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Moving away from traditional methods: lessons from recent Japanese TP cases

The Tokyo District Court recently issued two judgments regarding transfer pricing (TP) cases, both in relation to the treatment of intangibles. These decisions provide insights into how the Japanese tax authorities will evaluate intangibles when dealing with TP issues in audits going forward, explain Yutaka Kitamura and Jun Sawada of **Deloitte**.

Tokyo District Court judgment of April 11 2017

Summary of the case

A taxpayer entered into a foreign related-party transaction to import English-language 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 (RP method) should be used for calculating the 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-language learning materials to an uncontrolled party, minus the amount of a normal profit margin multiplied by such price. A normal profit margin in this case means the weighted average ratio of gross margin to the total revenue for multiple transactions, where the party that purchased inventory assets, which were the same as the English-language learning materials, or of a similar sort, then 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 deemed comparable transactions to the import and door-to-door sales of English-language 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 featured in the English-language learning materials, while the characters used for the comparable materials were not known to the public.

Judgment of the court

The court held that, under the RP method, the arm's-length price was 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 analyse whether there are any differences which cause a gap

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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 the difference cannot be rationally quantified for appropriately adjusting the profit margin, 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.

Analysis showed that the gap between the gross profit margins that arose depending on whether nationwide sales locations were involved was not appropriately adjusted. Analysis also demonstrated 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 underlined that, since the fact that intangibles used in a transaction may impact various factors like sales price of inventory assets, gross revenue, advertisement expenses, sales expenses, negotiations with a seller and royalties, it was difficult to measure precisely the gap between the gross profit margins that arose depending on the intangibles used, and therefore that 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 court ruled in the taxpayer's favour.

Tokyo District Court judgment of November 24 2017

Summary of the case

A taxpayer entered into a series of foreign related-party transactions to grant licences 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 uncontrolled price (CUP) method should be used for these transactions and that 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 licences and providing services which were of the same sort as the licences 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 (RPSM) should be used.

The arm's-length price under the RPSM in this case was calculated in the following two steps. First, a routine return generated in the transaction between uncontrolled parties having no unique functions was allocated to the taxpayer and the 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 the profit.

Judgment of 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 licences and providing services for

multiple products, and not separately calculated for each product. It was vital to the deal that the taxpayer disclosed know-how for the manufacturing, use and management of a certain series of products, providing training for management on customer relationships, and dispatching technical experts. Therefore, in order to put an appropriate value on the deal, it was necessary to consider the deal as a whole, as it would not be possible to understand the value accurately if each transaction was looked at separately. The flavour of these arguments is the same as the 'pricing the real deal' tag line of the OECD during the BEPS project and is consistent with the general notions of 'aggregation' in TP analyses, rather than a 'fragmented' valuation, which, in the context of the 'most appropriate' method selection of the OECD, creates an aversion to transactional methods such as CUP/CUT (comparable uncontrolled transaction) and the resale price method (RSM), in favour of profit splits and income approach valuations.

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 have resulted in differences in how to support the foreign related party in selling products and the value of intangibles provided. The court also found that the circumstances could be different in terms of the countries or areas where products were manufactured or sold and whether or not the taxpayer granted exclusive licences.

Accordingly, the court concluded that there were differences to a considerable extent between the foreign related-party transactions and comparable transactions in terms of licences, services and circumstances in which 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, thus relaxing the requirement that the same sort of licences should be granted and that services should be provided under equivalent circumstances.

However, the court raised the question of whether it was 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 relaxed. Even setting this point aside, the court 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 licences, services and circumstances. Therefore, the court supported the application of the RPSM and ruled in favour of the tax authority.

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Jun has represented clients in various discussions with the Japanese tax authorities. He has defended companies under audit, assisted companies in their negotiations with tax authorities to obtain advance approval of their TP arrangements (unilateral/bilateral advance pricing arrangements (APAs)), and supported companies in domestic tax appeals. In particular, he has assisted clients in industries such as pharmaceuticals, medical devices, software, luxury goods, apparel, media, and entertainment. Jun has also assisted clients with their compliance needs, establishing TP policies, and determining tax effective supply chains and IP migration.

Jun has contributed articles to Tax Analysts, the *International Tax Review*, and several major Japanese tax magazines, and has also co-authored several books in Japanese regarding TP.

The taxpayer has appealed the court's decision to the Tokyo High Court.

How would TP audits involving intangibles evolve?

These two cases are typical in terms of recent trends in how to deal with intangibles when applying a method for calculating an arm's-length price. The court seems to emphasise the uniqueness of the intangibles and rigorously analyse whether there is a difference between a foreign related-party transaction and a 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 and income methods (DCF) when dealing with intercompany 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 related party transaction concerns the licensing of important intangible assets, application of the RPSM is

often considered as it is difficult to identify appropriate comparable transactions.

Historically, the Japanese tax authorities have demonstrated a preference for applying different types of profit split methods when evaluating intercompany transactions involving intangibles and it is further expected that the profit split methods will be used for scrutinising TP analyses that are based on one-sided approaches (i.e. applying the transactional net margin method (TNMM) which allows a routine return in the tested party and full allocation of the residual profit to the IP owner). The tax authorities have available both qualitative and quantitative information obtained from master files and country-by-country reporting, and also have stronger authority in requesting overseas financial information based on the legislated local file requirements, which allows them to perform both high-level analyses of the profit allocation situation among the related parties, and in-depth analysis of the appropriate allocation of profits based on global value chain analyses. However, at the same time, it is unrealistic to expect the tax authorities to apply highly sophisticated profit split analyses due to a lack of resources and experience. Accordingly, it is likely that the RPSM or contribution profit split method will be applied in practice, with some tweaks to reflect recent developments under the BEPS initiative, when determining the profit allocation factors (i.e. assets, capital, and costs). It should be noted that the final guidance on the appropriate application of the transactional profit split (TPS) method, released by the OECD on June 21 2018, did not fundamentally change the guidance on when TPS is appropriate.

If a taxpayer wishes to apply the traditional transaction methods to intercompany transactions involving intangibles (i.e. a one-sided approach or CUP/CUT) in Japan, it might be recommended to rigorously analyse the various components of the comparable transactions and prepare supporting documents to provide more detailed explanations than previously required. In addition, conducting an analysis regarding applying a profit split method is prudent in order to mitigate surprises from TP audits in Japan. The caveat is that other jurisdictions may have inconsistent treatment; for example in the US, the judicial preference has been the opposite of that in Japan. The US Tax Court has overwhelmingly favoured transactional-type methods of direct price comparison, even if not very comparable in relation to the profit splits and income methods that the IRS favours. This difference in preference of TP methods suggests the potential for additional controversy and compliance burdens for taxpayers.