

# Japan Tax Bulletin

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## ***Transfer Pricing for Limited Risk Distributors in Japan***

This issue discusses applying the Transactional Net Margin Method (“TNMM”), using the Berry Ratio as a Profit Level Indicator (“PLI”), to a Japanese subsidiary which is a limited risk distributor.

### *1. Limited Risk Distributor*

A Limited Risk Distributor (“LRD”) is a buy-sell distributor that distributes products in its own name, and for its own account, for a principal company under an arrangement in which most risks are borne by the principal and only limited risks are borne by the LRD. The LRD takes title to the product for distribution to customers and therewith assumes certain economic risks. However, there is an intercompany agreement between the LRD and the principal by which important functions and risks are taken on by the principal. For example, bad debt loss and inventory loss are covered and marketing expenses are reimbursed by the principal.

LRDs are frequently used when foreign companies enter the Japan market to sell their products or services.

### *2. Transfer Pricing Method for LRDs in Japan*

As LRDs perform simpler functions and assume lower risks than the foreign principal, the TNMM is usually used for comparisons with other LRDs.<sup>1</sup> When applying the TNMM, the following Profit Level Indicators can be used:

- (i) Operating Margin/Sales (“OM/Sales”)<sup>2</sup>;

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<sup>1</sup> Article 66-4(2) of The Act on Special Measures concerning Taxation (“ASMT”), Article 39-12(8) of Special Taxation Measures Law Enforcement Ordinance (“STLEO”)

<sup>2</sup> Article 39-12(8)(2) of STLEO

- (ii) Operating Margin/(Sales-OM) (“Full Cost Mark Up”)<sup>3</sup>; or

- (iii) (Operating Margin + Selling General and Administrative expenses)/Selling General and Administrative expenses (“Berry Ratio”)<sup>4</sup>.

The Berry Ratio became available as a PLI under the TNMM in the 2013 tax reform.

Where an LRD is used, OM/Sales would be generally more consistent than the other PLIs, considering the legal form. OM/Sales is appropriate in cases where the value of functions performed by the buyer of the inventories is recognized to be related to the sales, in consideration of the assets used or risks borne (for example, in the case of testing a reselling company). On the other hand, if a commissionaire<sup>5</sup> is used, a cost base PLI would be generally more consistent. However, where the LRD’s function/risk profile is more similar to that of a service provider, a cost based PLI would be applicable.

### *3. Berry Ratio for an LRD*

An LRD is usually operated under a buy/sell model. The Berry Ratio is applicable as PLI under the TNMM where certain conditions are satisfied as below.

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<sup>3</sup> Article 39-12(8)(3) of STLEO

<sup>4</sup> Article 39-12(8)(4), 39-12(8)(5) of STLEO

<sup>5</sup> A commissionaire is a person who sells and distributes products in its own name and for the principal’s account. A commissionaire, therefore, enters into an agreement with customers and transfers economic benefits from transactions with customers to the principal. A commissionaire is compensated through commission from the principal.

Under the Japan Commercial Code, a commissionaire is defined as a “Toiya”. A Toiya is a person who engages in business of selling or purchasing of goods in its own name for other persons purchasing of goods in its own name for other persons

Case 6 of “Reference Case Studies on Application of Transfer Pricing Taxation (Supplement)”, discusses the application of the TNMM and the precondition 2 discusses the Berry Ratio as a PLI for a distributor<sup>6</sup>.

In the case, where a subsidiary purchases products from its parent company and sell them to a third party, their respective functions and activities are as follows:

“Company P, concerning the sales business of Product A, establishes a global sales plan for its product, and manages the business operation of its sales subsidiaries including Company S. Company P, based on the sales plan, sells the Product A it manufactured to Company S. Company S does not conduct original advertisement/sales promotion activities in country X, but purchases Product A from Company P, in accordance with Company P’s sales plan and sells it to a third-party agency. Although Product A is sold to a third-party agency through Company S in the transaction flow, the actual product does not go through Company S in the distribution flow, but is delivered directly from Company P to the agency.”

Based on the functions and activities above, the value contribution by Company S is reflected in operating costs. The conclusion is that applying the TNMM with the Berry Ratio as a PLI is appropriate.

Sales subsidiaries in the early entry stage into the Japan market are sometimes operated under the operational control of their foreign parent. Under such circumstances, applying the TNMM to subsidiaries with the Berry Ratio as a PLI may be appropriate.

#### 4. *Post-transaction transfer pricing adjustments*

When an LRD is operated under the buy/sell model, it may be that the profit calculated using the Berry Ratio is not within the range between the upper quartile and the lower quartile of comparables, when closing books at year end.

Although post transaction transfer pricing adjustments can be made, such adjustments need to be made carefully. Downward adjustments cannot be made on a tax return and need to be

made in the company’s books.<sup>7</sup>

Further, where paying or accruing post transaction adjustments, the entire amount may be disallowed unless the reasonableness of the adjustments is evidenced and documented.

The following need to be made clear<sup>8</sup>:

- Reasons for payments or accrual;
- Pre-determined adjustment policy;
- Method and basis of calculating adjustments;
- Date when payments or accruals were decided; and
- Date when payments or accruals were made.

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<sup>6</sup> [https://www.nta.go.jp/foreign\\_language/08.pdf](https://www.nta.go.jp/foreign_language/08.pdf)

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<sup>7</sup> 66-4(8)-2 of the STML Circular

<sup>8</sup> 2-20 of Commissioner’s Directive on the Operation of Transfer Pricing