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Japan Inbound Tax & Legal Newsletter

OECD's hard-to-value intangibles approach to be introduced

March 2019, No. 37

In Brief

Japan's 2019 tax reform package contains new rules that represent the domestic implementation of the OECD's guidance on hard-to-value intangibles (HTVI). At the date of writing this article, the tax reform bill has passed the lower house and is expected to pass the upper house with limited changes. Additional detail is expected to be included in the cabinet orders (expected shortly after the law passes) and commissioners directives (expected later in 2019).

Similar to other BEPS-related changes, Japan is among the first movers to introduce domestic law based on the OECD guidance.

1. OECD Guidance

The OECD's HTVI guidance was developed as part of BEPS action 8, which mandates the development of rules for the transfer of HTVIs. This mandate is in response to a perceived shifting of profits resulting from moving valuable, non-routine intangibles among group members. The OECD's view is that the shifting of profits is possible due to information asymmetry between the tax authorities and the taxpayer (i.e. the tax authorities only have access to the information that the taxpayer presents to it). A simple example is as follows:

- An intangible asset is sold to a related party in a low tax jurisdiction;
- The intangible is valued based on projected future cash flows relating to that asset, such as a discounted cash flow model; and
- Actual profits accruing to the purchaser far exceed the forecasts made at the time of the transaction.

The perceived result is income flowing into the low tax jurisdiction and an overall lowering of the tax burden over the lifetime of the asset.

The OECD has developed an approach that allows tax authorities to consider ex-post outcomes as presumptive evidence on the appropriateness of the ex-ante pricing arrangements. Tax authorities can make an adjustment where there is a significant deviation of actual outcomes from forecasts used to price the transaction. Exceptions to an adjustment exist where the deviation does not exceed 20% or where the financial forecasts were based on appropriate weighting of developments or events known at the time of the transaction. Taxpayers also should be granted an exception where a bilateral APA is in place, the assumption being that thorough due diligence was performed as part of the APA process.

This approach is included in chapter VI of the 2017 OECD transfer pricing guidelines, and additional guidance was published by the OECD on 21 June 2018.

2. Proposed Japanese Law

The 2019 tax reform package is set to introduce the HTVI approach in Japan. When enacted, the revisions would apply from fiscal years beginning on or after 1 April 2020.

In addition to the introduction of the HTVI adjustment mechanism, the following changes would be made to the tax law:

- The definition of intangible assets would be clarified;
- The methods for calculating arm's length prices would be revised;

- The statute of limitations would be extended; and
- The interquartile range would be formalized.

While these changes would apply independently of the HTVI adjustment mechanism, they appear to be part of a broader package of changes that would allow or facilitate the ability of the Japanese tax authorities to use the HTVI adjustment mechanism.

(1) HTVI adjustment mechanism

The proposed HTVI adjustment rules would apply to "specified intangible assets." To qualify as a "specified intangible asset," the asset would have to be an intangible asset under the new definition (described below) and meet each of following three criteria:

- The asset is unique and has an important value;
- The arm's length price is calculated using forecasts; and
- The forecasts used are recognized to be uncertain.

There currently is no guidance to assist with the interpretation of the criteria (e.g. the meaning of "important value" and "unique").

Under the proposed rules, the Japanese tax authorities could make transfer pricing adjustments where actual outcomes significantly differ from the forecast used to calculate the price, subject to two exceptions:

- 20% threshold: An exception would be available where the difference between the forecasts and actual result does not exceed 20%. To take advantage of this exception, the taxpayer would have to be able to provide documentation supporting that the difference does not exceed 20% (e.g. projections used in valuing the asset at the time of the transaction and other financials relating to that asset). As a result, it would be important for historical information be maintained and be able to be produced, if requested.
- Deviation difficult to predict or appropriately take into account: Japan's implementation of this exception appears to be more limited than the OECD approach. The OECD exception allows for deviations caused by unforeseen events, which includes business events such as removal of a product from the market, significant technological breakthroughs of competitors, etc. The proposed Japanese exception, on the other hand, is for a "disaster or similar event," which may not include business events such as those listed in the OECD guidance. This could give rise to cases where a Japanese taxpayer believes it appropriately risk weighted all the factors known at the time of the transaction, but because of some unforeseen business event, the results deviated by more than 20% and an adjustment is made.

It is worth noting that, similar to the 20% exception, the taxpayer would be expected to produce documents supporting the exception. This may include details of the valuation, such as financial forecasts, the basis for assumptions, etc. Creating and maintaining an appropriate level of documentation would be important.

(2) Clarification of definition of intangible assets

Under the proposed new rules, the term "intangible assets" would be defined as (English translation of the Japanese definition):

- Assets owned by a juridical person (that is, a legal entity such as a corporation), other than tangible and financial assets such as cash, deposits and securities, for which consideration would be paid between unrelated parties, for example, a transfer or license of assets between independent parties according to ordinary business terms.

The definition is not overly detailed and is not drafted in a prescriptive manner. This approach to defining the term, and the definition itself, generally is consistent with the OECD definition.

(3) Inclusion of discounted cash flow as allowable pricing method

The discounted cash flow (DCF) would be included as a method that can be used for calculating transfer prices where no comparable transactions exist.

A core aspect of the HTVI approach is a comparison of a value calculated based on projected future revenue and actual revenue generated. The calculation of future projected revenue often would take the form of a DCF analysis. Although DCF calculations already are used by taxpayers in Japan for transfer pricing purposes, Japanese law does not formally allow its use. Accordingly, this change may have been seen as necessary to formally allow the valuation of an intangible using a DCF calculation for the purposes of applying the HTVI approach.

The DCF method would be available for taxpayers and the tax authorities, and it is expected there will be an increase in the use of the DCF by both.

(4) Extension of statute of limitations

The statute of limitations for transfer pricing, which sets a limit on how many fiscal years are open for audit by the tax authorities, would be extended from the current six years to seven years, allowing the tax authorities more time to make an adjustment.

The additional time may have been considered necessary, given the potential lag between the time a transaction occurs and when the profits arising from the asset are actually realized. For example, intangibles relating to a pharmaceutical product, which are subject to a lengthy clinical trial and regulatory approval process, may have long time interval before generating significant income. The extension allows the tax authorities more time to determine whether the price paid for the asset was reasonable in the context of the revenue ultimately generated.

(5) Formalization of interquartile range

The use of an interquartile range, as applicable to results of an economic analysis, is proposed to be formalized in Japanese law through the introduction of a "quartile method." Although Japanese taxpayers use the interquartile range, Japanese law does not formally allow its use, and the definition of a "range" for transfer pricing purposes is the full range of results.

It is unclear how the interquartile range will be defined in Japanese law. For example, the US has a specific formula for calculating the quartiles that involves counting the number of observations. It is not known whether the Japanese rules would adopt this approach over an excel formula that uses interpolation.

Deloitte's View

The HTVI adjustment mechanism and related changes being introduced as part of the 2019 tax reform package are likely to result in more transfer pricing adjustments and more controversy. Although the proposed rules contain exceptions to adjustment, these exceptions may be more limited than the OECD equivalents. While the proposed Japanese rules do not contain a specific exception for cases where a bilateral APA is in place (which the OECD guidance provides), in practice, a transaction covered by a bilateral APA should be protected from audit in both countries. On this basis, a bilateral APA would appear to be a good strategy for taxpayers considering transactions relating to intangibles within their group.

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