

Japan Tax Update

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PwC Japan Tax Newsletter

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First Taxpayer Success in Japanese Transfer Pricing Litigation

This month's edition of Japan Tax Update provides an overview of a decision of the Tokyo High Court given on October 30, 2008. This court case is significant in that it represents the first time a taxpayer has been successful in litigation involving the Japanese transfer pricing legislation.

If you would like to obtain further details of this court case and its potential impact on transfer pricing practice in Japan, please contact one of the persons listed at the end of this newsletter.

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On October 30, 2008, the Tokyo High Court upheld an appeal by Company A (“Appellant”) against a decision of the Tokyo District Court, and entered judgment to overturn certain corporation tax assessments made by the Tokyo Regional Taxation Bureau (“TRTB”) pursuant to the Japanese transfer pricing legislation.¹ This is the first decision to overturn a transfer pricing tax assessment by a Japanese court, and as such provides a guide to predict how the transfer pricing legislation may be enforced by the Japanese tax authorities in the future².

One of the issues under appeal was whether the transfer pricing method used by the TRTB in making the assessment was appropriate or not.³ Pursuant to service agreements with foreign-related parties, the Appellant provides services to support the software product sales activities conducted by those foreign-related parties in Japan. In making its assessment, the TRTB calculated the purported arm’s length price based on the gross margins (i.e., resale price method) of a Japanese company that the TRTB considered was comparable, which was engaged in the import and sale of a variety of third party software products. However, in making its decision, the Tokyo High Court compared and analyzed the functions performed and risks assumed by the Appellant in the foreign-related transactions and the functions performed and risks assumed by the Japanese company in the “comparable” transaction. Based on this review, the Tokyo High Court determined that there were significant differences between the two, and accordingly, that the Japanese transfer pricing legislation did not permit application of the resale price method used by the TRTB.

In giving its judgment, the Tokyo High Court emphasized the following points:

- The Appellant’s foreign-related transactions were transactions related to the provision of services, both legally and in (economic) substance;
- The Appellant did not perform a sales function (a difference in functions to the TRTB’s “comparable” company); and
- Pursuant to the service agreements, the Appellant was guaranteed a level of remuneration that exceeded the expenses incurred to provide the services (a difference in risks to the TRTB’s “comparable” company).

Accordingly, it seems that the Tokyo High Court attached importance to the contents of the service agreements with the foreign-related parties in conducting its functional and risk analysis.

Based on this decision it would appear that, as long as a taxpayer providing support for the sales activities of foreign-related parties has concluded a substantive service agreement with those foreign-related parties, it may be difficult for the Japanese tax authorities to use the gross margins (i.e., the resale price method) of companies engaged in buy and sell transactions to determine an arm’s length price for those services. Going forward, we anticipate that the Japanese tax authorities will be more likely to use a markup on costs for providing services (the cost plus method, or the transactional net margin method using a full-cost markup) as a profit level indicator. However, given there is likely to be a lack of comparable companies engaged in the provision of sales support activities to third parties, what is not clear is the comparable companies that should be used to set the target range, or how the “plus” component of such methodologies should be determined.

¹ Since the Respondent has abandoned its right to appeal, the judgment of the Tokyo High Court should be considered binding.

² A decision of a Japanese court is only binding on the parties in that specific case (unless appealed to a higher court). Thus, in theory, this Tokyo High Court decision has no precedential value for other taxpayers. Obviously, however, in practice decisions of the Japanese courts carry weight with both taxpayers and the tax authorities.

³ The TRTB used data about third parties that was not publicly available (so-called “secret comparables”) in making its original assessment against the Appellant. The Tokyo High Court made no decision on this issue, although the decision of the Tokyo District Court dated December 7, 2007 explicitly upheld the TRTB’s use of secret comparables. Thus, the position in relation to the use of secret comparables is, as yet, undecided.

For more information, please consult your international tax representative or contact any of the following members listed below:

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