

Introduction of the Transactional Net Margin Method into the Japanese Transfer Pricing Legislation – Significance and Practical Use of the Method

I. Purpose of introducing the transactional net margin method

As a result of the 2004 administrative year tax reform, paragraph (8), Special Taxation Measures Law Enforcement Order Article 39-12 (“STML Enforcement Order Article 39-12”) was revised in order to introduce a transfer pricing methodology into the Japanese transfer pricing legislation that evaluates the arm’s length nature of transfer prices based on the level of operating profit earned in a controlled transaction. Although the newly introduced transfer pricing methodology is not given a specific name, it is substantially the same as the Transactional Net Margin Method (“TNMM”) provided by the Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (“OECD Transfer Pricing Guidelines”). This amendment applies to fiscal years beginning on or after April 1, 2004.

Given that the TNMM has already been adopted by the OECD Transfer Pricing Guidelines as well as incorporated into the legislation of a number of countries including the European Union (“EU”) member countries, Australia and Korea, the Japanese tax authorities intention through the introduction of TNMM is to harmonize the transfer pricing legislation of Japan with that of other countries, and enhance international cooperation in taxation. This is also supported by the Exchange of Notes to the Convention Between the Government of Japan and the Government of the United States of America for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income (“Convention”), revised for the first time in some thirty years, which state “The domestic transfer pricing rules, including the transfer pricing methods, ... may be applied in resolving transfer pricing cases under the Convention only to the extent that they are consistent with the OECD Transfer Pricing Guidelines (paragraph 3, Exchange of Notes)”.

II. Status and interpretation of the TNMM prescribed by STML Enforcement Order Article 39-12 under the Japanese transfer pricing legislation

1. Status of the TNMM prescribed by STML Enforcement Order Article 39-12

Under the Japanese transfer pricing rules, Special Taxation Measures Law Article 66-4 (“STML Article 66-4”) provides “three basic methods”, namely Comparable Uncontrolled Price Method (“CUP Method”), Resale Price Method (“RP Method”) and Cost Plus Method (“CP Method”) (paragraphs (2)(i) (a) through (c), STML Article 66-4). If none of these methods are available, a method similar to one of the above three methods or “other methods prescribed by cabinet order” may be applied (paragraph (2)(i) (d), STML Article 66-4).

Before the addition of the TNMM as an acceptable transfer pricing methodology under the Japanese transfer pricing legislation, the only “other” method prescribed by cabinet order was the Profit Split Method (“PS Method”) (paragraph (8), STML Enforcement Order Article 39-12 (before amendment)). The amendment has expanded paragraph (8) by increasing the number of “other” methods to four.

2. Interpretation of the TNMM prescribed by STML Enforcement Order Article 39-12

The TNMM prescribed by STML Enforcement Order Article 39-12 determines arm’s length prices by comparing the operating margin or the cost plus markup on total costs earned in a controlled transaction with that earned in comparable transactions. More specifically, the three types of TNMM newly introduced into STML Enforcement Order Article 39-12 are as follows: (i) TNMM under paragraph (8)(ii) uses the operating margin (operating profit to sales), and is primarily applicable to buyers of inventory assets such as resellers; (ii) TNMM under paragraph (8)(iii) uses the full-cost markup (total costs plus markup on total costs), and is primarily applicable to sellers of inventory assets such as manufacturers and exporters; and (iii) TNMM under paragraph (8)(iv) is a method similar to the methods listed in (8)(ii) or (8)(iii). Overall, paragraph (8) of the amended STML Enforcement Order Article 39-12 can be summarized as follows:

Subparagraph (i): PS Method (former text of paragraph (8))

Subparagraph (ii):

$$\text{Arm's length price} = \text{Resale Price}_{\text{taxpayer}} - [(\text{Resale Price}_{\text{taxpayer}} \times \text{Operating Margin}_{\text{comparable}}) + \text{SG\&A}_{\text{taxpayer}}]$$

Subparagraph (iii):

$$\text{Arm's length price} = \text{Total Costs}_{\text{taxpayer}} + [\text{Total Costs}_{\text{taxpayer}} \times (\text{Operating Profit}_{\text{comparable}} / \text{Total Costs}_{\text{comparable}})] \quad (\text{Note: Total Costs represents the total of COGS and SG\&A})$$

Subparagraph (iv): a method similar to subparagraph (ii) or (iii)

3. Types of transactions to which the TNMM prescribed by STML Enforcement Order Article 39-12 can be applied, etc.

Given that the TNMM prescribed by paragraphs (8) (ii) and (iii) of STML Enforcement Order Article 39-12 are examples of “other methods prescribed by cabinet order” under paragraph (2)(i)(d) of STML Article 66-4, which specifies transfer pricing methodologies that can be applied to inventory assets transactions, the TNMM under paragraphs (8)(ii) and (iii) of the cabinet order can be applied to inventory assets transactions. Likewise, the TNMM under paragraphs (8)(ii) and (iii) of the cabinet order can also be applied to service transactions and intangible asset transactions, on the basis that paragraph (2)(ii)(b) of STML Article 66-4, which lists acceptable transfer pricing methodologies for transactions other than inventory assets transactions, stipulates “A method which is equivalent to a method listed in (d) of the preceding subparagraph”, meaning “other methods prescribed by cabinet order” etc. under paragraph (2)(i)(d) of STML Article 66-4.

As described above, the TNMM under paragraph (8) of the amended STML Enforcement Order Article 39-12 uses operating margins, i.e., operating profit to sales ratios (subparagraph (ii)), or full-cost markups, i.e., total costs plus markup on total costs (subparagraph (iii)) as profit level indicators (“PLIs”). Although subparagraph (iv), which is only described as “a method similar to the methods listed in (8)(ii) or (8)(iii)”, does not specifically provide applicable PLIs, it would permit use of other PLIs, if they were used in similar ways to those as described in paragraph (8)(ii) or (8)(iii).

Therefore, as the OECD Transfer Pricing Guidelines provide that “The transactional net margin method examines the net profit margin relative to an appropriate base (e.g. costs, sales, assets) that a taxpayer realizes from a controlled transaction (paragraph 3.26)”, the TNMM under STML Enforcement Order Article 39-12 should allow the use of not only operating profit to sales ratios and full-cost markups but also return on assets (“ROA”) and return on capital employed (“ROCE”).

III. Practical use of the TNMM prescribed by STML Enforcement Order Article 39-12

1. Points to be noted in transfer pricing audits

In the context of transfer pricing audits, it is reasonable to assume that the use of the TNMM will be restricted to situations where none of the three basic methods are applicable and operating margins of comparable companies are available on a specific transaction (or specific product line) basis. Thus, only when these conditions are satisfied may the taxpayer be able to negotiate with the auditors on the validity of the taxpayer’s transfer prices based on the level of operating profit, which was not permitted before the amendment.

On the other hand, even if a taxpayer earns an arm’s length gross profit, it is more likely that the tax authorities will perform an audit and eventually make a tax assessment using the TNMM, their justification being that the requirements for application of that method have been met. Hence, it is now critical for taxpayers to understand the practice and positions likely to be taken by the Japanese tax authorities, as well as to prepare and maintain documentation that substantiates the arm’s length nature of their transfer prices.

2. Points to be noted in APAs

In Advance Pricing Arrangements (“APAs”), the TNMM defined in STML Enforcement Order Article 39-12 is expected to prove even more useful. Generally, in bilateral APAs, the competent authorities of both countries negotiate in a flexible manner in accordance with the OECD Transfer Pricing Guidelines. In fact, it has long been the case that a methodology based on taxpayers’ operating margins has been used in bilateral APAs. That methodology was called the Modified Resale Price Method under Japanese transfer pricing practice before the amendment. This is equivalent to the methodology stipulated in paragraph (8)(ii) of STML Enforcement Order Article 39-12 after the revision mentioned above (i.e. the arm’s length gross margin is calculated by adding a taxpayer’s SG&A to sales ratio to an arm’s length operating margin). In bilateral APAs, the Modified Resale Price Method is likely be called “TNMM” in the future. In addition, with the introduction of the TNMM defined in STML Enforcement Order Article 39-12, it is expected that Japanese taxpayers will be able to expedite their bilateral APA processes with countries in which the TNMM is also applied, and obtain agreement sooner than ever before.

IV. Closing remarks

The introduction of the TNMM defined in STML Enforcement Order Article 39-12 at this time is seen as a groundbreaking move, which provides a greater range of options for both taxpayers and tax authorities when selecting a transfer pricing methodology. However, there are currently a number of issues still under discussion relating to the TNMM in many countries, including the difference between the TNMM and the Comparable Profits Method (“CPM”), a controversy likely to emerge in Japan as well. It is therefore desired that the Japanese tax authorities will issue a Commissioner’s Directive, etc. concerning the TNMM at the earliest possible opportunity.

<The Introduction of Transfer Pricing Regulations in Taiwan>

In January 2004, the Ministry of Finance (“MOF”) of Taiwan made public a new auditing standard for audits of corporate tax returns (Article 114-1 of the Assessment Rules for Income Tax Returns of Profit-Seeking Enterprises) and introduced transfer pricing legislation in Taiwan. Before the introduction of this standard, Article 43-1 of the Taiwan Income Tax Law had been applied as the general rule throughout Taiwan.

Article 114-1 of the Assessment Rules for Income Tax Returns of Profit-Seeking Enterprises provides that transfer pricing methodologies include the Comparable Uncontrolled Price Method (“CUP Method”), the Resale Price Method (“RP Method”), the Cost Plus Method (“CP Method”) and “other methods stipulated by the MOF”, and the application of the transfer pricing methodology should be considered in light of this order. The article also provides taxpayers with the ability to obtain APAs from the Taiwanese authorities; however, the article provides no procedure for doing so.

Transfer pricing audits conducted in Taiwan in the past were not full-scale audits in comparison to audits conducted in other countries, partly because the necessary legal system was not fully developed. The Taiwanese tax authorities, however, have tended to ask more questions concerning transfer pricing in recent regular audits. They have also publicly stated that they have begun intensive preparation for transfer pricing audits in accordance with the introduction of the transfer pricing legislation. Taxpayers are well advised to make preparations in advance to support the transfer pricing methodology they deem reasonable, and to take necessary measures to defend transfer pricing audits accordingly.