

Assessing burden of proof in transfer pricing disputes

Japan's transfer pricing legislation was amended in 2011 to incorporate revisions in the 2010 Organisation for Economic Cooperation and Development (OECD) Transfer Pricing Guidelines. This update discusses the allocation of the burden of proof in transfer pricing disputes in Japan.

1 'Most appropriate method' standard adopted

The previous transfer pricing legislation provided a hierarchy of methods for calculating an arm's-length price in line with the OECD's 1995 guidelines. Traditional transaction methods (ie, the comparable uncontrolled price method, the resale price method and the cost-plus method) were preferred to profit-based methods (ie, the transactional net margin method and the profit split method). Profit-based methods were permitted only where the traditional transaction methods could not be applied.¹

The 2010 guidelines abolished the preference for traditional transaction methods and instead allowed for the application of the "most appropriate method" in a particular case. Japanese legislation was amended to accommodate the change. The new legislation came into effect on October 1 2011. As the 2010 guidelines direct, it provides that an arm's-length price is calculated in accordance with the most appropriate method for a particular case.²

2 Selecting the most appropriate method

In October 2011 the National Tax Agency issued a circular notice and guidelines to implement the new legislation. These rules specify the elements to be considered in selecting the most appropriate method, and are intended to allow taxpayers to predict the agency's determination. For example, Articles 66-4(2)-1 (1) to (4) of the circular essentially follow Paragraph 2.2 of the 2010 guidelines. The elements to be considered in selecting the most appropriate method are:

- the respective strength and weakness of a calculation method;
- the appropriateness of a calculation method, considered in light of the nature of the controlled transactions and the functions of the transactional parties;
- the availability of the information needed to calculate

- an arm's-length price; and
- the degree to which controlled and uncontrolled transactions can be compared, including the reliability of comparability adjustments that may be needed to eliminate material differences between them.

3 Burden of proof

The allocation of the burden of proof in tax disputes varies between jurisdictions. In Japan, there is established court precedent that the agency generally bears the burden of proof with respect to the legality of tax assessments. In exceptional cases, where the subject matter is too difficult for the agency to prove, the courts have shifted the burden of proof to the taxpayer in order to avoid an unfair outcome.

In *Adobe Systems Inc v Japan*³ the Tokyo High Court rendered a significant decision regarding the allocation of the burden of proof under transfer pricing legislation before the 2011 amendments. This was the only transfer pricing case in Japan in which a taxpayer had prevailed before the courts. The Tokyo High Court, as an appellate court, reversed the first instance decision, holding as follows:

- The agency bears the burden of proving that it is impossible to apply traditional transaction methods. However, if it can demonstrate this through a reasonable investigation, the burden of proof shifts to the taxpayer.
- The agency bears the burden of proving that the calculation method which it has selected is applicable to the case.

In *Adobe Systems* the taxpayer was primarily a service provider, whereas the party to the comparable transaction (as chosen by the agency) was primarily a vendor of goods. Therefore, the court concluded that the agency had failed to satisfy the burden of proof on the second criterion above, stating that it had not demonstrated that the transaction cited for comparison was comparable to the transaction at issue in terms of functions and risks. The appellate court reversed the decision because it interpreted the allocation of the burden of proof differently from the first instance court. This decision emphasised the importance of the burden of proof in transfer pricing disputes in which it is difficult to establish an arm's-length price.

Authors

Akihiro Hironaka
Partner
a_hironaka@jurists.co.jp



Masaki Iwasaki
Associates
m_iwasaki@jurists.co.jp

The content of this newsletter is written by lawyers and tax counsel of Nishimura & Asahi to be issued by International Law Office, cited under the permission of International Law Office, and also available on-line at www.internationallawoffice.com. This newsletter is intended to be general guidance and does not constitute legal advice or a substitute for legal advice. Individual legal and factual circumstances should be taken into consideration in consultation with professional counsel prior to taking any action related to the subject matter of this newsletter. This newsletter was written by its authors and does not reflect the views or opinions of either Nishimura & Asahi or International Law Office. Please contact us as indicated below with respect to newsletter subscription cancellations, notification of a change of address or other contact information, and for other general inquiries about this newsletter.

Public Relations, Nishimura & Asahi
(Phone: +81-3-5562-8353 E-mail: newsletter@jurists.co.jp)

© Nishimura & Asahi 2012

4 Allocation of burden of proof after 2011 amendments

The new legislation indicates that the most appropriate method for a particular case should be applied. If the general rule on allocating the burden of proof - which requires the agency to prove the arm's-length price - is strictly read to mean that the chosen calculation method must be the "most appropriate" of various methods that might apply in a particular case, it could be argued that the authorities must prove that all other calculation methods are less appropriate. However, such a formalistic allocation of the burden of proof might impose too heavy a burden on the agency and produce unfair results. Paragraph 2.8 of the 2010 OECD guidelines states that the guidance in Paragraph 2.2 "does not mean that all the transfer pricing methods should be analyzed in depth or tested in each case in arriving at the selection of the most appropriate method". In addition, Paragraph 4.16 states that:

"it would be appropriate for both taxpayers and tax administrations to take special care and to use restraint in relying on the burden of proof in the course of the examination of a transfer pricing case."

It is difficult to arrive at an interpretation that is consistent with both the Japanese rules for allocation of burden of proof and these guidelines. One possible view under the current Japanese transfer pricing legislation might be as follows:

- The agency bears the general burden of proving that its proposed method is the most appropriate in a particular case.
- If the agency offers prima facie evidence that its proposed method is the most appropriate for a particular case based on a reasonable investigation in a transfer pricing audit, it is relieved of the burden of proof, which shifts to the taxpayer.
- In this situation, the taxpayer may challenge the calculation method that the agency has proposed, but must prove that another method is more appropriate.

Even after the 2011 amendments to the transfer pricing legislation, the National Tax Agency Guidelines stipulate that if two or more calculation methods are equally reliable, the comparable uncontrolled price method should be used. If this method does not apply and the resale price and cost-plus methods are equally reliable, one of these methods must be used.⁴ This approach follows Paragraphs 2.3 and 2.14 of the 2010 OECD guidelines. Thus, the current transfer pricing legislation maintains a degree of preference for the traditional calculation method.

5 Importance of balanced allocation of burden of proof

The premise that the allocation of the burden of

proof must be balanced between the taxpayer and the tax authorities has practical significance for both sides. In 2010 Japan's transfer pricing legislation was amended to include a detailed list of documents that a taxpayer must present during a transfer pricing audit. If the taxpayer fails to do so, the agency may assess the taxable income according to its own presumed arm's-length price.⁵ This so-called 'presumptive taxation' is essentially a penalty imposed on taxpayers that fail to respond to the authority's requests. As this regulation obliges the taxpayers to present or submit certain types of document regarding transfer pricing, this regulation has come to be referred to as the Japanese version of transfer pricing documentation. It has been argued that the 2010 amendments were intended to modify the general rules on burden of proof regarding arm's-length prices in tax disputes, and to shift the burden from the agency to the taxpayer.⁶ In any event, the burden of proving arm's-length prices must be allocated fairly between the agency and the taxpayer. Unreasonably heavy burdens on the agency in the context of tax litigation may result in unreasonably heavy burdens on taxpayers in complying with the accompanying documentation requirements.

6 Comment

In Japan, tax consultants and economic analysts, rather than tax attorneys, have dominated discussions in the area of transfer pricing. This may be partly because most transfer pricing disputes in Japan have traditionally been resolved through mutual agreement between the respective governments. As a result, the debate over this issue from a legal perspective is still in its early stages. However, overseas business opportunities for Japanese companies are increasing, particularly in developing countries, while the Japanese economy remains beset by power shortages, the appreciation of the yen and comparatively high corporate tax rates. In these circumstances, transfer pricing disputes involving developing countries are likely to increase in number and value. Disputes involving developing countries are less likely to be resolved through mutual agreement procedures and more likely to lead to the Japanese courts.

¹ Act on Special Measures Concerning Taxation, Article 66-4(2)(i) (repealed).

² Id, Article 66-4 (2).

³ October 30 2008.

⁴ Guidelines for the National Tax Agency, Article 3-2.

⁵ Article 66-4(6) of the act and Article 22-10(1) of the Ordinance for Enforcement of the Act on Special Measures Concerning Taxation.

⁶ Akira Akamatsu, *Practice and Theory of International Taxation - Global Economy and Tax Laws*, third edition 2011, at 415, (in Japanese).