

IV Tax Administration in the Era of Globalization

The NTA promotes tax administration, including cooperation with foreign tax authorities to meet the era of globalization.

As multinational enterprises conduct various cross-border economic activities amid growing economic and social globalization, one country's taxation system and tax administration can have a great impact on another nations' taxation systems and enforcement. The environment surrounding tax administration has thus changed dramatically. The elimination of international tax avoidance and double taxation risks emerging from such environmental change has become a major issue for tax authorities worldwide. In this respect, it is necessary to develop common rules on international transactions, promote cooperation among tax authorities and share experiences between them. Under this situation, the NTA actively responds to the globalization of tax administration by enhancing mutual trust and cooperation with other countries. Furthermore, in order to tackle the problems of international tax avoidance and transfer pricing, the NTA is enhancing and strengthening its organizational systems.

1 Discussion on Development of Common Taxation Rules and Enforcement Issues

The NTA is enhancing multinational or bilateral collaboration by actively participating in discussions in OECD Committee on Fiscal Affairs*¹ on taxation issues related to international transactions, as well as engaging in talks with taxation authorities in nations or regions that have close economic relations with Japan.

(1) Developing Common Taxation Rules

(i) Review of Transfer Pricing Taxation

The OECD Guidelines, which serve as a model for the transfer pricing taxation system*² of each country, have been unchanged for more than a decade since the last update in 1995. It is necessary to refine and review the OECD Guidelines, paying due attentions to recent changing practices of multinational enterprises,

development of practice and the accumulated experiences of the tax authorities of each country. For example, due to the increase of transactions involving intangible assets, it is becoming more difficult to apply the traditional comparable method, while the practical importance of the profit method*³ is growing.

(ii) Discussion on Taxation Issues Arising from Business Restructuring

In the business restructuring process of multinational enterprises, some turn their supplier or sales subsidiary into a commissionaire*⁴ or turn their manufacturing subsidiary into contract manufacturer. If a trademark, brand, production know-how or any other important intangible asset is transferred to an overseas affiliated firm in its group in the business restructuring process,

the problem of transfer pricing will emerge in compensation. In addition, there may be cases where a subsidiary after business restructuring is treated as an agent of its overseas parent company. OECD Committee on Fiscal Affairs has been discussing these new problems toward the announcement of new guidelines.

*1 OECD Committee on Fiscal Affairs provides a forum where OECD member nations engage in discussions to set international common taxation rules, such as the Model Tax Convention and the Transfer Pricing Guidelines, and the tax authorities of OECD member nations share their knowledge and experience. OECD Committee on Fiscal Affairs has organized working groups to exchange opinions among member nations.

*2 In the 1986 tax reform, Japan introduced a "transfer pricing taxation system" in order to achieve proper international taxation by addressing overseas income transfers through transactions with foreign affiliated firms (overseas related parties). Currently, more than 40 nations, including major developed nations, have adopted such system. In the basic framework of the system, if a transaction with an overseas related party has a price gap with a transaction with a third party, and such gap brings about a decrease in taxable income in Japan, then the tax authority will recalculate their income in line with the arm's length principles.

*3 The "Profit method" is an approach taken to calculate transfer pricing. It includes the "Profit Split Method," which redistributes the parties' total profits according to their proportion of contribution, and the "Transactional Net Margin Method (TNMM)," which employs an operating profit ratio related to comparable transactions.

*4 "Commissionaire" corresponds to the commission agent specified in the Commercial Code. Although it has the rights and obligations as a party in a transaction legally, from an economical standpoint, it merely receives commission, without assuming these rights and obligations by transferring them to the consigner.

(iii) Reviewing the Taxation Rules for Foreign Corporation's Branch Offices

Although the legal character of branch offices of foreign corporations (permanent establishments) and subsidiaries differs, there is now a strong belief that they should be treated in the same manner in terms of taxation, with the economic reality in mind. Having been reviewing taxation rules on permanent establishments, OECD Committee of Fiscal Affairs is

now at the stage of final consideration concerning how the transfer pricing approaches should be applied to branch offices of foreign corporations. In addition, the Committee plans to revise the Model Tax Convention on income and capital and related commentaries (interpretive criteria).

(iv) Eliminating Harmful Tax Practice and Achieving Fair Competitive Condition

Certain nations and regions provide tax incentives to attract "light-footed" economic activities such as financial services from foreign nations. This could lead to more difficulties in taxing such "light-footed" economic activities and the erosion of tax base on a global scale. On the other hand, the tax burden of "slow-moving" labor and consumption could be

relatively heavier. OECD Committee on Fiscal Affairs announced a report on such harmful tax competition in 1998 and has been working on follow-up activities. To reduce "harmfulness" by enhancing "transparency" and "the effective exchange of information," the Committee is taking actions covering nations and regions that have tax havens*¹ and important financial centers.

(2) Sharing Tax Administrative Experiences with Foreign Tax Authorities

Adaptation to the environmental change surrounding tax administration, including economic globalization and the diffusion of IT, has been a common issue for tax authorities worldwide, despite the gaps in their taxation systems. In this context, the tax authorities are cooperating and sharing their experiences in dealing with common issues, such as reinforcement of compliance and improvement of taxpayers services.

OECD Committee on Fiscal Affairs has been playing central roles in setting international common taxation rules. In recent years, the OECD Forum on Tax Administration (FTA), which consists of heads of tax authorities of OECD members and major non-OECD members, has been studying common issues.

As a small top-level forum, the Leeds Castle

Group (Tax Administrators Meeting)*², consisting of 10 nations (Japan, U.S., Canada, Australia, U.K., France, Germany, China, South Korea, and India), discusses how they should address abusive tax planning. Moreover, the Study Group on Asian Tax Administration and Research (SGATAR), consisting of tax authorities in 13 countries and regions in Asia, is holding a forum that contributes to regional cooperation.

In addition, the NTA holds tax administrator-level meetings every year with the tax authorities of China and South Korea, who have close historical and economic relationships with Japan, in order to promote cooperation.

Technical Cooperation to Developing Countries

The NTA is positively engaging in technical cooperation to developing countries. In cooperation with the Japan International Cooperation Agency (JICA), the NTA holds the International Seminar on Taxation (ISTAX) and has recently conducted country-specific projects. Especially in the fields of tax examination, tax collection, organizational management, taxpayers' services, and international taxation, the NTA is sending experts to ASEAN countries and providing training sessions in Japan by inviting the staff of foreign tax authorities. The NTA is also actively contributing to technical cooperation in seminars held by OECD or the Asian Development Bank (ADB). Through these technical cooperation activities, Japanese tax administrative experiences and know-how will improve tax administration in developing countries. These activities will also contribute to improving region-wide tax administration and enhancing regional cooperative relationships.

*1 "Tax haven" is a nation or region that levies zero or extremely low tax on corporate income.

*2 This meeting is called the Leeds Castle Group, since the preparatory meeting was held in Leeds Castle in the U.K. in 2006.

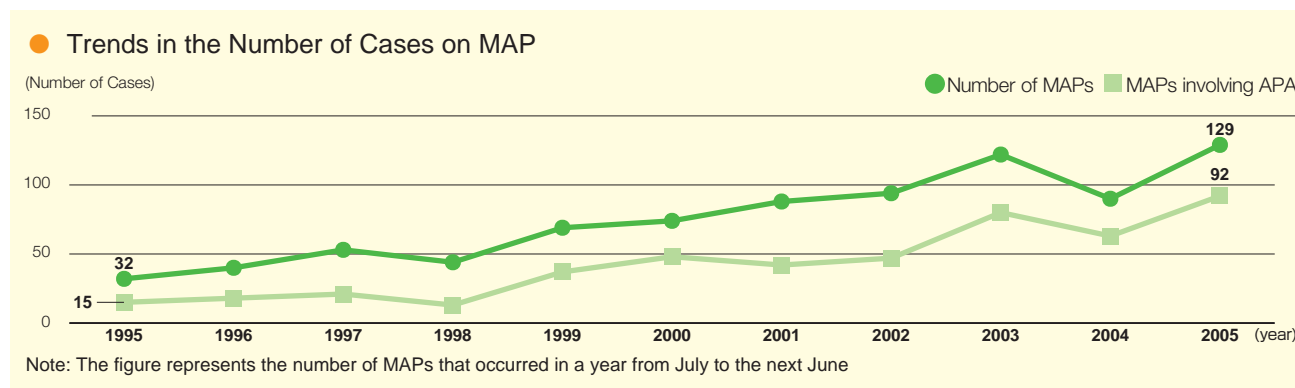
2 Mutual Agreement Procedures and Exchange of Information

Using a system of mutual agreement procedures*¹ based on tax treaties, the NTA is striving to smoothly handle taxation issues, such as the prevention of international double taxation. From the viewpoint of preventing malicious tax avoidance relating to international transactions, the NTA is actively utilizing the tax treaty and exchanging information with foreign tax authorities.

(1) Increase of Mutual Agreement Procedure (MAP): Expansion of the Advance Pricing Arrangement (APA)

Cases of MAP have been increasing in recent years, more than 90% of which are related to transfer pricing. As for cases on transfer pricing, increasing numbers of cases are involving APA, targeting predictability for taxpayers and preventing double taxation. In the year from July 2005 to June 2006, 129 cases on MAP occurred, of which 119 cases were related to transfer pricing and 92 involving APA for transfer pricing. Compared to 10 years ago, the number of cases on MAP has increased approximately fourfold, while cases on MAP involving APA have also increased approximately sixfold.

Due to such increase in MAPs, Japan now has a MAP with an increased number of nations, from the total of 11 nations a decade ago to 23 nations at the end of June 2006. Likewise, APAs with MAP have been recently increasing in relation with Asian countries, which were not previously involved in APAs. To solve these MAP-related cases properly and promptly, the NTA is enhancing cooperative relations with foreign tax authorities and engaging in talks more effectively.



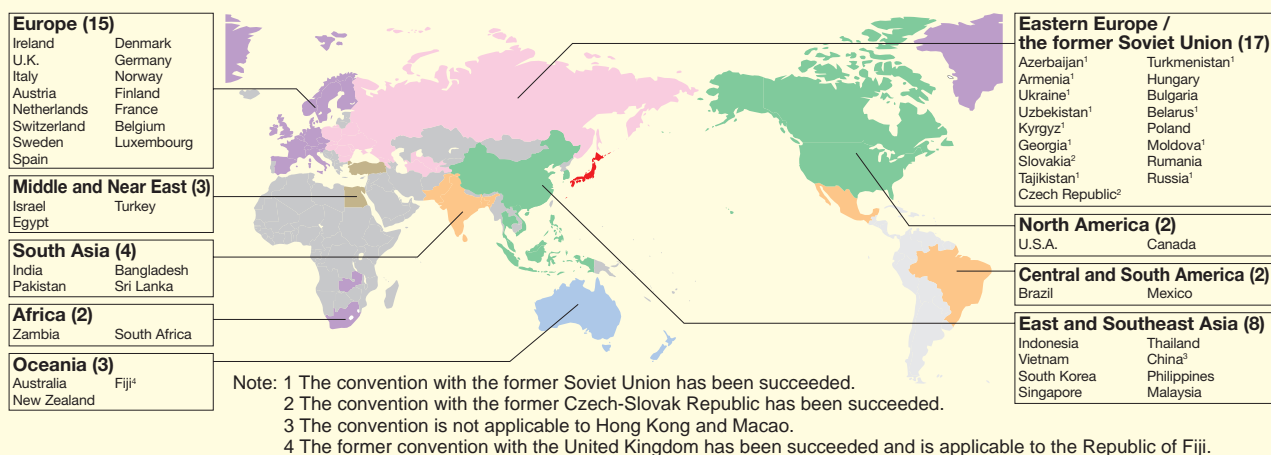
Trend of International Discussion on MAP

As for dispute resolution on international taxation, including MAPs, OECD Committee on Fiscal Affairs has been discussing how to improve the effectiveness of MAPs and issues concerning the supplementary dispute resolution mechanism. This is to explore best practices and a proper arbitration process in order to solve such issues, considering opinions such as the excessive time required for some cases of MAP and the fact that the current MAP does not completely solve the problem of double taxation. The NTA has posted the detailed information in the “Improvement of International Taxation Dispute Resolution” and “Manual on Effective MAP” sections on its website.

Notes: 1 “Mutual agreement procedure (MAP)” refers to a negotiation procedure between tax authorities of contracting parties to a tax treaty to eliminate taxation incompatible with the applicable tax treaty when a taxpayer is or likely to be subject to tax incompatible with provisions in the tax treaty. All of the 45 tax treaties that Japan has concluded (applicable to 56 nations) provide for the MAP.

2 “Advance Pricing Arrangement (APA) on Transfer Pricing” refers to the District Director of a Tax Office confirming calculation methods used for arm’s-length price and its details related to international transactions in advance, in order to ensure predictability on transfer pricing taxation for taxpayers according to their request. Japan introduced the measure ahead of any other country in 1987. Subsequently, APA was introduced in the U.S. in 1991, followed by Canada (1994), Australia (1995), South Korea (1996) and China (1998). To date, more than 30 countries have introduced APA.

● Japan's Tax Convention Network (45 conventions applied in 56 countries, as of May 2007)



(2) Exchange of Information under Tax Treaties

In international transactions, not only the risk of double taxation but also “taxation loopholes”, in which no tax is levied by any country, has been an issue. The tax authority of each country has been enhancing their actions regarding international taxation in order to address various tax avoidance schemes, but proper information collection from outside the country is essential for proper and fair taxation. With this in mind, each country is reinforcing the exchange of information under the tax treaties.

Through the 2003 and 2006 tax reforms, Japan also developed legislation concerning the exchange of

information, including investigation on tax violations. In July 2005, a new team exclusively in charge of the exchange of information was established in the International Operations Division of the NTA. Thus, the NTA is setting up a system to respond to requests from foreign countries promptly and also proactively request their cooperation. The effective exchange of information would require close cooperation among tax authorities. In addition to participating in working-level EOI meetings at the OECD Committee on Fiscal Affairs, the NTA actively provides technical assistance for developing countries.

(3) Linkage with Foreign Tax Authorities, Information Collection and Research Activities

To properly collect information outside Japan and enhance linkage with foreign tax authorities, the NTA has placed NTA liaison officers in the U.S. and some other countries and regions with close economic relations with Japan since 1985. The NTA

now has liaison officers in 12 countries (17 regions) to collect information on the local tax systems and tax administration. They also serve as a important pipeline when cooperation with foreign taxation authorities is needed.

3 Addressing International Tax Avoidance

Concerning tax evasion and tax avoidance through the exploitation of cross-border transactions, the NTA implements proper taxation after properly grasping the facts through examinations. To this end, the NTA has enhanced the examination framework, such as increasing the number of Senior Examiners (International Taxation), setting up a project team and so forth, and taking every opportunity available to collect information helpful to taxation through, such as making the best use of information exchange under the tax treaties and grasping the flow of funds to foreign countries. Furthermore, the NTA is properly handling the transfer pricing issues involved in the prices for transaction with related companies located overseas, based on information collected by examinations.

(1) International Tax Avoidance Schemes

As cross-border activities of individuals and corporations expand, international tax avoidance involving reducing tax liability by cleverly exploiting differences between national tax systems and the tax treaties is developing into a major international issue. Finance specialists, legal counsels and Certified Public Tax Accountants have all become involved in international tax avoidance, and various entities such as sleeping partnership (Tokumei Kumiai) contracts, partnerships, LLC (Limited Liability Companies) and similar, or complicated schemes making free use of new financial technology, are used for international tax avoidance.

From the viewpoint of realizing proper and fair taxation, the NTA is endeavoring to grasp and elucidate the actual state of transactions; taking every opportunity available. If there are recognizably problems for taxation purposes, the NTA conducts close examinations and deals strictly with tax evaders, so that no amount of tax avoided under such tax avoidance scheme is finally borne by conscientious taxpayers.

To this end, the NTA has increased the number of

Senior Examiners (International Taxation) and has endeavored to enhance and strengthen the examination framework, such as setting up the International Examination Division in key Regional Taxation Bureaus. In recent years, international taxation problems have begun to extend from large enterprises and corporations that have overseas subsidiaries to wealthy individuals. In order to deal with such circumstances, the NTA established the “Project Team to Deal with Internationalization” in the key Regional Taxation Bureaus and is endeavoring to grasp or elucidate such tax avoidance schemes and collect information on financial assets held overseas by tax evaders.

The National Tax College provides training courses on international tax law, tax treaties, derivatives and foreign languages.

As for tax avoidance schemes that cannot be properly handled under current legislation, the NTA requests the departments and bureaus in charge to reform the relevant system.

(2) Transfer Pricing Issues

With the globalization of corporate activities, transfer pricing issues have become important in the field of international taxation. For example, if a Japanese parent company sets a low price when exporting products to its overseas subsidiary, the income is transferred overseas. The transfer pricing tax system has been developed to address such issues.

As corporations have been expanding their business activities on a global scale due to internationalization, increasing numbers of transactions are subject to transfer pricing taxation and the transactions have been getting more complicated and sophisticated. In particular, the importance of transactions involving intangible assets is increasing. To properly address these changes in economic conditions and prevent Japanese taxable income from escaping abroad, the NTA is striving to realize proper international taxation through definite enforcement of the transfer pricing taxation.

To ensure transparency and predictability on transfer pricing taxation, the NTA also implements its operations in a more transparent manner and reinforces the framework for addressing APAs.

To enhance operational transparency, the NTA has set up and revised the directives concerning the interpretation of the laws on transfer pricing taxation and administrative guidelines for operation on virtually

a yearly basis. Through the announcement of these activities, the NTA is clarifying the applicable criteria and enforcement policies. In addition, the NTA has decided to prepare and disclose Case Studies on Transfer Pricing as a supplementary volume of the administrative guidelines for operation, which outlines taxation practices under certain conditions, using examples from recent taxation practices.

Increasing numbers of taxpayers are filing applications for APAs due to the recent increase in international transactions. In this context, Regional Taxation Bureaus provide Pre-filing Conference (i.e. consultations before taxpayers actually file applications for APA). The NTA is also improving the environment for users, such as posting the outline of the APA process or Pre-filing Conference on the NTA Website. Furthermore, the NTA is conducting its duties smoothly by increasing the number of officers in charge of examining APA, streamlining its operations and promoting a cooperative relationship with countries involved in the MAP.

Considering the characteristics of the transfer pricing taxation, the NTA introduced a system of grace of tax payment to mitigate double taxation burdens until an agreement is formed at bilateral talks in the MAP.