

Japan tax bulletin

Newsletter on important tax and business developments in Japan

December 2009

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Japan's new taxation agreements and recent transfer pricing litigation

This edition of our quarterly newsletter contains updates on Japan's international tax agreements and recent transfer pricing litigation brought by taxpayers.

2009 has seen Japan either enter into taxation agreements or open discussions with a number of new countries. A common theme is that the countries involved are rich in natural resources. A broad overview of the agreements is included below.

In addition a landmark court ruling relating to Japanese transfer pricing is discussed.



New taxation agreements

Japan is one of the World's top three importers of oil and natural gas and as such has sought to enter into tax treaty negotiations with a number of resource-rich countries.

During 2009 Double Taxation Agreements (DTAs) have been signed with Brunei Darussalam and the Republic of Kazakhstan. In addition basic agreements have been reached with Kuwait and Saudi Arabia. These are the first of their kind with states in the Persian Gulf and talks are underway to reach agreement with the United Arab Emirates.

Brunei Darussalam and the Republic of Kazakhstan

Double Taxation Agreements (DTAs) have been signed with Brunei and Kazakhstan and represent the first time Japan has signed tax treaties with those countries.

The effect of the agreements will be to enable Japanese companies to invest in the countries without fear of double taxation and will also encourage investment into Japan from the countries involved.

The agreement with Brunei will enter into force on 19 December 2009 and apply in Japan from 1 January 2010. It contains a clause exempting interest paid to the Brunei Investment Agency, a sovereign wealth fund, from taxation in Japan. This will help encourage direct investment from the Brunei government in Japanese stocks, bonds and real estate.

The treaty with Kazakhstan will enter into force on 30 December 2009 and apply in Japan from 1 January 2010.

Although these treaties have not yet entered into force the headline facts are as follows:

	Kazakhstan	Brunei
Dividends	5% ¹ / 15% ²	5% ¹ / 10% ²
Interest	0% ³ / 10% ²	0% ³ / 10% ²
Royalties	10% ⁴	10%

¹ If the beneficial owner is company that has owned directly or indirectly at least 10% of the voting shares in the paying company for a period of the of six months ending on the date entitlement to the dividends is determined

² In all other cases

³ If the beneficial owner of the interest is a government entity/wholly owned financial institutions

⁴ In the case of royalties arising in Kazakhstan the 10% withholding rate is charged on an amount equal to 50% of the gross amount of the royalties. In the case of royalties arising in Japan it is charged on 5% of the gross amount.

Persian Gulf nations

Basic agreements have been reached with Kuwait and Saudi Arabia. These are the first of their kind with states in the Persian Gulf and talks are underway to reach agreement with the United Arab Emirates.

Saudi Arabia and the UAE provide Japan with 50-60% of its oil imports and the agreements will encourage mutual investment between the countries.



When published some of the agreements may contain clauses similar to the Brunei agreement exempting the overseas governments' investment vehicles from taxation in Japan in order to encourage investment.

Bermuda

In addition Japan has agreed in principle on a tax information exchange agreement with respect to individual taxation with Bermuda. It is hoped that the new agreement will enhance transparency and prevent international tax evasion.

The agreement is one of many that Bermuda has signed as it seeks to confirm its status as a member of the OECD's "white list" of countries that have substantially implemented the OECD's international tax standard.

Switzerland

In addition to the above countries Japan and Switzerland have agreed in principle on a revised DTA. The revisions include reductions to the

permitted withholding tax rates on dividends, interest and royalties.

The agreement contains a clause relating to extended administrative assistance in tax matters and in doing so has contributed to Switzerland being moved to the OECD's "white list".

Belgium and Singapore

Japan has recently agreed in principle to revise its agreements with Belgium and Singapore to include clauses on the exchange of tax information. As with Switzerland, this has contributed to the countries being moved to the OECD's "white list".

Summary

Japan's recent efforts in reaching agreements with resource rich nations should encourage cross border investment and help to secure Japan's energy future. Clauses similar to that included in the Brunei agreement will also encourage direct investment into Japan from sovereign wealth funds as they look to diversify their interests.

Transfer Pricing litigation

Decision of Tokyo High Court on 30 October 2008

The Tokyo High Court ruled in favour of Adobe Systems Co., Ltd. ("Appellant") in their appeal against a District Court's decision to uphold a transfer pricing assessment made by the Tokyo Regional Taxation Bureau ("TRTB").

In Japan there have only officially been three other cases which questioned the suitability of transfer pricing assessments made by the tax authorities and in each of these cases the rulings were in favour of

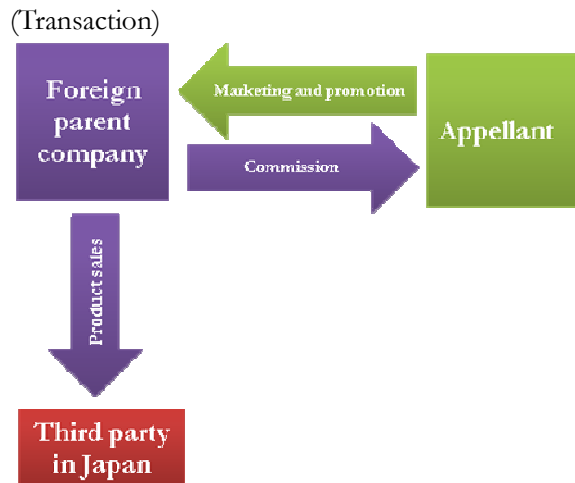
the tax authorities. This court case is therefore very important as it represents the first time a taxpayer has won in litigation involving the Japanese transfer pricing legislation. The decision by the Tokyo High Court was not appealed and so is final.

Background

The Appellant, a 100% owned Japanese subsidiary of a foreign corporation, provided marketing and support activities relating to software that its foreign parent sold in Japan. In consideration for providing the services it received a commission based on the following formula:

Direct and indirect expenses incurred + (domestic net sales×1.5%)”

The issue for the court was whether the commission paid by the parent company fell short of the arm's length standard or not.



The TRTB selected an undisclosed company that engaged in the import and sale of a variety of third party software products as a comparable (a secret comparable), and argued that the commission of the Appellant should be based on the gross profit margin of the secret comparable multiplied by the foreign parent company's sales in Japan. They argued that this method was comparable to resale price method¹.

The Tokyo District Court's decision

The Tokyo District Court upheld the TRTB's reassessment based on following reasons:

1. The services provided by the Appellant were similar to the resale activities of the comparable chosen by the TRTB.
2. The functions performed and the risks borne by the Appellant were equivalent to those of the comparable selected by the TRTB.

¹ The tax authorities are required to use 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, the authorities are required to use methods comparable to the three basic methods, or certain other methods such as the profit split method or transactional net margin method.

Final decision

Contrary to the District Court's decision, the Tokyo High Court ruled against the TRTB's reassessment and in doing so emphasized the following points:

1. The functions performed by the Appellant and the secret comparable were significantly different as the Appellant did not perform a sales function.
2. The Appellant's transactions with its foreign parent were the provision of service for wholesalers based on the service agreement both legally and in economic substance.
3. The risks borne by the Appellant and those borne by the secret comparable were different as the Appellant was guaranteed a level of consideration that exceeded the expenses incurred in providing the services.

Also, the Tokyo High Court mentioned that when the TRTB insisted that one of the three basic methods could not be used, the Appellant had a duty to prove that their own method was appropriate.

Unresolved issues

1. The legality of using a "secret comparable" was one of the issues raised but it was not addressed by the Tokyo High Court's decision
2. The appropriateness of the Appellant's commission calculation was also not addressed.

Comments

The decision has shown the importance of a taxpayer having supporting evidence to challenge to the tax authorities' position. It has therefore become vital for taxpayers to prepare transfer pricing analysis and documentation in advance. In addition, agreements for transactions with foreign related parties should be worded carefully in order to reflect the economic substance of the transaction as it is now clear that these agreements will be important in analyzing the functions provided.

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