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# Global Tax Alert

**News from Transfer Pricing**

# Japan: Post COVID-19 tax audit trends

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## Executive summary

For the last several years, the National Tax Agency (NTA) of Japan's tax audit program has increasingly focused on the cross-border transactions of multinational enterprises. At the same time, with a view to strategically allocate the NTAs' audit resources, the NTA is taking a risk-based approach and has reviewed its transfer pricing (TP) audit program. This new tax audit approach has been strengthened as a result of the COVID-19 economic impact.

This Alert summarizes the NTA's new audit approach and discusses actions that multinational enterprises operating in Japan can take to prepare for tax audit risks.

## Detailed discussion

### Tax audits resume in October 2020

Due to the impact of COVID-19, the NTA refrained from commencing new tax audits from April 2020, however NTA have resumed starting new tax audits. For tax audit activities undertaken during the continued prevalence of COVID-19, the NTA is expected to be more selective of target taxpayers and will focus more on high risk taxpayers. During this time, tax auditors will reduce the number of face-to-face interactions with taxpayers.

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### Audit focus on cross-border transactions

In 2016, the NTA announced the International Taxation Total Plan. According to the plan, the tax authorities will conduct vigorous tax audits on the cross-border transactions of multinational enterprises and high-net-worth individuals.

As a result, the amount of adjustments for companies with cross-border transactions has jumped from US$2.2 billion (JPY237 billion) in Administrative Year 2016 to US$3.4 billion (JPY367 billion) in 2017 and US$6.6 billion (JPY697 billion) in 2018.

The key issues addressed by tax auditors include transfer pricing (TP), donations to overseas associated enterprises (i.e., payments recharacterized as non-deductible gratuitous payments or gifts)[1] and controlled foreign company rules.

### The new transfer pricing audit program

Previously, ordinary corporate tax audits and TP audits were conducted separately. However, from this year, the NTA has combined these audit programs and consequently, TP audits are now conducted as part of the corporate tax audit. As a result, more taxpayers may be subject to a TP audit.

In order to be prepared for the new TP audit program, taxpayers are advised to complete robust TP documentation prior to any tax audit as it is critical to help tax auditors understand the taxpayer's facts (functions, risks, and assets) and economic analysis at an early stage of a tax audit, as well as support that the related party transactions were conducted at arm's length.

### The risk-based approach

The NTA has been using a risk-based approach in their identifying which taxpayers to audit. This means that they conduct audit activities to assess the tax compliance risk of each taxpayer, and more audit resources are allocated to high-risk taxpayers.

Factors contributing to compliance risks include: (i) the governance and behavior of a taxpayer; and (ii) the control over the accounting department and accounting procedures. If the NTA identifies a taxpayer with weak tax governance and high tax compliance risk, the audit interval can be shorter, and the duration of the next audit may be extended.

### The evidence gathering process

To prepare for controversy procedures at the national tax tribunal and the courts, tax auditors are strengthening the evidence gathering process. If a tax auditor questions a tax position, a taxpayer is required to explain the position with appropriate documentation, not merely contracts, but also decision-making processes.

### The international information exchange among tax authorities

Through the international information exchange mechanisms, the NTA has been extensively exchanging information, including information related to tax audit, TP documentation and financial accounts, with other tax authorities. The NTA has made it clear that they are actively making the best use of information it receives from overseas tax authorities and conducting their tax audit activities on cross-border transactions. It is not surprising that information from an overseas tax authority could initiate a tax audit on a multinational enterprise in Japan.

## Implications

In response to the NTA's focused approach to cross-border transactions, multinational enterprises operating in Japan should undertake activities to mitigate tax audit risks before the next tax audit. Typical activities include working with tax advisors, identifying high risk issues, and taking measures such as preparing documentation. Reviewing cross-border transactions is resource-intensive, and once a tax audit has started, it may be difficult to address issues adequately in a limited time frame. Advance consultation with the tax authorities is also an effective means to mitigate any identified risks.

If a taxpayer receives a tax audit notice from the tax authorities, they should consult with their tax professionals before responding or providing information to the tax authorities. Tax professionals can provide guidance on the scope of the tax audit and how best to prepare for it, and also directly communicate with the tax authorities on issues including the logistical arrangements of the tax audit.

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**Endnote**

1. Including payments for or recharges of royalties, management fees, research and development costs, information and communication technology costs, and merger and acquisitions costs.

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