

Tax Controversy Newsletter for Inbound

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Latest trends in tax controversy in Japan Rationality of the arm's length price in transfer pricing taxation

1. Practical countermeasures for unexpected taxation risk

Under the principles of transfer pricing taxation, a Japanese company engaging in the sale or purchase of assets, service provision, or any other kind of transaction (foreign related party transaction) with one of its related parties, such as a foreign subsidiary (foreign related party), is subject to corporate tax as if the transaction was conducted at an arm's length price. "Arm's length price" refers to the price that would be appropriate for the transaction were it conducted under the same conditions between independent companies (uncontrolled parties).

As the arm's length price may vary significantly depending on the method by which it is calculated, the taxpayer and the tax authority are likely to have different perspectives on the price. Under transfer pricing taxation, the amount of tax to be imposed on a Japanese company may be larger than expected. Note, however, that if there is a tax convention between Japan and the country in which the foreign related party is located, the tax amount imposed on the foreign related party located in that country may be adjusted upon agreement (mutual agreement procedure) regarding tax reduction between Japan and the country in question. In practice, controversies are often resolved through such mutual agreement procedure. If, for any reason, mutual agreement procedure fails, the tax to be imposed on the foreign related party cannot be adjusted and the unconvinced Japanese company may seek judgment from a Japanese tribunal or court with regard to the rationality of the arm's length price insisted on by the tax authority. The number of cases related to transfer pricing taxation has been increasing over the past 10 years, and there are already more than 25 cases available for reference (Precedents No. 1–10, Determinations No. 1–16).

In order to practically prevent the risk of such unexpected taxation, it is very important to analyze the functions performed, assets used, and risks assumed by a Japanese company and its foreign related party in a foreign related party transaction, and execute a written agreement between the parties in advance. This is because any agreement between the parties is the first document to be reviewed when analyzing the arm's length price. Without such an agreement, it would be necessary to start with understanding the actual conditions of the transaction, which is likely to create misunderstandings between the taxpayer and the tax authority and, in turn, lead to unexpected taxation.

The major issue discussed in the currently available judicial precedents and determinations regarding transfer pricing is the rationality of the arm's length price. We will therefore discuss said issue in this Newsletter.

2. Methods for calculating the arm's length price

Under applicable laws and ordinances, there are five major methods for calculating the arm's length price as below.

(i) Comparable uncontrolled price (CUP) method	The arm's length price is equivalent to the price charged in an uncontrolled transaction for inventory assets, which are of the same sort as the inventory assets relating to a foreign related party transaction, under circumstances comparable to those of a foreign related party transaction.
(ii) Resale price (RP) method	The arm's length price is equivalent to the price at which a purchaser of inventory assets relating to a foreign related party transaction resells such inventory assets to an uncontrolled party, minus a normal profit.
(iii) Cost plus (CP) method	The arm's length price is equivalent to the cost incurred by a seller of inventory assets relating to a foreign related party transaction for purchase, manufacturing, or other acquisition of such inventory assets, plus a normal profit.
(iv) Profit split (PS) method	The arm's length price is equivalent to the price calculated by allocating the profit arising to a Japanese company and its foreign related party (the parties to the transaction) as a result of the acquisition and sale of inventory assets relating to the foreign related party transaction in an agreed manner.
(v) Transactional net margin method (TNMM)	The arm's length price is equivalent to the price at which a purchaser of inventory assets relating to a foreign related party transaction resells such inventory assets to an uncontrolled party, minus the (i) the amount of such a resale price multiplied by the operating margin ratio arising from the comparable transaction, and (ii) the amount of SGA incurred for the resale of such inventory assets.

Other methods corresponding to the methods listed above are also acceptable as methods for calculating the arm's length price. If a foreign related party transaction does not concern the sale or purchase of inventory assets, the arm's length price is calculated with an equivalent method. We will analyze the judicial precedents and determinations regarding each calculation method below.

3. Judicial precedents and determinations regarding the CUP method

When the foreign related party transaction concerns the sale or purchase of inventory assets, the arm's length price under the CUP method is the price charged in an uncontrolled transaction for inventory assets which are of the same sort as the inventory assets relating to the foreign related party transaction, under circumstances equivalent to those of the foreign related party transaction, specifically in terms of trade stage, trade volume, and other similar factors (comparable transaction). This method is theoretically deemed to be the most appropriate and easiest calculation method and generally superior to the other methods (Precedent No. 1). In the case of a transaction in which inventory assets of the same sort are transferred under conditions different from the foreign related party transaction in terms of trade stage, trade volume, or similar factors, the price adjusted to reflect such differences is also deemed to be the arm's length price (if the price is adjustable).

In the judicial precedents and determinations regarding the CUP method, the major issue is the rationality of selection of comparable transactions and the adjustment of differences (Precedents No. 1 and 2, and Determinations No. 1, 2, 3, 6, 14 and 16). When selecting a comparable transaction, there are two methods: (i) Comparable transactions are limited to transactions between parties to foreign related party transactions and uncontrolled parties (internal CUP), and (ii) Any transactions between third parties (external CUP). The former method is generally deemed superior because the internal CUP has fewer matters to be adjusted and is easy to adjust (Precedent No. 1). If any transaction exists between uncontrolled parties that is comparable to a foreign related party transaction, such an existing transaction must, in principle, be deemed a comparable transaction. Even if such a transaction does not exist, a virtual transaction comparable to a foreign related party transaction, assumed to be based on an objective and realistic indicator such as market price, is also acceptable as a method corresponding to the CUP method (Precedent No. 2 and Determinations No. 6, 14 and 16).

Upon specific selection of comparable transactions, it is generally most reasonable to narrow down the multiple pricing factors by focusing on the most influential factor in order to select the most comparable transaction, except in special circumstances where such a factor is inappropriate. For example, in the case of selecting a transaction comparable to ship construction service, it was determined that market conditions are the most influential factor affecting ship price. In this case, the court determined that it was reasonable to give primary importance to market conditions as a factor to be considered in the selection of the most comparable transaction. The standard for selection is, in principle, that the contract date of the foreign related party transaction is close to the contract date of the comparable transaction (Precedent No. 1).

Any difference is adjusted in order to ensure that the uncontrolled transaction selected is rational as a comparable transaction. Therefore, the difference subject to adjustment does not always include all the differences causing a price gap. It is limited to those objectively and obviously influencing the price. It should also be noted that there may be a range between the prices even after the adjustment, as it is not always possible to make an adjustment under fully identical conditions. In addition, there may be a range between the prices when it is difficult to select one comparable transaction from multiple transactions that have equal comparability, and selecting one specific transaction would rather impair the rationality of taxation. When such exceptional circumstances do not apply, the arm's length price should be determined uniquely (Precedent No. 1).

4. Judicial precedents and determinations regarding the RP method

When the foreign related party transaction concerns the purchase of inventory assets, the arm's length price under the RP method is equivalent to the price at which a purchaser of inventory assets relating to the foreign related party transaction resells such inventory assets to an uncontrolled party, minus the amount of a normal profit margin multiplied by such a price. A normal profit margin means the ratio of gross margin to the total revenue for the transaction when the party that purchased the inventory assets, which are of the same sort as or similar to the inventory assets relating to the foreign related party transaction, resells such inventory assets to an uncontrolled party (comparable transaction). Note that if there are any differences between the comparable transaction and the resale transaction conducted by the purchaser of the inventory assets related to the foreign related party transaction, in terms of the function performed by the seller (reseller) or in other similar terms, the gap in the margin resulting from such differences is adjusted as necessary.

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 function performed by the seller, focusing on the fact that the profit margin relating to the resale transaction has a close relation to the function performed and risk 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 function performed or risk assumed by the seller (Precedent No. 9).

The main issue discussed in the judicial precedents and determinations regarding the RP method is the rationality of selection of the comparable transaction and difference adjustment (Precedents No. 3 and 9). As described above, the RP method is a method for calculating the arm's length price based on the profit margin in a comparable transaction. Therefore, upon selection of a comparable transaction, it is necessary to analyze whether there are any differences causing 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. 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 (Precedent No. 9).

For example, in one case, the tax authority argued that a transaction to procure learning materials for children and sell them door-to-door should be selected as a comparable transaction to the import and door-to-door sales of English learning materials for infants, and issued a correction order. 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. Because 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 arises 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 used in the learning materials was not appropriately adjusted. Based on such analysis, the comparable transaction selected was rejected as inappropriate (Precedent No. 9).

In addition, in another case, the tax authority argued that a resale of products of the same sort or similar products on orders between uncontrolled parties should be selected as a transaction comparable to the foreign related party transaction delegated by the foreign related party to promote sales to Japanese wholesale dealers, and issued a correction order. The issue in this case was whether the applied calculation

method can be deemed equivalent to the method corresponding to the RS method, and whether such a calculation method is reasonable in order to conform to the foreign related party transaction and not diverge from the concept of the RS method. The court held that this issue should be analyzed from the aspect of functions performed and risks assumed by the seller. The court concluded that there was a difference that could not be overlooked between the function performed by the seller (or the service provider), as the selected comparable transaction was mainly a resale transaction while the foreign related party transaction was service provision from the standpoints of law and economic substance. The court also concluded that there was a fundamental difference in the risks assumed, as the service provider in the foreign related party transaction did not assume the risk relating to the resale of products by the wholesale dealer, while the seller in the comparable transaction assumed the risk relating to the resale of products. Based on such analysis, this calculation method was not deemed a method equivalent to the method corresponding to the RS method, and was therefore rejected (Precedent No. 3).

In the precedents and determinations regarding the RS method, there is a tendency to thoroughly investigate differences between the function performed and risk assumed by the seller and, if any differences exist, whether such differences can be appropriately adjusted.

5. Judicial precedents and determinations regarding the CP method

When the foreign related party transaction concerns the sale of inventory assets, the arm's length price under the CP method is equivalent to the sum of (i) the cost incurred by a seller of inventory assets relating to the foreign related party transaction for purchase, manufacturing, or other acquisition of such inventory assets, and (ii) the amount of a normal profit margin multiplied by such a cost. A normal profit margin means the ratio of gross margin to the total cost for the transaction, when the party that purchased from an uncontrolled party, manufactured, or otherwise acquired inventory assets of the same sort as or similar to the inventory assets relating to the foreign related party transaction sells such assets to an uncontrolled party (comparable transaction). If there are any differences between the comparable transaction and the foreign related party transaction in terms of the function performed by the seller or in other similar terms, the gap in the margin resulting from such differences is adjusted as necessary.

The main issue discussed in the judicial precedents and determinations regarding the CP method is also the rationality of selection of the comparable transaction and adjustment of differences (Precedent No. 4, Determination No. 4). Upon selection of a comparable transaction, the type of inventory assets to be sold could be an issue. In this regard, the inventory assets to be sold in the comparable transaction include inventory assets similar to the inventory assets relating to the foreign related party transaction in terms of property, structure, function, and so on. Any difference in inventory assets is acceptable unless such a difference materially affects the calculation of the normal profit margin. If any difference exists that could materially affect the normal profit margin between the foreign related party transaction and its comparable transaction, and it is impossible to calculate the specific effects of such a difference, the comparable transaction selected is rejected. Note, however, that a taxpayer can easily provide the evidence sufficient to prove the existence of a difference that could have a certain effect on the normal profit margin. Therefore, if the tax authority reasonably verifies that there is no difference that could affect the normal profit margin in light of transaction type, etc., the taxpayer should specifically verify the difference described above. If the taxpayer fails to sufficiently verify this difference, it is presumed that no difference exists as there is no evidence to disprove it (Precedent No. 4).

For example, in a case involving the export of crimp-type terminals and connectors to multiple uncontrolled parties, this was selected as a transaction comparable to a foreign related party transaction by the same taxpayer to export crimp-type terminals and connectors to foreign related parties. In this case, each product was deemed to be of the same sort or a similar inventory asset in terms of property, structure, function, and so on. Considering that the comparable transaction was conducted between multiple uncontrolled parties under a distributor agreement or as continuing product supply, it was determined appropriate to treat the entire transaction of crimp-type terminals and connectors in each business year as a comparable transaction. It was further determined that placing importance on the differences between multiple uncontrolled parties is not reasonable, and that treating transactions with multiple uncontrolled parties as one comparable transaction, which allows for the equalization of profit margin by offsetting the difference and, in turn, highly appropriate comparison, is rather reasonable (Precedent No. 4).

Note, however, that with respect to service provision incidental to the primary business, the total cost of such service provision may be the arm's length price, or such a calculation may be deemed equivalent to the method corresponding to the CP method. The court once held that, in a case in which production control,

technical assistance, and other services were provided at the factory of a foreign related party in order to favorably operate said factory and stably import the products manufactured at said factory, such services were provided incidentally to the primary import business and therefore the total cost of such service provision was the arm's length price (Precedent No. 8).

6. Judicial precedents and determinations regarding the PS method

The PS method is mainly categorized into (i) the contribution profit split method and (ii) the residual profit split method.

(i) Contribution profit split method

When the foreign related party transaction concerns the sale and purchase of inventory assets, the arm's length price under the contribution profit split method is calculated based on the assumption that the profit relating to the acquisition by way of purchase, manufacture or similar and sale conducted by a Japanese company and foreign related parties (profit subject to split), is attributable to each party according to the amount of expenses, value of fixed assets used, or other factors relating to each party (splitting factors) that are sufficient to presume their respective degrees of contribution to generating the profit subject to the split.

The main issue discussed in the judicial precedents and determinations regarding the contribution profit split method is the rationality of the selection of splitting factors (Precedent No. 6, Determination No. 7). Under the contribution profit split method, the splitting factors, such as amount of labor expense incurred, value of fixed assets used, and amount of capital invested by each party, that are sufficient to presume the relative degree of contribution by each party to generating the profit subject to the split, are first selected. The arm's length price is then calculated by dividing the profit in proportion to the contribution ratios. Thus, splitting factors that are sufficient to presume the relative degree of contribution by each party to generating the profit subject to the split should be selected based upon an analysis of functions performed by each party depending on the details of the foreign related party transaction and, if there is any difference in the functions performed, while taking into account the degree or nature of contribution by such functions to generating the profit subject to the split (Precedent No. 6).

For example, there is a case in which the SGA was considered as a splitting factor upon calculation of the arm's length price under the contribution profit split method for the foreign related party transaction to import Ecuadorian bananas from a foreign related party. In this case, the SGA was generally deemed to contribute to the generation of a company's operating profit. The services in which a Japanese company and its foreign related party were involved in relation to the foreign related party transaction were purchase, sale, and relevant administrative services. The expenses for such services incurred by each party was recorded as the SGA. It was not considered that such parties carried out a certain business in relation to the foreign related party transaction and incurred certain expenses. Therefore, the SGA incurred by each party with respect to the foreign related party transaction was deemed to be a splitting factor sufficient to presume the relative degree of each party's contribution in generating the operating profit relating to the foreign related party transaction (Precedent No. 6).

(ii) Residual profit split method

When the foreign related party transaction concerns the purchase and sale of inventory assets, the arm's length price under the residual profit split method is calculated in the following two steps. First, normal income (primary profit) generated in the transaction between uncontrolled parties having no unique functions is allocated to a Japanese company and its foreign related party. Second, the amount remaining after the allocation of primary profit (residual profit) is distributed to each party according to its function. Residual profit is allocated to each party based on the splitting factors relating to each party, such as amount of expenses incurred and value of fixed assets used, that are sufficient to presume the degree of contribution to the generation of said profit. The residual profit split method is supposed to apply when a Japanese company or its foreign related party has important intangible assets or otherwise performs a unique function. Especially when a foreign related party transaction concerns the licensing of important intangible assets, application of the residual profit split method is often considered as it is difficult to find a comparable transaction.

For example, with respect to foreign related party transactions to grant licenses to use intangible assets, including technology or know-how relating to product manufacturing and sales, or otherwise provide services to a foreign related party, a case exists in which a taxpayer insisted on application of a method equivalent to the method corresponding to the CUP method, albeit with a somewhat looser requirement of the definition of "same sort" or "similar circumstances," the comparable transaction for which was the licensing of intangible

assets to uncontrolled parties. However, the court raised the question of whether it is acceptable to apply the method equivalent to the CUP method, as the comparable transaction would not be a comparable transaction unless the requirement of defining “same sort” or “similar circumstances” was loosened. The court supported the application of the residual profit split method based on its analysis that it is not reasonable to apply a method equivalent to the method corresponding to the CUP method because the foreign related party transaction and the comparable transaction were substantially different in terms of target and conditions of transaction (Precedent No. 10).

The major issues discussed in the judicial precedents and determinations relating to the residual profit split method are the rationality of calculating profit subject to split and primary profit, and the selection of splitting factors regarding residual profit (Precedents No. 7 and 10 and Determinations No. 8, 9, 10, 12, 13, and 15). The profit subject to split under the PS method is the operating profit achieved by a Japanese company and its foreign related party through sales etc. of inventory assets relating to the foreign related party transaction. The operating profit is the amount of income after deducting expenses incurred. Therefore, when calculating the profit subject to split, the expenses incurred to gain such income should be deducted from the income amount (Precedent No. 10).

For example, when applying the residual profit method in a foreign related party transaction to grant a license to use intangible assets or otherwise provide services as described above, the calculation of profit subject to split becomes an issue. In this case, for the purpose of calculating the profit subject to split, a certain amount of R&D costs are deducted from a Japanese company’s royalty income obtained from a foreign related party. For the purposes of corporate accounting, R&D costs are treated as expenses corresponding to the total profit of each fiscal year upon their occurrence in accordance with the applicable accounting standard. Deductible expenses relating to corporate tax are, in principle, treated as the SGA corresponding to the fiscal year, and not as the cost directly corresponding to income. Therefore, with respect to the calculation of the profit subject to split, it was deemed reasonable to deduct the R&D expenses incurred in one fiscal year from the royalty income of that year (Precedent No. 10).

The primary profit is calculated based on the profit indicator reflecting the ratio of operating profit to business assets or sales amount of an uncontrolled party (comparable party), which engages in business of the same sort as that of the foreign related party transaction, having similar market and business scale but no unique functions. Therefore, the uncontrolled party selected as a comparable company must be a party engaging in business of the same sort as that of the foreign related party transaction, having similar market and business scale but no unique functions (Precedent No. 7).

For example, let us look at a case in which the tax authority argued that a Brazilian corporation not located in the Manaus Free Trade Zone, a free import and export trade area with special tax incentives, should be selected as a company comparable to the foreign related party located in the Manaus Free Trade Zone and issued a correction order. In this case, government regulation and intervention were deemed to have an effect on the market price of inventory assets and company profit, constituting market conditions. In addition, a tax incentive in the Manaus Free Trade Zone was deemed to affect the company’s operating profit and constitute the market conditions of the zone as measures with the nature of government intervention, such as government bounty and grants. The court held that a Brazilian company not located in the Manaus Free Trade Zone cannot be comparable to the foreign related party enjoying tax incentives in the zone (Precedent No. 7).

When selecting splitting factors of residual profit, if a Japanese company or its foreign related party performs a unique function by using intangible assets, which splitting factor to select may become an issue. On this point, the value of intangible assets attributable to each party and the expenses to develop such assets incurred by each party are deemed to be the splitting factors sufficient to presume the degree of contribution by intangible assets. With respect to the attribution of intangible assets, it is necessary to consider not only legal ownership of intangible assets, but also the degree of contribution by each party to generate, maintain, or develop such intangible assets. Furthermore, when determining the degree of contribution in generating intangible assets, the functions performed by each party in the course of decision-making, service provision, cost burden, and risk management must be comprehensively taken into account (Determination No. 12).

For example, in one case the tax authority argued that the clinical trial expenses to sell ethical drugs in the United States, incurred by a Japanese company, should be used as the splitting factor relating to the Japanese company when calculating the arm’s length price of the export of ethical drugs to a foreign related party and the licensing of intangible assets relating thereto in accordance with the residual profit split method, and issued a correction order. In this case, the Japanese company was regarded as a pharmaceutical

company developing and manufacturing ethical drugs, while the foreign related party was regarded as a sales company. In addition, the results of clinical trials directly contributed to the profit of the foreign related party, a sales company, and the foreign related party directly bore the risk of success and failure. Based on such analysis, the clinical trial expenses was considered as the splitting factor relating to the foreign related party, as it was the party to make decisions and manage risks regarding the generation of intangible assets relating to clinical trials (Determination No. 12).

7. Judicial precedents and determinations regarding TNMM

Under the TNMM, the arm's length price of inventory assets purchased in a foreign related party transaction is the price at which the purchaser of inventory assets relating to the foreign related party transaction resells the inventory assets to an uncontrolled party, minus (i) the amount of such a resale price multiplied by the operating margin ratio of a comparable transaction, and (ii) the amount of SGA incurred for the resale of inventory assets. A comparable transaction is a transaction in which a party that purchases inventory assets of the same sort or similar inventory assets from an uncontrolled party (comparable company) sells such assets to an uncontrolled party. The operating margin ratio is the ratio of operating profit to the total income relating to a comparable transaction. If there is any difference 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 function performed by seller (reseller) or similar, the difference causing a gap in the operating margin ratio is adjusted as necessary.

The TNMM is a method to calculate the arm's length price by comparing not the price in a foreign related party transaction and the comparable transaction, but the operating margin ratio in these transactions. Actual transactions are the intended comparable transactions. Note, however, that if it is possible to extract multiple comparable transactions, obtaining the average of such transactions and using a virtual transaction as the comparable transaction to calculate the arm's length price is acceptable as a method corresponding to the TNMM (Determination No. 11).

The issue mainly discussed in the judicial precedents and determinations relating to the TNMM is the rationality of selecting a comparable transaction and adjusting differences (Determination No. 11). On this point, whether the Japanese company or its foreign related party performs a unique function, especially whether either of them has important intangible assets, becomes an issue. If either party has important intangible assets, it may be necessary to adjust differences in relation to the functions performed by a comparable company. When analyzing how much the intangible assets contribute to the income of the Japanese company or its foreign related party, (i) patent rights, trade secrets, and other elements arising from technical innovation, (ii) know-how and other elements that employees have obtained from corporate activities such as business management, sales, production, R&D, and promotion, and (iii) the commerce network relating to production, negotiation procedures, development, sales, financing, and other valuable sources of income are comprehensively taken into account. Important intangible assets are those affecting the operating income of the Japanese company or its foreign related party and becoming sources of excess profits not included in the comparable company's operating profit (Determination No. 11).

For example, take the case in which, upon applying the TNMM to a foreign related transaction to export inventory assets to a foreign related party, it was deemed that no important intangible assets that affect the operating profit of the foreign related party existed. In this case, specifically speaking, it was determined that the brand relating to the inventory assets was widely recognized by customers in the market as one of the identifying marks of the Japanese company, and was not a source of excess profit that would affect the operating profit of the foreign related party. It was also determined that, considering that all sales companies generally have their own commerce networks, any profits that the foreign related party gains from its commerce network are included, in principle, in the operating profit of the comparable company. Furthermore, as the commerce network owned by the foreign related party in this case was organized under the active involvement of the Japanese company, it was determined that said network was not a source of excess profit affecting the operating profit of the foreign related party, and was therefore not deemed an important intangible asset (Determination No. 11).

Note that an indicator for the TNMM is operating profit relating to the comparable transaction as described above. If there are some differences in the functions performed by each party, such differences may be reflected in the gap in the operating cost. In other words, differences in operating profit may be reflected to a certain extent and differential adjustment may not be required (Determination No. 11).

8. Conclusion: The risks of presumptive taxation

The application of transfer pricing taxation as described above may cause the risk that the arm's length price ends up being higher or lower than the price expected by the taxpayer. Of course, all or part of correction orders are often reversed as the result of a court or tribunal reviewing the rationality of the arm's length price (Precedents No. 3, 7, and 9 and Determinations No. 2, 3, 4, 8, 9, 10, 12, 13, 15 and 16). However, it is undeniable that this system rests on a practical mindset; for example, the difference is adjusted only when it is objectively obvious that it affects the price and profit margin. It is therefore essential to prepare a contract between the relevant parties in advance, as described in the first section of this document.

In principle, the tax authority is responsible for verification of the arm's length price (Precedents No. 3 and 5). Note, however, that a taxpayer's failure to present or submit documents deemed important and required by the tax authority for the purpose of calculating the arm's length price of a foreign related party transaction is a different story. If a taxpayer fails to do so, the tax authority may presume that the arm's length price is equivalent to the price calculated based on the gross profit margin of a company engaging in the same sort of business as that of the foreign related party transaction, and at a business scale and with content similar to that of the foreign related party transaction (a "similar company engaging in the same sort of business"). If no documents are presented or submitted by the taxpayer, it is a kind of shift in responsibility by the government to have the taxpayer verify the arm's length price (Precedent No. 5).

The main issue discussed in the judicial precedents and determinations relating to presumptive taxation is identity of business field and similarity of business content (Precedent No. 5, Determination No. 5). On this point, if the imposition of presumptive tax becomes impossible or considerably difficult, the reason for the transfer pricing taxation's existence might be ignored. Therefore, the identity of business field and similarity of business content are not highly or severely required. As taxpayers may overturn the presumption by insisting on and verifying the appropriate arm's length price, presumptive taxation is not deemed severe and unreasonable for taxpayers (Precedent No. 5).

For example, take the case of a foreign related party transaction to import motors for coin hoppers used by a slot machine ("*pachi-suro*" in Japanese) manufacturer from a foreign related party. This transaction was subject to presumptive taxation because books and records were not presented or submitted without delay. In this case, three companies were deemed to be similar companies engaging in the same sort of business as the foreign related party, which was engaged in the procurement of mainly small motor products and the resale of such products without processing as a wholesale dealer. The court therefore held that the businesses of said companies were identical in kind to that of the foreign related party and, even though the gross margin varies slightly depending on the stage of transaction that the wholesale dealer is involved in, from manufacturing to wholesale, there are no big obstacles to selecting a similar company engaging in the same sort of business. Furthermore, a small motor is generally a versatile product, even though the details vary from product to product depending on the specification of the product in which the motor is incorporated. Therefore, any difference arising from the handling of motors for different use did not immediately result in denial of identity or similarity (Precedent No. 5).

In addition, with respect to presumptive taxation, it is acceptable to calculate the amount presumed to be the arm's length price based on a price including the price for transaction between related parties. Moreover, tax authority personnel may make inquiries to a similar company engaging in the same sort of business, inspect books and records, and request presentation or submission of such books and records before imposing presumptive taxation. Such personnel are, as a matter of course, responsible for maintaining the confidentiality of the detailed business content and financial conditions of such similar companies engaging in the same sort of business. The tax authority may impose presumptive taxation by referring to materials relating to similar companies engaging in the same sort of business, the details of business content, and financial conditions of which cannot be disclosed (secret comparable) (Precedent No. 5).

The application of presumptive taxation in the manner described above may place taxpayers at risk of further unexpected taxation. Note, however, that such risk of presumptive taxation can be avoidable by preparing documents important for calculating the arm's length price in advance. In conclusion, the secret to successfully countering transfer pricing taxation is careful preparation in advance.

List of cited precedents and determinations

- Precedent No. 1 Takamatsu High Court Judgment of October 13, 2006, Shomu Geppo Vol. 54, No. 4, p.875
- Precedent No. 2 Tokyo District Court Judgment of October 26, 2006, Shomu Geppo Vol. 54, No. 4, p.922
- Precedent No. 3 Tokyo High Court Judgment of October 30, 2008, Zeimu Sosho Shiryo No. 258, 203 Jungo
- Precedent No. 4 Osaka High Court Judgment of January 27, 2010, Zeimu Sosho Shiryo No. 260, 11370 Jungo
- Precedent No. 5 Tokyo High Court Judgment of March 14, 2013, Shomu Geppo Vol. 60, No. 1, p.149
- Precedent No. 6 Tokyo High Court Judgment of March 28, 2013, Zeimu Sosho Shiryo No. 263, 12187 Jungo
- Precedent No. 7 Tokyo High Court Judgment of May 13, 2015, Zeimu Sosho Shiryo No. 265, 12659 Jungo
- Precedent No. 8 Osaka High Court Judgment of June 10, 2016, TAINS Database
- Precedent No. 9 Tokyo District Court Judgment of April 11, 2017, not yet recorded in casebook
- Precedent No. 10 Tokyo District Court Judgment of November 24, 2017, not yet recorded in casebook
- Determination No. 1 Tribunal Determination of November 30, 1998, TAINS Database
- Determination No. 2 Tribunal Determination of March 31, 1999, TAINS Database
- Determination No. 3 Tribunal Determination of May 24, 2002, TAINS Database
- Determination No. 4 Tribunal Determination of June 28, 2002, TAINS Database
- Determination No. 5 Tribunal Determination of June 23, 2005, TAINS Database
- Determination No. 6 Tribunal Determination of September 30, 2005, TAINS Database
- Determination No. 7 Tribunal Determination of February 27, 2007, TAINS Database
- Determination No. 8 Tribunal Determination of July 2, 2008, TAINS Database
- Determination No. 9 Tribunal Determination of January 27, 2010, TAINS Database
- Determination No. 10 Tribunal Determination of June 28, 2010, TAINS Database
- Determination No. 11 Tribunal Determination of March 5, 2013, TAINS Database
- Determination No. 12 Tribunal Determination of March 18, 2013, TAINS Database
- Determination No. 13 Tribunal Determination of March 5, 2015, TAINS Database
- Determination No. 14 Tribunal Determination of February 19, 2016, TAINS Database
- Determination No. 15 Tribunal Determination of June 21, 2016, TAINS Database
- Determination No. 16 Tribunal Determination of September 26, 2017, TAINS Database

We hold briefing sessions regarding latest trends in tax controversy in Japan from time to time. If you are interested in the sessions, please contact us by email.

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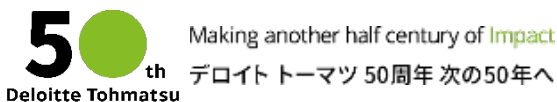
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