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Japan Inbound Tax & Legal Newsletter

Japanese Transfer Pricing Law Amended and Interpretative Material Issued

August 2019, No. 41

In Brief

Tax law amendments that passed the upper house of Japan's legislature in the spring contain some of the most significant changes to Japanese transfer pricing rules in recent years. The amendments to the transfer pricing law, which were first announced in December 2018 as part of the 2019 tax reform package, are effective for fiscal years beginning on or after 1 April 2020. Subsequent to the amendments to the law, the interpretative circulars and National Tax Administration (NTA) Transfer Pricing Directives were updated, and an explanatory memorandum was issued by the Ministry of Finance.

A previous edition of our newsletter explored the changes to the law as proposed at the time of the announcement, and this newsletter summarizes the final amendments and the interpretative guidance, and considers the practical implications of each amendment.

The amendments make the following five changes to Japan's transfer pricing law:

(1) Clarification of the definition of intangible assets;

(2) Introduction of the discounted cash flow (DCF) method for calculating the arm's length price;

(3) Introduction of the OECD's "hard to value intangibles" (HTVI) approach into Japanese domestic law;

(4) Formalization of the interquartile range in Japanese law; and

(5) Extension of the statute of limitations relating to transfer pricing.

Each of these changes is discussed below.

1. Clarification of definition of intangible assets

Overview of the revision

Prior to the amendment, the term "intangible asset" was not clearly defined. The amendment inserts the following definition of the term into Japanese law (please note that the following represents an unofficial English translation of the Japanese language definition):

> Patent rights, utility model rights and other assets (other than the [excluded] assets listed below), where under a transfer or license of the assets (including the establishment of rights pertaining to the assets and any other acts that cause other persons to use the assets) or similar transaction, consideration would be paid between unrelated parties according to ordinary business terms.
>
> [Excluded assets:]
>
> (i) Securities;
>
> (ii) Cash, deposits and savings, accounts receivable, loans, [other] securities, rights relating to certain derivative transactions and any other financial asset or similar asset.

The amendment provides the following examples of intangible assets:

- Industrial property rights, technology rights, special technology production methods, copyrights and certain amortizable assets (e.g. mining rights, patent rights, trademark rights, utility model rights, software, goodwill, etc.);

- Customer lists and sales networks;
- Know-how and trade secrets;
- Trade names and brand names;
- Rights established through licensing or transactions equivalent to licensing of intangible assets; and
- Contractual rights not included in one of the above categories.

Practical considerations

While the new definition of intangible asset is similar to the definition in the 2017 OECD Transfer Pricing Guidelines, it does not include the language that requires the asset to be "capable of being owned or controlled." In relation to this language, the OECD notes that "[i]t is important to distinguish intangibles from market conditions or local market circumstances. Features of a local market, such as the level of disposable income of households in that market or the size or relative competitiveness of the market are not capable of being owned or controlled." The omission of this language may give rise to an interpretation that location specific advantages are intangible assets under Japanese law. However, the Japanese tax authorities have not announced an intention for the definition to deviate from the OECD definition, and the requirement that "consideration would be paid between unrelated parties according to ordinary business terms" may be interpreted as sufficient to exclude location specific advantages from the definition. Taxpayers should consider consulting a Japanese tax professional if this is a point of concern.

2. Introduction of the DCF method for calculating arm's length prices

Overview of the revision

The DCF method is included as an acceptable method of calculating an arm's length price for transactions in cases where comparable transactions cannot be identified.

Practical considerations

While Japanese taxpayers historically have used the DCF method as a valuation method in their transfer pricing calculations, prior to the amendment, the legal and regulatory standing of the DCF method was uncertain. The amendment clarifies the acceptability of the DCF method and, therefore, it is likely that the Japanese tax authorities will use DCF calculations on a more regular basis.

In terms of the types of assets to which the DCF method can apply, the examples provided in the guidance include transactions relating to, and business transfers involving, intangible assets. However, the explanatory memorandum issued by the Ministry of Finance states that the application of the DCF method is not limited to intangible assets.

From a practical perspective, Japanese taxpayers are required to use the most appropriate transfer pricing method when pricing intercompany transactions. Therefore, the DCF method represents an additional method that may be selected by taxpayers. However, the NTA Transfer Pricing Directives provide that when the DCF method is one of multiple candidates for the most appropriate method, a method other than the DCF method should be selected. That is, the DCF method should be considered the most appropriate method only when no other methodologies are an option.

In terms of the calculation, a core element of the DCF method is the use of financial projections. Financial projections by their nature are uncertain, and reliability of the data is an important consideration. In this respect, the NTA Transfer Pricing Directives provide the following guidance:

- The financial projections should be based on information such as business plans determined from reliable and objective facts.
- In examining the reliability of the data, the basis and purpose of the financial projections, the length and duration of the forecast period and consistency with past earnings should be considered.
- Projected growth rates should take into consideration the future prospects of the business and growth of the overall market.
- The appropriate discount rate should be based on individual factors, including facts and risks relevant to the transaction, and calculation of the projected profits.
- The forecast period should be determined taking into account the legal protection period for the intangible asset and the degree of change in the technical environment.
- Projected profit should be calculated by taking into consideration income tax based on the projected effective tax rate (depreciation should be deducted from taxable income, and the effective tax rate should take this into account).

The NTA Transfer Pricing Directives also contain case studies that emphasize the importance of using an appropriate discount rate that can be verified by the tax authorities. The directives also note that the DCF

method cannot be applied when verifiable and reasonable information cannot be obtained for calculating the arm's length price.

3. Introduction of the HTVI approach into Japanese domestic law

Overview of the revision

The 2017 OECD Transfer Pricing Guidelines contain a mechanism that allows tax authorities to consider after the fact (ex-post) outcomes as presumptive evidence on the appropriateness of certain pricing arrangements relating to hard to value intangible assets ("HTVI approach"). Under the HTVI approach, the tax authorities can make an adjustment where there is a significant deviation of actual outcomes from forecasts used to price the transaction, subject to certain exceptions.

The HTVI approach is now included in Japanese law, making Japan among the first countries to introduce such rules in their domestic law. The new rules apply to "specified intangible assets," which are defined as intangible assets that meet the following three criteria:

(i) The asset has unique characteristics and is used to generate high added value;

(ii) The arm's length price for the transaction involving the asset is calculated based on forecasts; and

(iii) The forecasts on which the calculation is based have been found to be uncertain.

An exception exists where the deviation from the financial forecasts does not exceed 20% (i.e. where the amount regarded as the arm's length price does not exceed 120% and is not less than 80% of the original transaction price).

A further exception exists where the deviation from the financial forecasts was difficult to predict or appropriately take into account. Specifically, the exception applies where the Japanese taxpayer can furnish documentation showing the following:

- The factors upon which the calculation of the arm's length price for the intangible asset transaction with the foreign affiliate was based;
- Evidence that, at the time of the transaction, it was difficult to predict the occurrence of a disaster or similar event that resulted in the forecast differing from the outcome, or that the arm's length price was calculated at the time of the transaction by appropriately taking into consideration the possibility of the occurrence of this cause.

Practical considerations

The exception for deviations that are difficult to predict uses the language "disaster or similar event." At the time the draft legislation was issued, there was little guidance on this term and commentators considered that the Japanese exception may be narrower than the OECD equivalent (specifically, whether business events would be covered). However, the amended law and accompanying interpretative materials clarify this point. Specifically, the term "disaster or similar event" refers to events that were clearly difficult to predict at the time the transaction took place, with the following provided as examples:

- Significant changes in economic conditions, such as a financial crisis;
- Changes to the laws or the guidance issued by government agencies; or
- Significant changes to the market, such as a sharp increase or decrease in market share in a business resulting from the bankruptcy of a major competitor.

From a practical perspective, the exceptions require taxpayers to provide documentation supporting the application of the specific exception (e.g. for the 20% exception, projections used in valuing the asset at the time of the transaction and other financials relating to the asset likely will have to be provided). In this context, creating and maintaining an appropriate level of documentation is highly important when undertaking relevant transactions.

Finally, while the Japanese exception does not appear to vary significantly from the OECD equivalent, taxpayers should monitor any comments from the Japanese tax authorities on their view of this exception.

4. Formalization of the interquartile range in Japanese law

Overview of the revision

The use of an interquartile range of results of an economic analysis is formalized in Japanese law through the introduction of a “quartile method.” Although Japanese taxpayers regularly use the interquartile range in practice, Japanese law previously did not formally allow its use.

Based on the revised law, the interquartile range may be used as a method of accounting for comparability differences where the differences are found to be minor and provided that adjustments cannot be made to account for the differences. In other words, while the median value in the interquartile range is considered by the Japanese tax authorities to be the arm's length price, if the consideration for the transaction with the foreign related party is within the interquartile range, the transaction still will be considered to be arm’s length.

The interquartile range concept is incorporated into Japanese law through the quartile method, in which the results of comparable transactions are ranked from lowest to highest, with the interquartile range being the results between the 25th and 75th percentile.

To use the quartile method, the NTA Transfer Pricing Directives provide that the following criteria should be met:

- There is a difference in comparability that is difficult to quantify even after making relevant adjustments, and the difference is minor;
- Four or more comparable transactions have been identified;
- Differences that are difficult to quantify have been identified; and
- Where adjustments can be made for differences, and the differences are likely to impact profitability, such adjustments are made.

Practical considerations

The interquartile range is commonly calculated by taxpayers based on either an excel formula (which uses interpolation) or a formula specified by the US Internal Revenue Service (which does not use interpolation). At the time of the announcement of the introduction of the method in Japan, it was not clear which method would be acceptable. The interpretative material issued with the changes to the law clarifies that the calculation can be based on either method.

In terms of the practical impact on taxpayers, after the formal introduction of the interquartile range, taxpayers can expect additional scrutiny when using the full range in an analysis. When relying on the full range, taxpayers should ensure that appropriate supporting arguments are contained in their transfer pricing documentation, or can be provided to the tax authorities if challenged.

5. Extension of the statute of limitations relating to transfer pricing

Overview of the revision

The statute of limitations for transfer pricing, which sets a limit on how many fiscal years are open for audit by the tax authorities, is extended from six years to seven years.

Practical considerations

The granting of additional time for the tax authorities to make transfer pricing adjustments may have been considered necessary given the potential lag between the time a transaction occurs and when the profits arising from the asset are realized. For example, intangibles relating to a pharmaceutical product that is subject to a lengthy clinical trial and regulatory approval process may not generate income until after the process concludes. The extension of the statute of limitations allows the tax authorities more time to determine whether the price paid for the asset was reasonable based on the revenue ultimately generated.

From a practical perspective, taxpayers now should prepare and maintain transfer pricing documentation covering seven fiscal years.

Deloitte's View

The amendments to Japan's tax law contain some of the most significant changes to Japanese transfer pricing rules in recent years. The core changes to the law impact the pricing of intangible assets, and arm the tax authorities with the tools to make after-the fact (or ex-post) pricing adjustments. In addition, the extension to the statute of limitations for transfer pricing allows the tax authorities to make transfer pricing adjustments for up to seven years after a transaction. Because the amendments could impact the risk profile of transactions involving intangible property, taxpayers should consider the application of the new rules to proposed transactions, as well as potential risk mitigation strategies (including, e.g. advance pricing arrangements, or APAs).

While the introduction of the DCF method likely is seen as necessary to allow the HTVI approach to be applied by the tax authorities, its application is not limited to HTVI scenarios. As such, taxpayers can expect the Japanese tax authorities to use DCF calculations more regularly. Finally, while the interquartile range is commonly used by taxpayers in Japan, it now is formally recognized under Japanese law. Given this, taxpayers that choose to rely on the full range instead of the interquartile range should expect more scrutiny from the tax authorities.

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