

Client Alert

Tokyo

BAKER & MCKENZIE

東京青山・青木・狛法律事務所

April 2009

Japanese Taxpayer Wins for the First Time in Domestic Transfer Pricing Litigation – Represented by Baker & McKenzie Tokyo

On October 30, 2008, the Tokyo High Court upheld an appeal brought by Baker & McKenzie Tokyo on behalf of its client, Adobe Systems Co., Ltd. (“Taxpayer”), in the first ever successful transfer pricing case brought by a taxpayer in Japan. The appeal before the High Court was against a decision of the District Court which upheld the authorities’ transfer pricing reassessment. The authorities did not file an appeal and the High Court’s decision became final. This client alert briefly reports the case.

Outline of Japanese Transfer Pricing Rules – Priority of the Three Basic Methods (CUP, Resale Price, Cost Plus) Over Other Acceptable Methods

Unlike the US and some other jurisdictions, Japan does not follow the “best method” rule with respect to calculating the arm’s length price for a given transaction. Rather, the authorities are required by law to use either the CUP method, resale price method or cost plus method (collectively referred to as the “three basic methods”). If one of the three basic methods cannot be used for the case at issue, the authorities are required by law to use methods comparable to the three basic methods, or certain other methods such as the profit split method or the transactional net margin method.

Background Facts

The Taxpayer is a wholly owned Japanese subsidiary of a US-based software company. The Taxpayer’s foreign related entities sold software products to Japanese distributors, and the Taxpayer provided certain marketing, training and support services for the benefit of these foreign related entities. The Taxpayer received, as a fee for its services, a fixed percentage of the annual net sales of the software products in Japan, plus reimbursement of direct and indirect expenses incurred. The issue for the court was whether the fees paid by the foreign related entities to the taxpayer fell short of the arm’s length standard.

For details, please contact the following:

Edwin T Whatley
edwin.t.whatley@bakernet.com

Hideyuki Yamamoto
hideyuki.yamamoto@bakernet.com

Toshio Ishikawa
toshio.ishikawa@bakernet.com

Yoshihito Ueno
yoshihito.ueno@bakernet.com

www.taalo-bakernet.com
www.bakernet.com

Baker & McKenzie GJB
Tokyo Aoyama Aoki Koma Law Office
(Gaikokuho Joint Enterprise)
The Prudential Tower, 11F
13-10, Nagatacho 2-chome,
Chiyoda-ku, Tokyo 100-0014, Japan
Tel: +81 3 5157 2700

This may qualify as “Attorney Advertising” requiring notice in some jurisdictions. Prior results do not guarantee a similar outcome.

Required “Comparability” of Method Not Met – Distinct Differences between the Comparable Transaction and the Controlled Transaction

In this case, the authorities used a calculation method that was not among the three basic methods, asserting that none of the three basic methods could be used. The authorities chose a comparable transaction in which similar software products were purchased by a reseller and resold to its end users.¹ The authorities computed the arm’s length fees that they contended should have been receivable by the Taxpayer by multiplying the gross margin ratio of the comparable transaction by the value of the gross sales of the software products realized by the Taxpayer’s foreign related entities in Japan. The authorities took the position that such a method was comparable to the resale price method, one of the three basic methods, and should therefore be accepted.

The court explained that the resale price method is based on the assumption that margins realized by resellers performing identical functions and assuming identical risks should be of an identical level. Thus, the court held that the determinative factor in this case was whether the functions performed and risks assumed by the resellers in each of the controlled transaction and the comparable transaction were similar enough that the authorities could rightfully rely on the selected comparable.

After scrutinizing the similarities between the comparable transaction and the controlled transaction, the court ruled that it was impossible to ignore the differences that clearly existed between the functions performed by the reseller in the comparable transaction and the Taxpayer in the controlled transaction, since the reseller in the comparable transaction purchased and sold software products and provided ancillary customer support services in order to facilitate sale, whereas the Taxpayer performed various services for the distributors as required under contractual agreements with the foreign related entities. The court also ruled that the risks assumed by the reseller in the comparable transaction and the Taxpayer in the controlled transaction were fundamentally different since the reseller assumed the risk of resale revenues falling below break-even, whereas the Taxpayer, being entitled to receive a fixed percentage of the annual net sales of the software products in Japan plus direct and indirect expenses incurred, did not assume such a risk.

Comments

Traditionally, it has generally been considered extremely difficult to have a transfer pricing reassessment reversed by the Japanese courts, even where that reassessment is unreasonable. While speculative, a reason for this difficulty might be the highly technical nature of transfer pricing matters for which court judges, being more like generalists than specialists, do not necessarily have extensive experience. Indeed, only two transfer pricing matters have been litigated by taxpayers prior to this case, and taxpayers were

¹ The comparable transaction identified by the authorities was a “secret comparable”, the acceptability of which was one of the issues at the District Court level. However, the High Court did not address this issue, upholding the Taxpayer’s appeal on other grounds. Thus, the acceptability of secret comparables appears to still be an open issue in Japan.

unsuccessful in both. However, we believe that this taxpayer victory should clear up much anxiety and tax litigation can now be considered as a practical and feasible means of resolving tax disputes in Japan.