Deloitte.
デロイト トーマツ

Japan Inbound Tax & Legal Newsletter

Movement away from traditional methods – lessons from recent transfer pricing cases involving intangibles

June 2018, No. 29

Overview

The Tokyo District Court recently issued two judgments regarding transfer pricing cases, both in relation to dealing with intangibles when applying a method for calculating arm's length price. Although one case has not been finalized as of the date of this newsletter, we believe both cases offer insight in this area and we introduce them and provide our views as follows.

1. Tokyo District Court Judgment of April 11, 2017

(1) Summary of the case

A taxpayer entered into a foreign related party transaction to import English learning materials for children from a foreign related party and resold them through door-to-door sales in Japan. The tax authority argued that the resale price method (the RP method) should be used for calculating arm's length price for the foreign related party transaction.

The arm's length price under the RP method alleged by the tax authority was the price at which the taxpayer resold the English learning materials to an uncontrolled party, minus the amount of a normal profit margin multiplied by such price. A normal profit margin means the weighted average ratio of gross margin to the total revenue for multiple transactions where a party that purchased inventory assets, which were of the same sort as or similar to the English learning materials, resold them to an uncontrolled party.

The tax authority argued that transactions to procure learning materials for children and sell them door-to-door should be selected as comparable transactions to the import and door-to-door sales of English learning materials for children, and an appropriate adjustment could be made to the difference between the two in this case. However, one important distinction was that a famous character was used in the English learning materials, while the characters used for the comparable materials were not known to the public.

(2) Judgment by the Court

The Court held that, under the RP method, the arm's length price is calculated based on the normal profit margin in similar transactions conducted over a certain period of time. This is a calculation method based mainly on the similarity of the functions performed by the seller, focusing on the fact that the profit margin relating to the resale transaction has a close relation to the functions performed and risks assumed by the seller, rather than the type of inventory assets relating to the transaction. Therefore, it is important to ensure that no gap exists between the comparable transaction and the resale transaction conducted by the purchaser of inventory assets relating to the foreign related party transaction, in terms of the functions performed or risks assumed by the seller.

Accordingly, upon selection of a comparable transaction, it is necessary to analyze whether there are any differences which cause a gap between the profit margins and, if there is any gap, whether that gap can be adjusted. Note that the gap is adjusted only when it is objectively obvious that such a difference affects the calculation of a normal profit margin. However, if such a difference exists, the gap in profit margin resulting from the difference must be adjusted. If it is impossible to make such an adjustment, the arm's length price should not be calculated based on the comparable transaction in question.

In this case, it was determined that the functions performed by the respective sellers in each transaction were not substantially different because both transactions were door-to-door sales by sales representatives, learning materials were developed and produced by respective suppliers, and the seller did not perform the manufacturing function. However, as the method and content of advertising and the compensation of sales representatives differed between these transactions, the differences in functions performed by the sellers, affecting the calculation of the normal profit margin, were deemed objectively obvious differences.

It was analyzed that the gap between the gross profit margins that arise depending on whether they have nationwide sales locations was not appropriately adjusted. It was also analyzed that the gain in gross profit margin arising from differences in name recognition and the customer appeal of characters (intangibles) used in the learning materials was not appropriately adjusted.

In particular, the Court underscored that, since the fact that intangibles are used in a transaction may impact various factors like sales price of inventory assets, gross revenue, advertisement expenses, sales expenses, negotiations against a seller and royalties, it is difficult to measure precisely the gap between the gross profit margins that arise depending on the intangibles used, and therefore such gap may not have been adjusted appropriately.

Based on such analysis, the comparable transactions selected by the tax authority were rejected as inappropriate, and the taxpayer won the case.

2. Tokyo District Court Judgment of November 24, 2017

(1) Summary of the case

A taxpayer entered into a series of foreign related party transactions to grant licenses to use intangible assets, including technology or know-how relating to product manufacturing and sales, and to otherwise provide services to a foreign related party. The taxpayer argued that the comparable unrelated price method (the CUP method) should be used for these transactions and there were internal comparable transactions between the taxpayer and uncontrolled parties.

The arm's length price under the CUP method in this case should be the price charged in an uncontrolled transaction for granting licenses and providing services which were of the same sort as the licenses granted and services provided by the taxpayer, under circumstances equivalent to those of the foreign related party transactions, specifically in terms of trade stage, trade volume, and other similar factors.

The taxpayer argued that the above requirements for the CUP method were satisfied in this case. However, the tax authority denied the taxpayer's argument and insisted rather that the residual profit split method (the RPSM) should be used.

The arm's length price under the RPSM in this case was calculated in the following two steps. First, routine return generated in the transaction between uncontrolled parties having no unique functions was allocated to the taxpayer and foreign related party. Second, the amount remaining after the allocation of the routine return (i.e., residual profit) was distributed to each party according to its unique functions. Residual profit was allocated to each party based on the allocation factors relating to each party, such as amount of expenses incurred and value of fixed assets used, which were sufficient to presume the degree of contribution to the generation of said profit.

(2) Judgment by the Court

For the following reasons, the Court pointed out that in this case the arm's length price should be calculated for one packaged deal granting licenses and providing services for multiple products, and not separately calculated for each product. It was indispensable in the deal that the taxpayer disclosed know-how for the manufacture, use and management of a certain series of products, provided training for management of customer relationships, and dispatched technical experts. Therefore, in order to evaluate the value of the deal appropriately, the deal should be taken into consideration as a whole, as it is not possible to understand the value correctly if each transaction is looked at separately.

Based on the above determination, the Court compared the foreign related party transactions as a whole with comparable transactions specified by the taxpayer. It found that the product lines, how to use them and frequency of dispatching employees to support the foreign related party were not necessarily the same between the two, rather they were different, and this may result in differences of how to support the foreign related party in selling products and the value of intangibles provided. Also it found that the circumstances may be different in respect of countries or areas where products were manufactured or sold and whether or not the taxpayer granted exclusive licenses.

Accordingly, it concluded that there were differences to a considerable extent between the foreign related party transactions and comparable transactions in terms of licenses, services and circumstances where the transactions were conducted, and therefore the CUP method was inappropriate.

The taxpayer further argued that, even if the CUP method was inappropriate, the method corresponding to the CUP method (the Quasi-CUP method) should be applied, relaxing the requirement that the same sort of licenses be granted and services be provided under equivalent circumstances.

However, the Court raised the question of whether it is acceptable to apply the Quasi-CUP method, since the alleged comparable transactions would not be appropriate comparable transactions unless the requirement of defining “same sort” or “equivalent circumstances” was loosened. Even setting this point aside, it held that the Quasi-CUP method was inappropriate because the foreign related party transactions and the alleged comparable transactions were substantially different in terms of licenses, services and circumstances. Therefore, the Court supported the application of the RPSM and the tax authority won the case.

As mentioned in the introduction, it should be noted that the taxpayer appealed to the Tokyo High Court and therefore this judgment has not been finalized yet. There is some anticipation as to how the Tokyo High Court will decide in this case.

Deloitte’s View

These two cases are in line with recent trends regarding how to deal with intangibles in applying a method for calculating arm’s length price. Currently, the Court seems to emphasize the uniqueness of the intangibles and rigorously analyze whether there is a difference between a foreign related party transaction and comparable transaction. As a result, the Court may prefer not to uphold traditional transaction methods like the CUP or RP methods, but rather use the RPSM in terms of transactions involving intangibles.

The RPSM is applicable when two or more related parties contribute to the creation of important intangible assets or otherwise perform unique functions. Especially when a foreign related party transaction concerns the licensing of important intangible assets, application of the RPSM is often considered as it is difficult to find an appropriate comparable transaction.

If the taxpayer would like to apply the traditional transaction methods to a transaction involving intangibles, it may be recommendable to rigorously analyze the comparability of the transactions and prepare materials to explain in greater detail than previously required.

Newsletter Archives

To see past newsletters, please visit our website. www.deloitte.com/jp/inboundtaxnewsletter

Subscribe to Japan: Inbound Tax Alert and tax@hand

To automatically receive future newsletters, please email deloitte-tokyo.newsletter@tohmatsu.co.jp and register by providing your name, company, position, and email address.
Click here to download our tax@hand app to view inbound tax alerts and other content on your mobile device.

Contacts

Deloitte Tohmatsu Tax & Legal Inbound Group

Not all facts and circumstances are covered in this alert. If you have any questions regarding your specific situation, please contact one of the tax professionals at our Deloitte office in Tokyo as follows:

Jun Sawada, Inbound Group Leader		jun.sawada@tohmatsu.co.jp	+81 3 6213 3927
Business Tax Services	Sunie Oue, Partner	sunie.oue@tohmatsu.co.jp	+81 3 6213 3753
	David Bickle, Partner	david.bickle@tohmatsu.co.jp	+81 3 6213 3743
Indirect Tax Services	Chikara Okada, Partner	chikara.okada@tohmatsu.co.jp	+81 3 6213 3900
Global Employer Services	Russell Bird, Partner	russell.bird@tohmatsu.co.jp	+81 3 6213 3979
Transfer Pricing	Timothy O'Brien, Partner	timothy.obrien@tohmatsu.co.jp	+81 3 6213 3923
	Samuel Gordon, Partner	samuel.gordon@tohmatsu.co.jp	+81 3 6213 3760
Tax Management Consulting	Sam Reeves, Director	sam.reeves@tohmatsu.co.jp	+81 80 4087 6475
Financial Service Industry	Yang Ho Kim, Partner	yangho.kim@tohmatsu.co.jp	+81 3 6213 3841
	Kai Hielscher, Partner	kai.hielscher@tohmatsu.co.jp	+81 90 9855 9819
Tax Controversy	Yutaka Kitamura, Director	yutaka.kitamura@tohmatsu.co.jp	+81 70 3192 5611
Legal	Kaori Oka, Partner	kaori.oka@tohmatsu.co.jp	+81 3 6895 2678
Immigration	Yoshito Kijima, Partner	yoshito.kijima@tohmatsu.co.jp	+81 80 4183 4429

Issued by

Deloitte Tohmatsu Tax Co.
Tokyo Office
Shin-Tokyo Building 5F, 3-3-1 Marunouchi, Chiyoda-ku, Tokyo 100-8305, Japan
Tel: +81 3 6213 3800
email: tax.cs@tohmatsu.co.jp
Corporate Info: www.deloitte.com/jp/en/tax