Transfer Pricing During COVID-19 Pandemic

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Grant Thornton LLP

Introduction

1. Basics of transfer pricing

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Transfer Pricing US Leader

Steve has more than 25 years of experience in transfer pricing and tax controversy across all industries. He has negotiated over 200 advance pricing agreements and mutual agreement procedures and has been involved in international tax planning and tax provision work for multinational corporations. Steve teaches transfer pricing at New York University School of Law. He also co-authored "Transfer Pricing: Rules, Compliance and Controversy", widely considered a top resource for transfer pricing professionals globally.

2. Pandemic Transfer Pricing Measures

Shunichi Tsutsui

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Japan Business Group Transfer Pricing Leader

Shunichi has been engaged in transfer pricing consulting in a Big4 firm for 25 years since 1995. He conducted strategic transfer pricing analysis and negotiated with the IRS on nearly 80 APAs for Japanese companies, including Japan-U.S., U.S. unilateral, U.S.-Canada, U.S.-Mexico, and U.S.-Swiss APAs. He has experience in a wide range of industries, including automotive parts, industrial machinery, trading, fine chemicals, home electronics, foods, and asset management. Joined Grant Thornton LLP in June 2020.

Today's agenda

1. Basics of transfer pricing
2. Pandemic and the U.S. economy
3. Characteristics of CPM
4. CPM Range (Sales and Automotive Parts Manufacturing)
5. APA pandemic response
6. Document pandemic response
7. About APA
8. About tariffs
9. Discussion with IRS APMA Director

Basics of transfer pricing

- Transactions between controlled entities are usually defined as "intercompany transactions" or "controlled transactions" which are subject to transfer pricing examination.
  - Companies with direct or indirect ownership in excess of 50% are usually considered "controlled."
  - In limited cases, companies are treated as having control even though less than 50% ownership exists.
  - Even if direct and indirect ownership does not exceed 50 percent, "real" control is considered to exist when a one party effectively controls the other.
- In the United States, transactions between affiliated companies, which are not consolidated tax groups under the federal corporate tax law, are subject to the transfer pricing taxation.
- Transactions between affiliated companies are subject to U.S. transfer pricing taxation not only for cross-border transactions but also for transactions between affiliated companies within the United States.
- The Internal Revenue Service ("IRS") typically does not prioritize US domestic controlled transactions, but the IRS may require taxpayers to analyze domestic controlled transactions between different tax groups in certain cases.

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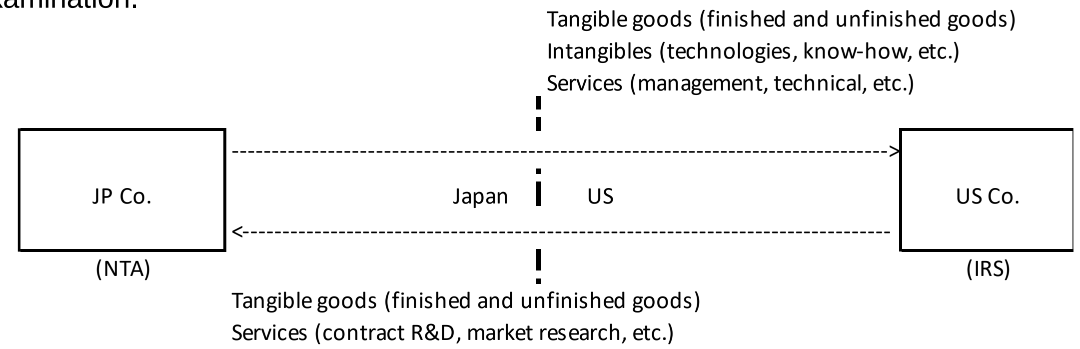
Basics of transfer pricing

- Controlled transactions generally include all transactions that have an impact on taxable income (i.e., income before income taxes).
  - Tangible goods transactions (inventory transactions, transactions of capitalized machinery and equipment)
  - Intangibles transactions (royalties on intellectual property)
  - Provision of services (service transactions, headquarters cost allocation)
  - Financial transactions (loans and loan guarantee)
  - Cost share of jointly developed intangibles
  - Transactions that do not affect taxable income (dividends, capital transactions, etc.) are not generally subject to the transfer pricing examination.



Basics of transfer pricing

- Profits and taxable income of the parent company and its subsidiaries are sensitive to transfer prices.
- The NTA taxes only the taxable income of the parent company, while the IRS taxes only the taxable income of the subsidiary company. The NTA and IRS are greatly concerned with transfer pricing.

JP. Co.
Income statement

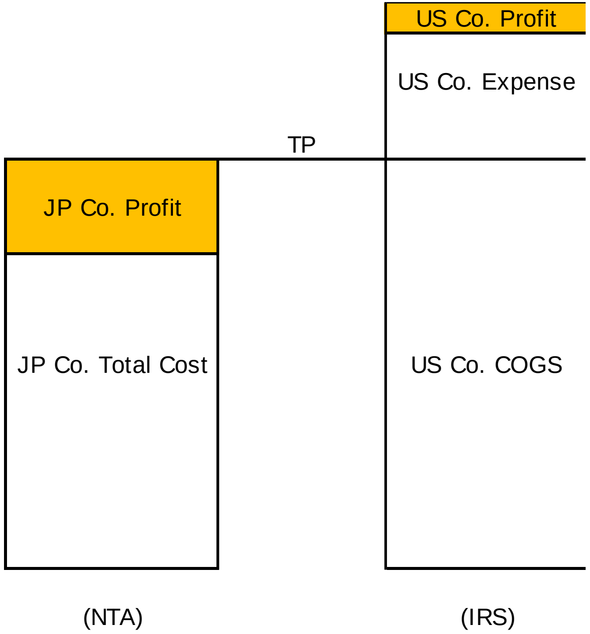
Case 1 (transfer price = 100)	
Sales to US subsidiary	100
Cost of sales	70
Operating expenses	20
Operating income	10

Case 2 (transfer price = 95)	
Sales to US subsidiary	95
Cost of sales	70
Operating expenses	20
Operating income	5

US. Co.
Income statement

Case 1 (transfer price = 100)	
Sales to 3rd party customers	120
Cost of sales	100
Operating expenses	15
Operating income	**5**

Case 2 (transfer price = 95)	
Sales to 3rd party customers	120
Cost of sales	95
Operating expenses	15
Operating income	**10**



Basics of transfer pricing

- The transfer pricing rules are a legal "tool" to ensure proper taxation.
- The outline of the US transfer pricing rules are as follows.
  - Section 482 of the Internal Revenue Code (which consists of two sentences)
  - Treasury regulations interpreting and implementing Section 482 are more than 200 pages
  - Section 6662 of the Internal Revenue Code and related Treasury regulations for contemporaneous document and penalties
  - Revenue Procedure 2015-41 for Advance Pricing Agreements (APAs)

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Basics of transfer pricing

- Illustration of double taxation due to US Co.'s transfer pricing adjustment.

JP Co. taxable income	US Co.taxable income

Too much income for JP. Co.
Too little US Co. income
The IRS increases US Co. taxable income

Income subject to NTA
———————————————————————————————————>

JP Co. taxable incom	Subject to double tax <—————————> IRS income assessment	US Co. taxable income

<————————————————————————————
US Co. taxable income after IRS assessment

The IRS unilaterally determines "correct" income.
The NTA does not automatically accept the IRS assessment.
Double tax arises. US Co. is entitled to seek a relief from double tax under the provision of the US-Japan tax treaty.
US Co. can also seek a relief rom double tax through US domestic procedures.

Basics of transfer pricing

- Controlled transactions between controlled companies satisfying third-party prices (ALP = Arm‘s Length Price) are those whose prices would have been realized between third parties under similar facts and circumstances. The ALP attempts to eliminatie arbitrariness inherent in controlled transactions,

- The ALP standard is internationally accepted, including OECD (Organization for Economic Co-operation and Development) member countries (Japan, United States, and other industrialized countries).

- The risk of double taxation is not completely eliminated, as the application of ALP differs among various countries.
    - In Japan, the ALP of the transfer pricing policy is important, while in the U.S., it is important for the result to meet the ALP.
    - In recent years, many Japanese companies have introduced transfer pricing policies, prompted by the implementation of BEPS (base erosion and profit shifting) recommendations. However, since the policy does not generally guarantee ALP outcomes, it is possible that this will cause a problem in the U.S.

- The transfer pricing tax laws and regulations recognize that the functions and risks of the parties in a transaction are important in determining ALP; hence, a functional (risk) analysis is required.
    - Transfer pricing should reflect the controlled parties’ functions and risks.

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Basics of transfer pricing

- Functional Risk Analysis Items.

Item	Details	Screens Used	Typical Quant Screens
Functions	Research and development Product design and engineering Manufacturing, production and process engineering Product fabrication, extraction, and assembly Purchasing and materials management Marketing and distribution functions, including inventory management, warranty administration, and advertising activities Transportation and warehousing Managerial, legal, accounting and finance, credit and collection, training, and personnel management services	SIC codes Quant Qualitative	R&D/sales ratio Sales OPEX/sales ratio ADVT/sales ratio PPE/sales or PPE/OA ratio Net working capital/sales ratio
Risks	Market risks R&D risks Financial risks Credit and collection risks Product liability risks General business risks	No direct screen except for collection risk	
Economic conditions	The similarity of geographic markets The relative size of each market and the extent of the economic development of each market The level of market The relevant market shares The location-specific costs of the factors of production and distribution The location-specific costs of the factors of production and distribution The alternatives realistically available to the buyer and seller	SIC codes Qualitative	
Property or services		SIC codes Qualitative	

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Basics of transfer pricing

- Transfer pricing method (TPM = Transfer Pricing Method) for evaluing ALPs as defined in the U.S. regulations.

区分	TPM	検証項目	判定基準
取引ベースのTPM	第三者価格法 (CUP = Comparable Uncontrolled Price Method)	価格	第三者取引価格
	再販売価格法 (RPM = Resale Price Method)	粗利率	第三者取引粗利率
	原価法 (CP method = Cost plus method)	対原価粗利率	第三者対原価粗利率
利益ベースのTPM	利益比準法 (CPM = Comparable Profits Method)	ビジネス営業利益利益	比較対象企業（コンパラ）
	利益分割法 (PSM = Profit Split Method) 比較利益分割法 (CPSM = Comparable PSM) 残余利益分割法 (RPSM = Residual PSM)	グループ合算営業利益の合理的配分	RPSMではノーマルリターンはコンパラで算出する

- The Best Method Rule applies to select the best TPM considering the availability and reliability of the data.
- Transactional TPMs are rarely selected because of data issues. In about 90% of cases, CPM is adopted.

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Basics of transfer pricing

- Controlled transactions are required in the United States and other countries to comply with ALP. There are two options for taxpayers in the United States.
    - Prepare “contemporaneous” documents to verify that the controlled transactions are ALP annually prior to the filing of the federal tax return^.
        - If the ALP is not satisfied and taxable income is understated, that amount must be added to the tax return (tax filing adjustment). However, self-initiated adjustments create "double tax" for taxpayers*.
    - APA (Advance Pricing Agreement) is used to agree in advance with the IRS on the TPM to ensure ALP. BAPAs (bilateral) can avoid double tax.
- The vast majority of TPMs used in documentation and APA are the CPM**, where a taxpayer‘s profitability is evaluated against the comparable companies for the taxpayer’s functions and risks.

^ A penalty of 20% to 40% of the tax could be imposed if there were no documentation and the income is adjusted in tax audit.
* In order to avoid double tax, it is necessary to reduce the taxable income in Japan, but it is not easily done in practice.
** Outside the U.S., it is called the transactional income method (TNMM = Transactional Net Margin Method) rather than CPM.

Pandemic and the U.S. economy

- The outbreak of a new virus in China has triggered a pandemic since the beginning of 2020; the spread of virus the continues today.
- "Stay-at-home" and "Shelter-in-place" laws were implemented in New York, California, and Washington to prevent the spread of infectious diseases, and other states followed.
- As of June 23, 2020, New York Times reports the number of infections in the U.S. was 2.3 million with 120,345 deaths; the number of infections worldwide exceeded 9 million with 472,125 deaths.
- Resumption of activities (Reopening) began in May in phases according to the state and region: it is Phase 2 of Reopening in many regions at present.

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Pandemic and the U.S. economy

- Social distancing was implemented in order to prevent infections, forcing economic activities to cease except for telework-enabled and essential businesses.
- In particular, businesses such as hotels, restaurants, and public transportation, which require interpersonal contact, had their sales plummet by 90% in April.
- In addition, to prevent the spread of infections between countries, entry restrictions have been implemented in many countries; business travel has stopped.
    - The number of passengers on JAL and ANA international flights in April 2020 is estimated to decrease by 95% from the same month of the previous year.
    - It is believed that the restrictions on international mobility will not be eased immediately when Reopening is launched.

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Pandemic and the U.S. economy

- The unemployment rate in the U.S. was 4.4% in February 2020, but rose to 14.7% in March and 13.3% in April.
    - The decline in the April unemployment rate was thought to have been the result of more than $2 trillion in economic stimulus measures enacted in March 27. The fiscal stimulus of $2 trillion has already been used up, additional fiscal stimulus may be essential in the future.
    - The unemployment rate is defined as the rate of unemployed in the labor force (Civilian Labor Force). It is noteworthy that the labor force is shrinking by about 5 million people.
- In mid-June 2020, the number of unemployment insurance recipients was estimated to be 20 million.

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Pandemic and the U.S. economy

- The U.S. economy continued its longest post-war economic expansion through 2019, following the recession of 2008-2009, with real GDP (gross national product) of about $19 trillion in 2019.
    - Real GDP is measured using 2012 price levels.
    - Nominal GDP in 2019 was $21.7 trillion.
- The outlook for GDP in the future will change according to the level of pandemic response taken by the public. There are estimates of real GDP declines from the 2019 peak of 10% to 30%.
- The following slides are based on real GDP, unemployment rates, and working populations published by the research division of St. Louis, a Federal Reserve Bank (FRED).

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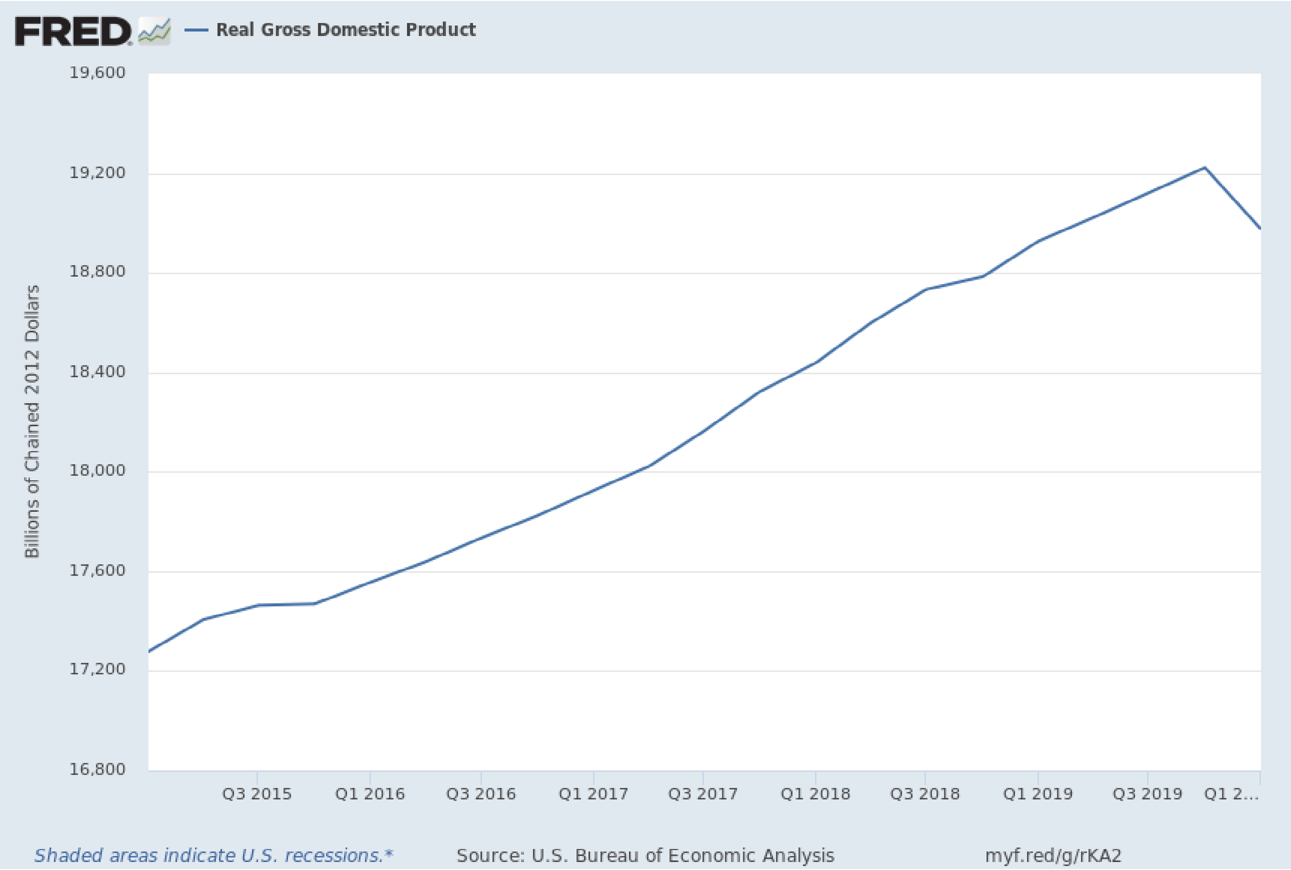
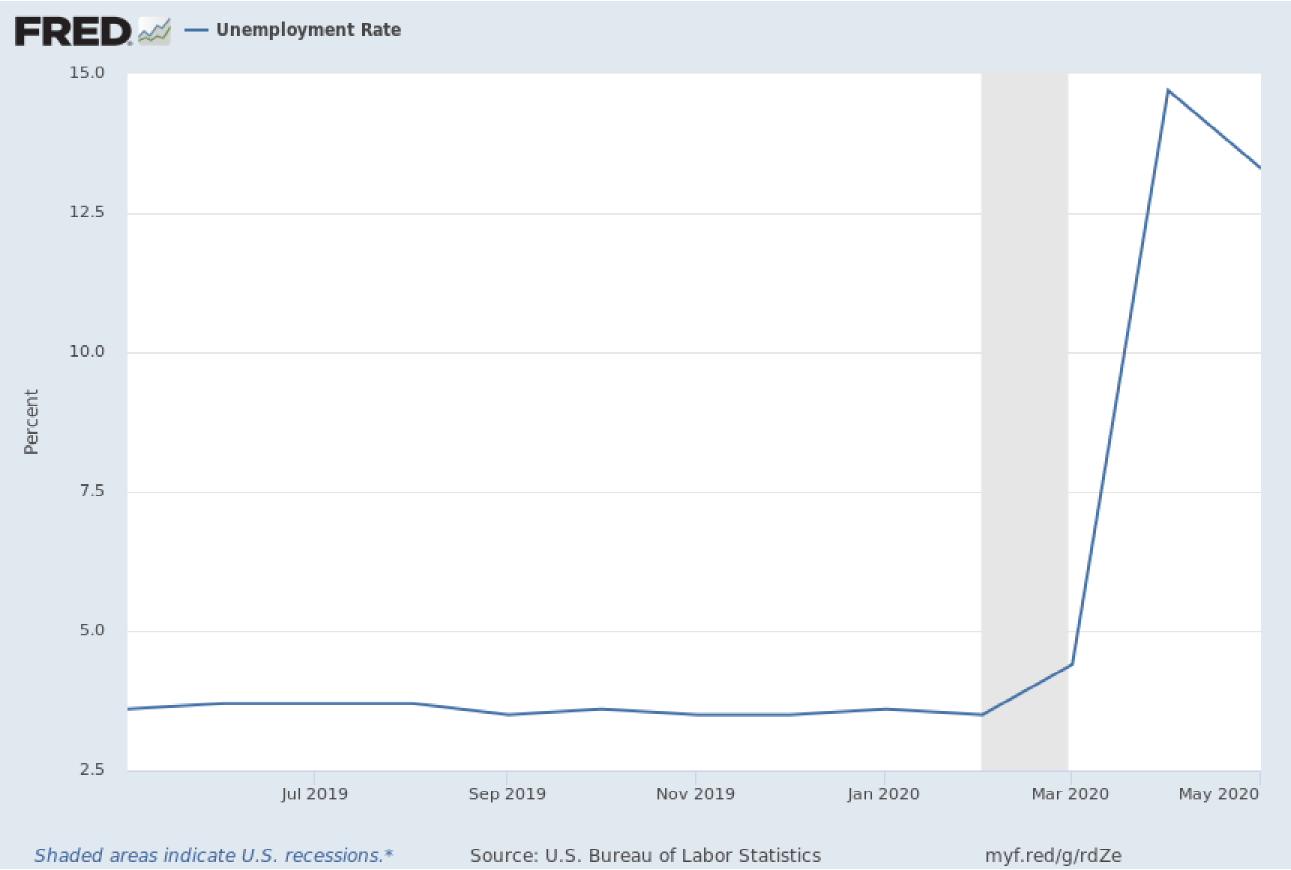

FRED
Real Gross Domestic Product
19,600
19,200
18,800
18,400
18,000
17,600
17,200
16,800
Billions of Chained 2012 Dollars
Q3 2015
Q1 2016
Q3 2016
Q1 2017
Q3 2017
Q1 2018
Q3 2018
Q1 2019
Q3 2019
Q1 2...
Shaded areas indicate U.S. recessions.*
Source: U.S. Bureau of Economic Analysis
myf.red/g/rKA2


FRED
Unemployment Rate
15.0
12.5
10.0
7.5
5.0
2.5
Percent
Jul 2019
Sep 2019
Nov 2019
Jan 2020
Mar 2020
May 2020
Shaded areas indicate U.S. recessions.*
Source: U.S. Bureau of Labor Statistics
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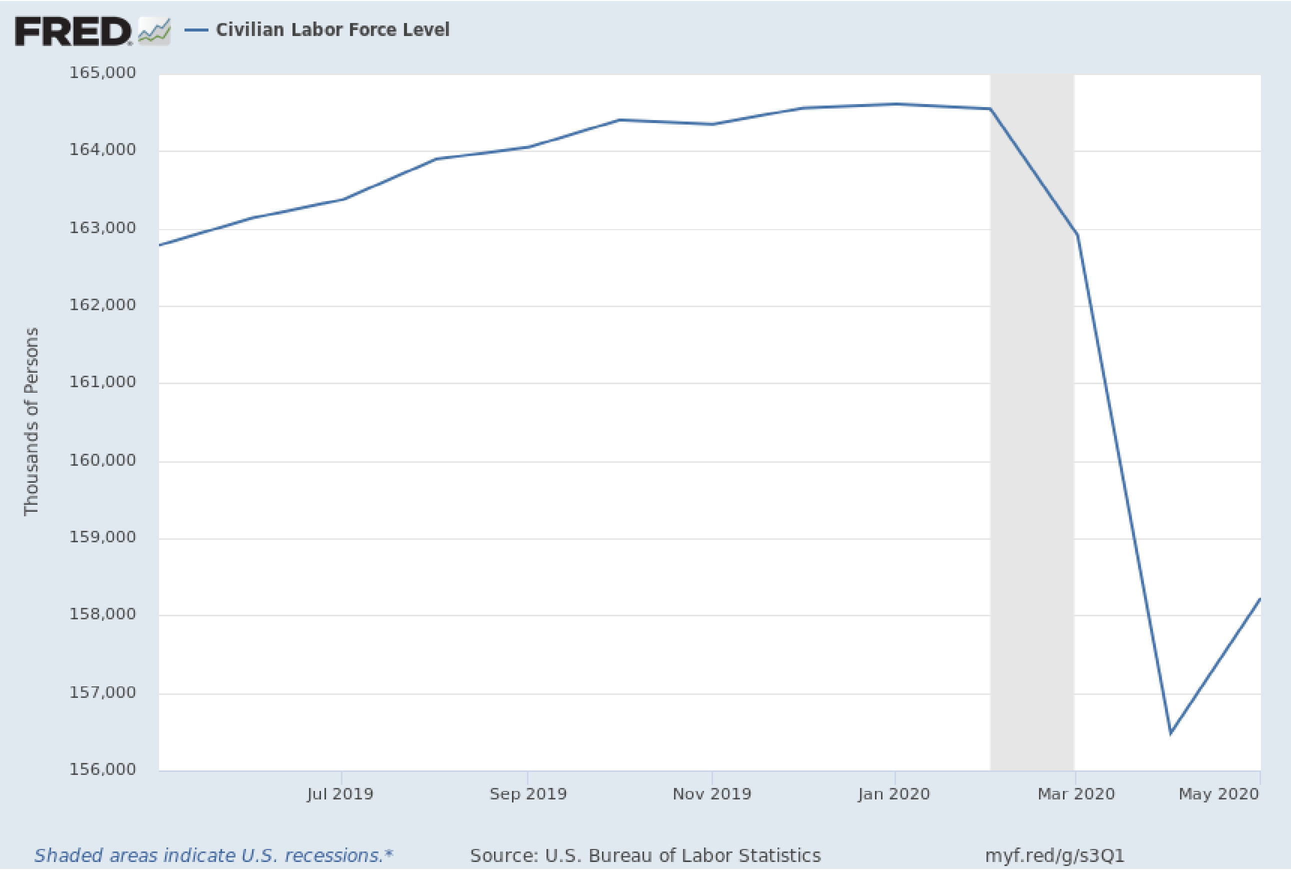
FRED
Civilian Labor Force Level
165,000
164,000
163,000
162,000
161,000
160,000
159,000
158,000
157,000
156,000
Thousands of Persons
Jul 2019
Sep 2019
Nov 2019
Jan 2020
Mar 2020
May 2020
Shaded areas indicate U.S. recessions.*
Source: U.S. Bureau of Labor Statistics
myf.red/g/s3Q1

Pandemic and the U.S. economy

- The reduction in the U.S. economy brought about by the pandemic is assumed to be comparable to the Great Depression (The Great Depression) from 1929 to 1933.
  - Real GDP in the United States shrank by about 20 percent from 1929 to 1933, and the unemployment rate rose from 3.2 percent in 1929 to 24.9 percent in 1933.
  - Real GDP recovered until 1936, and the unemployment rate exceeded 10 percent until 1941.
  - During the Great Depression, the importance of Keynesian economics was not well recognized, and the lack of expansionary fiscal and monetary policies was said to have delayed the recovery from the Great Depression.
    - In the pandemic, Keynesian economic policies are put in place.
- The full-scale recovery of the economy by the pandemic is said to be difficult until effective vaccine is developed.
  - There are many economists who do not expect a V-shaped recovery (including FDR President J. Powell).

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Pandemic and the U.S. economy

- The pandemic is thought to be accompanied by structural changes in the U.S. economy.
    - Review of corporate organization and operations to be more consistent with the spread of teleworking.
    - Expansion of non-human contact businesses (e.g.,online shopping) and shrinkage of in-person business.
    - Greater use of artificial intelligence and automation.
    - Reversal of globalization due to the policy of on-shoring of key manufacturing industries among developed countries.
    - Review of supply chains involving China.

Characteristics of CPM

- One-sided test.
  - The CPM examines only the profitability of one party (often a subsidiary) and does not examine the profitability of the counterparty(ies) (e.g., parent or other non-U.S. affiliates).
- Indirect test.
  - Examine the profitability of the business associated with the transaction rather than the transactions themselves.
- In the United States, comparables are chosen from independent U.S. listed companies in order to evaluate the profitability of the tested tested party (often a subsidiary).
  - Because audited financial statements are available.
- The criterion for selecting comparables is their similarity of functions and risks to the tested party.
  - The similarity of products and markets is also important, but it is not always possible to establish in practice.
- The profit under review is operating profit.
- The principle of high-risk, high-return is the underlying principle.
  - The higher the risk, the higher the average profit margin.

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Characteristics of CPM

- Use the multiple-year average profitability (rate of return) (actually the weighted average rate of return) to eliminate short-term fluctuation noise.
    - It is reasonable to determine the analysis period considering the business cycle of the tested party, but it usually is a three-or five-year analysis period.
    - Theoretically, it is necessary to maintain comparability in terms of functions and risks, both during the analysis period and during the analysis period.
    - For example, for the three-year analysis period, we use the average 2017-2019 profit rate for the 2019 analysis.
- It is common to establish ALPs using the interquartile range (IQR = Interquartile Range) of the operating margins of several comparables.
    - In the CPM, since the comparability of the comparables is not high and thus the profit rate is noisy, so we are trying to eliminate noise by using IQR instead of full range.

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Characteristics of CPM

- An income statement (P&L) is required at a minimum, but balance sheet data is also required for balance sheet adjustments.
    - Financial data in accordance with U.S. GAAP or International GAAP are used.
    - If the financial data used is not a company-wide financial statement, it is important that it be reasonably traced from the financial statements.
- When the levels of accounts receivable, accounts payable, and inventory of the tested party differ from those of the comparables, adjustments are made to account for the difference in implicit interest cost of carrying these balance sheet items.
    - Similar adjustments may be made for fixed assets.
- Change LIFO inventory accounting to FIFO inventory accounting as an accounting adjustment.
- The IRS also often makes adjustments to exclude amortization of intangible assets.

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Characteristics of CPM

- The purpose of choosing a profit level indicator is to capture the reality of business as accurately as possible.
    - ROS = Return on sales or OM = Operating margin (the ratio of operating income to sales) is used to analyze all businesses.
    - Full cost markup or total cost markups (the ratio of operating income to total costs) are often used to analyze manufacturing and services businesses.
    - Berry ratio (gross margin divided by SG&A) applies only to distribution businesses.
    - ROA = Return on asset (the ratio of operating income to operating assets) and ROIC = Return on invested capital (the ratio of operating income to invested capital) are the two types of PLIs that are based the balance sheet data.

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CPM Range (Sales and Automotive Parts Manufacturing)

- Examples: ROS is adopted as a profit indicator.
- 40 companies are selected for distributors.
  - Companies are selected with reference to the those used by the APAM program of the IRS. In documentation and APA, we further narrow the comparables, taking into account the characteristics of the taxpayer.
- 46 companies are selected for manufacturers of automotive parts.
  - Auto parts manufacturing comparables are chosen with reference to the companies used in documentation and APA benchmarks. In documentation and APA, we further narrow the comparables, taking into account the characteristics of the taxpayer.
    - Compared to distribution comaprables, the auto parts manufacturing comparables are more comparable in terms of product and market. If the taxpayer is an auto parts manufacturer, the taxpayer's profit margin may also fall within the range of the updated profit margin of the comparables through FY2020.
- No balance sheet adjustments.
- Range is for the year ending March 2019 (fiscal 2018); data for the year ending March 2020 is not yet available.

CPM Range (Sales and Automotive Parts Manufacturing)

Distribution	2016-2018 3 Yr. Wtd. Avg. ROS	2014-2018 5 Yr. Wtd. Avg. ROS	2018	2017	2016	2015	2014
Minimum	**-2.73%**	**-0.80%**	-6.33%	-5.26%	-10.54%	-3.36%	-0.50%
Lower Quartile	**1.74%**	**2.06%**	2.58%	1.59%	1.85%	2.40%	2.58%
Median	**3.36%**	**3.56%**	3.68%	3.60%	3.52%	4.05%	4.03%
Upper Quartile	**4.80%**	**5.13%**	4.68%	5.15%	6.07%	6.89%	6.71%
Maximum	**12.78%**	**12.92%**	12.10%	13.15%	13.16%	13.48%	14.25%

Auto Parts Mfg	2016-2018 3 Yr. Wtd. Avg. ROS	2014-2018 5 Yr. Wtd. Avg. ROS	2018	2017	2016	2015	2014
Minimum	**-26.74%**	**-44.97%**	-11.93%	-26.60%	-50.87%	-91.61%	-101.23%
Lower Quartile	**5.25%**	**4.90%**	3.89%	5.14%	4.61%	5.53%	4.27%
Median	**7.58%**	**7.34%**	7.14%	7.53%	7.59%	7.24%	7.61%
Upper Quartile	**9.96%**	**9.58%**	10.34%	10.83%	11.78%	11.37%	9.65%
Maximum	**30.47%**	**29.24%**	34.17%	30.68%	30.48%	29.72%	29.00%

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CPM Range (Sales and Automotive Parts Manufacturing)

- The IQR is Upper Quartile to Lower Quartile.
- In the 2016-2018 three-year analysis:
    - ROS IQR is 1.74%-4.80% for distribution
    - ROS for automotive parts manufacturing has an IQR of 5.25%-9.26%
- In the 2014-2018 five-year analysis:
    - ROS IQR is 2.06%-5.13% for distribution
    - ROS for automotive parts manufacturing has an IQR of 4.90%-9.58%
- The median is the rate of return that the IRS will adjust to if the income falls below Lower Quartile.

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APA pandemic response

- For existing APAs, the CPM ranges have already been determined, and the ranges do not take into account the impact of the pandemic. Hence, there is a high likelihood for a taxpayer to need to amend the existing APA.
  - The operation of APA requires that ”critical assumptions" be met: there are no material changes to the taxpayer's functions and risks.
  - Taxpayers can amend the APA if a critical assumption of the APA is not met.
- It is unclear whether the tax authorities will actually amend the APA as a failure of critical assumptions because of the pandemic.
  - In the 2008-2009 Lehman recession (The Great Recession), the IRS was reluctant to revise the APA, but the NTA is generally more willing to allow the U.S. subsidiaries to lose money.
  - A U.S. unilateral APA (UAPA) involves only the IRS, but bilateral APA (BAPA)involves the NTA and the IRS.
  - Tax authorities can be reluctant to amend existing APAs, so taxpayers need to approach them strategically.

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APA pandemic response

- The UAPA amendment that we experienced was based on the extension of the APA term rather than a change in the CPM range. It was amended to the term of the Lehman recession period plus extra years, with an annual test replaced with cumulative test.
- Since many U.S.-Japan BAPAs employ a term test (a cumulative test covering the entire APA term), it is likely that the IRS will respond to the APA term extension without changing the CPM range.
  - If the term test is extended, there is room to cover unexpected losses such as pandemic with future years' income without changing the existing CPM range.
- The IRS may also publish pandemic response guidance because it is a 100-year pandemic and has a significant impact on an extremely large number of taxpayers.
  - We had APA cases before where a large loss occurred due to an unavoidable event and the taxpayers' profitability fell below the lower bound of the CPM range for two consecutive years. This loss was recognized and excluded as "Accepted as filed."
  - There is a possibility that tax authorities may allow the same kind of treatment.

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APA pandemic response

- The APA period is the standard 5-year covering from FY2018 to FY2022.
- The average ROS of 2% for 2018-2022 is less than 3% in the case (default) where no adjustments are made to the 2021 and 2022 transfer prices in order to bring the transfer prices into the APA range.

<------------------------------------APA Term------------------------------------>

			Pandemic Year			
Default	Financial Statement	Financial Statement	Financial Statement	Financial Statement	Financial Statement	Term Test
	2018	2019	2020	2021	2022	2018-2022 Wtd. Average
Sales	90	95	60	100	100	89
COGS	65	68	50	70	70	64.6
Gross profit	25	27	10	30	30	24.4
SG&A expenses	20	22	25	23	23	22.6
Operating income	5	5	-15	7	7	1.8
ROS	6%	5%	-25%	7%	7%	2%

APA CPM Range	
Lower Quartile	3%
Median	5%
Upper Quartile	8%

Out of Range

- In this case, the taxpayer is required to make compensating adjustment on the tax return in the final year (i.e., 2022) of the APA.
  - 4.35 tax compensatimg adjustments are required to achieve the lower bound of 3% for the term test.
  - A tax compensatimg adjustment of 13.25 is required to achieve the median of 5% for the term test.

APA pandemic response

- The APA term is the standard 5-year covering from FY2018 to FY2022.
- Suppose TP adjustments are made in FY2022 in order to bring into the APA range. Now the average ROS of 4% from 2018-2022 will exceed the lower bound of 3%, but for this the ROS of FY2022 will need to be 15%.

<——————APA Term——————>

TP Adjust (2022)	Financial Statement 2018	Financial Statement 2019	Financial Statement 2020 (Pandemic Year)	Financial Statement 2021	Financial Statement 2022	Term Test 2018-2022 Wtd. Average
Sales	90	95	60	100	110	91
COGS	65	68	50	70	68	64.2
Gross profit	25	27	10	30	42	26.8
SG&A expenses	20	22	25	23	26	23.2
Operating income	5	5	-15	7	16	3.6
ROS	6%	5%	-25%	7%	15%	4%

APA CPM Range	
Lower Quartile	3%
Median	5%
Upper Quartile	8%

In Range

- There is also a possibility that the parent company's transaction related profits may be negative due to large transfer pricing adjustments.
  - Transfer pricing adjustments, unlike compensating adjustments, are adjustments that are reflected in the financial statements.

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APA pandemic response

- Extending the APA term by two years to seven years, covering the period from FY2018 to FY2024
- In this case, there is no need for large transfer pricing adjustments in 2022 to bring transfer prices into the APA range. The average ROS of 4% of 2018-2024 exceeds the lower bound of 3%.

<——APA Term——> <—— APA Extension ——>

Term Extension	Financial Statement 2018	Financial Statement 2019	Financial Statement 2020 (Pandemic Year)	Financial Statement 2021	Financial Statement 2022	Financial Statement 2023	Financial Statement 2024	Term Test 2018-2024 Wtd. Average
Sales	90	95	60	100	100	100	100	92.1
COGS	65	68	50	70	70	70	70	66.1
Gross profit	25	27	10	30	30	30	30	26.0
SG&A expenses	20	22	25	23	23	23	23	22.7
Operating income	5	5	-15	7	7	7	7	3.3
ROS	6%	5%	-25%	7%	7%	7%	7%	4%

APA CPM Range	
Lower Quartile	3%
Median	5%
Upper Quartile	8%

In Range

- Since there is no need for large transfer pricing adjustments, it is unlikely that the parent company's transaction related profits will be negative.

APA pandemic response

- Even if the APA term is extended without changing the CPM range, a taxpayer's profitability may not be able to fall within the CPM range. In such a case, compensating adjustments should be made to bring the CPM into the range.
    - The NTA considers compensating adjustments problematic since they arise because the taxpayer was not in compliance with the APA. Many Japanese companies are also reluctant to make compensating adjustments from a management perspective
    - In contrast, transfer pricing adjustments are considered to be the adjustments to comply with the APA. As a result, the NTA does not regard transfer pricing adjustments as a problem.
- If a taxpayer is not willing to make compensating adjustments, tax authorities need to accept pandemic losses.
    - Clearly, the TPM needs to be amended in this case. It is now necessary to convince the tax authorities, especially the IRS, that the existing CPM cannot properly evaluate the ALP due to changes in functions and risks.

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APA pandemic response

- An example of an adjusted income statement (Adjusted P&L) that excludes losses due to a pandemic.

FYE March 2021	Financial Statement	Adjusted P&L	Pandemic Revenue Loss (+)	Government Assistance (-)	Pandemic Expenses (-)
Sales	60	100	45	5	
COGS	50	75	25		
Gross profit	10	25			
SG&A expenses	25	20			5
Operating income	-15	5			
ROS	-25%	5%			

APA CPM Range		
Lower Quartile	3%	3%
Median	5%	5%
Upper Quartile	8%	8%

	Out of Range	In Range

- Excluding sales losses, government subsidies, and additional expenses related to pandemic countermeasures, 5% of the adjusted ROS is in the CPM range. The unadjusted ROS is-25%, well below the low bound of the CPM range of 3%.

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APA pandemic response

- The APA term is the standard 5-year covering from FY2018 to FY2022.
- For the pandemic year 2020, Adjusted P&L is used. The 6% ROS over the APA term implies that the taxpayer's adjusted ROS for 2018-2022 exceeds the lower bound of 3%.

<————————————APA Term————————————>

			Pandemic Year			
Adjusted PL (2020)	Financial Statement	Financial Statement	Adjusted P&L	Financial Statement	Financial Statement	Term Test
	2018	2019	2020	2021	2022	2018-2022 Wtd. Average
Sales	90	95	100	100	100	97
COGS	65	68	75	70	70	69.6
Gross profit	25	27	25	30	30	27.4
SG&A expenses	20	22	20	23	23	21.6
Operating income	5	5	5	7	7	5.8
ROS	6%	5%	5%	7%	7%	6%

APA CPM Range	
Lower Quartile	3%
Median	5%
Upper Quartile	8%

In Range

APA pandemic response

- In Adjusted P&L, which excludes pandemic losses, the key is to quantify the impact of the individual items.
    - While it is often necessary to allocate the impact items when quantifying them, it is necessary to explain the rationality of the pro-rata allocation to the tax authorities.
    - Adjusted P&L needs to show that it can trace to the financial statements so as to show that the adjusted P&L is not arbitrary.
- It is often unclear whether the IRS will actually accept Adjusted P&Ls that exclude pandemic losses.
    - The policy of the IRS is to basically not allow the use of Adjusted P&L, which is called "special factor analysis" from actual P&L (P&L in financial statements). But there are cases in which Adjusted P&L, which excludes the effects of the Great East Japan Earthquake in 2011, was approved by the IRS.
        - The IRS argues that it is too one-sided to exclude "specific items" only when they are below the range, since the average range should be higher because of the principle of high risk and high return.
    - As the impact of pandemics far exceeds that of the Great East Japan Earthquake, the possibility that the IRS will accept Adjusted P&Ls is considerable.

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APA pandemic response

- It might be argued that an existing CPM is not "optimal" in a pandemic because the appropriate TPM depends on the functions performed and risks assumed.
- The risk profile of many companies is likely to change dramatically in the pandemic and to change the nature of transactions between third parties.
  - It is quite possible that even unrelated parties, in their effort of survival, agree to share the loss and change the terms of the trade.
  - There is a reason to propose a different TPM during the pandemic period.
  - There are two approaches to such a proposal: TPM based on CPM and TPM other than CPM.

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APA pandemic response

- One of possible CPM-based TPMs is to recalculate the range only during the pandemic without changing the comparables. For the fiscal years other than pandemic year(s), the existing CPM range is applied. The term test calculates the average rate of return except for the pandemic year(s).
- Approaches that employ different TPMs during the APA term are commonly referred to as the "Bifurcation" approach.
  - The TPM is based on the fact that the comparables are also affected by the pandemic, as are taxpayers, so that the effect of the pandemic should be taken into account by using the pandemic year's rate of return of the comparables.
  - If the pandemic is only 2020 and 2021, the range is recalculated using only two years of data and the updated range is applied.
  - If the pandemic ends in 2020, a range will be created with single-year 2020 data.
  - Consider not only the IQR but also the full range (the range from Minimum to Maximum).
  - For example, suppose that the taxpayer's profit rate is-25% during the pandemic year. If the IQR or full range is -30% to 1%, the taxpayer can conclude that the-25% profit rate falls within the updated CPM range.

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APA pandemic response

- Another approach to CPM-based TPM is to construct a separate TPM by calculating the range for the pandemic years.
  - The existing CPM range is based on the comparables that were selected without considering the pandemic.
  - Select companies with large historical sales fluctuations as comarables with high risk profiles.
    - Similar methods have been proposed by IRS as a Down−economy Adjustment to deal with the Great Recession and a different set of distribution comparables was proposed.
    - Down-economy Adjustment uses the sales growth rate and the SG&A expenses to sales ratio. It is to be noted that this IRS Down-economy Adjustment is problematic because the SG&A expenses to sales ratio is unreliable in non distributors.
    - It is not easy to find comparables with high risk profiles because there has been only the Great Recession in U.S. over the past two decades. Therefore, some transfer pricing practitioners seem to advocate Adjustment using regression analysis. I have also conducted a 15-year to analyze the Great Recession and the 2000-2002 slowdown in economic growth to look for the comparables of high-risk distributors. We are currently working on the pandemic adjustment along with this approach.

APA pandemic response

- The APA term is the standard 5-year covering from FY2018 to FY2022.
- TPM is a bifurcation approach, and existing CPM range and term tests are applied for fiscal years other than pandemic year.

<---APA Term--->

TPM Bifurcation	Financial Statement	Financial Statement	Pandemic Year	Financial Statement	Financial Statement	Term Test
	2018	2019		2021	2022	2018-2022 Wtd. Average
Sales	90	95		100	100	96.25
COGS	65	68		70	70	68.25
Gross profit	25	27		30	30	28
SG&A expenses	20	22		23	23	22
Operating income	5	5		7	7	6
ROS	6%	5%		7%	7%	6%

APA CPM Range	
Lower Quartile	3%
Median	5%
Upper Quartile	8%

In Range

Pandemic Year

TPM Bifurcation	Financial Statement
	2020
Sales	60
COGS	50
Gross profit	10
SG&A expenses	25
Operating income	-15
ROS	-25%

APA CPM Range	
Lower Quartile	-30%
Median	-18%
Upper Quartile	1%

In Range

APA pandemic response

- There is a possibility to adopt transactional TPM(s).
    - A transactional TPM does not examine the operating profit margin of the subsidiary, but rather divides the controlled transactions into the following groups and examines the ALP for each transaction group.
        - Import transactions of parts and raw materials, purchase export transactions, export transactions of manufactured goods, royalty, and provision of services
    - By testing the ALP for each transaction group, it is possible to establish the ALP separately from the profits of the subsidiary.
    - It is necessary to obtain gain and loss data for each transaction group. The TPM is determined depending on whether gross profit or operating profit data is available.
        - You need to be able to trace your financial data to your financial statements.
        - For royalty, its rate is normally evaluated.
    - For example, when the parent company manufactures parts and raw materials or procures them from external sources and sells them to a subsidiary, these transactions are grouped into parts and raw material import transactions. We test if the margins and prices obtained by the parent company from manufacturing and procurement are ALP.
        - We worked on several Japan-U.S. BAPA with transactional TPMs.

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APA pandemic response

- A variant of transactional TPM is the use of the "historical" transactional TPM.
    - Transactional TPMs include Comparable Uncontrolled Price Method, the resale-price method (Resale Price Method), and the cost method (Cost plus).
        - The CUP method examines product prices ,and the resale price method and the cost method examines gross margin of the controlled transactions.
    - Assuming that the CPM was in a range until 2019. Then we can conclude that the controlled "prices" were ALP in 2019. If the 2020 controlled "price" is approximately the same as in 2019, then the 2020 controlled "price" is also ALP. “Historical” in the sense that we use the most recent historical "prices" between group companies.
    - For example, if the product price in 2019 was $100 and the price in 2020 was $100.
    - However, since the ALP should be determined according to the functions and risks, the use of the "historical" transactional TPM is not theoretically perfect, and this method can only be used for a short period of time.
        - We were involved in several US-Japan BAPAs where the historical TPM was used on the controlled transactions with the U.S. sister companies.

APA pandemic response

- Another non-CPM TPM is profit splitting.
  - The profit split method (PSM = Profit Split Method) is used to test the appropriateness of income allocation within the group members.
    - There are residual PSM and comparable PSM in the profit split method. OECD guidelines also allow for contribution PSM.
  - Under the profit split method, the total business income (system profit or loss) from controlled transactions between the parent company and its subsidiaries or between the associated companies is divided according to the contribution of the participants.
  - It is reasonable to share pandemic risk to jointly between the parent company and its subsidiaries. But the IRS has traditionally been skeptical that many subsidiaries can bear the same risk as the parent company, and the IRS concluded that the application of the profit split method to TPM is unreasonable.
    - In order to capture the system profit and loss, it is necessary to create complex profit and loss data that can be traced to the financial statements. This is not easily done in practice.

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APA pandemic response

- The vast majority of APAs need to be amended if they expect the profitability to fall below the lower bound of the existing CPM range and if it is difficult to adjust transfer prices to bring them into the range in the future.
    - Since the number of existing APAs is estimated to be hundreds, it is anticipated that the APA amend requests will rush to the IRS. As a result, it would be prudent for taxpayers to consult with the IRS and the NTA as soon as possible when APA amend becomes imperative.
- There is no "standard" approach to APA amend.
- Although we have listed a few approaches, ranging from relatively simple ones to more sophisticated ones, the amends require negotiations with the tax authorities and therefore, there are actually more amend possibilities.
- In particular, you need to prepared to spend time negotiating with tax authorities when proposing TPM changes to avoid compensating adjustments.
    - It is not always disadvantageous that it takes time to reach an APA amend. The reason is that only after the pandemic is over, its true impact can be evaluated objectively and then is is possible to to achieve a fair income distribution for the NTA and the IRS.
- It is important to consult with experts for the best possible approach.

Document pandemic response

- There are many overlapping areas of APA's pandemic response and approach, but there are significant differences.
  - Unlike APAs, it is not possible to recover the average profit margin by combining future year profits. It is not possible to apply the term test.
  - If it turns out that the transfer price does not meet the ALP at the time of tax return filing, the self-initiated income adjustment must be made to satisfy the ALP. In this case, unlike BAPA, it is generally difficult to reduce the taxable income of the Japanese parent company. Accordingly, this results in double taxation.
    - In the case of self-initiated income adjustments, it is doubtful whether the NTA will accept the application for double taxation relief under the tax treaty.
    - Relief can be sought for double taxation resulting from the IRS income assessment.
  - APA amends are ultimately approved by the tax authorities, which eliminates the possibility of IRS TP examination and assessment. This is not feasible for TP documents.
  - However, because the documentation requirements are lower than the those required by the FIN48 in financial statements audit and the tax return UTP, a more aggressive TPM can be adopted if the primary objective is to avoid penalty.
    - For example, we construct a CPM range using a regression-based Adjustment.

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Document pandemic response

- In order to avoid self-initiated adjustments, it is necessary to set a transfer price that meets the ALP by the closing date. However, if the CPM is a TPM, the CPM range reflecting the pandemic may not be available in time because the financial statements of the comparables will not have yet been published.
    - The use of quarterly data may be possible, but the company databases do not necessarily have quarterly financial data access. Therefore, it takes time to analyze. In addition, even if the CPM range is estimated, there is no guarantee that the estimated CPM range will be same as the actual CPM range.
- If the CPM-based TPM is used for the pandemic year(s), there are the following options.
    - Using CPMs up to 2019 and Adjusted P&Ls excluding losses related to the pandemics.
    - Use CPM up to 2019, but greatly extend the analysis period from the usual three-and five-year horizons.
        - For example, a 10-year analysis covering the period from FY 2011 to FY 2020 will be tried.
        - However, it is difficult to explain that there is good economic rationality for the 10-year analysis period.
    - Unlike the CPM used before, adopt CPM that is consistent with the pandemic risk rather (this corresponds to the case of separate TPM in APA).

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Document pandemic response

- If a non CPM TPM is tried during the pandemic,
    - Consider the use of transactional TPM(s).
    - Consider the profit split method.
    - Keep in mind the aforementioned issues when using these TPMs.
- Pandemic is the biggest challenge in the history of transfer pricing analysis, and timely construction of TPM satisfying ALP is a significant task for taxpayers. In particular, it is not easy to come up with a TPM that satisfies the ALP for transfer pricing for the current year 2020.
- Many Japanese subsidiaries do not sufficiently monitor whether the transfer price is ALP before the year end closing and prepare a document just before the tax return filing. Therefore, it is highly probable that they will be forced to make self-initiated tax return income adjustment due to the inability to put their TPs within the CPM range for the pandemic year.
- It is prudent to prepare document more proactively than in the past.
- It is important to consult with experts for the best advice.

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About APA

- APA, which began in 1991 in the United States, has been widely used by taxpayers with U.S.-Japan transactions as an effective measure of managing transfer pricing tax risk.
- The IRS submits reports on the operations of the APA to the Congress every year, and Japan-U.S. transactions account for a prominent position.

Cases	Filed (Japan)	Filed Total	Executed (Japan)	Executed Total	Pending (Japan)	Pending Total
2019	39	121	59	120	222	454
2018	69	203	42	107	142	458
2017	38	101	66	116	220	386
2016	30	98	46	86	215	398
2015	71	183	51	110	189	410
2014	44	108	47	101	158	336
2013	57	111	77	145	175	331
Total	348	925	388	785	1321	2773
Japan (%)	38%		49%		48%	

- The number of submissions (Filed), the number of completed (Executed) and the number of projects under review (Pending) significantly exceed the number of APAs with other countries.

About APA

- It is known that APA provides the following advantages.
  - Assessment and elimination of penalty risk in transfer pricing tax examinations.
  - Avoidance of double taxation in BAPA.
  - Determination of customs duty. (If the transfer price is corrected, it will also affect customs duties)
  - Elimination of tax risks to be disclosed on accounting and tax returns.
  - Avoidance of negative reports by newspapers and the media.
  - Reduction of costs for transfer pricing compliance compared to documentation.
- With economic globalization and the growing popularity of Digital businesses, tax authorities are increasingly monitoring transfer pricing.
  - According to OECD statistics, litigation among tax treaty countries increased from 3328 in 2010 to 6831 in 2017, and 20 transfer pricing cases are currently under review in the US Tax Court.
  - In 2015, OECD's BEPS project was announced, and reporting requirements for transfer pricing were established.

About APA

- In the United States, the tax reforms took effect at the end of 2017, introducing the following taxes and regulations relating to transfer pricing:
    - Tax (BEAT = Base Erosion and Anti-Abuse Tax) to prevent tax base erosion and tax abuse.
    - Rule on Intangible Property Income in Low-Tax Countries (GILTI = Global Intangible Low Tax Income).
    - Rule (FDII = foreign country Derived Intangible Income) on the incomes of intangibles from foreign sources.
- These taxes and rules make document-based transfer pricing compliance and risk management more complex and unpredictable for taxpayers, further enhancing the benefits of using APAs.

About tariffs

- With the aim of correcting the trade imbalance and protecting the U.S. manufacturing industry, the Trump administration's retaliatory tariff policy has put high tariff rates on products manufactured in China, and this has put pressure on the profits of many Japanese companies.
  - In some cases, exemption from retaliatory tariffs is granted.
- In the CPM, it is quite possible that the profitability of some Japanese companies falls below the lower bound of the range due to retaliatory tariffs.
- It seems reasonable to exclude retaliation tariffs as factors outside the transfer price issues. However, it should be noted that the IRS may not accept such tariff exclusion unless similar retaliation tariff adjustments are made.
- At present, there are no clear answers on how to deal with retaliatory tariffs, and it is necessary to formulate measures based on the actual conditions of each company.
  - The retaliatory tariff covers not only products imported directly from China, but also imports of China made goods from Japan through the parent company.

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Discussion with IRS APMA Director

- Grant Thornton organized a web-seminar on July 9, 2020 with respect to the APA Update. The panelist includes the APMA (Advance Pricing and Mutual Agreement) Director John Hughes, Steven Wrappe co-hosted this seminar and Tsutsui also participated as a panelist.
  - Grant Thornton's archived webinar: ***"2020 Advance Pricing Update"*** https://www.grantthornton.com/events/tax/2020/07-09-advance-pricing-agreement-update.aspx
- The following are the contents of the web-seminar that are relevant to this JETRO presentation.
  - Structure of the APMA program and the APA process under the pandemic
    - All electronic filing and teleconference in place of in-person meetings
  - Update on the FCD (Functional Cost Diagnostic) model with respect to marketing intangibles
  - Multilateral APA and coordinated APAs
    - More cases involving more than two countries (e.g., Japan – US – Canada)
  - Tariff and Pandemic
    - The APMA are in active discussion with tax treaty partners and OECD members on these issues. Currently, the APMA and other tax authorities take a wait-and-see position since it is difficult to assess the overall impact at this point due to uncertainty.

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If you have any questions, please feel free to contact our professionals.

Inquiries

Thank you very much for attending today's webinar.
Please contact us if you have any questions.

Please stay safe and healthy

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