

Japan Tax Update

Monthly tax update



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Transfer Pricing Issues - Intangible Assets

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1. Background

The Japanese tax authorities increasingly have been concerned with transfer pricing issues related to intangible assets as a result of the advanced globalization of business activities. Newspapers have reported cases where significant tax assessments have been made when the underlying disagreement with the tax authorities related to the value and location of intangible assets.

As a result of globalization, many Japanese companies have been transferring their manufacturing bases to countries with lower costs. Under the traditional model where Japanese companies manufactured goods in Japan and exported them overseas, the value of intangibles was imbedded in the sales price. However, under a business model where goods are produced overseas using intangibles developed by the Japanese company, unless there is adequate compensation paid by the overseas affiliate to the Japanese company in, for example, the form of royalties or management fees, income earned (and taxed) in Japan will decrease.

In assessing Japanese companies, the Japanese tax authorities often argue that high profits earned by foreign related parties are attributed to technologies and know-how possessed by Japanese companies and thus such profits should be reflected to Japanese companies' income. The Japanese tax authorities are concerned with intangible assets related to not only manufacturing but also sales activities (e.g., brands). Therefore, care must be taken if intangibles are developed in Japan and used by foreign related parties and the use of such intangibles is not adequately reflected in Japan.

Intangible assets in terms of transfer pricing are broadly defined, and it is generally considered that economic value of intangible assets should be attributed to those who developed or enhanced such assets.

2. Revision of the Transfer Pricing Administrative Guideline

The Japanese tax authorities have published revised Transfer Pricing Administration Guideline and a collection of Case Studies as additional guidance,

The revised Guidelines give specific examples of intangible assets, which should be investigated in transfer pricing audits including:

- i. Patents and trade secrets generated from technological innovation.
- ii. Know-how developed by employees through their business experiences such as management, sales, manufacturing, research and development, and sales promotion.
- iii. Manufacturing processes, negotiation procedures, and networks for development, sales and fund raising”

In addition, with regard to the determination as to whether the intangible asset is the source of the income, the revised guideline provides “activities related to the creation and functions of such intangible assets must be thoroughly analyzed (Transfer Pricing Administrative Guideline 2-1)”. Also the guideline reads “in identifying comparable transactions, similarity of the type, range, and use of the intangible assets must be taken into consideration (Transfer Pricing Administrative Guideline 3-1).”

3. Publication of the collection of Case Studies

The collection of 26 Case Studies regarding transfer pricing issues, which were finalized after public comments, was published on June 25, 2007. Case Studies presented the following issues

- Case Studies 1 through 8: Basic calculation methods of transfer price
- Case Study 9: Methods for adjusting for differences between comparables
- Case Studies 10 through 15: Treatment of intangible assets
- Case Studies 16 through 22: Application of the residual profit split method for cases where intangible assets belong to both parties
- Case Study 23: Services provided to related parties
- Case Study 24: Consideration for multiple years
- Case Studies 25 and 26: Advance Pricing Agreements

The collection contains many cases related to intangible assets. For example, Case Study 21 describes the procedure for identifying comparable corporations in order to calculate the basic profit where the residual profit split method is applied. Also, Case Study 22 lists the following expenses as examples of factors, which are related to the creation of valuable intangible assets, to be evaluated for residual profit splits.

- i. Intangible assets related to manufacturing activities, such as patent and manufacturing know-how: expenses related to research & development and manufacturing departments.
- ii. Intangible assets related to marketing activities, such as brand, trademark, sales networks, customer list: expenses related to advertising, sales promotion, and marketing departments.
- iii. Intangible assets used for activities other than above, such as business decision, risk management, fund raising, operating know-how: expenses related to planning, administrative, finance and sales departments.

4. Advance Pricing Agreement (APA) and Pre-filing

In order to smooth the application process of an APA, a pre-filing system where taxpayers can consult with the Japanese tax authorities in advance of an APA application, has been developed. With regards to APAs, the revised Guideline indicates that “[Japanese tax authorities will] secure the predictability of transfer pricing assessments, and accurately and quickly conduct APAs, being a procedure to properly and smoothly implement the transfer pricing taxation system, bearing in mind the complexity and the importance of each case, while exercising care to secure its right of taxation.” The pre-filing process was put in place in order to improve the convenience for corporations and to shorten the time required for APAs (Transfer Pricing Administrative Guideline 5-1.)

In addition, the number of staff for mutual agreement procedures and transfer pricing APAs at the NTA was significantly increased in July 2007 in order to promote APAs.

On the other hand, the revised Guideline provides that a significant amount of documentation which are required to be attached to the application for APA (for example, calculation methods for arm’s length price, explanation of the reasons why such calculation method is the most reasonable, information about underlying business and economic conditions, description of functions, etc), would be requested for as part of the pre-filing process (Transfer Pricing Administrative Guideline 5-10). Also, the guideline indicates that Japanese tax authority can demand corrections against such APA requests, where APA is deemed inappropriate, for example, a case in which the transaction in question is not commonly held between non-related parties and the tax liability in Japan is alleviated without appropriate economic reasons, and can reject the request in case such correction is not made (Transfer Pricing Administrative Guideline 5-14).

5. Conclusion

The Japanese tax authorities have become increasingly concerned with transfer pricing issues related to intangible assets and has attempted to improve APA process in response to demands from taxpayers who want predictability and transparency with respect to transfer pricing assessments. The collection of case studies reflects the Japanese tax authorities’ effort to help taxpayers understand transfer pricing issues, however, it does not clearly indicates how transfer pricing assessments would actually be made.

Growing interest in transfer pricing is prevailing in various countries, and transfer pricing issues in Japan will be affected by trends in such other countries. Therefore, attention must be paid to transfer pricing assessments, especially on intangible assets, in countries which have close economic relationship with Japan. As changes in business activities are driven by changes in international business transactions, each corporation must be more careful about the effects of intangible assets on profit allocation.

You have a vision. PricewaterhouseCoopers helps bring that vision to reality. We hope you enjoy the current issue of Japan Tax Update and appreciate your comments or ideas for what you’d like to see covered in future issues.

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