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Japan Tax Bulletin

Transfer pricing rule changes in the 2019 Tax Reform

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The 2019 tax reform brought changes to the transfer pricing rules in order to bring them in line with OECD transfer pricing guidelines. The changes will be effective for fiscal years beginning after 31 March 2020.

1. *Definitions of intangible property*

Under the revised transfer pricing rules, the definition of intangible property is property satisfying the following conditions:

- Patents, utility model rights or other properties excluding:
  - ✓Tangible property
  - ✓Financial property - cash, bank deposit, monetary claims such as loans receivable, securities, rights in relation to derivative transactions or other similar properties.
- If transferred, licensed or otherwise transacted, consideration for the transactions is similar to comparable arm's length transactions.

2. *Approach to Hard to Value Intangibles (HTVI)*

An approach to HTVI was introduced in the transfer pricing rules. Where a corporate taxpayer is engaged in transactions of specified intangible properties with foreign related persons, and the conditions for computing the transfer price of the transaction have turned out to be different from the facts, the tax authorities are authorized to correct the taxable income of the taxpayer. The tax authority is able to deem the arm's length price with reference to reasons for the differences and the likelihood of the occurrence of the difference.

(1) Definition of specified intangible properties

Specified intangible properties are intangible properties that satisfy the following conditions:

- They have unique characteristics and are used in high-value generating activities.
- An arm's length price for transactions with foreign related persons is calculated based on forecasted profits over the projected profit-generating period.
- There is uncertainty when calculating the arm's length price relating to the intangibles and other conditions.

(2) Definition of specified intangible property foreign-related transactions

Specified intangible property foreign-related transactions are defined as foreign-related transactions where specified intangible properties are transferred, licensed (including grants of the rights to exploit the intangibles or all other actions where the intangibles are exploited) or other similar transactions to these.

(3) Conditions for triggering adjustments

The tax authorities are not allowed to rely on these adjustment measures where the discrepancy, between the price deemed as arm's length under the adjustment measures and the original transaction price, is within the following range:

- For a corporation that receives consideration for specified intangible property foreign-related transactions - the price deemed as arm's length under the adjustment measures does not exceed 120% of the amount of the consideration.
- For a corporation that pays consideration for specified intangible property foreign-related transactions - the price deemed as arm's length under the adjustment measures is not less than 80% of the amount of the consideration.

(4) Exemption from the adjustment measures

Where a corporation satisfies the following two conditions, the adjustment measures are not applied as long as the corporation attaches Schedule 17(4) to its corporate income tax return indicating certain items as specified intangible property foreign-related transactions.

- Documentation

  The corporation has prepared or obtained documents describing specified intangible property foreign-related transactions including:
  - ✓ Items the corporation has forecast such as projected revenue amount, risks in relation to the transaction and conditions for calculating the price for specified intangible property foreign-related transactions.
  - ✓ Details of the reasons for the differences between the actual facts and the conditions for calculating the price for specified intangible property foreign-related transactions.
- Revenue discrepancy
  - ✓ For a corporation that receives consideration for specified intangible property foreign-related transactions, the profit amount generated from specified intangible property foreign-related transactions for a judgement period does not exceed 120% of the profit amount that was forecasted for that period, when the specified intangible property foreign-related transactions started.
  - ✓ For a corporation who pays considerations for specified intangible property foreign-related transactions, the profit amount generated from specified intangible property foreign-related transactions for a judgement period is not less than 80% of the profit amount that was forecasted for that period, when the specified

intangible property foreign-related transactions started.

The judgement period referred to above is 5 years from the beginning of the business year that includes the commencement of revenue from unrelated parties related to the specified intangible properties.

3. Discounted Cash Flow (DCF) method as a transfer pricing method

The DCF method has been added as an applicable transfer pricing method. The DCF method can be used not only for foreign-related transactions of intangible properties, but also for those of other properties or services. Under the DCF method, an arm's length price is calculated as the present value, being the total projected profit discounted by appropriate ratios for each year over the projected profit-generating period. The projections are made when properties or services in foreign related transactions are transferred or acquired.

4. Use of the quartile method

Where there are differences between tested transactions and comparable transactions, the comparable transactions cannot be used in calculating an arm's length price unless necessary adjustments are made. If there are some comparable transactions where the differences cannot be adjusted for, the quartile method can be used. This method can only be used if it has an immaterial impact on ratios such as profit level indicators after the adjustable transactions have been adjusted for (the adjusted ratio). The ratio used under the quartile method is the median of adjusted ratios in the 25%-75% quartile range of 4 or more of the comparable transactions, in order of ascending size.

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