managing a corporate tax audit are likely to be asked questions on transfer pricing and international tax matters.

Transfer pricing audits can be intrusive with NTA issuing many requests for documents and information. Questions can often be open ended and abstract. Therefore, it is important to understand the rationale for a request to be able to be efficient and responsive in a manner that does not increase audit risk.

Accordingly, taxpayers should consider the following in preparing for a tax audit:

- Before any audit starts, multinational enterprises (MNEs) should ensure that personnel in Japan, who generally provide the first responses to an audit, understand the need to consult and whom to consult on the MNE's regional or global tax team.
- When a tax audit starts, personnel should review the business cards of all examiners. Understanding the department and background of the examiners will help determine the likely focus of the audit.
- If questions regarding cross-border transactions are asked, taxpayers should not provide an immediate response, but should consult with the regional or global tax team, as appropriate.
  - This is particularly important for sensitive requests relating to functions and risks or segmented profit and loss information, for example.
- Personnel in Japan should also be aware that donation taxation levied on transactions with foreign related parties will lead to double taxation. (In certain circumstances, Japanese tax auditors might deem an inappropriately priced transaction to be a "donation." Donations to related parties are non-deductible for Japanese corporate tax purposes.)
- Personnel in Japan should be prepared to request a reasonable time to respond to questions and should not provide quick or preliminary responses on cross-border transactions. This may lead to misunderstandings which benefit neither the taxpayer nor the auditor. (Note, however, that transfer pricing local files and related information are required to be provided by the deadline determined by the examiner, which can be a maximum of 45 or 60 days after the request, depending on the transaction volume and type of information requested.)
- As audit activity could be intense and sustained over many months, MNEs should ensure sufficient qualified staff are available to respond to both domestic and international tax issues simultaneously.
- Personnel in Japan should consider that the audit results in Japan could affect the outcome of tax audits in other jurisdictions through Country-by-Country Reporting (CbCR).
  - Specifically, adjustments to a Japanese taxpayer's income and taxes (including changes to future transfer pricing to prevent a repeat of the audit result) will be reflected in the CbCR for that taxpayer's multinational group. The CbCR is shared with other tax authorities, who may use the increased profitability in Japan to propose higher levels of profit in their country as well.

For additional information with respect to this Alert, please contact the following:

Ernst & Young Tax Co., Tokyo

- Karl Gruendel karl.gruendel@jp.ey.com
- Keith Thomas keith.thomas@jp.ey.com
- Shigeki Takeuchi shigeki.takeuchi@jp.ey.com
- Jonathan Perry jonathan.david.perry@jp.ey.com

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