

Dispute Resolution

under Mutual Agreement Procedures

1. Introduction

1.1 Organization Structure in relation to MAP

Office of Mutual Agreement Procedures (hereinafter referred to as “MAP Office”) in the National Tax Agency (hereinafter referred to as “NTA”) is responsible for all MAP cases in Japan. Deputy Commissioner (International Affairs) represents a senior competent authority at senior competent authority meetings, while director of MAP office represents a competent authority at normal MAP meetings.

As the number of MAP cases, consisted of both cases in which the NTA received MAP requests from taxpayers in Japan, and cases in which the NTA received MAP requests from foreign tax authorities, has been increasing in recent years, the NTA has increased the number of staff in MAP Office accordingly: in 2000, the number of staff in the MAP Office was just 9, but 41 staffs are working in the MAP Office in 2012.

Reflecting Japan’s foreign economic relationship, the treaty partner from which the NTA receives MAP cases most is the United States. Similar to this, the number of MAP cases with Asian countries has been increasing. Based on such situation, MAP Office is largely divided into three teams: U.S. team, Asia team and Europe team.

1.2 Related Legislation

MAP is operated under bilateral tax treaties. As of September 2012, Japan has 53 tax treaties in effect (covering 64 countries and regions). All of Japan's tax treaties have MAP provisions, and Japan has MAP cases with 23 countries as of September 2012.

As domestic legislations, "Act on Special Provisions of the Income Tax Act, the Corporation Tax Act, and the Local Tax Act Incidental to Enforcement of Tax Treaty" and its Ministerial Order, and "Act on General Rules for National Taxes" provide general rules of MAP. "Commissioner's Directive on Mutual Agreement Procedures" provides the details of MAP.

2. Implementation of MAP

2.1 Country's Experience on MAP Cases

2.1.1 Types of MAP Cases

As stated above, MAP Office is responsible for all MAP cases. Recently more than 90% of the MAP cases are related to transfer pricing and most of them are bilateral Advance Pricing Arrangements (hereinafter referred to as "APA"), which Manual on Effective Mutual Agreement Procedures (hereinafter referred to as "MEMAP") published by the OECD defines as "an arrangement that determines, in advance of controlled transactions, an appropriate set of criteria (e.g. method, comparables and appropriate adjustments thereto, critical assumption as to future events) for the determination of the transfer pricing for those transactions over a fixed

period of time”. Other than transfer pricing cases, withholding cases and permanent establishment cases are counted with small numbers. Also, as provided in the tax treaties, MAP cases in relation to the interpretation or application of the tax treaties and the elimination of double taxation in cases not otherwise provided for in tax treaties are possible.

2.1.2 Current Procedures

As with other countries and regions, in Japan, MAP process is divided into two categories: MAP including transfer pricing taxation and a bilateral APA.

(a) MAP Process

As provided in Paragraph 1 of Article 25 of the OECD Model Tax Convention, “where a person considers that the actions of one or both of the Contracting States result or will result for him in taxation not in accordance with the provisions of this Convention, he may, irrespective of the remedies provided by the domestic law of those States, present his case to the competent authority of the Contracting State of which he is a resident or, his case comes under paragraph 1 of Article 24, to that of the Contracting State of which he is a national”.

MAP procedures are divided into the following 3 steps: (i) submission of a MAP request, (ii) review of the request by the MAP Office, and (iii) MAP negotiations and agreements.

(i) Submission of a MAP Request

MAP cases are initiated through a taxpayer's request for competent authority assistance, while a taxpayer may have a pre-filing consultation with the MAP Office before deciding whether to apply for a MAP. Many of our tax treaties provide that the case must be presented within 3 years from the first notification of the action resulting in taxation not in accordance with the provisions of the Convention, as the OECD Model Tax Convention does.

(ii) Review of the Request by the MAP Office

Once the MAP request is submitted to the MAP Office, the MAP Office scrutinizes the request and may require the taxpayer or the Regional Taxation Bureau (hereinafter referred to as "RTB") relevant documents in addition to the documents attached to the MAP request, if necessary.

(iii) MAP Negotiations and Agreements

Then analysts in the MAP Office develop position papers. Face-to-face meetings with the foreign tax authority concerned are generally held several times per year. In addition, analysts in the MAP Office exchange views with their counterparts by telephone, fax and other means. In the course of MAP negotiations they may request necessary information to the field tax examiners in the RTB, if necessary.

Once the MAP is reached an agreement, the taxpayer is notified in writing of the decision and is provided with the explanation of the result. After the taxpayer accepts the result, written confirmation of the agreement is exchanged between competent authorities and provided to the taxpayer. Each tax authority processes the result in each jurisdiction as soon as possible.

(b) Bilateral APA Process

Bilateral APAs commence with the request of the taxpayer, while a taxpayer may have a pre-filing consultation with the NTA before deciding whether to apply for a bilateral APA. The NTA does not charge any fee for APA proceedings. Bilateral APA procedures are divided into the following 4 steps: (i) submission of a bilateral APA request, (ii) review of the request by the RTB's APA review team, (iii) bilateral APA negotiations and agreements, and (iv) review of an annual compliance report.

(i) Submission of a Bilateral APA Request

In the case of bilateral APAs, a taxpayer is required to submit an APA request to the RTB and a MAP request to the MAP Office respectively. The taxpayer is required to attach the necessary documents to the request form for the purpose of facilitating the review of the request by the RTB's APA review team.

(ii) Review of the Request by the RTB's APA Review Team

Once the APA request is submitted to the RTB, the RTB's APA team commences the review immediately. The RTB's APA review team conducts its review based on "Commissioner's Directive on the Operation of Transfer Pricing". The APA review team may require the taxpayer relevant documents for the review in addition to the documents attached to the APA request, if necessary. After finishing the review, the RTB's APA review team reports the results of its review to the division in charge at the NTA. The division reviews the report internally and sends it to the MAP Office.

(iii) Bilateral APA Negotiations and Agreements

In the case of Bilateral APAs, analysts in the MAP Office develop position papers based on the conclusion reached in the APA review by the RTB's APA review team. Face-to-face meetings with the foreign tax authority concerned are generally held several times per year. In addition, analysts in the MAP Office exchange views with their counterparts by telephone, fax, and other means. Analysts in the MAP Office and the APA review team in the RTB exchange views to confirm facts, if necessary.

The RTB's APA review team sends a notice of APA confirmation to the taxpayer if a bilateral APA is agreed with the same terms as those of the original APA request. The taxpayer is required to submit a modified APA request in accordance with the agreement

if a bilateral APA is agreed with different terms from those of the original APA request. The RTB's APA review team then sends a notice of APA confirmation to the taxpayer.

(iv) Review of an Annual Compliance Report

After the APA confirmation notice is received, the taxpayer is required to submit, by the due date of its final tax return or by another designated date, the annual compliance report that explains whether or not the business results reported in the year's tax return accord with the bilateral APA result. The RTB's APA team, if necessary, may request a further explanation from the taxpayer and also visit the taxpayer for review.

The taxpayer is obliged to adjust the actual income to the income level agreed in the bilateral APA in the amended tax return if the actual income is lower than the income level agreed in the bilateral APA.

The taxpayer is obliged to submit a new bilateral APA request and make a compensating adjustment, which is a request for correction of tax return for downward adjustment, based on the bilateral APA agreement in the years covered by the bilateral APA, if the actual income is higher than the income level agreed in the original bilateral APA,

Also the taxpayer is obliged to submit a new bilateral APA request

if the conditions provided in critical assumptions change.

2.1.3 Strengths and Weaknesses of MAP Implementation

(a) Strengths of MAP Implementation

With the globalization of the world economy, where multinational enterprises do business around the world, they may encounter the international double taxation. Obviously the international double taxation is an obstacle for their business activities. MAP can provide them high possibility to eliminate international double taxation completely, although it is not mandatory for competent authorities to resolve the case. It can be observed that in most cases the possibility of complete elimination of the international double taxation through MAP is higher than that through domestic litigations.

In the case of bilateral APAs, they may provide legal stability and predictability to taxpayers. As the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations explains, “APAs are intended to supplement the traditional administrative, judicial, and treaty mechanisms for resolving transfer pricing issues. They may be most useful when traditional mechanisms fail or are difficult to apply.” Also bilateral APAs may provide taxpayers with remarkably short period of time to resolve international double taxation, compared with the total time spent on transfer pricing examination and MAP.

Reflecting such strengths of bilateral APAs, the number of bilateral APA cases which the NTA receives is on the trend of increase this past more than 10 years. During the 2010 business years (July 2010 – June 2011), the NTA received 157 MAP cases, of which 135 were on bilateral APAs.

(b) Weaknesses of MAP Implementation

MAP plays an essential role in ensuring the effective operation and application of tax treaties. There are situations, however, where it is difficult to reach an agreement. In order to improve efficiency of MAP implementation, it is inevitable to identify potential barriers in MAP resolution.

(i) Domestic Legislation

In some countries, cases proceed simultaneously in litigation and in MAP without suspending either process. Consequently MAP decision may be delayed and restricted by the court decision. This would be a potential barrier for the efficient MAP process.

Time limitation on tax refunds is also a domestic legislation issue. Paragraph 2 of Article 25 of the OECD Model Tax Convention provides that any agreement reached shall be implemented notwithstanding any time limits in the domestic law of the Contracting States. Most of our tax treaties include the same provision with the OECD Model Tax Convention, but some of our

old tax treaties do not include it and we sometimes face with time limitation issues raised by our treaty partners. MAP resolutions would be substantially breached if MAP agreement was not implemented due to the domestic time limitation on tax refunds.

(ii) Absence of Corresponding Adjustment Provision

Some of our tax treaties, which are old, do not contain corresponding adjustment provision. Even in the absence of this provision, competent authorities should seek to avoid double taxation by giving corresponding adjustments, which is a clear role of MAP.

(c) Authority of a Competent Authority

It seems that some competent authorities are not given enough authority to conclude MAP cases. In some countries, local government agencies implement transfer pricing rules and the central government agency, with which we negotiate, cannot prevail over local agencies. Some competent authorities are not fully independent of assessment or audit functions which make the resolution through MAP difficult. It is important for competent authorities to have appropriate authority within tax administrations to carry out their responsibilities.

(d) Philosophical Posture

While competent authority's role is to eliminate or reduce double

taxation to the fullest extent possible, a competent authority may have an ambivalent feeling that they should protect their tax revenue as much as possible. Caused by such desire, there is a possibility of irrational arguments in MAP. This sort of philosophical conflict may trigger functional failure of MAP. It would be necessary to recognize that MAP should be regarded as a cooperative resolution rather than a competitive negotiation. Also it should be noted that aggressive tax administration may deteriorate investment environment. Consequently it may cause reducing tax revenue, job opportunities and perhaps reputation of the jurisdiction concerned in the long run.

2.1.4 Relationship between Dispute Resolution under MAP and Domestic Laws

In principle there are three remedies for taxpayers to eliminate double taxation in Japan: MAP (bilateral APA included), domestic appeal and a unilateral APA. Since in most cases competent authorities reach an agreement and relieve double taxation through MAP, taxpayers, who are taxed not in accordance with the provisions of the tax treaty, normally file a request for MAP.

(a) Domestic Appeal

As a domestic appeal, when the tax authorities do a disposition for taxation and taxpayers object to that disposition, taxpayers can use the following remedy during a certain period. There is no procedure in Japan such as negotiated resolution between tax authority and

taxpayers.

(i) Request for Reinvestigation

A request for reinvestigation is the first stage in administrative appeal with regard to national taxes. In cases where tax authorities took action for a correction, determination or seizure, with which taxpayers are dissatisfied, taxpayers can request the tax authorities to revoke or change the ruling, within two months from the date when the decision by tax authorities was made.

(ii) Request for Reconsideration

Taxpayers, who remain dissatisfied with the decision made following the request for reinvestigation above, are entitled to file a request for reconsideration to the Director-General of the National Tax Tribunal, within one month from the date when the decision of reinvestigation was made.

(iii) Litigation

Taxpayers, who remain dissatisfied with the decision by the Director-General of the National Tax Tribunal, are entitled to file litigation with the judiciary seeking a legal remedy, within six months of the date when the decision by the Director-General of the National Tax Tribunal was made.

In practice, when taxpayers file a request for MAP, they file a request

for reinvestigation at the same time to prepare for the situation that they may need a domestic remedy as they are dissatisfied with the result of MAP. (i.e. taxpayers need to do so because they are required to file a request for reinvestigation within two months from the date when the decision by tax authorities was made, while it normally takes more than two months to resolve a MAP case.). Although taxpayers file a request for reinvestigation together with MAP, a request for reinvestigation is suspended until MAP is completed in order to avoid duplication of effort. Once taxpayers accept the result of MAP, a request for reinvestigation is turned down.

(b) Unilateral APA

A unilateral APA is another possibility to eliminate double taxation in certain circumstances: where no applicable tax treaties exist, or when a taxpayer finds it meaningless to file a request for MAP or domestic appeal after the cost and benefit analysis, the taxpayer may submit a unilateral APA request to the RTB.

2.2 Improving Efficiency of MAP Implementation

Given growing MAP inventories and the importance of cross-border transaction, in our experience, the following items are key issues which should be considered to improve efficiency of MAP implementation.

(a) Resources

Lack of resources will be the most serious issue for most countries and

regions. Resource issues include human resources, budgetary resources and information resources. Among them, human resources are likely to have the most fundamental impact on the capacity to operate an effective MAP program. In this regard, human resource management will be the most important area which should be focused to improve efficiency of MAP implementation.

In the MAP Office of the NTA, junior officials are getting on-the-job training from senior officials. In addition to it, various seminars are being held in the MAP office such as a training session for newly appointed personnel and a case study session for a specific industry.

Needless to say, budgetary resources to pay translations and travel/accommodation expenses for face-to-face meetings with other competent authorities are crucial for a practical reason. Information resources, for example, access to company database and industry data, are also important.

(b) Face-to-Face Meetings

Empirically we can conclude that face-to-face meetings are the most efficient way of implementing MAP. Compared to e-mail discussions or conference calls, face-to-face meetings can provide a more open discussion and a more relaxed environment. Moreover, from a logistic point of view, face-to-face meetings can establish a milestone toward achieving efficient MAP resolutions: competent authorities need to

prepare before a meeting and ensure follow-up after the meeting. As a result, MAP may proceed in an efficient manner. The NTA holds more than 40 face-to-face MAP meetings per year.

(c) Procedural Arrangement

Although most competent authorities have endeavored to complete a MAP case within two years, it is not necessarily the case depending on the facts and circumstances. The NTA has concluded procedural arrangements with some competent authorities to make procedures more efficient. The arrangements provide the details of MAP procedures such as a schedule for face-to-face meetings and a case list. By establishing such arrangements, we expect that both competent authorities make their best efforts to continuously enhance case resolution procedures.

(d) International Discussions

We may benefit from international discussions. With the aim of improving the functioning of existing international tax dispute procedures and developing supplementary dispute resolution mechanisms, the OECD published MEMAP in 2007. MEMAP provides competent authorities and taxpayers with basic information on the operation of MAP and identifies best practices for MAP. MEMAP seems, however, not necessarily well-received: there is an argument that competent authorities have not relied much on MEMAP to improve their procedures. MEMAP may not provide enough guidance to all

circumstances, but it is certain that there is no alternative for MEMAP and we believe that MEMAP is still worth to be used for reference to improve efficiency of MAP implementation. For information, MEMAP can be found at <http://www.oecd.org/ctp/memap>.

(e) Technical Assistance

The NTA is providing technical assistance on tax administration including MAP to Asian countries and regions. Based on the requests from the foreign tax authorities, the NTA dispatches its officials to Asian countries and regions, or holds seminars in Japan, for the purpose of sharing experience and exchanging views with our colleagues in Asia.

(f) Arbitration

After the revision of Japan-Netherlands Tax Treaty in 2011, Japan intends to include the arbitration clause in our tax treaties for the purpose of promoting efficient resolution of MAP cases with our treaty partners. As Commentaries on the OECD Model Tax Convention explains, arbitration is “an extension of the mutual agreement procedures that serves to enhance the effectiveness of that procedure by ensuring that where the competent authorities cannot reach an agreement on one or more issues that prevent the resolution of a case, a resolution of the case will still be possible by submitting those issues to arbitration”. In other words, arbitration is expected to promote MAP precisely because every taxpayers and competent authorities would wish to resolve a case without going into arbitration.

Thus the NTA is working with tax treaty teams in the Ministry of Finance for the arbitration clause. As of September 2012, three tax treaties, namely Japan-Netherlands tax treaty, Japan-Hong Kong tax treaty and Japan-Portugal tax treaty, contain arbitration clause.

3. Conclusion

3.1 Purpose of a Competent Authority

Competent authority's role is obvious: eliminating double taxation. A competent authority is committed to ensure a good faith application of a tax treaty and endeavors to resolve MAP requests in accordance with the applicable tax treaty. Every effort should be made to reach a satisfactory resolution of the issues involved.

There are three relationships which a competent authority should treat as important: relationship with other competent authorities, relationship with taxpayers and relationship with field office.

Regarding the relationship with other competent authorities, above all, a competent authority should engage in discussions with other competent authorities in a principled, fair and objective manner. Considering that there are many opportunities to discuss with treaty partners, it is important to foster a long-term mutual trust and respect with treaty partners. Also, a competent authority should be consistent and reciprocal in the positions, look for appropriate opportunities for compromise in

order to eliminate double taxation, where an agreement is not otherwise achievable.

Regarding the relationship with taxpayers, a competent authority should make taxpayers understand the following issues:

- Taxpayers can best help themselves by providing competent authorities with complete and accurate information required to resolve the case,
- It would be constructive and advantageous for the taxpayers to ensure that the same information is provided to both competent authorities at the same time, and
- MAP discussions between competent authorities are government-to-government process in which there is generally no direct taxpayer involvement. However, taxpayers may be invited to make a presentation to both competent authorities, where appropriate, to ensure the common understanding of the facts of a particular case.

Regarding the relationship with the field office, a competent authority should be independent from the field office: a competent authority should play a role of ensuring a fair and appropriate application of the tax treaty, not seeking to uphold all adjustments proposed by its own tax authority nor rejecting all adjustments by the tax authorities of its treaty partners. In this regard, tax officials directly or indirectly involved in the initial adjustment should not take part in the competent authority discussions.

3.2 Improving Tax Compliance in Transfer Pricing

While improving efficiency of MAP implementation as stated above, the NTA has just started a new approach as a dispute prevention measure in transfer pricing. In order to prevent the occurrence of problems concerning transfer pricing, the NTA and the enterprise corporate and promote the voluntary and appropriate actions of the enterprise.

Under the self-assessment system, enterprises are required to file proper tax returns including transfer pricing. The reality is, however, that this is not necessarily the case.

By taking this approach, enterprises can minimize tax risks and the burden of handling tax examinations, while the NTA can greater focus on tax examinations of corporations with a high need for an examination and prevent the problem of international double taxation.

In our experience, the NTA recognizes that the following key points are expected for enterprises to prevent occurrence of transfer pricing problems:

- Knowledge of the transfer pricing tax systems,
- Involvement of top management,
- Recognition of status and problem areas, etc in foreign related party transactions,
- Establishment of global transfer pricing policies,
- Transaction price setting taking into account the transfer pricing

methodology,

- Transfer pricing compliance by overseas related parties (governance by parent company), and
- Communications with tax authorities.

As part of their efforts directed toward the enhancement of corporate governance concerning taxes, the NTA encourages enterprises to themselves plan for the maintenance and improvement of tax compliance in transfer pricing, while confirming the status of the efforts of the enterprises concerning transfer pricing. To put it more concrete, the NTA explains the importance for enterprises to themselves maintain and improve their tax compliance in transfer pricing through orientation sessions. Also the NTA confirm the status of efforts in transfer pricing through a request to fill in a “Check Sheet for Transfer Pricing” (hereinafter referred to as “Check Sheet”), which is a questionnaire on the basic transfer pricing related issues. The NTA exchanges views with top management concerning transfer pricing based on their answers to the Check Sheet.

Obviously enforcement of appropriate tax examinations is an important mission for tax authorities. Likewise enhanced relationships with taxpayers are important, and as part of it APAs are globally recognized as quite effective. Other than APAs, we believe that it is worthwhile to consider the enhanced relationships between tax authorities and taxpayers from a long perspective, which is a form of corporation rather

than a form of confrontation.