

Supplement

## Reference Case Studies on Application of Transfer Pricing Taxation

This document is a translation of the original Japanese-language Case Studies. The Japanese original is the official text.

#### Points to Note

This supplement describes the treatment for transfer pricing taxation purposes of a number of cases meeting certain preconditions. The aim is to illustrate the key points to take into consideration when applying the Commissioner's Directive on the Operation of Transfer Pricing (Administrative Guidelines).

The cases are grouped into three sections: The cases in Section 1 illustrate selecting the method of calculation of arm's length price; those in Section 2 illustrate points to note when applying the method of calculation of arm's length price; while those in Section 3 provide examples of advance pricing arrangement.

Drawing on past cases of transfer pricing taxation and advance pricing arrangement (APA), these cases were chosen on the basis of their meeting certain preconditions in order to illustrate the important points when applying the Commissioner's Directive on the Operation of Transfer Pricing. Thus, there are also other cases which, though similar, are based on different preconditions, and their treatment for the purposes of transfer pricing taxation will also differ as a result.

When conducting transfer pricing examinations and APA evaluations in practice, therefore, attention shall be paid to the following: 1) Determining whether a particular case presents any difficulties from the point of view of transfer pricing taxation. 2) Selecting and applying the most appropriate method of calculation of arm's length price by correctly ascertaining the particular circumstances of the foreign-related transactions in each individual case, based on the provisions of 1-2 (Basic Policies), 2-1 (Examination Policies), 5-1 (APA Policies) and other relevant provisions of the Commissioner's Directive on the Operation of Transfer Pricing. 3) Consulting the other cases contained in this supplement, in addition to 1) and 2).

## Definitions

The terms used in this supplement are defined as prescribed in Definitions 1-1, the Commissioner's Directive on the Operation of Transfer Pricing, and additionally as prescribed below:

1. Administrative Guidelines: "Commissioner's Directive on the Operation of Transfer Pricing (Administrative Guidelines)" issued on June 1, 2001. [Document ID: Large Enterprise Examination Division 7-1, etc.]
2. Internal comparable transaction: A comparable transaction except an external comparable transaction.
3. External comparable transaction: A comparable transaction between parties which have no special relations prescribed in Article 66-4(1) of the ASMT with a company or the foreign-related party.
4. Comparable PS method: The method listed in Item 1(a) of Article 39-12(8) of the Order for Enforcement of the ASMT, among the profit split methods.
5. Contribution PS method: The method listed in Item 1(b) of Article 39-12(8) of the Order for Enforcement of the ASMT, among the profit split methods.
6. Residual profits: Residual profits prescribed in Item 1(c-2) of Article 39-12(8) of the Order for enforcement of the ASMT.
7. Splitting factor: A factor to be used for allocation of profits to be split or residual profits
8. Routine transaction: A transaction listed in ASMT Directive 66-4(3)-1(5)

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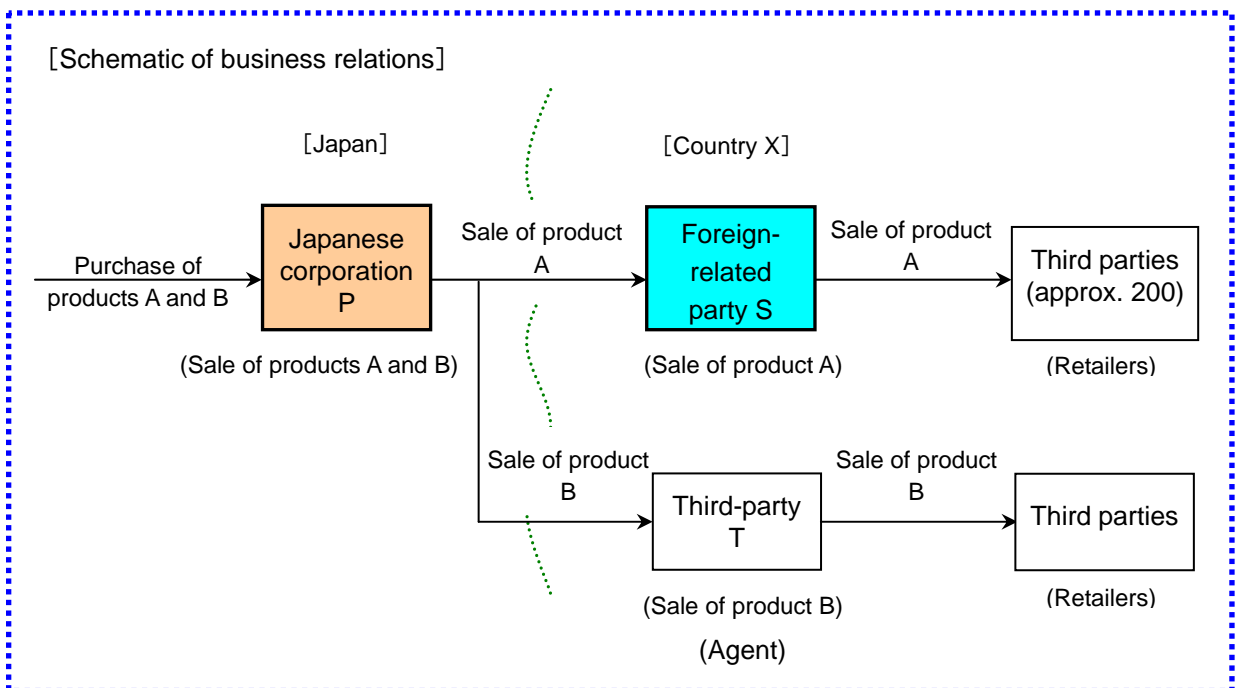
## Section 1: Cases concerning the selection of method of calculation of arm's length price

### Case 1: Case of use of comparable uncontrolled price method

#### Key point

In this case, it was found that the CUP method was the most appropriate method of calculation of arm's length price.

#### Preconditions



#### (Summary of business of corporation and foreign-related party)

Japanese corporation P is a distributor of products A and B, and 10 years previously it established corporation S in country X as a subsidiary to distribute product A.

#### (Summary of foreign-related transaction)

Company P sells product A to company S, which then sells it to approximately 200 third-party retailers in country X.

Company P has sold product B to third-party agent T in country X since company S's establishment, and company T then sells the product to retailers in country X. At company P, product B is classified as a different product (i.e. has a different model number) from product A, but the two are similar in terms of properties, structure, functions, etc.

#### (Functions and activities of corporation and foreign-related party)

The function performed by company P in the sale of product A to company S and the sale of product B to company T (hereinafter referred to as the "two transactions") is that of purchase of inventories of product A and product B, and the sale of these inventories to company S and company T. Company P engages in no unique activities, and there are no differences between the two transactions in function. In neither case is use made of trademarks or other such properties.

**(Terms of contracts for sale of product A and product B)**

The two transactions are the same in transaction stage (e.g. retail or wholesale), and substantially the same in volume. The terms of the contracts for the two transactions (e.g., delivery terms, payment terms, product warranties, and the conditions for returns) are also, with the exception of the transaction price, the same.

**Treatment for transfer pricing taxation purposes**

**(Consideration of comparability study)**

In calculating the arm's length price, selecting the most appropriate method of calculation for each case is required by the provisions of Article 66-4(2) of the ASMT, therefore a comprehensive study was made based on 66-4(2)-1, 66-4(3)-1, and 66-4(3)-3 of the Commissioner's Directive on the ASMT, the Administrative Guideline 3-1, etc. The result was as shown below:

- Both company P and company S perform sales functions and no significant difference is recognized between their levels. Therefore, it is deemed to be appropriate to adopt either of them as the tested party.
- A potential internal comparable transaction for application of the CUP method can be found within the transaction in which company P sells product B to company T.
- From openly accessible information, no potential external comparable transactions can be found.
- Product A and product B were found to be the same type of product in terms of properties, structure, and functions, despite being classified into different product categories at company P.
- No differences were found in the role and functions of P in the two transactions, and no use was made of intangible properties.
- The two transactions are substantially the same in the terms of contracts, and there were found to be no differences in the contract terms of the transactions.
- Both company S and company T are wholesale traders selling products to retailers in country X, so the two transactions are the same in transaction stage. They are also the same in volume, and there are no pricing regulations on either product A or product B.
- There were found to be no differences in company P's business strategies toward product A and product B.

(Note) In applying the RP method, the CP method and the TNMM (including other methods consistent with, or equivalent to them), the profit level indicator of either of the parties of foreign-related transactions is to be verified. In these case studies, the party of foreign-related transaction subject to the relevant verification is called the "tested party".

**(Selection of method of calculation of arm's length price)**

As a result of the above study, comparability in the application of the CUP method is fully recognized for the sales transactions of product B from company P to company B.

Therefore, in this case, for the transactions of inventories of product A from company P to company S,

it is deemed adequate to select the CUP method which uses the price concerning the sales of product B from company P to company T as the most appropriate method, and to calculate the arm's length price.

### Explanation

1. The calculation of the arm's length price shall be done by selecting the most appropriate method to calculate the price to be paid by a foreign-related transaction among the statutory method of calculations (See Reference 1 of "Explanation" 3.), in consideration of the contents of the foreign-related transactions, the functions performed by the parties thereof, and other circumstances, assuming that the relevant foreign-related transaction is conducted in accordance with the ordinary transaction conditions between unrelated parties (Article 66-4(2) of the ASMT). Therefore, the basic concept in selecting the most appropriate method can be said to find the method the most consistent with the arm's length principle in accordance with the each status of foreign-related transaction.

The contents of the arm's length principle are prescribed in Article 9-1 of OECD Model Tax Convention. The concept is to adjust the profits associated with the foreign-related transaction by referring to the transaction terms which would have been obtained in an uncontrolled transaction between unrelated parties. Note that it is essential to select the most appropriate method through the comparison and assessment on the terms concerning the foreign-related transaction and those concerning an uncontrolled transaction. (This is to examine the contents and terms of foreign-related transaction based on the factors which may affect the transaction terms between unrelated parties and, based on the result, to analyze the level of similarity (comparability) between the foreign-related transaction and uncontrolled transaction. In these case studies, this is called "Comparability Analysis".) (Administrative Guidelines 3-1)

In the comparability analysis, start with the search for selecting comparable transactions to examine whether comparable transactions exist or not. To conduct this search appropriately, it is necessary to fully understand the contents and terms of foreign-related transaction in advance, and to precisely seize the factors (factors listed in 66-4(3)-3 of the Commissioner's Directive on the ASMT) for comparison. It is important to fully examine beforehand the type of assets and the contents of services of the foreign-related transaction, and the functions performed by the party therein.

#### *(Reference) OECD MODEL TAX CONVENTION ARTICLE 9*

##### *1. Where*

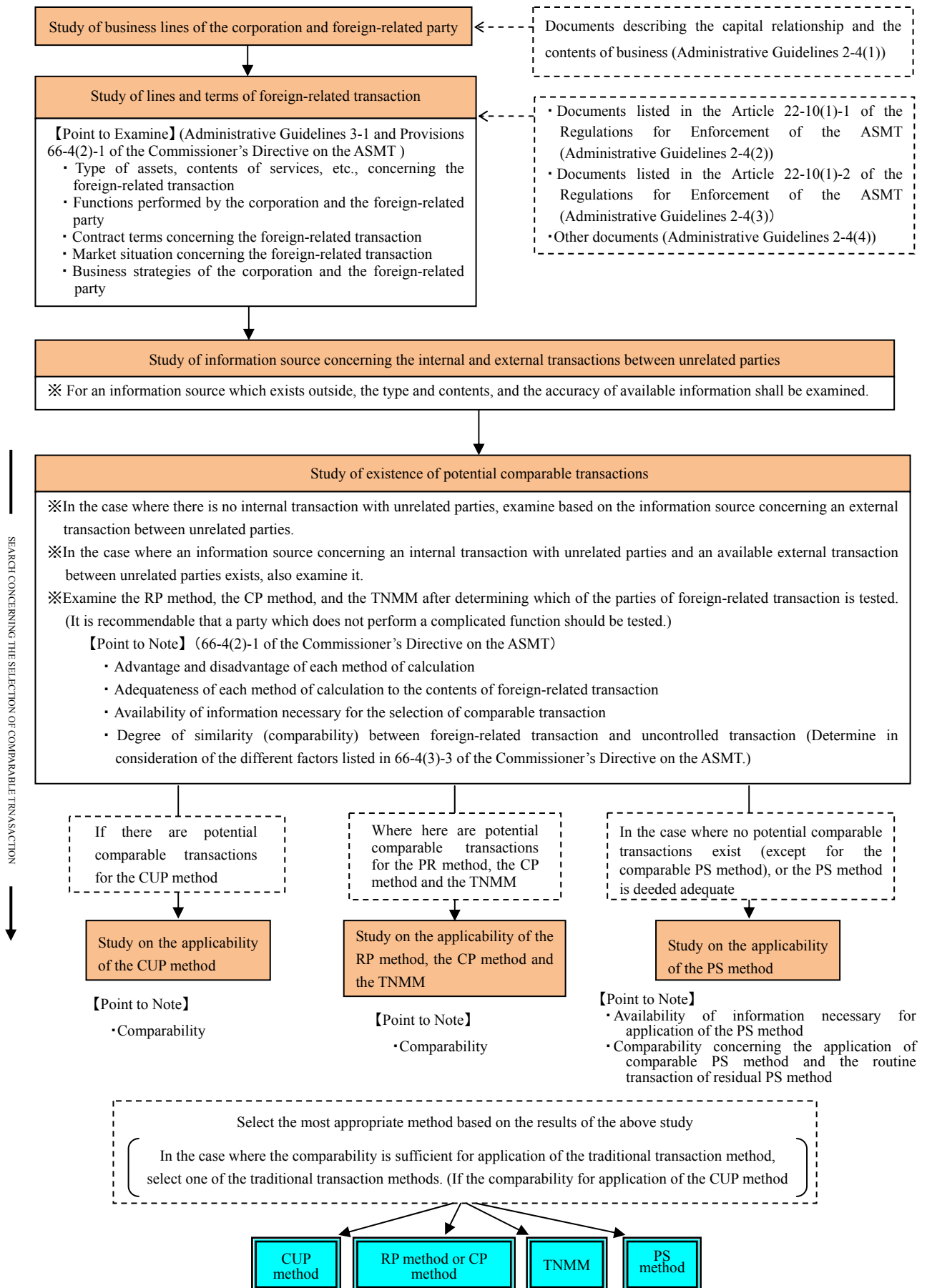
- a) an enterprise of a Contracting State participates directly or indirectly in the management, control or capital of an enterprise of the other Contracting State, or*
- b) the same persons participate directly or indirectly in the management, control or capital of an enterprise of a Contracting State and an enterprise of the other Contracting State, and in either case conditions are made or imposed between the two enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises, then any profits which would, but for those conditions, have accrued to one of the enterprises, but, by reason of those conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly.*



2. As stated above, in calculating the arm's length price, the most appropriate method to calculate the arm's length price shall be selected, in respecting the arm's length principle and in consideration of the contents of foreign-related transaction, functions performed by the parties of the relevant foreign-related transactions and other circumstances. The specific matters to be taken into consideration are as follows. In addition to the factors listed in 66-4(3)-3 of the Commissioner's Directive on the ASMT concerning foreign-related transactions and uncontrolled transactions, the following four factors are listed: (1) advantage and disadvantage of each method of calculation of arm's length price, (2) adequateness of each method of calculation to the contents of foreign-related transaction and the functions performed by the parties of relevant foreign-related transaction, (3) availability of necessary information to apply each method of calculation, (4) similarity between foreign-related transaction and transaction between unrelated parties (See Reference 2 of "Explanation" 3.) (66-4(2)-1 of the Commissioner's Directive on the ASMT).

In selecting the method of calculation of arm's length price, in consideration of information relating to the foreign-related transaction and uncontrolled transactions and the above points (1) to (4), a comparability analysis shall be conducted on whether a method of calculation using a comparable transaction can be adopted, and if so, what type of uncontrolled transaction is appropriate as comparable transaction to select the most appropriated method under the procedure shown in Figure 1 below.

[Figure 1 : Flow of selection of method of calculation of arm's length price (Example of comparability analysis)]



3. The advantages of traditional transaction methods (especially that of the CUP method) is that they enable a direct calculation of arm's length price. Therefore, regarding the most appropriate method, as a result of study in consideration of the points listed in 66-4(2)-1 (1) to (4) of the Commissioner's Directive on the ASMT, if more than one potential comparables for the most appropriate method exists, select it as follows: in the case where the comparability is sufficient in applying the CUP method, the CUP method shall be selected based on such an advantage. (In the case where adjustment is necessary for the difference between the foreign-related transaction and the comparable transaction, the CUP method can be selected only when that adjustment is possible. The same shall apply in the following.) In the case where the CUP method cannot be selected, but the comparability in the application of the RP method or the CP method is sufficient, select the RP method or the CP method based on the similar advantage (Administrative Guidelines 3-2).

Furthermore, even in the case where information necessary for determining whether a transaction falls under a comparable transaction for applying the traditional transaction methods or not cannot be obtained, if the availability of information based on the characteristics (advantage) of each method of calculation is taken into consideration, a method consistent with the traditional transaction methods listed in Article 66-4(2)-1(d) of the ASMT or other method provided for by the Cabinet Order (or a method equivalent to these methods) may be selected as the most appropriate method.

Regarding methods consistent with the traditional transaction methods, see Note 3 below. Regarding other methods prescribed in the Cabinet Order of the ASMT, see Case 6 (TNMM), Case 7 (contribution PS method), and Case 8 (residual PS method).

(Reference 1) Methods of calculation of arm's length price

Inventory sales transactions	Transactions other than inventory sales transactions
<p>Traditional transaction methods:</p> <ol style="list-style-type: none"> <li>1. CUP method (Article 66-4(2)-1(a) of the ASMT)</li> <li>2. RP method (Article 66-4(2)-1(b) of the ASMT)</li> <li>3. CP method (Article 66-4(2)-1(c) of the ASMT)</li> </ol>	<p>Methods equivalent to the traditional transaction methods:</p> <ol style="list-style-type: none"> <li>1. Methods equivalent to the CUP method (Article 66-4(2)-2 of the ASMT)</li> <li>2. Methods equivalent to the RP method (Article 66-4(2)-2 of the ASMT)</li> <li>3. Methods equivalent to the CP method (Article 66-4(2)-2 of the ASMT)</li> </ol>
<p>Methods consistent with the traditional transaction methods:</p> <ol style="list-style-type: none"> <li>1. Methods consistent with the CUP method (Article 66-4(2)-1(d) of the ASMT)</li> <li>2. Methods consistent with the RP method (Article 66-4(2)-1(d) of the ASMT)</li> <li>3. Methods consistent with the CP method (Article 66-4(2)-1(d) of the ASMT)</li> </ol>	<p>Methods equivalent to methods consistent with the traditional transaction methods:</p> <ol style="list-style-type: none"> <li>1. Methods equivalent to methods consistent with the CUP method (Article 66-4(2)-2 of the ASMT)</li> <li>2. Methods equivalent to methods consistent with the RP method (Article 66-4(2)-2 of the ASMT)</li> <li>3. Methods equivalent to methods consistent with the CP method (Article 66-4(2)-2 of the ASMT)</li> </ol>
<p>Other methods prescribed in the Cabinet Order of the ASMT:</p> <ol style="list-style-type: none"> <li>1. Comparable PS method (Article 39-12(8)-1 of the Cabinet Order of the ASMT, limited to the part pertaining to item (a) of said article)</li> <li>2. Contribution PS method (Article 39-12(8)-1 of the Cabinet Order of the ASMT, limited to the part pertaining to item (b) of said article)</li> <li>3. Residual PS method (Article 39-12(8)-1 of the Cabinet Order of the ASMT, limited to the part pertaining to item (c) of said article)</li> <li>4. TNMM (Item through (2) to (5) of Article 39-12(8) of the Cabinet Order of the ASMT)</li> <li>5. Methods consistent with those methods described above 1 through 4 (Article 39-12(8)-6 of the Cabinet Order of the ASMT)</li> </ol>	<p>Methods equivalent to other methods prescribed by law:</p> <ol style="list-style-type: none"> <li>1. Methods equivalent to the comparable PS method (Article 66-4(2)-2 of the ASMT)</li> <li>2. Methods equivalent to the contribution PS method (Article 66-4(2)-2 of the ASMT)</li> <li>3. Methods equivalent to the residual PS method (Article 66-4(2)-2 of the ASMT)</li> <li>4. Methods equivalent to the TNMM (Article 66-4(2)-2 of the ASMT)</li> <li>5. Methods equivalent to the 5th methods described in the left column (Article 66-4(2)-2 of the ASMT)</li> </ol>

(Reference 2) Explanation of the following four points within the items to be taken into consideration in selecting the most appropriate method

(1) Advantage and disadvantage of each method of calculation (including an equivalent method in the following explanation) in calculation of arm's length price

A Since the CUP method directly compares the price concerning the foreign-related transaction

and the comparable transaction, this is the most direct method for calculation of arm's length price.

On the other hand, a strict similarity of types is required for the assets and the contents of services in its application. The differences of characters, structures, functions, etc. of assets often affect the price in an objectively clear manner, and it is generally difficult to adjust these differences. Also, the influence by the difference of functions performed by the party of transaction is not easy to adjust. Therefore, in applying the CUP method, no comparable transaction can be often found from openly accessible information (Openly accessible information means the corporate information such as Securities Report, database on which financial information of the corporation is recorded, and external information such as information from industry organizations. The same shall apply in the following cases.)

- B The RP method and the CP method compare the level of gross profit on sales concerning the foreign-related transaction and that of the comparable transaction. Taking into consideration the fact that the sales price is composed of the gross profit on sales and the costs, and that the gross profit on sales and the price are closely related, this may be the second most direct method to calculate the arm's length price, after the CUP method.

On the other hand, the level of gross profit on sales is not easily affected by the difference of assets or services themselves, however, it is easily affected by the difference of functions performed by the parties of the transaction, and it is often impossible to find comparable transactions from openly accessible information.

- C The TNMM is a method that compares the level of operating profit concerning the foreign-related transaction and that of comparable transaction. Operating profit is not so closely related with price as gross profit on sales, therefore, calculation of arm's length price is relatively indirect when compared with the case of traditional transaction methods.

On the other hand, the level of operating profit may be affected by the difference of functions performed by the parties of transactions. However, it is considered that the difference of functions performed in the conduct of business is reflected as the level difference of sales expenses and general administrative expenses generally expensed with the performing of functions (hereinafter referred to as the "operating costs"), and that the operating profit level balances to a certain extent, even if there exists a substantial difference on the level of gross profit on sales. For this reason, adjustment may be unnecessary even if there is a difference of functions performed by the parties of transactions. Therefore, it can be said that the TNMM is not easily affected by the difference than the traditional transaction methods, and a comparable transaction can be more frequently found from openly accessible information.

For this reason, it should be noted that, unless a difference which is recognized in objectively clear manner to affect the calculation of the ratio (the profit level indicator) provided for in Article 39-12(8)-2 to 5 of the Cabinet Order for Enforcement of the ASMT between the foreign-related transaction and the uncontrolled transaction, the relevant transaction between unrelated parties can be adopted as a comparable transaction in applying the TNMM.

From the characteristics as described above, in the application of the TNMM, in the case where

the similarity of the functions performed by unrelated party in an enterprise-based business and the functions performed by the parties of the foreign-related transaction is high, and a difference of functions that is objectively clear to affect the calculation of profit level indicator is not recognized, the business may be deemed as a single transaction corresponding to the foreign-related transaction and it may be selected as a comparable transaction.

Furthermore, there may be some factors (for example, difference concerning the efficiency of management) that may affect more strongly the level of operating profit than the levels of price and gross profit on sales. Therefore, this point shall be considered when examining the application of the TNMM.

- D The Profit Split (PS) method is a useful method in the case where a comparable transaction cannot be found. However, in the case where financial and other information necessary for the calculation of profits to be split or the identification of split factors is not available, the PS method is not applicable.

There are three categories of the PS method: the comparable PS method, the contribution PS method, and the residual PS method. For each of them, characteristics other than above are described below:

- Comparable PS method:

The comparable PS method is a method to calculate the arm's length price by allocating the profits to be split associated with the foreign-related transaction to the corporation and the foreign-related party, by using the profit allocation ratio corresponding to the profits to be split among the unrelated parties in the controlled transactions under a similar situation to the foreign-related transactions.

- Contribution PS method:

The contribution PS method is a method to calculate the arm's length price by allocating the profits to be split associated with the foreign-related transaction to the parties of foreign-related transaction in accordance with the factors which are suited to estimate the extent of contribution to yield the profit. Since it is not necessary to find a comparable transaction between unrelated parties, the applicability of contribution PS method is higher than that of the comparable PS method in the case where foreign-related transactions are highly integrated.

- Residual PS method:

The residual PS method is a method to calculate the arm's length price in the case where unique and valuable contribution by the both parties of foreign-related transaction is recognized in the foreign-related transaction with their performing of unique functions (for example, in the case where the both parties of foreign-related transaction are performing their unique functions by employing their intangible assets). Routine profits within the profits to be split are allocated to the both parties of foreign-related transaction. Then, the residual profits, which are the difference between the said profits and the sum of the allocated routine profits (the part which is generated by the unique and valuable contribution), are allocated to the both parties in accordance with the factors which are

suiting to estimate the extent of contribution to yield the profits. In this method, the profits to be split are allocated in two stages by dividing the profits to be split into the routine profits and the residual profits. It may be sometimes difficult to measure the split factors associated with the residual profits.

Furthermore, in the case where a party of the foreign-related transaction performs only simple functions, it is normally appropriate to select a method of calculation under which that party is tested, instead of the residual PS method.

(2) Adequateness of each method of calculation to the contents of foreign-related transaction and the functions performed by the parties of the foreign-related transaction

To select the most appropriate method, it is necessary to select a method of calculation which conforms to the contents of the foreign-related transaction and the functions performed by the parties thereof. For this reason, in the comparability analysis, each method of calculation (including equivalent methods in the following explanation) shall be examined in consideration of the following points.

Furthermore, in the case where it is deemed reasonable to calculate the arm's length price by taking multiple transactions as one transaction (66-4(4)-1 of the Commissioner's Directive on the ASMT), it shall be noted that the method of calculation shall be examined in light of the reasonable transaction unit.

A Regarding the CUP method, a similar type of assets or services concerning the transactions between unrelated parties to the assets or services of the foreign-related transaction shall be found.

B In selecting a comparable transaction to apply the RP method, the CP method, and the TNMM, similarity of functions performed by the parties of foreign-related transaction is more important than the similarity of the assets or services.

Also, in assessing the above three methods, it is necessary to determine which of the corporation and the foreign-related party is the tested party. From the viewpoint of finding a fully comparable transaction between unrelated parties, it is recommended that a party which is recognized to perform a simpler function shall be adopted as the tested party, based on the function analysis.

Furthermore, since the TNMM has three profit indicators for its application (ratio provided for in Article 39-12(8)-2 of the Cabinet Order for Enforcement of the ASMT [operating margin on sales], ratio provided for in Article 39-12(8)-3 [operating margin on total costs] and the ratio provided for in Article 39-12(8) 4 and 5 [gross margin on operating costs]), it is necessary to examine which of the profit margins is adequate to use.

C Regarding the PS method, in the case where the corporation and its foreign-related party acquire higher profit by having intangible properties than that of a corporation which conducts only routine activities in the foreign-related transaction, (See "Treatment for transfer pricing taxation purpose" of Case 8.) no comparable transaction can be obtained due to the individuality and uniqueness of the intangible properties, and it may be appropriate to allocate

the high profits to the corporation and its foreign-related party in accordance with the extent of contribution by the intangible properties.

Also, in applying the PS method in the case where multiple parties are associated with the foreign-related transaction due to the chaining of transactions (See [Case 16].), it is necessary to adequately determine the scope of the parties to whom the profits to be split are allocated.

(3) Availability of information necessary for application of each method of calculation

Regarding the availability of information concerning the uncontrolled transactions necessary for application of each method of calculation, in the comparability analysis on internal and external information of the parties of foreign-related transactions, each method of calculation (including equivalent methods in the following explanation) shall be examined in consideration of the following points. Also, regarding the external information on the uncontrolled transactions, availability in accordance with each method of calculation is foreseeable as stated in (1) above. Therefore, in the comparability analysis, whether potential comparable transactions exist or not shall be examined efficiently based on the point.

Furthermore, in the case where the RP method, the CP method, or the TNMM is selected as the most appropriate method, it shall be noted that financial information of the tested party concerning the foreign-related transaction is required.

A Regarding the CUP method, whether information on a transaction between unrelated parties concerning the same type of assets or services as the assets or services of foreign-related transaction is available. Also, in the case where a difference which affects objectively in a clear manner the price is recognized between the transaction terms of the foreign-related transaction and those of the uncontrolled transactions, whether necessary information for adjustment of the difference of price caused thereby is available.

B Regarding the RP method, the CP method, and the TNMM, whether information is available on the gross profits on sales or the operating profits in the relevant uncontrolled transaction by the unrelated party who performs a similar function to that of the tested party, among the uncontrolled transactions concerning the same or similar type of assets or services as that of the assets or services subject to the foreign-related transactions. Also, in the case where a difference which is objectively clear to affects the level of gross profits on sales or operating profits between the functions performed by the tested party and those performed by the unrelated party, whether necessary information is available for adjustment of the difference of levels of gross profits on sales or operating profits which were brought from the difference.

C Regarding the PS method, whether financial information necessary for calculation of the profits to be split and for identification of the split factors is available

(4) Extent of similarity between foreign-related transaction and uncontrolled transaction

To select uncontrolled transactions as comparable transactions or transactions which are used to calculate the routine profits (routine transactions) in applying the residual PS method, the extent of similarity (comparability) of the transaction between unrelated parties and the foreign-related



party shall be sufficient (66-4(3)-1 of the Commissioner's Directive on the ASMT). For the compatibility, decision shall be made in consideration of the similarity of various factors listed in 66-4(3)-3 of the Commissioner's Directive on the ASMT (66-4(3)-3 of the Commissioner's Directive on the ASMT).

Furthermore, in the case where a difference exists between the foreign-related transaction and the comparable transaction or the routine transaction, and where necessary adjustment shall be made on the difference of price generated by the difference, it shall be noted to conduct an appropriate adjustment based on Administrative Guidelines 3-3.

#### (Reference 3) Methods consistent with the traditional transaction methods

Methods consistent with the traditional transaction methods are considered to leave the way open to employing reasonable methods suited to the content of transactions provided that they do not diverge from the concept behind the traditional transaction methods.

In the cases of foreign-related transactions for which comparable transactions cannot easily be found when applying the traditional transaction methods as prescribed by law, there are instances in which it is possible to select comparable transactions by using reasonable similar methods of calculation focusing on the various forms of these transactions, or in which the arm's length price can be calculated by adopting reasonable transactions as comparable transactions. As these methods allow a wider choice of comparable transactions than the traditional transaction methods, comparability therefore needs to be considered, bearing in mind the possibility of applying the methods consistent with the traditional transaction methods.

It shall be noted that in the cases of methods consistent with the traditional transaction methods, there is no relaxation of the requirements for comparability required of comparable transactions when applying the traditional transaction methods (regarding the similarity of the factors prescribed in ASMT Directive 66-4(3)-3), and that transactions that do not meet these requirements cannot be used as comparable transactions when applying methods consistent with the traditional transaction methods either.

#### Examples of methods consistent with the traditional transaction methods

- (1) In cases where actual uncontrolled transactions comparable with foreign-related transactions cannot be found: The calculation of the arm's length price based on objective and practical indicators, such as commodities exchange prices or other market prices.
- (2) In cases where the purchaser of inventories in a foreign-related transaction sold the inventories to an unrelated party via a party which has special relations (hereinafter, related party): The calculation firstly of the selling price from the buyer to the related party after deduction of normal profit when applying the RP method based on the price of inventories sold to an unrelated party, and then calculating the arm's length price for the foreign-related transaction on this basis.
- (3) In cases where the buyer of inventories in a foreign-related transaction manufactured a product or other goods using these inventories and sold them to an unrelated party: The calculation of the arm's length price after deducting the cost of manufacture of such products (excluding the

amount of consideration for inventories in the foreign-related transaction) and profit commensurate with the manufacturing functions of the products, in addition to the normal profit in the case of application of the RP method from the selling price of the products sold to the unrelated party.

- (4) In cases where a company's own products are sold as a set with products purchased from another company to a foreign-related party: The calculation of the arm's length price through parallel use of the CUP method or the CP method.
- (5) Method to calculate the arm's length price by using the average value of the price or the profit margin of those transactions, in the case where more than one transaction is comparable transactions in applying one of the traditional transaction methods

(Note) In calculating the arm's length price in the case where more than one comparable transaction concerning the foreign-related transaction exists, and where the price or profit margin concerning the foreign-related transaction is outside of the specified range formed by the price or operating margin concerning the comparable transactions (in the case where adjustment is required for the difference between the foreign-related transaction and the comparable transactions, only after the adjustment), in principle, the mean of the prices or the operating margins concerning that range shall be used. However, in the case where another reasonable figure in accordance with the status of distribution of the prices or the operating margins concerning the relevant comparable transactions is recognized, the figure shall be used (Administrative Guidelines 3-5).

4. As stated above, in the comparable analysis, the search for selection of comparable transactions is done based on the result of study on the contents of foreign-related transaction. In general, whether internal comparable transactions or external comparable transactions exist or not shall be examined based on openly accessible information, in addition to the internal information such as transaction documents of the corporation or the foreign-related party.

To select a comparable transaction, comprehensive study shall be made for each type of foreign-related transaction based on the Commissioner's Directive on the ASMT, provisions 66-4(3)-1 of (Meaning of the comparable transaction), Article 66-4(7)-2 (Handling of loans of tangible assets), Article 66-4(7)-4 (Handling of loan or borrowing of money), Article 66-4(7)-5 (Handling of provision of services), or Article 66-4(7)-6 (Handling of licensing of intangible assets). Furthermore, to determine the level of similarity (comparability) between the foreign-related transaction and the uncontrolled transaction, whether it falls under a comparable transaction or not, the similarity of various factors shown in 66-4(3)-3 (Various factors to be examined in selecting comparable transactions) of the Commissioner's Directive on the ASMT shall be taken into consideration.

Also, in the case where the corporation or the foreign-related party has conducted a foreign-related transaction associated with the use of intangible assets, it is necessary to assess the comparability especially focusing on the intangible assets used by the seller or the buyer of 66-4(3)-3 (Note 1) of the Commissioner's Directive on the ASMT. In this case, in selecting a comparable transaction, it shall be noted to examine the similarity of type, scope, form of use, etc. of intangible assets (Administrative

Guidelines 3-4).

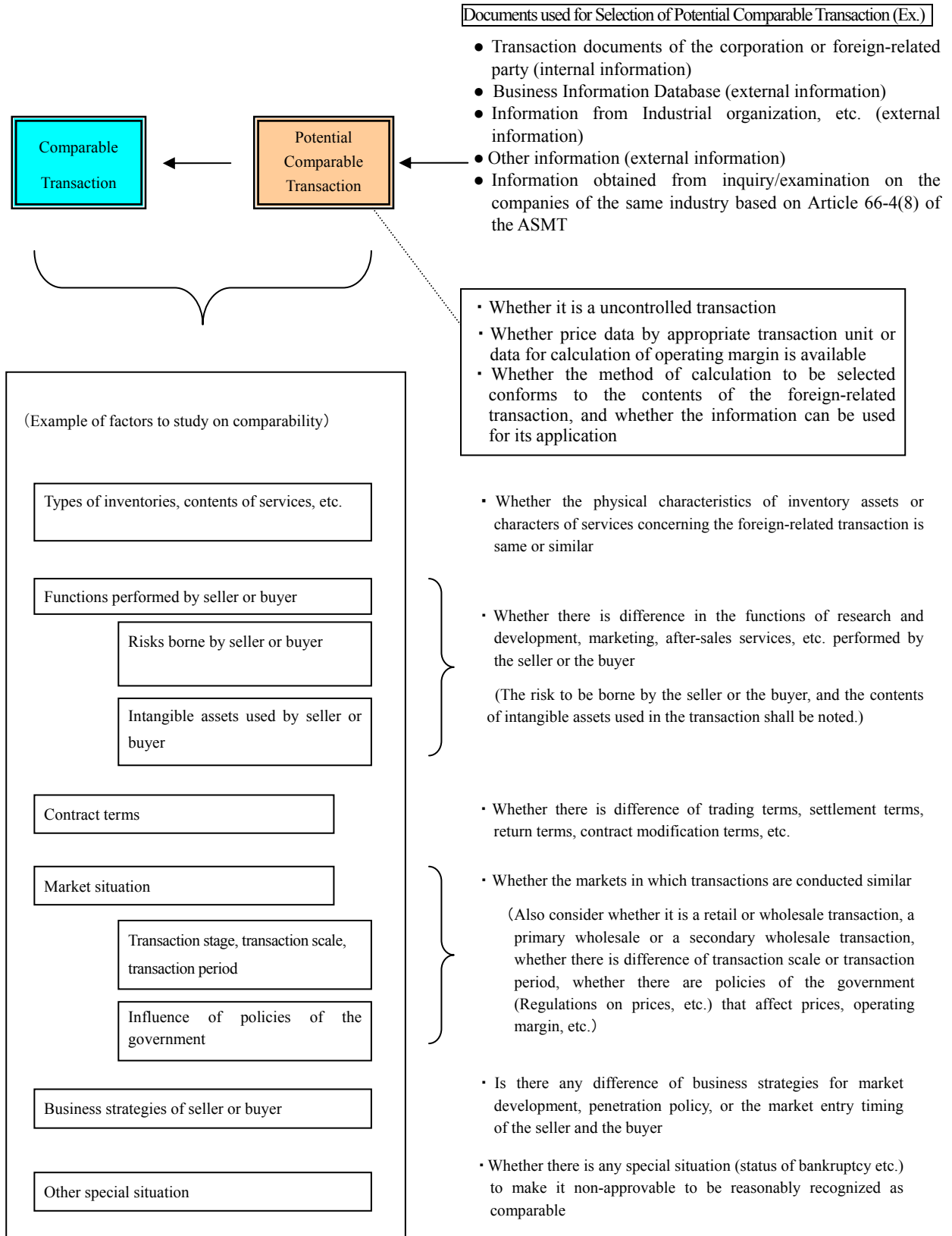
Also, in the search concerning the selection of a comparable transaction, the decision on whether an internal comparable transaction falls under a comparable transaction seems relatively easy because the corporation or the related party thereof has information on the transaction. To select a comparable transaction, search shall be made by making ordinary efforts to obtain information in the normally possible scope. However, it shall be noted that there exists a certain restriction in the collection of necessary information, for example, there is no openly accessible information, or the information is held overseas. The procedures concerning the selection of comparable transactions are as shown in Figure 2 and Figure 3 below.

(Reference) Screening of potential comparable transactions (Search of selection)

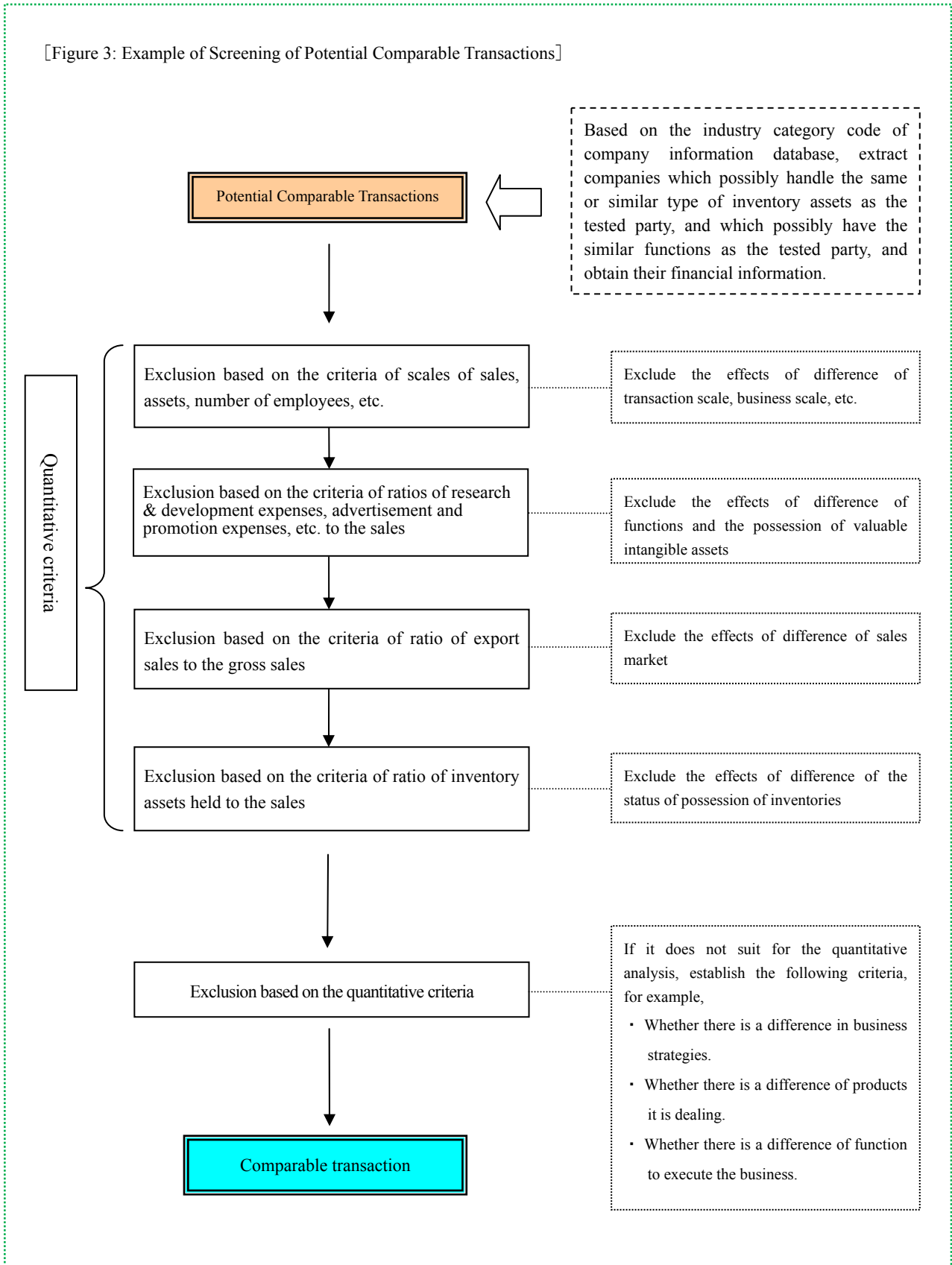
In general, to select a comparable transaction, information is collected concerning the transactions between unrelated parties which are potential comparable transactions, taking into consideration the points shown in Figure 2, and screening is conducted.

Furthermore, in the screening, the following procedure is adopted in general: the quantitative and qualitative criteria as shown in Figure 3 are specified in accordance with the situations of individual cases, and the transactions which do not conform to certain criteria are deemed insufficient in terms of comparability, and excluded from the potential comparable transactions.

[Figure 2 : Points to be noted in the search of selection of comparable transaction (Ex.)]



[Figure 3: Example of Screening of Potential Comparable Transactions]



5. In calculation of the arm's length price based on the method of calculation selected as the most appropriate, there may be a case in which more than one transaction between unrelated parties with sufficient comparability (comparable transaction) and the arm's length price has a certain range. In such a case, if the price of the foreign-related transaction falls within that range, it is not subject to transfer pricing taxation (66-4(3)-4 of the Commissioner's Directive on the ASMT).

On the other hand, as a factor to determine whether there exists a problem under the transfer pricing taxation, whether the margin ratio etc. concerning the foreign-related transaction falls within the range of margins associated with the transactions which are deemed to be potential comparable transactions may be examined (Administrative Guidelines 2-2(1)). The transactions which are considered to be potential comparable transactions are in the status before full screening. In consideration of the above, the range of margins specified in Administrative Guidelines 2-2(1) may have a considerable width.

Therefore, in the search under the Administrative Guidelines 2-2(1), it shall be noted that the use of ranges by the quartile method may be appropriate, as necessary.

(Note) In general, the range by the quartile method is a range composed of the first quartile and the third quartile of the total data.

6. Owing to the importance to be presented reasons of selecting the most appropriate method of calculation properly by the taxpayer, together with information concerning the grounds for determining the transaction prices to be considered and other ordinary transaction prices, and information on other matters including the functions performed by the counterpart foreign-related parties in transactions, it is necessary to draw taxpayers' attention to the following points listed below. This is in order to ensure the smooth and proper administration of transfer pricing taxation, since it is concerned with the validity of the transaction price determined by a diversity of factors. (This applies to all the following cases as well.)

- Unless taxpayers, upon request from the tax authority, promptly present or submit the documents or copies prescribed in the Ordinance of the Ministry of Finance required to calculate the arm's length price, their cases will meet the conditions for application of estimated taxation (Article 66-4(6) and (8) of the ASMT, Item 1 of Article 22-10(1) of Ordinance for Enforcement of the ASMT).
- Taxpayers shall endeavor to acquire the books of account or copies kept by foreign-related parties as required by the tax authority to calculate the arm's length price in transfer pricing taxation examinations (Paragraph 7 of preceding article), and unless, upon request from the tax authority, they promptly present or submit the requested materials that are required to calculate arm's length price, the conditions for application of estimated taxation will be considered to have been met.

When inspecting the documents set forth in Administrative Guidelines 2-4 that form the basis for final tax returns by taxpayers, and submission of necessary materials is requested, if the results produced by the methods of calculation of arm's length price employed by the taxpayer are not found to be the arm's length price, care shall be taken to fully explain to the taxpayer the reasons therefore and the details of the method of calculation of the arm's length price to be used instead based on the

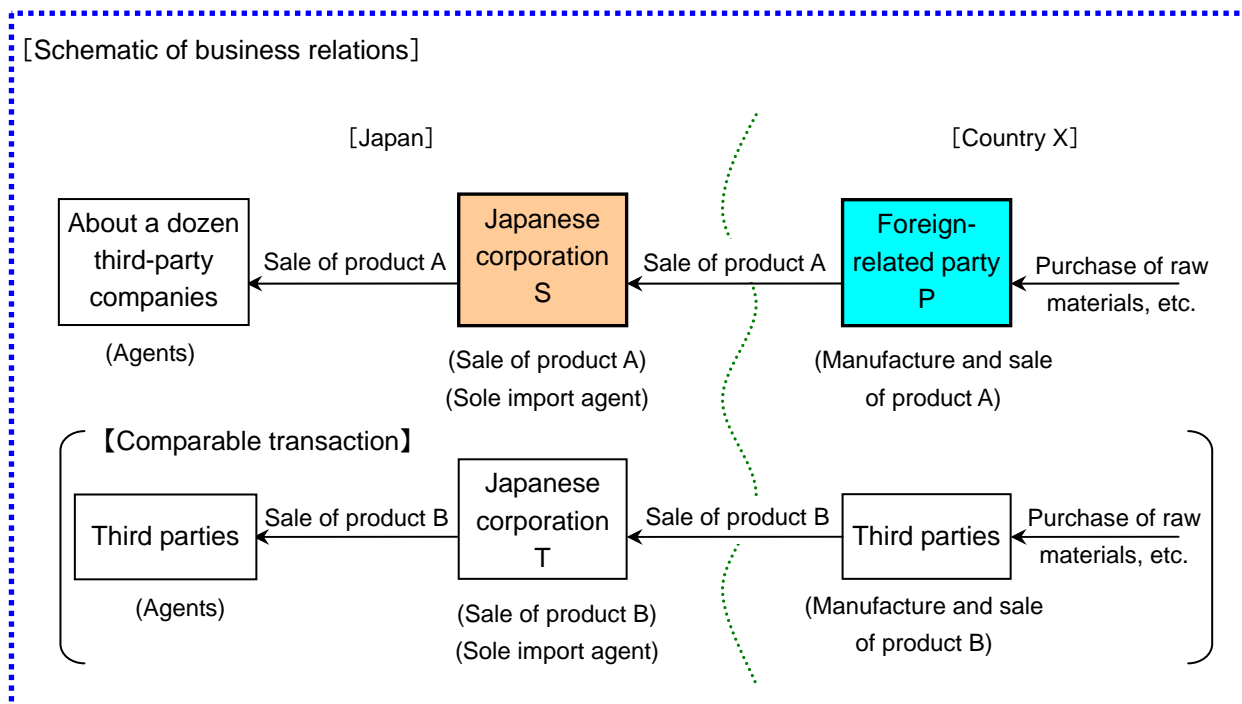
examination findings, and to gain the taxpayer's understanding.

## Case 2: Case of use of resale price method

### Key point

In this case, it was found that the RP method was the most appropriate method of calculation of arm's length price.

### Preconditions



### (Summary of business of corporation and foreign-related party)

Japanese corporation S is a distributor of product A in Japan. Corporation P in country X, which is company S's parent company, manufactures and distributes product A in country X.

### (Summary of foreign-related transaction)

Company S imports product A as company P's sole import agent, and sells it to some 10 third-party agents in Japan.

### (Functions and activities of corporation and foreign-related party)

Company S does not engage in unique or original advertising or sales promotion activities, and makes no use of its own trademarks or other such properties in its distribution activities.

### (State of Japanese market)

About a dozen foreign manufacturers making products that compete with product A have entered the Japanese market. Five of the sole import agents for these foreign manufacturers file financial statements that are openly accessible, and other information is also available, including information from the companies' websites and analyses published by market researcher companies. Following these materials, company T is a reseller of products imported from a third-party foreign manufacturer to third-party agents in Japan, and that it does not engage in any other business. Product B sold by



company T is not same type of product as product A but bears a strong similarity to product A in terms of its properties, structure, and function, and it was also found that company T is largely the same as company S in terms of volume of sales, transaction stage, and sales functions (e.g., advertising, sales promotion, after-sales service, packing, and delivery). Company T was also found not to use its own trademarks or other such properties in its distribution activities.

#### Treatment for transfer pricing taxation purposes

##### **(Consideration of comparability study)**

In calculating the arm's length price, selecting the most appropriate method of calculation for each case is required by the provisions of Article 66-4(2) of the ASMT, therefore a comparability study was made based on 66-4(2)-1, 66-4(3)-1, and 66-4(3)-3 of the Commissioner's Directive on the ASMT, the Administrative Guideline 3-1, etc. The result was as shown below:

- Company S, which engages only in the sales of products, performs a simpler function than company P, which engages in production and sales. Based on this, it is deemed more appropriate to adopt company S as tested party.
- Company S resells the purchased product A to a third party. Based on this, it is deemed appropriate to apply the RP method and the TNMM with company S as the tested party.
- From the transactions executed by company S and company P, it is not possible to find potential internal comparable transactions.
- From openly accessible information on company T, potential external comparable transactions in applying the RS method and the TNMM with company S as the tested party can be found. However, it was not possible to find any potential comparable transactions for applying the CUP method or a method consistent with the CUP method from publicly available information.
- Product B imported from a third party and sold to agents in Japan by company T is not same type of product as product A but bears a strong similarity to product A. Company T was also found to be generally similar to company S in terms of its function as a reseller, market conditions, and so forth.

##### **(Selection of method of calculation of arm's length price)**

As the result of the above study, regarding the import transaction of product A by company S from company P, selection of the RP method and the TNMM is considered, adopting company S as the tested party. In the case where the import transaction of product B by company T from a foreign third party is the comparable transaction in the application of the RP method, the comparability is deemed sufficient.

Therefore, in this case, regarding the import transaction of product A by company S from company P, the import transaction of similar product B by company T from a foreign third party is deemed to be the comparable transaction. It is deemed appropriate to calculate the arm's length price by selecting the RP method as the most appropriate method, under which company S, buyer of inventories concerning the foreign-related transaction, is the tested party.

## Explanation

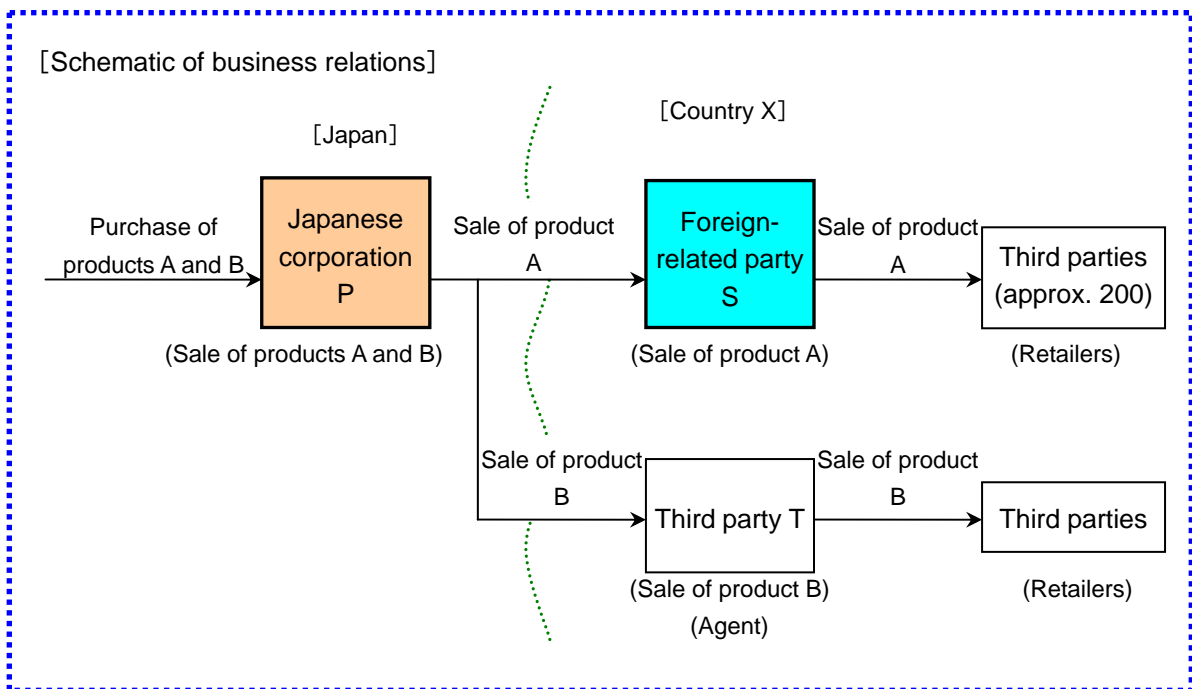
Regarding points to note when selecting the method of calculation of arm's length price and making a comparability study, see the "Explanation" to Case 1.

### Case 3: Case of use of cost plus method

#### Key point

In this case, it was found that the CP method was the most appropriate method of calculation of arm's length price.

#### Preconditions



#### (Summary of business of corporation and foreign-related party)

Japanese corporation P is a distributor of product A and product B, and 10 years previously it established corporation S in country X as a subsidiary to distribute product A.

#### (Summary of foreign-related transaction)

Company P sells product A to company S, which then sells it to around 200 third-party retailers in country X.

In conjunction with having established company S, company P sells product B to agent T, which is a third party in company X, and company T sells this to retailers in country X. Product B is not same type as product A, but the two products are similar in terms of properties, structure, function, and so forth.

The volume of product A sold by company P to company S and the volume of product B sold by company P to company T are about the same.

#### (Functions and activities of corporation and foreign-related party)

The function performed by company P is that of purchasing inventories of product A and product B, which it sells to company S and company T. However, it does not appear to engage in unique activities, and does not use trademarks or other such properties.

There are no differences in the functions performed by company P in the sales transaction with company S, and the sales transaction with company T.

**(Terms of contracts for sale of product A and product B)**

The terms and conditions of the contracts for sale of product A by company P to company S and product B by company P to company T (e.g. delivery terms, payment terms, product warranties, and conditions for returns) are, with the exception of the transaction price, the same.

**Treatment for transfer pricing taxation purposes**

**(Consideration of comparability study)**

In calculating the arm's length price, selecting the most appropriate method of calculation for each case is required by the provisions of Article 66-4(2) of the ASMT, therefore a comparability study was made based on 66-4(2)-1, 66-4(3)-1, and 66-4(3)-3 of the Commissioner's Directive on the ASMT, the Administrative Guideline 3-1, etc. The result was as shown below:

- Both of company P and company S perform the function of sales. No significant difference is recognized between their levels. It can be recognized as appropriate to adopt either of them as the tested party.
- It is impossible to find potential internal comparable transactions in applying the CUP method or a method consistent with the CUP method. However, from the transaction of sales of product B by company P to company T, it is possible to find potential internal comparable transactions in applying the CP method and the TNMM. Furthermore, the profit/loss data of company T, which is associated with the transaction, was not available to obtain, and it is not possible to find potential internal comparables in applying the RP method.
- It was impossible to find any potential external comparable transactions from publicly available information.
- Product A and product B have similar properties, structures, functions and so forth, and were deemed to be similar inventories.
- No differences were found in the role and functions of P in both sales to company S and sales to company T by company P (hereinafter referred to as the "two transactions"), and any intangible properties were not used in the two transactions.
- The two transactions are substantially the same in the terms of contracts, and no differences were found in the contract terms of transactions.
- Company S and company T are both wholesale traders selling products to retailers in country X, and the transaction stage was found the same. The volumes are also substantially the same, and there are no pricing regulations on either product A or product B.
- No differences were found in company P's business strategies toward product A and product B.

**(Selection of method of calculation of arm's length price)**

From the result of the above study, regarding the sales transaction of product A by company P to company S, it is possible to select the CP method and the TNMM under which company P is the tested party. In the case where the sales transaction of product B by company P to company T is the

comparable transaction in the application of the CP method, the comparability is deemed sufficient. Therefore, in this case, regarding the sales transaction of inventories of product A by company P to company S, the sales transaction of product B from company P to company T is deemed to be the comparable transaction. It is deemed appropriate to select the CP method as the most appropriate method under which company P is the seller of inventories concerning the foreign-related transaction and the tested party, and to calculate the arm's length price.

#### **Explanation**

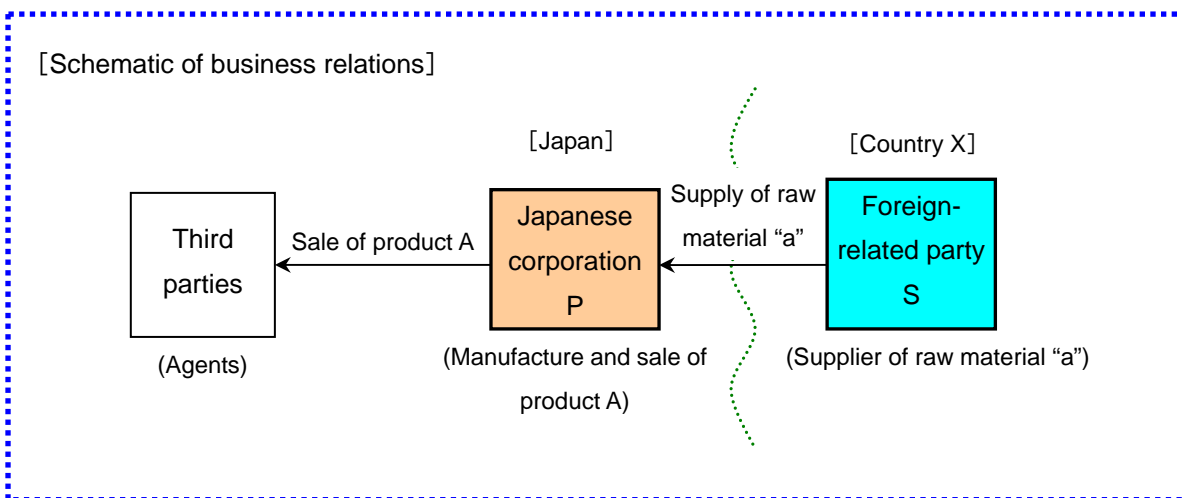
Regarding points to note when selecting the method of calculation of arm's length price and making a comparability study, see the "Explanation" to Case 1.

#### Case 4: Case of use of methods consistent with comparable uncontrolled price method

##### Key point

In this case, it was found that a method consistent with the CUP method (or a method equivalent to a method consistent with the CUP method) was the most appropriate method of calculation of arm's length price ("Preconditions 1" illustrates the case of sale of inventories, and "Preconditions 2" illustrates the case of a loan transaction.)

##### Precondition 1: In the case of sale of inventory



##### (Summary of business of corporation and foreign-related party)

Japanese corporation P is a manufacturer and distributor of product A, and 10 years previously it established company S in country X as a subsidiary to supply raw material "a" for product A.

##### (Summary of foreign-related transaction)

Company S sells its entire output of raw material "a" to company P, and company P manufactures product A from this for sale to third-party agents in Japan.

##### (Functions and activities of corporation and foreign-related party)

Company P receives no supplies of raw material "a" from any source except company S.

##### (State of market and other factors)

Raw material "a" for product A is sold worldwide on the commodities exchanges, and it has a quoted market price on these exchanges.

##### Treatment for transfer pricing taxation purposes

##### (Consideration of comparability study)

In calculating the arm's length price, selecting the most appropriate method of calculation for each case is required by the provisions of Article 66-4(2) of the ASMT, therefore a comparability study was made based on 66-4(2)-1, 66-4(3)-1, and 66-4(3)-3 of the Commissioner's Directive on the ASMT, the Administrative Guideline 3-1, etc. The result was as shown below:

- Company S, which only supplies raw materials, performs simpler functions than company P, which engages in manufacturing and sales, and it is deemed appropriate to select company S as the tested party.
- As company P performed a manufacturing function in producing product A from raw material “a” supplied by company S, it is also not possible to apply the RP method to company P.
- Company P receives no supplies of raw material “a” except from company S, in addition to which company S supplies its entire output of raw material “a” to company P. It was therefore not possible to find any potential internal comparable transactions for application of the CUP method or a method consistent with the CUP method. It was also not possible to find any potential external comparable transactions for applying the CUP method from publicly available information.
- It was not possible to find any potential external comparable transactions for applying the CP method or TNMM to company S from publicly available information.
- Raw material “a” is dealt with globally at commodity exchanges, and there exists its market price. Based on this, it is possible to adjust the differences of individual transaction terms (difference of transport costs, etc.). Therefore it is possible to find a comparable transaction in applying a method consistent with the CUP method.

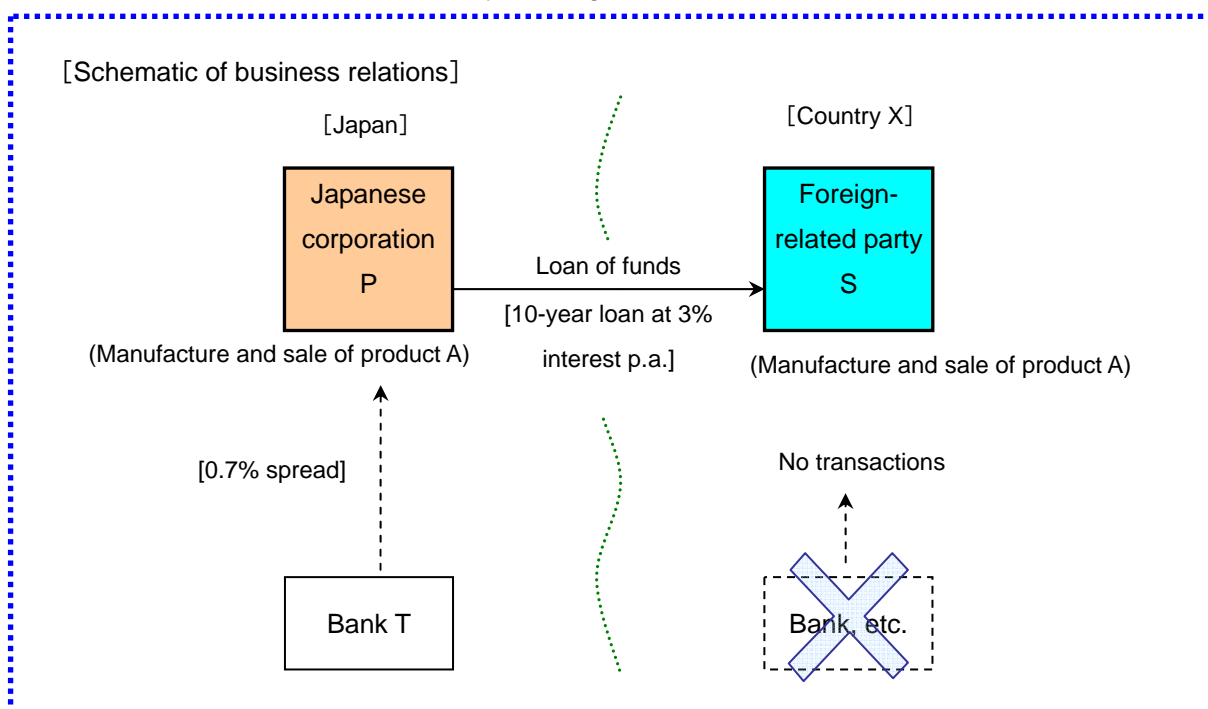
**(Selection of method of calculation of arm’s length price)**

From the results of the above study, regarding the import transaction of raw material “a” by company P from company S, in the case where the market price of the raw material “a” is deemed to be the comparable transaction, comparability is deemed sufficient in applying a method consistent with the CUP method. Therefore, in this case, it is deemed appropriate to select a method consistent with the CUP method which uses the market price of the raw material “a” as the most appropriate method, and to calculate the arm’s length price.

**Explanation**

1. Regarding the points to note when selecting the method of calculation of arm’s length price and making a comparability study, see the “Explanation” to Case 1.
2. If no transactions exist between unrelated parties that are comparable to the foreign-related transaction, it is possible to apply a method consistent with the traditional transaction methods where objective and realistic indicators of variables such as market prices (e.g., the quoted market price in this case) are available by using these transactions as the comparable transactions in order to calculate the arm’s length price. (Regarding methods consistent with the traditional transaction methods, see the “Explanation” to Case 1.)

## Preconditions 2: In the case of money lending transaction



### (Summary of business of corporation and foreign-related party)

Japanese corporation P is a manufacturer and distributor of product A. Company S in country X is a subsidiary of company P that manufactures and distributes product A. Company P and company S both manufacture and distribute product A, and do not engage in activities such as money lending. Company S is performing well, and is in no need of support from company P.

### (Summary of foreign-related transaction)

Seven years previously, company P extended a loan to company S denominated in the currency of country X to fund investment in the expansion of manufacturing capacity. This loan was funded from company P's funds on hand, and was prescribed a period of 10 years at annual interest of 3%.

### (Past fund-raising activities of corporation and foreign-related party)

Neither company P nor company S engages in money lending transactions with any unrelated parties apart from financial institutions. Company S has also never previously borrowed from banks or similar institutions, and so there is no prospect of being able to obtain spread information on company S.

Company P, on the other hand, once took out a long-term loan from bank T, which is its main bank. Asked about the spread (Note 1) for borrowing under the same terms and conditions as for company P's loan to company S, the bank T answered 0.7%.

According to information from a financial data provider, the swap rate (Note 2) for interest rate swaps involving country X's currency for a 10-year period on the lending date would be 5%.

(Note 1) The "spread" is the interest rate corresponding to the profit that a financial institution can expect to earn, and includes the portion corresponding to the administrative expenses of the



financial institution and the portion corresponding to the credit risk of the borrower.

(Note 2) The “swap rate” of an interest rate swap indicates the level of the long-term interest rate exchangeable for the short-term interest rate as indicated by the international financial markets.

#### Treatment for transfer pricing taxation purposes

##### **(Consideration of comparability study)**

In calculating the arm’s length price, selecting the most appropriate method of calculation for each case is required by the provisions of Article 66-4(2) of the ASMT, therefore a comparability study was made based on 66-4(2)-1, 66-4(3)-1, and 66-4(3)-3 of the Commissioner’s Directive on the ASMT, the Administrative Guideline 3-1, etc. The result was as shown below:

- The foreign-related transaction consists of financial loan transaction between company P and company S. Therefore, it is deemed appropriate to select either of them as the tested party.
- Given the information available, any potential comparable transactions for application of a method equivalent to the CUP method or a method equivalent to the CP method to company P could not be found.
- No information could be obtained on the interest rate that would have applied in cases where company S had taken out a loan from a bank or similar institution under the same terms and conditions, it was also impossible to apply a method of calculation using the interest rate prescribed in Administrative Guidelines 2-7(1)
- Company P has borrowed money from a bank. From the bank which deals with company P, the spread information concerning company P can be obtained. Therefore, it is possible to apply the method which uses the interest rate listed in the Administrative Guidelines 2-7(2) based on the information.

##### **(Selection of method of calculation of arm’s length price)**

From the result of the above study, in this case, it is deemed appropriate to select a method equivalent to the method consistent with the CUP method which uses the interest rate listed in the Administrative Guidelines 2-7(2) as the interest rate applied between unrelated parties, and to calculate the arm’s length price.

The arm’s length price (interest rate) for the money lending transaction between company P and company S was consequently calculated to be 5.7% (5% swap rate plus 0.7% spread).

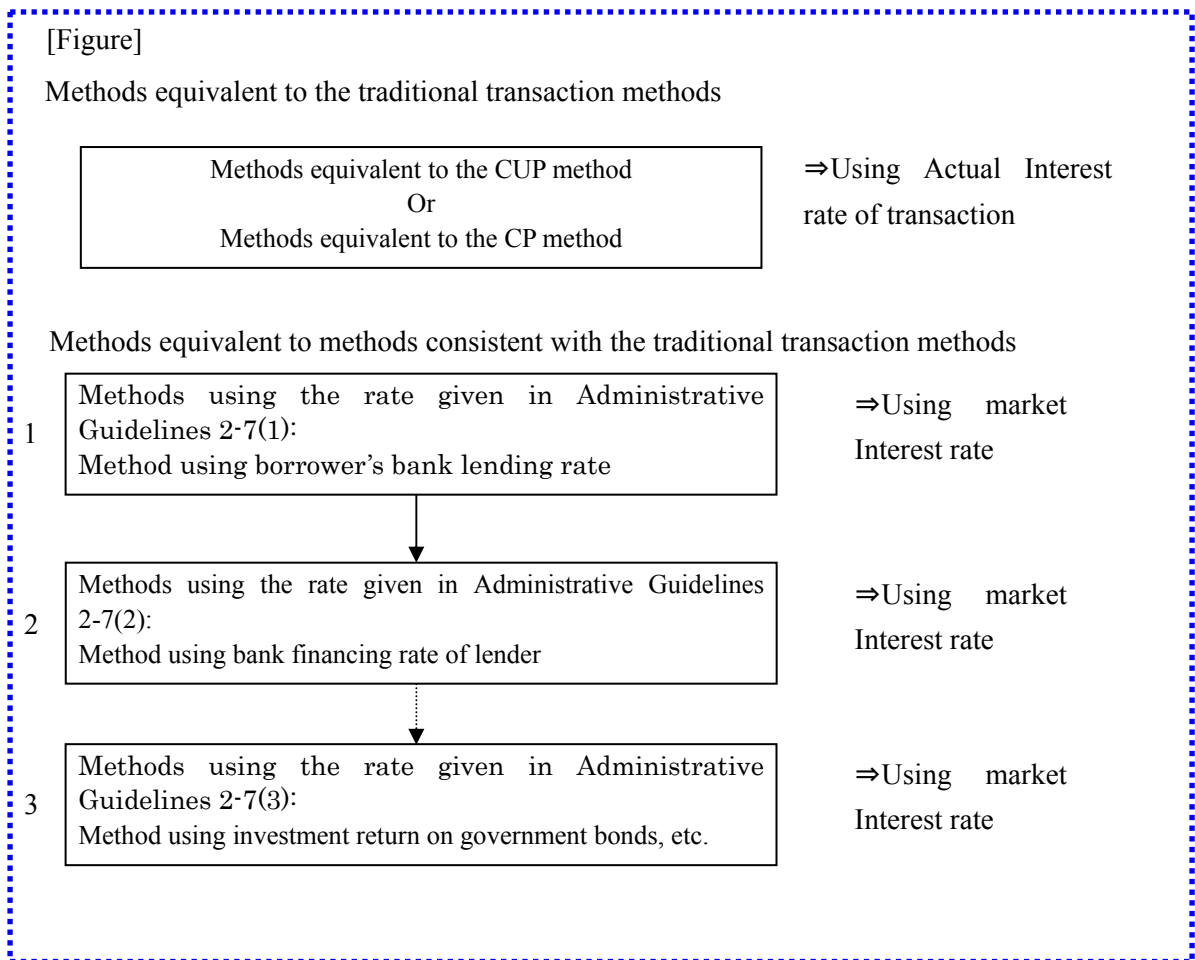
#### Explanation

1. Regarding the points to note when selecting the method of calculation of arm’s length price and making a comparability study, see the “Explanation” to Case 1.

2. In cases where no transactions between unrelated parties can be found that are comparable with the foreign-related transaction, it is possible to calculate the arm’s length price by a method consistent with the traditional transaction methods (or a method equivalent to a method consistent with the traditional transaction methods) that uses such transactions as the comparable transaction, provided

that objective and realistic indicators on market prices or similar variables (such as the market interest rate in the present case) are available. (Regarding methods consistent with the traditional transaction methods, see the “Explanation” to Case 1.)

3. Regarding a loan transaction of a corporation which does not engage in financial loans as its business, application of such a method as illustrated in the following figure is to be examined.



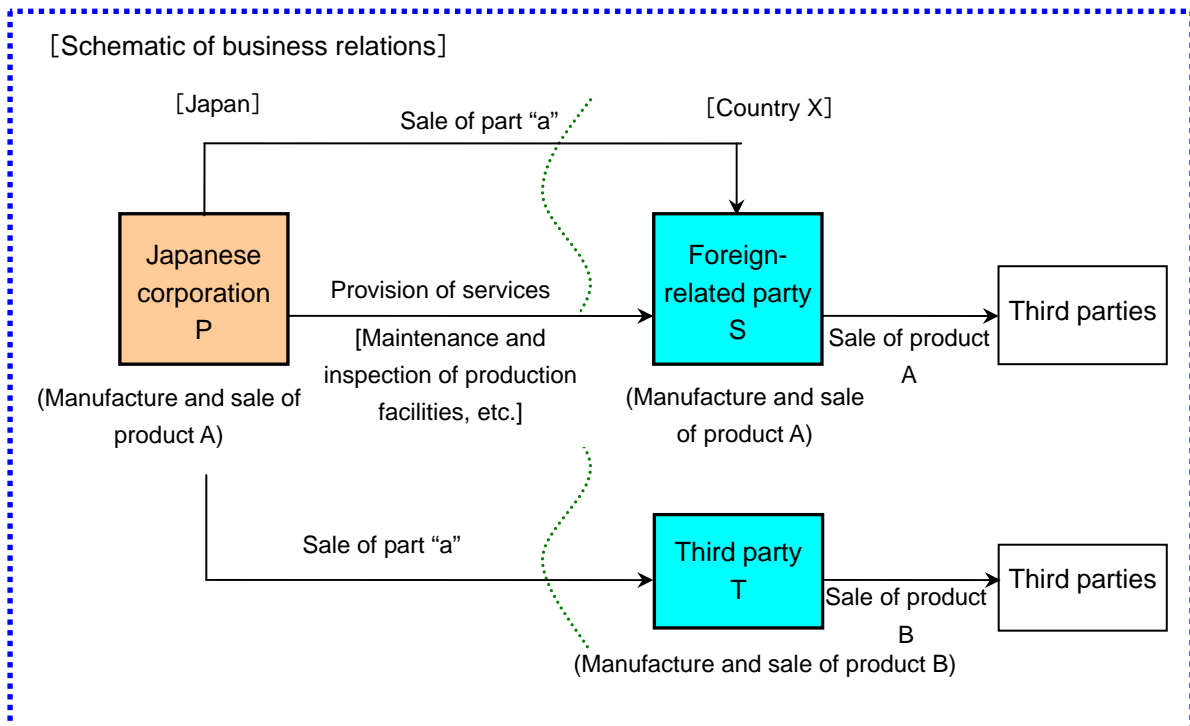
- A method equivalent to a method consistent with the above traditional transaction methods (a method equivalent to a method consistent with the CUP method) uses the market interest rate which is assumed to be the interest rate to be established between unrelated parties whose line of business does not include a money loan. Based on the above method, a result conforming to the arm's length principle can be obtained in the order of (i), (ii) and (iii).
- Treatment is the same regardless of whether a loan is provided using funds on hand or borrowed funds.
- In cases of a financial transaction under the same terms and conditions and in the same currency, there is no fundamental need to allow for differences due to markets as the levels of interest rates in each financial market are almost the same.

## Case 5: Case of use of methods equivalent to methods consistent with cost plus method

### Key points

In this case, it was found that a method equivalent to a method consistent with the CP method was the most appropriate method of calculation of arm's length price.

### Preconditions



### (Summary of business of corporation and foreign-related party)

Japanese corporation P is a manufacturer and distributor of product A, and 10 years previously it established company S in country X as a subsidiary to manufacture and distribute product A. Company S buys part "a" manufactured by company P, which it combines with other parts to produce product A for sale to third parties in country X. Company P also provides company S with services for the production facilities used to manufacture product A.

Company P also sells part "a" to company T, which is a third party in country X. Company T purchases part "a" from company P, which it combines with other parts to manufacture product B for sale to third parties in country X.

Company P's line of business is the manufacture and distribution of product A, and the sale of part "a". The provision of services is not a core business.

### (Summary of foreign-related transaction)

#### (1) Sale of part "a"

Company P sells part "a" to company S and company T at the same price, and the transaction stage and transaction terms (e.g. transaction volume) for the sales transaction are also the same.

## (2) Provision of services

Company P provides three engineers from its manufacturing division to company S for a total of around two months a year to maintain and inspect facilities used to manufacture product A at company S, and to train equipment operators. The maintenance, inspection, and other services undertaken by company P's three engineers are not unique and they do not make use of company P's manufacturing know-how, etc. Company S does not pay any consideration to company P for the provision of these services.

Neither company P nor company S engages in similar service provision transactions with unrelated parties. Furthermore, no similar service provision transactions could be found between unrelated parties.

## Treatment for transfer pricing taxation purposes

### **(Consideration of comparability study)**

#### (1) Sale of part "a"

In the calculation of arm's length price, selecting the most appropriate method of calculation for each case is required by the provisions of Article 66-4(2) of the ASMT, therefore a comprehensive study was conducted based on Articles 66-4(2)-1, 66-4(3)-1, and 66-4(3)-3 of the Commissioner's Directive on the ASMT, the Administrative Guidelines 3-1 and so on. Regarding the sales transaction of parts "a" between company P and company S, it is deemed appropriate to apply the CUP method, under which the sales transaction of parts "a" between company P and company T is the comparable transaction. As the result, no problem was recognized under the transfer pricing taxation.

#### (2) Service provision transaction

In calculating the arm's length price, selecting the most appropriate method of calculation for each case is required by the provisions of Article 66-4(2) of the ASMT, therefore a comparability study was made based on 66-4(2)-1, 66-4(3)-1, and 66-4(3)-3 of the Commissioner's Directive on the ASMT, the Administrative Guideline 3-1, etc. The result was as shown below:

- Since the foreign-related transaction consists of provision of services incidental to the core business (sales of parts "a" in this case) from company P to company S, it is deemed more appropriate to select company P as the tested party.  
However, due to the content of the transaction, it was found to be unfeasible to apply a method equivalent to the RP method.
- No potential comparable transactions for application of a method equivalent to the CUP method, a method equivalent to a method consistent with the CUP method or a method equivalent to the CP method to company P could be found due to the limited scope of the information available.
- It was found that the provision of services by company P to company S was incidental to the company's core business, and that the cost of service provision did not account for a significant portion of company P's costs in the taxable year in which service provision took place. Moreover, no use was made of intangible properties in the provision of services. Therefore, it is deemed appropriate to select a method which uses the amount of overall costs of the provision

of services as the arm's length price, without adding mark-up. (Administrative Guidelines 2-10(1))

**(Selection of method of calculation of arm's length price)**

Based on the result of the above study, it is deemed appropriate, in this case, to select a method equivalent to a method consistent with the CP method, which uses the amount of overall costs of the provision of services from company P to company S as the arm's length price, and to calculate the arm's length price.

The final cost in this case is the sum of the travel, transport, and accommodation costs of the engineers dispatched, their salaries, bonuses, retirement benefit expenses during the dispatch period, other direct costs required to dispatch them, and indirect costs allocated on a reasonable basis (such as the general administrative expenses of the division concerned and associated divisions).

**Explanation**

1. Regarding the points to note when selecting the method of calculation of arm's length price and making a comparability study, see the "Explanation" to Case 1.

2. Regarding methods consistent with the traditional transaction methods (including methods equivalent to methods consistent with the traditional transaction methods), see the "Explanation" to Case 1.

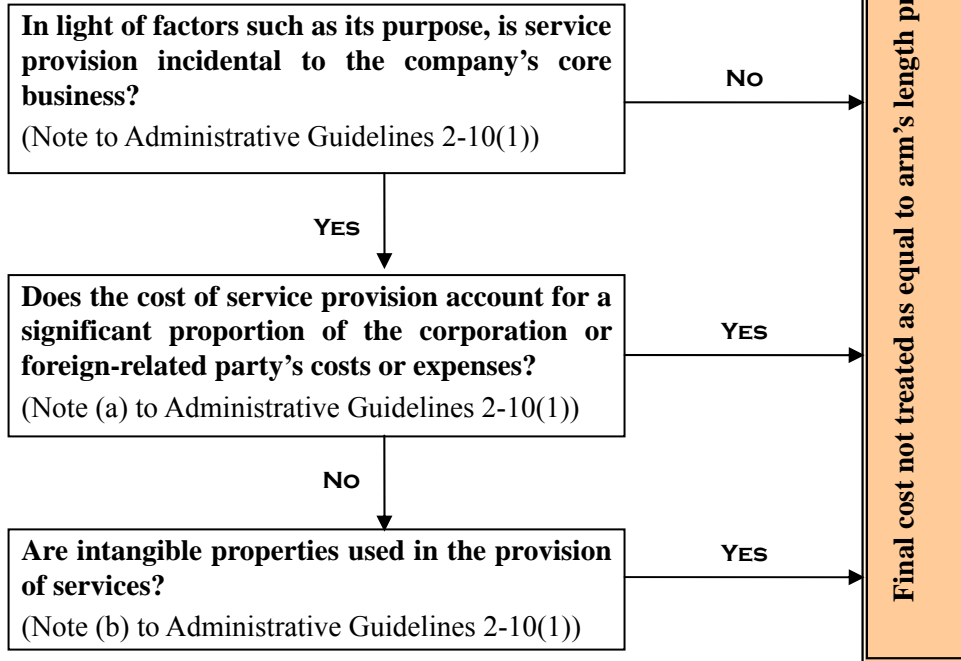
3. The points to note in cases of use of a method equivalent to the CUP method or a method equivalent to the CP method for service provision transactions are as set forth in ASMT Directive 66-4(7)-5. Although with the latter method there is a markup in the amount of expenses required to provide the services, it is generally considered difficult to find comparable transactions from among uncontrolled transactions for the provision of services incidental to core business activities (that are incidental or related to a corporation's core business).

In such cases, therefore, a method that the amount of final cost may be treated as the arm's length price without marking up the amount of expenses required to provide the services (a method equivalent to a method consistent with the CP method) shall be considered for application (Administrative Guidelines 2-10(1)).

If service provision is not incidental to the core business, the cost of service provision does not account for a significant proportion of the cost or expenses of a corporation or foreign-related business, or intangible properties are used in service provision, the amount of the final cost of service provision cannot be treated as the arm's length price (Administrative Guidelines 2-10(1) Note), and so another applicable method of calculation of the arm's length price shall be considered.

4. Whether or not the application of a method that total cost of the provision of services incidental to the core business engaged in by a corporation with a foreign-related party can be treated as the arm's length price is determined by following the criteria outlined in the diagram below:

[Figure]



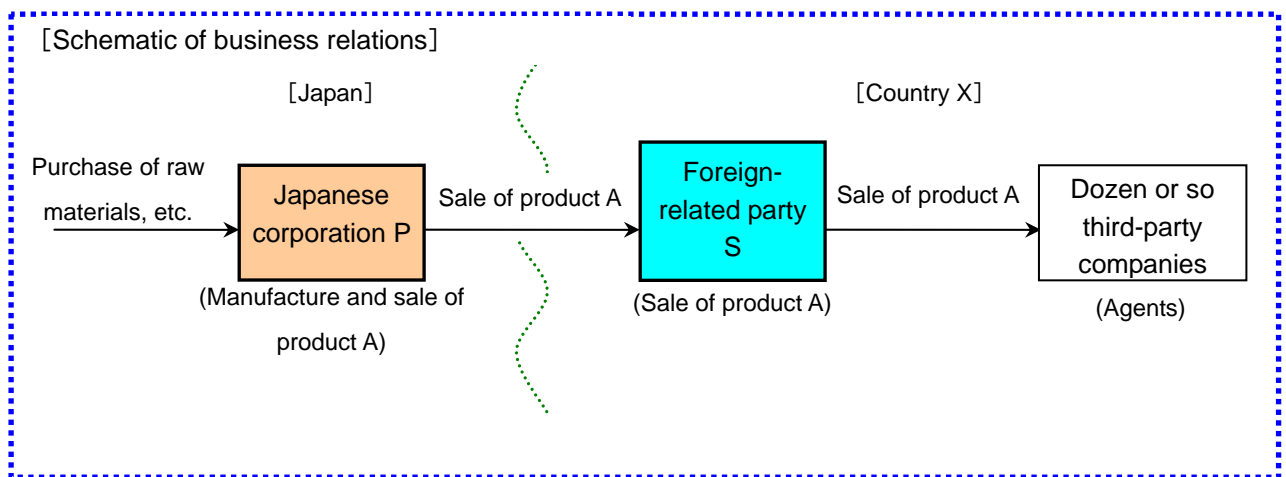
(Note) If a corporation engages in an inventory sales transaction and a service provision transaction with a foreign-related party, possible transfer pricing taxation problems need to be considered with respect to both.

## Case 6: Case of use of transactional net margin method

### Key points

In this case, it was found that the TNMM (or a method equivalent to a method consistent with the TNMM) was the most appropriate method of calculation of arm's length price. ("Preconditions 1" illustrates the case of sale of inventories (case of the most appropriate method with operating margin as a profit level indicator), "Preconditions 2" illustrates the case of sale of inventories (case of the most appropriate method with berry-ratio as a profit level indicator), and "Preconditions 3" illustrates the case of licensing of intangible properties.)

Preconditions 1: In the case of the most appropriate method with operating margin as a profit level indicator



### (Summary of business of corporation and foreign-related party)

Japanese corporation P is a manufacturer and distributor of product A, and 10 years previously it established company S in country X as a subsidiary to distribute product A.

Product A is manufactured using original technology developed as a result of R&D by company P.

### (Summary of foreign-related transaction)

Company P sells product A to company S, which sells it to a dozen or so third-party agents in country X.

### (Functions and activities of corporation and foreign-related party)

Company S does not engage in any original advertising or sales promotion activities.

However, it manages product A which it purchased from company P in accordance with its sales plan, in maintaining a certain level of stock, and resells the product in country X.

### (Miscellaneous)

Under the system for disclosure of corporate financial data in country X, entry of cost items is not required. (However, an item corresponding to operating income in Japan is recognized.)



## Treatment for transfer pricing taxation purposes

### **(Consideration of comparability study)**

In calculating the arm's length price, selecting the most appropriate method of calculation for each case is required by the provisions of Article 66-4(2) of the ASMT, therefore a comparability study was made based on 66-4(2)-1, 66-4(3)-1, and 66-4(3)-3 of the Commissioner's Directive on the ASMT, the Administrative Guideline 3-1, etc. The result was as shown below:

- Company S, which engages only in the sales of products, performs a simpler function than company P, which engages in manufacturing and R&D activities. Based on this, it is deemed more appropriate to adopt company S as the tested party.
- From the transactions executed by company S and company P, it is not possible to find potential internal comparable transactions.
- Product A sold by company P to company S is a product that utilizes original technologies resulting from R&D by company P, and it was not possible to find potential external comparable transactions from the available data for applying the CUP method. No potential external comparable transaction for application of a method consistent with CUP method could be found.
- Company S does not conduct original advertisement/sales promotion activities, and it cannot be recognized that company S offers unique and valuable contribution. (For the relationship between the intangible assets which makes unique and valuable contribution and the income source, see [Cases 10 – 15].) However, it manages product A which it purchased from company P in accordance with its sales plan, in maintaining a certain level of stock, and resells the product. Since gross profits and sales costs cannot be seized from openly accessible information in country X, and information necessary for adjustment of difference which affects the gross margin cannot be obtained, it is impossible to find potential external comparable transactions in applying the RP method under which company S is the tested party.
- Regarding the TNMM under which company S is the tested party, potential external comparable transactions can be found from openly accessible information. As the result of comparability analysis, it was confirmed that the value of functions performed by company S is related to the sales, instead of the operating costs. Furthermore, for the potential external comparable transactions, any difference that may affect in an objectively clear manner the calculation of the ratio provided for in the Article 39-12(8)-2 of the Cabinet Order for Enforcement of the ASMT is not recognized.
- For application of the comparable PS method, any potential external comparable transactions cannot be found. Furthermore, business concerning the above foreign-related transaction is not highly integrated as activities in global trading or joint ventures. The business does not fall under the type of transaction for which the PS method is more appropriate than the method of calculation under which either party of foreign-related transaction is tested.

### **(Selection of method of calculation of arm's length price)**

From the results of the above study, in this case, regarding the transaction in which company P sells product A to company S, it is deemed appropriate to select the TNMM under which company S is the

tested party as the most appropriate method, and to calculate the arm's length price. Furthermore, company S, which is the tested party, is recognized as a resale company which manages the products it purchased in accordance with its sales plan, in maintaining a certain level of stock, and resells them. Therefore, it is deemed appropriate to use the operating margin as the profit level indicator, as described in the following "Explanation".

Preconditions 2: In the case of sale of inventories (case of the most appropriate method with berry-ratio as a profit level indicator)

**[Schematic of business relations]**

It is the same as in the case of Preconditions 1

**(Summary of business of corporation and foreign-related party)**

It is the same as in the case of Preconditions 1.

**(Summary of foreign-related transaction)**

It is the same as in the case of Preconditions 1.

**(Functions and activities of corporation and foreign-related party)**

Company P, concerning the sales business of product A, establishes global sales plan, and manages business operation of its sales subsidiaries including company S. Company P, based on the sales plan, sells 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 them to a third-party agency. (Product A is sold to a third-party agency through company S in the flow of commerce, while the product does not go through company S in the flow of distribution, but is directly delivered from company P to the agency.)

Treatment for transfer pricing taxation purposes

**(Consideration of comparability study)**

In calculating the arm's length price, selecting the most appropriate method of calculation for each case is required by the provisions of Article 66-4(2) of the ASMT, therefore a comparability study was made based on 66-4(2)-1, 66-4(3)-1, and 66-4(3)-3 of the Commissioner's Directive on the ASMT, the Administrative Guideline 3-1, etc. The result was as shown below:

- Company S, which simply sells the product, is performing a simpler function than company P, which engages in manufacturing and sales, as well as R&D, planning of global sales plan, management business, etc. It is deemed more appropriate to select company S as the tested party.
- It is not possible to find any potential internal comparable transactions among transactions between company P and company S.
- Product A, which company P sells to company S, is a product using an original technology generated by company P's R&D activities. No potential external comparable transactions in the

application of the CUP method are found from openly accessible information.

It is not possible to find any potential external comparable transactions to apply a method consistent with the CUP method.

- Company S does not conduct original advertisement/sales promotion activities, and it cannot be recognized that company S offers unique and valuable contribution. Company S conducts substantially intermediary activities by selling the product it purchased in accordance with the sales plan of company P in maintaining little stock, and the functions performed by company S are recognized to be reflected on the operating costs. Regarding the TNMM under which company S is the tested party, potential external comparable transactions can be found from openly accessible information. As the result of comparability analysis, it was confirmed that the value of functions performed by company S is related to the operating costs, instead of the sales. Furthermore, for those potential external comparable transactions, any differences that may affect in an obviously clear manner the calculation of the ratio provided for in the Article 39-12(8)-4 of the Cabinet Order for Enforcement of the ASMT are not recognized. Furthermore, since the profit level indicator which has the sales as the denominator cannot appropriately reflect the functions performed by company S, application of the RP method is not appropriate.
- For application of the comparable PS method, any potential external comparable transactions cannot be found. Furthermore, business concerning the above foreign-related transaction is not highly integrated as activities in global trading or joint ventures. The business does not fall under the type of transaction for which the PS method is more appropriate than the method of calculation under which either party of foreign-related transaction is tested.

**(Selection of method of calculation of arm's length price)**

From the results of the above study, in this case, regarding the transaction in which company P sells product A to company S, it is deemed appropriate to select the TNMM under which company S is the tested party as the most appropriate method, and to calculate the arm's length price.

Furthermore, company S, which is the tested party, is recognized as a sales company which substantially conducts intermediary activities, therefore it is deemed appropriate to use the gross margin on operating costs as the profit level indicator, as described in the following "Explanation".

**Explanation**

1. Regarding the points to note when selecting the method of calculation of arm's length price and making a comparability study, see the "Explanation" to Case 1.

2. Regarding the characteristics (advantages and disadvantages) of the TNMM, see the "Explanation" to Case 1.

In applying the TNMM, even in the case where the difference between foreign-related transaction and uncontrolled transaction affects the calculation of the price prescribed in Article 66-4(2)-1(a) of the ASMT or the ordinary margin prescribed in Article 66-4(2) 1(b) and (c) of the ASMT, there may be cases in which it is not obviously clear that the difference affects the calculation of the ratio prescribed in Article 39-12(8)-2 to 5 of the Cabinet Order for Enforcement of the ASMT. Therefore, in applying

the TNMM, the comparable transactions shall be selected in consideration of the above (Administrative Guidelines 3-8).

However, in the case where the principle function performed by the party of foreign-related transaction and that performed by the party of uncontrolled transaction are different, it should be noted that the difference normally affects the calculation of the above-mentioned ratio (Administrative Guidelines 3-8 (Note)).

### 3. Regarding a profit level indicator in applying the TNMM

Profit level indicators used in the case of application of the TNMM include the operating margin on sales, operating margin on total costs, or gross margin on operating expenses. (See Article 39-12(8)-2 to 5 of the Cabinet Order for Enforcement of the ASMT.)

In selecting the profit level indicator, based on the results of comparability analysis, and in consideration of the assets used or risks borne by the tested party, it is necessary to select an indicator which exactly represent the value of the function performed by the tested party as the most appropriate profit indicator.

The methods to calculate the arm's length price based on these profit level indicators are as shown (1) to (3) below. In general, the following points shall be noted, respectively.

#### (1) Method based on the operating margin on sales

This is a method to calculate the appropriate amount of operating profits of the buyer (purchasing side) of the inventories concerning the foreign-related transaction by using the operating margin on sales concerning the comparable transaction, thus to calculate the arm's length price concerning the relevant foreign-related transaction.

This method is appropriate in the case where the value of functions performed by the buyer of inventories concerning the foreign-related transaction 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).

#### (2) Method based on the operating margin on total costs

This is a method to calculate the amount of appropriate operating profit of the seller (selling side) of inventories concerning the foreign-related transaction by using the operating margin on total costs concerning the comparable transaction, thus to calculate the arm's length price concerning the relevant foreign-related transaction.

This method is appropriate, in consideration of the assets used or risks borne, where the buyer of the inventories concerning the foreign-related transaction is deemed to have functions which are not reflected on the operating costs (such as manufacturing function), (for example, in the case of testing of manufacturing/sales company).

#### (3) Method based on gross profit margin on operating costs

This is a method to calculate the amount of appropriate gross profit on sales of the buyer (the buying side) or the seller (the selling side) of inventories concerning the foreign-related transaction, thus to calculate the arm's length price concerning the relevant foreign-related transaction.

This method is appropriate where the value of functions performed by the buyer or the seller of the

inventories concerning the foreign-related transaction is (i) recognized to be related with the operating costs, (ii) not substantially affected by the value of the products which were sold, and recognized to be unrelated with the sales, and (iii) recognized that it does not have function which is not reflected on the operating costs (such as manufacturing function) (for example, in the case of testing an intermediary agent, or simple service provider).

Furthermore, the level of similarity (comparability) of the transaction conducted by the tested party and the comparable transaction shall be sufficient, therefore, in the case where the gross margin on operating expenses is used as the profit level indicator, it should be noted that the sales costs and operating expenses of the both transactions shall be clearly separated.

4. The TNMM is a method of calculating the arm's length price by selecting comparable transactions for one of the counterparts to the transaction concerned. Depending on the roles and functions of the corporation and foreign-related party, however, there are cases where it is more appropriate to apply the PS method in order to calculate the arm's length price based on the contribution of both the corporation and the foreign-related party to the generation of profit.

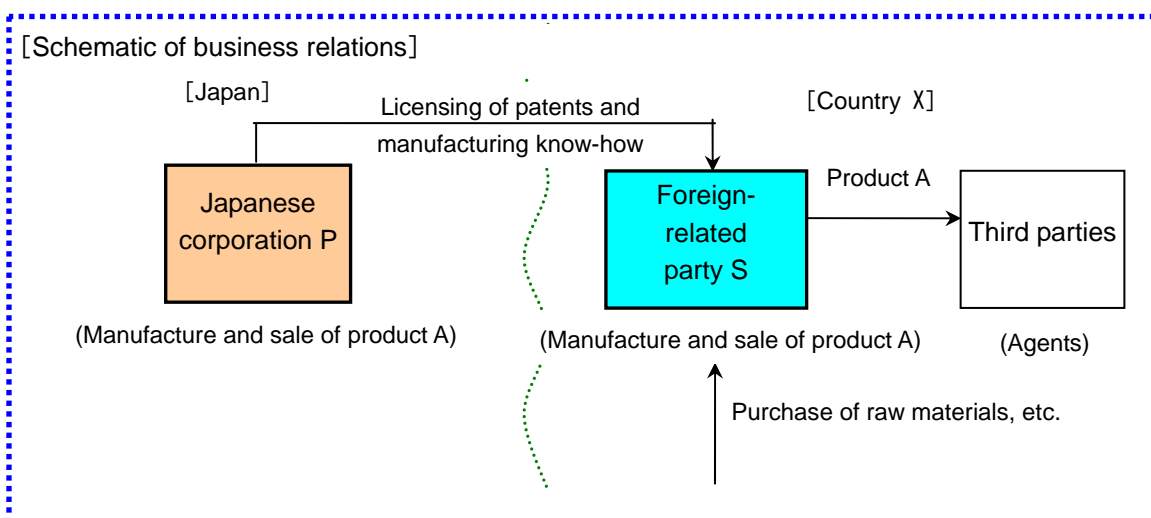
(Reference) Regarding the operating margin

In applying the TNMM, regarding the operating profits of the tested party concerning the foreign-related transaction, profits/losses which are directly or indirectly related to the relevant foreign-related transaction shall be adopted from the profits and losses recorded in association with the corporation's core operating activities (so-called business profits).

Therefore, items which belong to the non-operating profits/losses such as interests earned, interest paid, and corporate tax, and to the special profits/losses which do not have repeating character, are generally excluded.

Furthermore, in the work of selection of comparable transaction, in consideration of the above points, it is necessary to determine indicators which are consistent with profit level indicators concerning the foreign-related transaction.

### Preconditions 3: In the case of licensing of intangible properties



#### **(Summary of business of corporation and foreign-related party)**

Japanese corporation P is a manufacturer and distributor of product A, and 10 years previously it established company S in country X as a subsidiary to manufacture and distribute product A.

Product A is manufactured using original technologies developed as a result of R&D by company P.

#### **(Summary of foreign-related transaction)**

Company P licenses patents and manufacturing know-how (original technologies result from R&D by company P) relating to the manufacture of product A to company S.

Company S purchases raw materials and other supplies in country X to manufacture product A, which it then sells to third-party agents in country X.

No trading of inventories occurs between company P and company S.

#### **(Functions and activities of corporation and foreign-related party)**

Company S has no R&D operations, and manufactures product A using technology originating from and provided by company P.

Other conditions are the same as in the case of Preconditions 1.

#### **(Other conditions)**

Other conditions are the same as for Preconditions 1.

### Treatment for transfer pricing taxation purposes

#### **(Consideration of comparability study)**

In calculating the arm's length price, selecting the most appropriate method of calculation for each case is required by the provisions of Article 66-4(2) of the ASMT, therefore a comparability study was made based on 66-4(2)-1, 66-4(3)-1, and 66-4(3)-3 of the Commissioner's Directive on the ASMT, the Administrative Guideline 3-1, etc. The result was as shown below:

- Company S, which engages in manufacturing and the sales of products, performs a simpler function than company P, which engages in manufacturing and R&D activities. Based on this, it is deemed more appropriate to adopt company S as the tested party.  
However, due to the contents of transaction, it is difficult to apply a method equivalent to the RP method under which company S is the tested party.
- Patents and know-how licensed by company P to company S are original technologies created as a result of company P's R&D activities, and it is not possible to find potential comparable transactions for applying a method equivalent to the CUP method on the basis of the information available. No potential external comparable transactions for application of a method equivalent to a method consistent with the CUP method could be found.
- The operating margins on uncontrolled transactions that are comparable to the manufacturing and sales transactions undertaken by company S were obtainable from publicly available information.
- For application of a method equivalent to a method consistent with comparable PS method, any potential external comparable transactions cannot be found. Furthermore, business concerning the above foreign-related transaction is not highly integrated as activities in global trading or joint ventures. The business does not fall under the type of transaction for which the PS method is more appropriate than the method of calculation under which either party of foreign-related transaction is the tested party.

**(Selection of method of calculation of arm's length price)**

By calculating the arm's length price indirectly by calculating the normal profit commensurate with the functions of company S from the operating margin of comparable transactions and treating company S's residual profits in excess of this amount as the consideration for licensing of patents and manufacturing know-how, instead of by directly calculating the consideration for licensing of intangible properties between company P and company S, in this case, it was found to be most appropriate to select a method equivalent to a method consistent with the TNMM to company S .

Furthermore, company S, which is the tested party, is recognized as a manufacturing and sales company. Therefore, it is recognized to be appropriated to use the operating margin on total costs as the profit level indicator, as described in the "Explanation" to Preconditions 1 and 2.

**Explanation**

1. Regarding the points to note when selecting the method of calculation of arm's length price and making a comparability study, see the "Explanation" to Case 1.

2. Regarding methods consistent with the traditional transaction methods (including methods equivalent to methods consistent with the traditional transaction methods), see the "Explanation" to Case 1.

3. Regarding the characteristics (advantages and disadvantages) of the TNMM, see the "Explanation" to Case 1.

In cases where a corporation furnishes intangible properties to a foreign-related party through the licensing of patents or similar intellectual property, it is possible to apply the TNMM and indirectly calculate by calculating the normal profit commensurate with the functions of the foreign-related party and treating the residual profit of the foreign-related party in excess of this as the amount of consideration for the furnishing of intangible properties. This is possible if the foreign-related party engages in the same category of business as that of the foreign-related transaction, and only has comparable manufacturing functions or sales functions to other corporations in similar markets and of a similar size (excepting corporations performing unique functions).

The method of calculation of the arm's length price in this case is a "method equivalent to a method consistent with the TNMM."

(Note) This case is premised on intangible properties being licensed under a contract. Even if company P and company S do not have an agreement on the use of intangible properties between them, however, the same treatment will apply if it is deemed on the basis of the actual state of transactions that their use is licensed (Administrative Guidelines 2-13).

4. The TNMM is a method of calculating the arm's length price by selecting comparable transactions involving one or other of the counterparts to the transaction concerned. However, there are cases where the PS method may more appropriately be used to calculate the arm's length price based on the extent of the contribution of both the corporation and the foreign-related party to the generation of profit in light of the roles and functions of the corporation and foreign-related party.

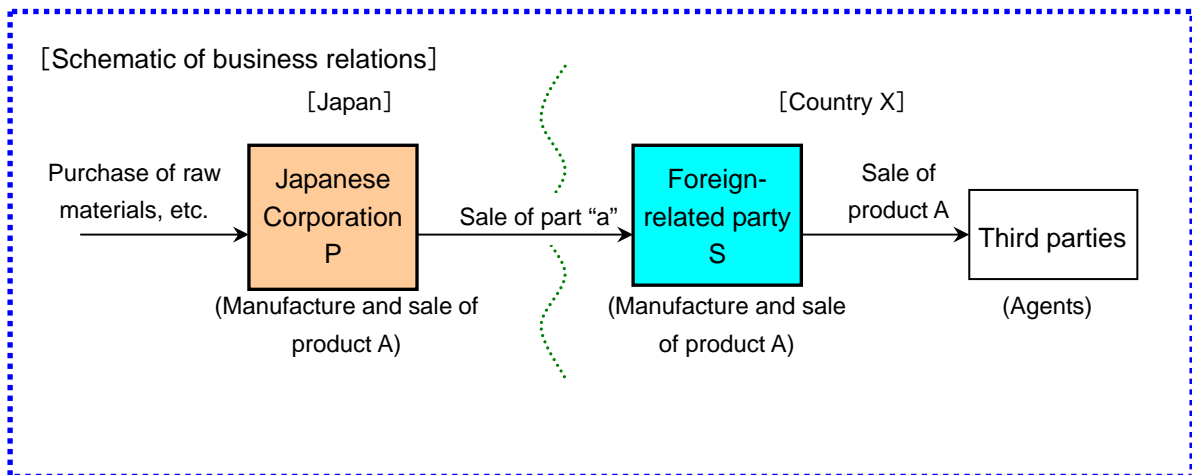


## Case 7: Case of use of contribution profit split method

### Key point

In this case, it was found the contribution PS method (or a method equivalent to the contribution PS method) was the most appropriate method of calculation of arm's length price.

### Preconditions 1



### (Summary of business of corporation and foreign-related party)

Japanese corporation P is a manufacturer and distributor of product A, and 10 years previously it established company S in country X as a manufacturing and distribution subsidiary.

### (Summary of foreign-related transaction)

Company P sells part "a" for product A to company S, and company S combines part "a" with other parts to produce product A, which it sells to third-party agents in country X.

### (Functions and activities of corporation and foreign-related party)

Company S has no R&D operations, does not engage in original advertising or sales promotion activities, and does not use its own trademark or other properties in its distribution activities.

### (Other conditions)

Company S sells product A to third parties in country X. However, similar products to product A are also manufactured and sold by two other corporations in country X (manufacturing subsidiaries whose parent companies are located outside country X; hereinafter referred to as the "two companies"). Consequently, the market in country X remains an oligopoly of these three companies.

Product A shares an equal share of the market with the similar products of the two companies, and is almost the same as the similar products of the two companies in terms of product performance and price.

Even in Japan, there is only one corporation manufacturing and selling a product similar to company P's product A, and transactions involving it are all controlled transactions.

## Treatment for transfer pricing taxation purposes

### **(Consideration of comparability study)**

In calculating the arm's length price, selecting the most appropriate method of calculation for each case is required by the provisions of Article 66-4(2) of the ASMT, therefore a comparability study was made based on 66-4(2)-1, 66-4(3)-1, and 66-4(3)-3 of the Commissioner's Directive on the ASMT, the Administrative Guideline 3-1, etc. The result was as shown below:

- Both of company P and company S perform manufacturing and sales functions concerning product A. No substantial difference is recognized in their levels, therefore, it is deemed appropriate to adopt either of them as the tested party.
- From the transactions executed by company S and company P, it is not possible to find potential internal comparable transactions.
- Regarding company P, there is only one corporation manufacturing and selling a similar product to product A in Japan, and the transactions involving it are all controlled transactions. It is therefore not possible to identify potential external comparable transactions for applying the CUP method, the CP method and the TNMM to company P based on the information available. No potential external comparable transactions could be found to apply methods consistent with these methods.
- Regarding company S, the fact that the transactions of the two companies dealing in similar products are controlled transactions meant that potential external comparable transactions for application of the RP method or the TNMM to company S could not be found. It was impossible to identify any potential external comparable transactions for application of methods consistent with these methods.
- In the foreign-related transaction of this case, unique and valuable contribution by company P and company S is not recognized. It was impossible to identify any potential comparable transactions for application of the comparable PS method.

### **(Selection of method of calculation of arm's length price)**

From the results of the above study, in this case, it is deemed appropriate to select the contribution PS method as the most appropriate method, and to calculate the arm's length price.

## Explanation

1. Regarding the points to note when selecting the method of calculation of arm's length price and making a comparability study, see the "Explanation" to Case 1.

2. Regarding methods consistent with the traditional transaction methods (including methods equivalent to methods consistent with the traditional transaction methods), see the "Explanation" to Case 1.

3. In cases where it is difficult to find comparable transactions due to the state of the market (such as the existence of an oligopoly), it may be more appropriate to use the contribution PS method without using comparable transactions as the method of calculation of arm's length price.

Furthermore, in the case where unique and valuable contribution by the corporation or by the foreign-related party in the foreign-related transaction is not recognized, the residual PS method cannot be applied. (Regarding the cases where the residual PS method is compatible, see the “Explanation” to Case 8.)

4. Regarding the factors used to split profit when employing the contribution PS method, factors that are suited to estimating the extent of the contribution of the parties to the creation of profits to be split depending on the content of the foreign-related transaction are required to use. These may include, for instance, the amount of expenses (such as expenditures of personnel costs) and the amount of capital employed by the corporation and foreign-related party.

For instance, if the function ordinarily performed (e.g., in manufacturing or distribution) contributes to the generation of profit, it would be logical to use the expenditures on human resources and depreciation expenses that reflect this function.

(Reference) Regarding the profits to be split

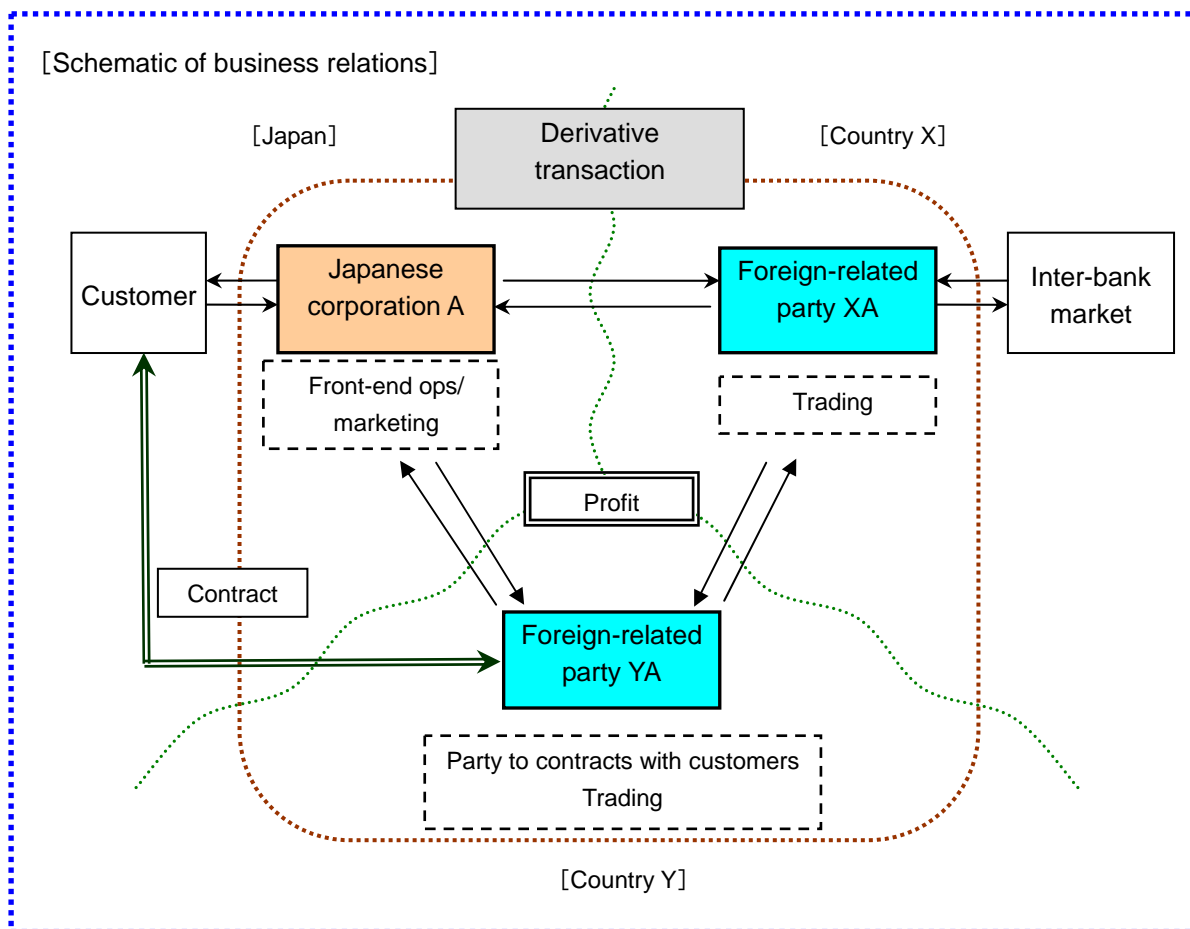
The PS method is a method to calculate the arm’s length price by allocating the incomes which occurred to the corporation and the foreign-related party from the sales of the inventories concerning the foreign-related transaction (the profits to be split) to the relevant corporation and the relevant foreign-related party, by using one of the methods listed in the Article 39-12(8)1-(a) to (c) of the Cabinet Order for Enforcement of the ASMT. In principle, the sum of operating incomes concerning the relevant corporation and the relevant foreign-related party shall be used as the profits to be split (66-4(5)-1 of the Commissioner’s Directive on the ASMT).

The reason the operating income is used for the profits to be split is that the PS method is to calculate the arm’s length price in consideration of “the way the profits concerning the business between the relevant entities are allocated if it were between unrelated parties”, therefore, it is more reasonable to allocate the sum of operating profits, which show the direct results of business activities, than the gross profit on sales or current net income.

Furthermore, the profits to be split are understood as the total of the profits/losses which occurred to all the related parties participating the foreign-related transaction, concerning the relevant transaction (in principle, operating profits/losses), therefore, operation losses are included (66-4(5)-1 of the Commissioner’s Directive on the ASMT).

The scope of operating profits concerning the application of the PS method is similar to that of operating profits concerning the application of the TNMM. In the application of the PS method, it shall be noted that communalization of standards related to the accounting practices and the currencies of both parties of the foreign-related transaction is necessary, and that the continuous use of the adopted standards in the applicable year of the PS method is required.

## Preconditions 2



### (Summary of business of corporation and foreign-related party)

Japanese corporation A is a financial institution with international operations. It does business with company XA and company YA as foreign-related parties in country X and country Y respectively, and company A, company XA, and company YA all engage in derivative transactions as a single group.

### (Functions of corporation and foreign-related parties)

Company A markets derivative products to Japanese customers and, in addition to taking orders from customers, also creates and develops (markets) derivative products to meet customer demands.

Company XA provides company A with information on pricing these derivative products through inter-bank transactions to the extent of the authority assigned to it according to company A's requests, and also engages in trading operations, including revenue and risk management concerning all financial products handled by company XA.

Company YA is a party to contracts with customers according to customer needs, and engages in trading operations.

### Treatment for transfer pricing taxation purposes

#### (Consideration of comparability study)

In calculating the arm's length price, selecting the most appropriate method of calculation for each

case is required by the provisions of Article 66-4(2) of the ASMT, therefore a comparability study was made based on 66-4(2)-1, 66-4(3)-1, and 66-4(3)-3 of the Commissioner's Directive on the ASMT, the Administrative Guideline 3-1, etc. The result was as shown below:

- In the sales of derivative products as in this case, a set of functions including sales, marketing, and trading is not dispersed to unrelated parties through service provision transactions with unrelated party in any case. Therefore, it is deemed inappropriate to adopt only one of the parties of foreign-related transaction as the tested party.  
Furthermore, in actuality, from the information within the scope available for collection, and in any method of calculation, it is impossible to find potential comparable transactions of which the contents of transactions and service provisions among company A, company XA and company YA are the same or similar and the conditions of service provision are similar (including comparable transactions in the application of an equivalent method to a method consistent with the traditional transaction methods).
- In the foreign-related transaction of this case, unique and valuable contribution by company A, company XA, and company YA was not recognized. No potential comparable transactions could be found to apply a method equivalent to the comparable PS method.

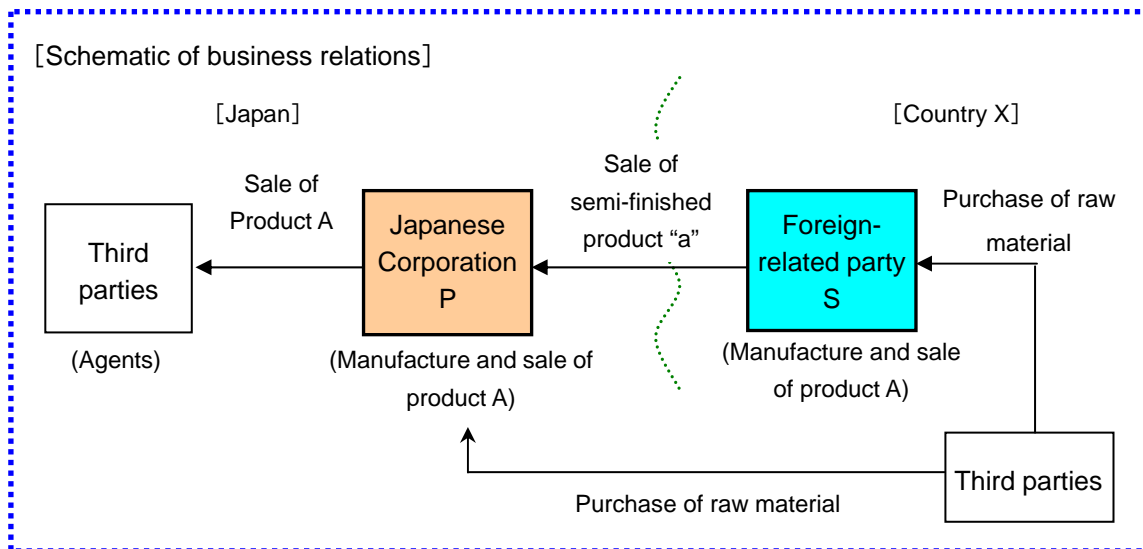
**(Selection of method of calculation of arm's length price)**

In consideration of the results above and the operations engaged in by company A were found to be performed as a single set of functions concerning the sale of derivative products to customers by the business group as a unit, it was found to be appropriate to apply a method equivalent to the contribution PS method by apportioning the profit arising from all transactions engaged in between company A, and companies XA and YA according to the level of each foreign-related party's contribution.

**Explanation**

1. Regarding the points to note when selecting the method of calculation of arm's length price and making a comparability study, see the "Explanation" to Case 1.
2. Regarding methods consistent with the traditional transaction methods (including methods equivalent to methods consistent with the traditional transaction methods), see the "Explanation" to Case 1.
3. Where transactions are highly integrated and global in nature, and functions are dispersed between a corporation and foreign-related parties that do business together cooperatively as a single unit, it is considered difficult to apply a method testing either party in the controlled transaction. Thus, it is generally appropriate to apply a method equivalent to the contribution PS method by allocating the profit arising from transactions overall to each of the operations concerned according to the contribution.

### Precondition 3



#### **(Summary of business of corporation and foreign-related party)**

Japanese corporation P is a manufacturer and distributor of product A in Japan. Corporation S in country X, which is corporation P's subsidiary, manufactures and distributes product A in country X.

#### **(Summary of foreign-related transaction)**

Company S sells a semi-finished product "a" of product A to company P. Company P processes the semi-finished product "a" purchased from company S (post-treatment of manufacturing of product A), and sells it to a domestic third-party agent.

#### **(Functions and activities of corporation and foreign-related party)**

Company P does not engage in original advertising or sales promotion activities, and does not use its own trademark or other properties in its distribution activities.

#### **(Other conditions)**

Company P and company S can procure the raw materials necessary for manufacturing product A at a significantly favorable price compared to other companies, due to its long-term and bulk purchase. Company P and company S do not perform any unique functions in the procurement of the raw materials.

No unique manufacturing technology is used for product A, therefore its sales price is at the same level as the similar products of other companies in our country as well as in Country X.

#### Treatment for transfer pricing taxation purpose

##### **(Consideration of comparability study)**

In calculating the arm's length price, selecting the most appropriate method of calculation for each case is required by the provisions of Article 66-4(2) of the ASMT, therefore a comparability study was made based on 66-4(2)-1, 66-4(3)-1, and 66-4(3)-3 of the Commissioner's Directive on the ASMT, the Administrative Guideline 3-1, etc. The result was as shown below:

- Both of company P and company S perform the function of sales. No significant difference is recognized between their levels. It can be recognized as appropriate to adopt either of them as the tested party.
- From the transactions executed by company S and company P, it is impossible to find potential internal comparable transactions.
- From openly accessible information, potential external comparable transactions for the application of one of the traditional transaction methods and a method consistent with those methods cannot be found. However, potential external comparable transactions for the application of the TNMM under which company P is the tested party and for the application of the TNMM under which company S is the tested party can be found.
- By using the above two potential external comparable transactions, provisional values of arm's length prices of the case in which company P is the tested party and that of the case in which company S is the tested party are calculated respectively, and based on these, the status of profit allocation was confirmed. In each case, excessive profits are to be allocated to the other party than the tested party. The reason is recognized that the profit generated by procurement of raw materials for product A by company P and company S at more favorable prices than other companies were allocated only to either of company P or company S. Furthermore, the profits generated by the procurement at a favorable price are recognized as a merit of scale caused by the bulk procurement by company P and company S.
- From the above, the fact that company P and company S can procure the raw materials at a more favorable price than other companies is recognized to affect the calculation of profit level indicator of the TNMM, however, the adjustment of difference is considered difficult.
- No potential comparable transactions could be found to apply the comparable PS method.

**(Selection of method of calculation)**

From the results of the above study, in the case where a calculating method, under which either of company S or company P is the tested party is used, an appropriate adjustment is impossible, and an excessively larger profit which does not match the functions performed by the other party is allocated to the party of the other side. In this case, it is deemed appropriate to select the contribution PS method as the most appropriate method, and to calculate the arm's length price.

**Explanation**

1. Regarding the points to note when selecting the method of calculation of arm's length price and making a comparability study, see the "Explanation" to Case 1.
2. Regarding methods consistent with the traditional transaction methods (including methods equivalent to methods consistent with the traditional transaction methods), see the "Explanation" to Case 1.
3. In the case where profits are generated from the improvement of efficiency due to the scale merit and business integration, and where the profits cannot be allocated appropriately by a method of

calculation under which either one party of foreign-related transaction is the tested party, application of the PS method is recognized as appropriate.

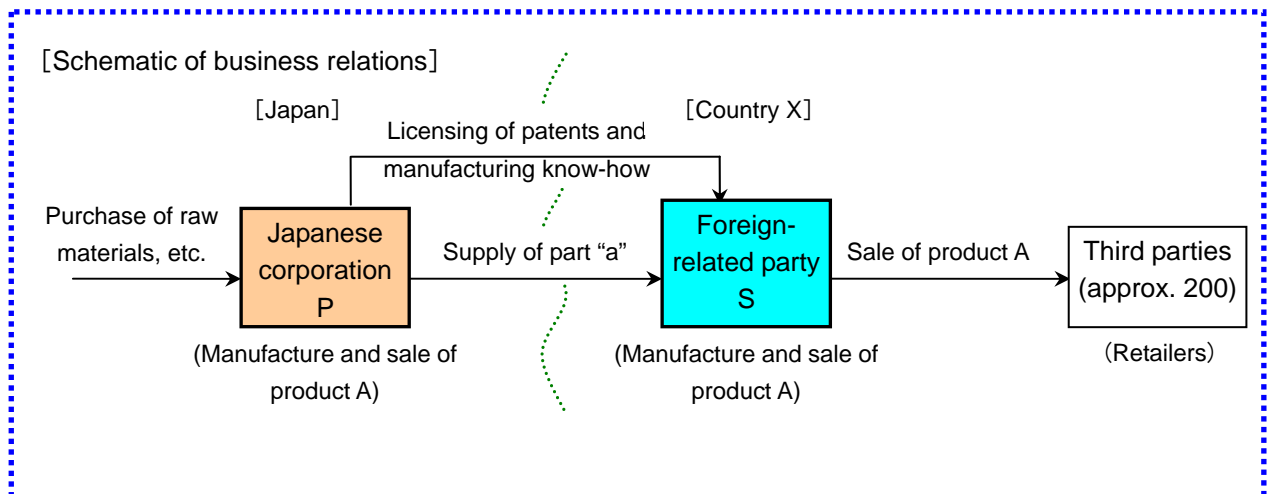


## Case 8: Case of use of residual profit split method

### Key points

In this case, it was found that a method consistent with the residual PS method was the most appropriate method of calculation of arm's length price.

### Preconditions



### (Summary of business of corporation and foreign-related party)

Japanese corporation P is a manufacturer and distributor of product A, and 10 years previously it established corporation S in country X as a subsidiary to manufacture and distribute product A.

Product A is manufactured using original technologies resulting from company P's R&D activities.

### (Summary of foreign-related transaction)

Company P both sells part "a" (a core part that aggregates original technologies produced by company P) for product A to company S, and licenses patents and manufacturing know-how (original technologies resulting from R&D by company P) for manufacturing product A.

Company S combines part "a" with other parts to manufacture product A, which it then sells to approximately 200 third-party retailers in country X.

### (Functions and activities of corporation and foreign-related party)

Company S has no R&D operations, and the manufacture of product A by company S is based on original technologies furnished by company P.

On the other hand, company S has numerous sales representatives, and engages in original advertising and sales promotion activities targeted at retailers and end consumers.

Product A has achieved a certain market share in country X thanks to its unique technical performance, combined with strong product recognition and a well-developed network of retailers built up through advertising and sales promotion activities, and it sells for a largely stable price.

## Treatment for transfer pricing taxation purposes

### **(Consideration of comparability study)**

In calculating the arm's length price, selecting the most appropriate method of calculation for each case is required by the provisions of Article 66-4(2) of the ASMT, therefore a comparability study was made based on 66-4(2)-1, 66-4(3)-1, and 66-4(3)-3 of the Commissioner's Directive on the ASMT, the Administrative Guideline 3-1, etc. The result was as shown below:

- The patents and know-how licensed by company P to company S are unique technologies created as a result of company P's R&D activities. Part "a" that company P sells is also manufactured using these unique technologies. Unique and valuable contribution by company P is recognized in the foreign-related transaction. It was impossible to find any potential comparable transactions for application of the CUP method (or an equivalent method), or the CP method or the TNMM (or equivalent methods) to company P given the information available. No potential comparable transactions could be found to apply methods consistent with these methods.
- As a result of its advertising and sales promotion activities, company S does business employing a better developed network of retailers and enjoying higher product recognition than a "corporation engaging solely in routine activities" (see note below). Unique and valuable contribution by company S is recognized in the foreign-related transaction.

Based on the information available, it was not possible to find any uncontrolled transactions taking place under the same conditions as the transactions engaged in by company S, and no potential comparable transactions for application of the RP method or the TNMM to company S's sales transactions could be identified. No potential comparable transactions could be found to apply methods consistent with these methods.

- Sales transaction of part "a" and licensing of patents and manufacturing know-how are recognized as being conducted in an integrated manner. Furthermore, the profits concerning the foreign-related transaction of company S cannot be separated into different categories of the sales transaction of parts "a" and the licensing of patents and manufacturing know-how.

(Note) In this case, a "corporation engaging solely in routine activities" would be a corporation that engages in the same category of business as that of the foreign-related transaction, is of a similar scale, is active in a similar market, and does not perform unique functions that contribute to generating profits that cannot arise from activities such as routine manufacturing and sales activities alone.

In the present case and the following cases, expressions such as "strong" product recognition, "well-developed" retailer networks, "unique" technologies, and "low" cost of manufacture are all used for comparison with corporations that engage solely in routine activities.

### **(Selection of method of calculation of arm's length price)**

From the results of the above study, intangible assets formed by the R&D activities of company P and the advertisement/sales promotion activities of company S are the source of incomes concerning the foreign related transactions of company P and company S in comparison with a corporation which conducts only routine activities. Since unique and valuable contribution by company P and company S

is recognized in the foreign-related transaction, in this case, it is deemed appropriate to select a method consistent with the residual PS method as the most appropriate method, to calculate the arm's length price.

#### Explanation

1. Regarding the points to note when selecting the method of calculation of arm's length price and making a comparability study, and note in cases of use of intangible properties in foreign-related transactions, see the "Explanation" to Case 1.

2. Regarding methods consistent with the traditional transaction methods (including methods equivalent to methods consistent with the traditional transaction methods), see the "Explanation" to Case 1.

3. As intangible properties typically put their users in an economically competitively advantageous position compared with corporations that engage solely in routine activities due to their originality and individuality (i.e., their "uniqueness"), it is often difficult to select comparable transactions for foreign-related transactions that involve of such properties.

For this reason, in the case where both of the corporation and the foreign-related party are recognized to have given unique and valuable contribution, for example, by using the intangible assets, it may be appropriate to select the residual PS method.

#### (Reference) Regarding a method consistent with the Residual PS method

The PS method is a method to calculate the arm's length price, under which the total amount of incomes, generated to the corporation and the foreign-related party by means of the purchase and sales of the inventories concerning the foreign-related transaction is subject to allocation (Article 39-12(8)-1 of the Cabinet Order for Enforcement of the ASMT). Therefore, as in this case, where other transactions are added to the sales transaction of inventories, and the arm's length price is calculated in considering these transactions as a single transaction, the method which uses the PS method in the similar concept to the residual PS method is a method consistent with the residual PS method (Article 39-12(8)-4 of the Cabinet Order for Enforcement of the ASMT).

Furthermore, in addition to the above, methods which are consistent with the residual PS method are as follows:

- In the case there is more than one routine transaction, a method which uses the PS method in the similar concept of the residual PS method, by using the amount equivalent to the routine profit calculated under the average by profit level indicators concerning the relevant routine transaction.
- In the case where the buyer of inventories concerning the foreign-related transaction leases those inventories to another party, a method which uses the PS method in the similar concept to the residual PS method, in considering the sum of the income associated with the lease of the inventories of the buyer and the income associated with the sales of the inventories of the seller

of the inventories as the subject of allocation

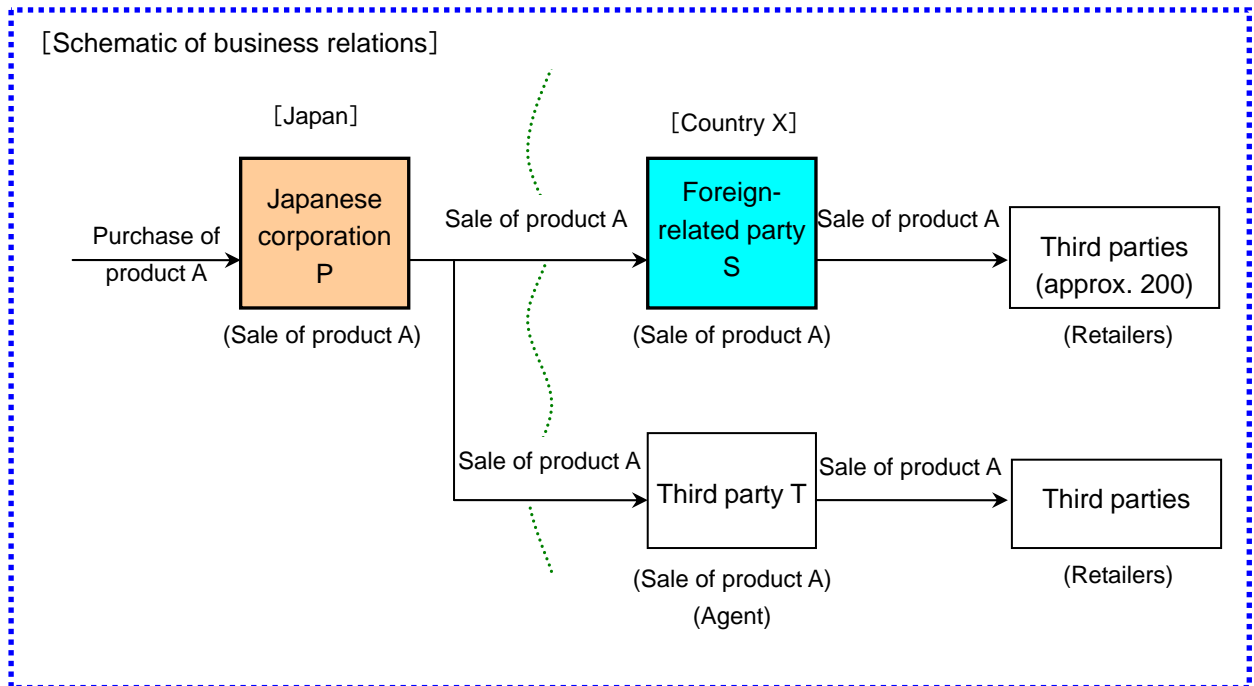
- In the case where the buyer of the inventories concerning the foreign-related transaction sold the inventories to a related party, a method which uses the PS method in the similar concept to the residual PS method regarding the sum of the income associated with the sales of the inventories of the buyer calculated by using a method consistent with the TNMM of which the related party is the tested party, and the income concerning the sales of the inventories of the seller of the inventories as the subject of allocation.

## Case 9: Adjustment for differences

### Key point

This case illustrates how to adjust for differences concerning comparable transactions.

### Preconditions



### (Summary of business of corporation and foreign-related party)

Japanese corporation P is a distributor of product A, and 10 years previously it established corporation S in country X as a subsidiary to distribute product A.

### (Summary of foreign-related transaction)

Company P sells product A to company S, which then sells its purchases of product A to approximately 200 third-party retailers in country X.

As company P has sold product A through third-party agent T in country X before company S's establishment, it has two sales channels in country X: through company S, and through company Y.

Company P's transactions with company S and with company T are almost the same in terms of transaction stage, volume, and terms, except in the following respects:

- (1) Whereas the delivery terms for transactions with company S are CIF (price including cost, insurance, and freight), transactions with company T are FOB (free on board).
- (2) Whereas the payment period for transactions with company S is 30 days, it is 90 days for transactions with company T. (The usance\* rate in both cases is 5%.)

(Note) \*Usance rate: rate charged for credit

### Treatment for transfer pricing taxation purposes

Since in this case company P sells product A to company S and also sells an identical product A to unrelated party T and, despite some differences in the delivery terms and other areas, the two transactions are highly comparable, one option is to apply the CUP method after adjusting for the differences.

Although differences in (1) the delivery terms and (2) the settlement terms are deemed to have an impact on the prices of both transactions, it is possible to adjust for the differences by, in the case of (1), adding freight and insurance premiums to the transaction price with company T (company T purchase price + freight + insurance premiums), and, in the case of (2), recalculating the interest component of the transaction price for transactions with company T to match the terms for company S (company T purchase price  $\div$   $\{1 + 0.05 \times (90 \text{ days} / 365 \text{ days})\} \times \{1 + 0.05 \times (30 \text{ days} / 365 \text{ days})\}$ ).

In this case, the consideration for the sale of product A by company P to company T after adjusting for this difference is the arm's length price.

### Explanation

1. As with the above case, differences may arise in, for instance, the price or profit margin due to differences between a foreign-related transaction and uncontrolled transactions selected as potential comparable transactions for applying the traditional transaction methods, the comparable PS method and the TNMM (including methods equivalent to the traditional transaction methods, the comparable PS method and the TNMM). However, these transactions may still be used as the comparable transactions for calculating the arm's length price provided that adjustments can be made for these differences (Item 1 of Article 66-4(2) of the ASMT, from Paragraph 6 to 8 inclusive of Article 39-12 of the Cabinet Order of the ASMT, and ASMT Directive 66-4(3)-1).

As differences are adjusted for in order to ensure that the uncontrolled transactions chosen as potential comparable transactions can serve as reasonable comparable transactions, the differences to be adjusted for shall be those that "objectively clearly affect" the amount of consideration (see the second paragraph of Administrative Guidelines 3-3), and do not include everything that could potentially give rise to "differences in the amount of consideration."

(Reference) See the decision of the Takamatsu High Court, October 13, 2006, and finally adjudicated by the Supreme Court on April 10, 2007 (dismissal of final appeal).

It shall be noted if the impact of differences between a foreign-related transaction and comparable transactions on the price or profit margin cannot be disregarded, and the concrete value of the impact due to such differences cannot be calculated, then the comparability of the transactions itself is problematic.

2. Regarding the adjustment method of difference, Administrative Guidelines 3-3 provides for four examples: In addition to the above, in the case where difference exists between the level of working capital related to the foreign-related transaction and the level of working capital related to the comparable transaction, there are examples of adjustment of difference of ratios (profit level

indicators) provided for in Article 39-12(8) 2 to 5 of the Cabinet Order for Enforcement of the ASMT (hereinafter referred to as “adjustment of difference related to working capital”).

Working capital, in general, refers to liquid capital which is invested for ordinary application of enterprise and recovered in a short period of time. It increases and decreases with the balance of accounts receivable and accounts payable, and the level of the inventories held. The size of this liquid capital affects the cash management and the scale of investment with surplus funds. In the case where a possibility of resulting in affecting the calculation of profit level indicators is recognized, adjustment of such difference may lead to an appropriate result.

However, in many cases, whether the difference related to the working capital will affect the calculation of profit level indicators is not necessarily clear. Therefore, such adjustment shall not be constantly done in an automatic manner, but the effect of the different shall be fully considered.

The account titles which are considered in the adjustment of difference related to working capitals includes, for example, accounts receivable, accounts payable, and inventories. In the case where the level of these titles differ between the foreign-related transaction and the uncontrolled transaction, the difference of levels shall be measured with the ratio shown by appropriate standards (for example, working capital related to foreign-related transaction / (divided by) sales of the tested party – (minus) working capital associated with transaction between unrelated parties / (divided by) sales of the unrelated party). Then, this ratio is multiplied with appropriate investment yield such as market rates, and added to, or deducted from the profit level indicators, to be adopted as adjustment method.

## Section 2. Cases illustrating points to note concerning application of method of calculation of arm's length price

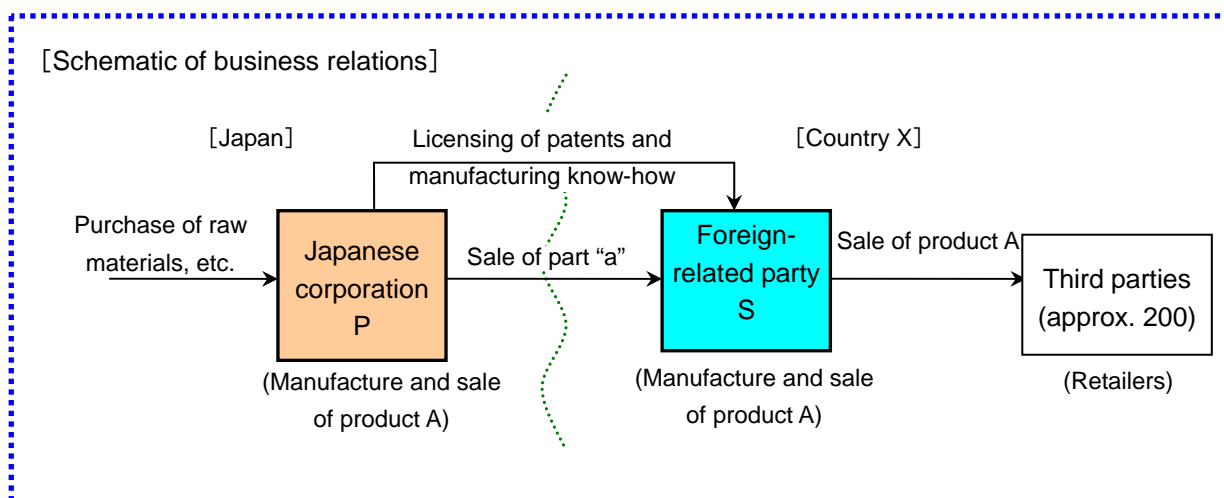
### (1) Cases illustrating treatment of intangible properties

#### Case 10: Intangible properties created by R&D and marketing activities

##### Key points

This case illustrates the treatment of intangible properties created by R&D activities and by sales and marketing activities.

##### Preconditions



##### (Summary of business of corporation and foreign-related party)

Japanese corporation P is a manufacturer and distributor of product A, and 10 years previously it established company S in country X as a subsidiary to manufacture and distribute product A.

Product A is made using unique technologies resulting from company P's R&D activities.

##### (Summary of foreign-related transactions)

Company P both sells part "a" (a core part that aggregates company P's unique technologies) for product A to company S, and also licenses to company S patents and manufacturing know-how (unique technologies created as a result of company P's R&D activities) for manufacturing product A. The licensing contract provides for the provision of technical assistance to company S.

Company S combines part "a" with other parts to manufacture product A, which it then sells to approximately 200 third-party retailers in country X.

##### (Functions and activities of corporation and foreign-related party)

Company P has created an efficient manufacturing process founded on the manufacturing know-how that it has built up through its R&D activities to date. With the benefit of company P's technical assistance, which covers the entire spectrum of manufacturing processes, including company S's plant layout, company S uses the same efficient manufacturing method and achieves a similarly low cost of manufacture as company P.



Large-scale global advertising planned by company P is undertaken to promote the company's corporate image, and its corporate name and logo are widely known in many countries. Large-scale global advertising activities planned by company P are also pursued to advertise product A in the media, including television, magazines and the Internet, and product A enjoys strong recognition in country X as well.

Company S has no R&D operations, and the manufacture of product A by company S is based on technologies originating from and furnished by company P.

On the other hand, company S has numerous sales representatives, engages in a variety of sales promotion activities targeted at retailers and end consumers, has a considerable number of client retailers, and has formed a well-developed retail store network.

Product A has acquired a certain market share in country X thanks to its unique technical performance, and its strong product recognition and well-developed retail store network built up through advertising and sales promotion activities, and it sells for a largely stable price.

#### Treatment for transfer pricing taxation purposes

The following forms of intangible properties were found to be involved in the foreign-related transactions in this case: (1) unique technologies and manufacturing know-how possessed by company P; (2) strong product recognition (brand or trademark); and (3) a well-developed retail store network.

These intangible properties were found to be created as a result of company P's R&D activities, large-scale advertising activities planned by company P, and company S's sales promotion activities.

Product A has secured a certain market share through its unique technical performance, strong product recognition, and well-developed retail store network, and is sold at a stable price, while cost-wise, company S has achieved a low cost of manufacture by employing efficient manufacturing methods based on company P's manufacturing know-how. Company P and company S are therefore regarded as engaging in unique R&D, advertising, and sales promotion activities differing from those of a corporation engaging solely in routine activities.

Compared with a corporation engaging solely in routine activities, therefore, intangible properties (1) to (3) were found to serve as a source of income in company P and company S's foreign-related transactions.

(Note) It shall be noted that Cases 10 through 15 in Section 2 are intended to illustrate the treatment of intangible properties, and do not extend to describing the preconditions necessary for selecting a specific method of calculation of the arm's length price.

#### Explanation

1. When considering the level of profit of the corporation or foreign-related party, it is necessary to consider from what the profit arises, and in particular whether it arises from the intangible properties of the corporation or foreign-related party.

Intangible properties are defined for transfer pricing purposes as "copyrights, industrial properties prescribed by Basic Directive 20-1-21, and other things having material value, such as customer lists and sales networks" (ASMT Directive 66-4(3)-3 Note1). However, proper consideration must be given

to the content of foreign-related transactions, the activities and functions of corporations and foreign-related parties, market conditions, and so forth when judging whether something has “material value” as an intangible property.

When conducting examinations, therefore, a wide range of factors, including the following sources of income that could have material value, need to be examined and comprehensive consideration given to whether these intangible properties are involved in foreign-related transactions, and whether they are sources of income (see first clause of Administrative Guidelines 2-11).

- (1) Patents, trade secrets, and so forth created as a result of technical innovation
- (2) Know-how created through the experience of employees and other human resources in management, front-end operations, production, R&D, sales promotion, and other business activities
- (3) Production processes, negotiation procedures, and trading networks relating to development, sales, financing, and similar activities

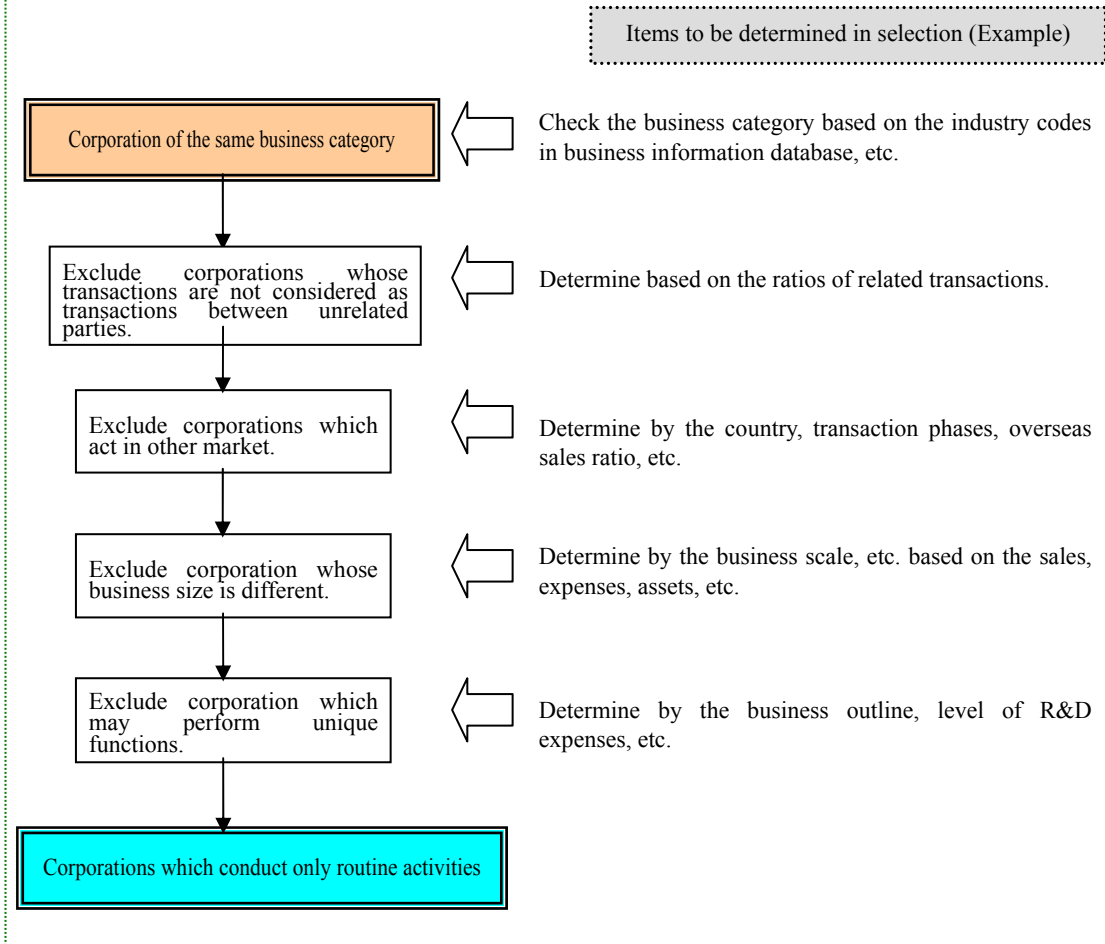
(1) may be categorized as intangible properties relating to technical innovation, (2) as intangible properties relating to human resources, and (3) as intangible properties relating to organizations.

(Note) Owing to the complexity and diversity of transactions involving intangible properties, the first clause of Administrative Guidelines 2-11 categorizes intangible properties according to their form in order to examine from various perspectives the relationship between intangible properties and the profit derived by a corporation. It does not provide new definitions of intangible properties.

When considering whether the intangible properties of a corporation or foreign-related party serve as a source of income, if it is possible to identify a corporation engaging solely in routine activities from among other corporations of a similar size doing business in the same category of business as the foreign-related transaction, and active in a similar market, it is necessary to do the following: Compare the level of factors such as the profit margin of the foreign-related transaction of the corporation or foreign-related party with that of a corporation engaging solely in routine activities, and also to fully analyze the activities and functions involved in the creation of intangible properties of the corporation or foreign-related party (such as activities and functions relating to R&D and advertising in the present case) (see the second clause of Administrative Guidelines 2-11).

Corporations engaging solely in routine activities are identified following the figure for procedure. However, as the information thus obtainable is one factor for determining whether there exist intangible properties serving as a source of income, rigorous comparability is not necessarily required for selecting such corporations.

[Figure: Example of Procedure for Selection of Corporation which Conducts only Routine Activities]



2. If it is thus found that the intangible properties of the corporation and the foreign-related party serve as a source of income compared with in the cases of a corporation engaging solely in routine activities, the residual PS method is considered to be applied.

In the residual PS method, at the first phase, routine profits out of the profits to be split shall be allocated to the relevant corporation and the foreign-related party, respectively. At the second phase, the residual profits, which is the difference between the relevant profits to be split and the sum of the relevant allocated routine profits shall be allocated in accordance with the factors suitable for estimation of the extent of contribution to the generation thereof.

As well as advertising activities, almost all enterprises engage in some kind of action or effort to, for instance, reduce costs, and thus it shall be noted that it is not possible to immediately judge that material intangible properties must serve as a source of income simply on the basis of such action or effort, compared with corporations that engage solely in routine activities.

(Reference)

The definitions of intangible properties for transfer pricing taxation purposes in ASMT Directive 66-4(3)-3 Note 1 are synonymous with the details of intangible properties described in Chapter 6 of the OECD Transfer Pricing Guidelines (published in 1996), shown in the following table.

In addition, they do not diverge greatly from the definitions given in §1.482-4(b) of the U.S. Treasury Regulations.

Comparison of definitions of intangible properties

ASMT Directive (Interpretation of Law Directive) 66-4(3)-3 Note 1	OECD Transfer Pricing Guidelines	U.S. Treasury Regulations §1.482-4(b)
<ul style="list-style-type: none"> <li>• Copyrights</li> <li>• Patents, utility models, designs, trademarks</li> <li>• Patent, utility model, design, and trademark licenses, etc.</li> <li>• Creations that are repeatedly usable in production or other operations (production-related systems employing unique ideas or methods, secrets, and other knowledge and designs, etc. having special technical value, including know-how, production systems embodied in the plans or drawings of machinery and facilities, and designs)</li> <li>• Customer lists, distribution channels</li> <li>• Other things having material value</li> </ul>	<p>(Paragraph 6.2)</p> <ul style="list-style-type: none"> <li>• Patents, trademarks, trade names, designs, models</li> <li>• Literary and artistic property rights, know-how, trade secrets</li> </ul> <p>(Paragraph 6.3)</p> <ul style="list-style-type: none"> <li>• Computer software</li> </ul> <p>(Paragraph 6.4)</p> <ul style="list-style-type: none"> <li>• marketing intangibles(trademarks, trade names, customer lists, distribution channels, and unique names, symbols or pictures that have an important promotional value)</li> </ul> <p>(Paragraph 6.5)</p> <ul style="list-style-type: none"> <li>• Know-how and trade secrets are proprietary information or knowledge that assists or improves a commercial activity.</li> <li>• Know-how is represents what a manufacturer cannot know from mere examination of the product and mere knowledge of the progress of technique.</li> <li>• Know-how may include secret process or formulae or other secret information concerning industrial, commercial or scientific experience that is not covered by patent.</li> </ul>	<p>an intangible is an asset that comprises any of the following items and has substantial value independent of the services of any individual:</p> <ul style="list-style-type: none"> <li>• Patents, inventions, formulae, processes, designs, or patterns, know-how</li> <li>• Copyrights and literary, musical, or artistic compositions</li> <li>• Trademarks, trade names, or brand names</li> <li>• Franchises, licenses, or contracts</li> <li>• Methods, programs, systems, procedures, campaigns, surveys, studies, forecasts, estimates, customer lists, or technical data</li> <li>• Other similar items ( an item is considered similar to those listed above if it derives its value not from its physical attributes but from its intellectual content or other intangible properties).</li> </ul>

(Note) The above table does not quote directly from the respective sources, and is intended simply to

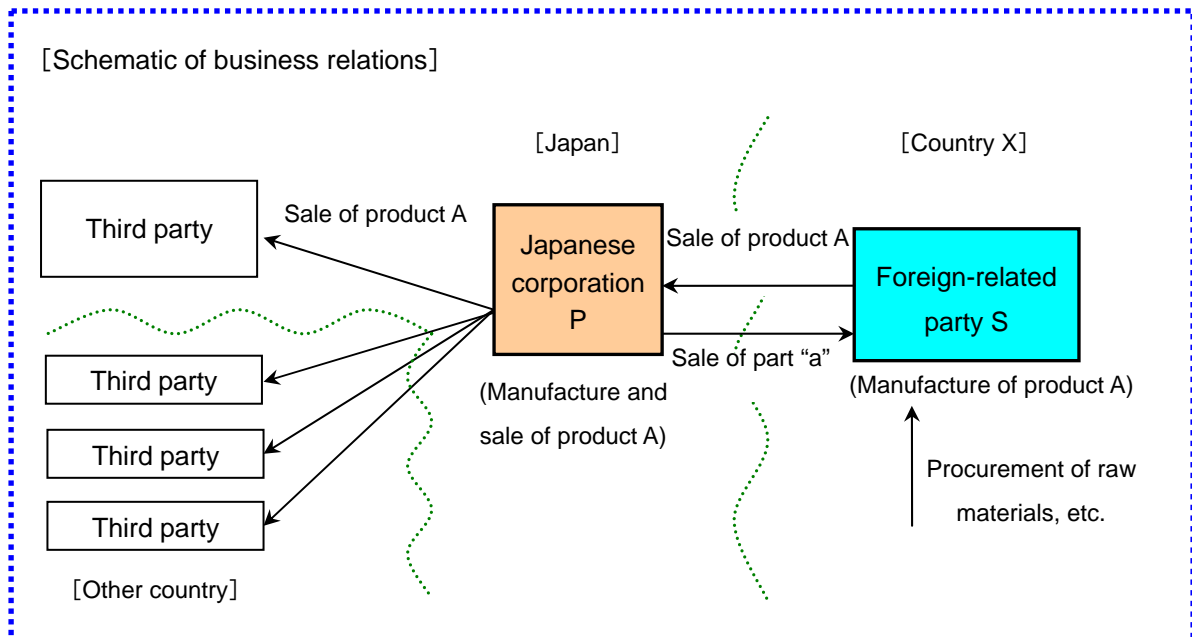
provide a simple side-by-side comparison for the definitions of intangible properties .

## Case 11: Intangible properties relating to distribution channels and quality control know-how

### Key point

This case illustrates the treatment of global distribution channels and original quality control know-how.

### Preconditions



### (Summary of business of corporation and foreign-related party)

Japanese corporation P is a manufacturer and distributor of product A, and 20 years previously it established company S in country X as a subsidiary to manufacture product A.

### (Summary of foreign-related transactions)

Company P sells part "a" for product A to company S, and S procures raw materials and other supplies in country X to manufacture product A, which it then sells entirely to company P. Company P sells its purchases of product A from company S in Japan and throughout the world.

As production of product A consists of typical process industry operations, fixed costs account for a large proportion of the cost of manufacture and thus scale merit can be realized.

### (Functions and activities of corporation)

Company P was quick to establish operations overseas. It has established sales branches in countries around the world following detailed market research to identify the most promising markets, and it also does business through agents in countries where it does not have its own marketing operations. Its global distribution channels, which is more broadly developed than that of corporations engaging solely in routine activities, have given company P's business group a large global market share.

In order to further expand its distribution channels into new countries, its marketing and sales promotion division leads development of business strategy suited to market needs in each country.

**(Functions and activities of foreign-related party)**

Company S has a separate quality control division from its manufacturing division, and over 10% of its workforce is engaged in checking products and inspecting production lines in order to maintain quality of product A.

Company S's quality control division has accumulated know-how on dealing with and solving the quality problems that have arisen in the course of its 20 years of manufacturing experience. Using its developed unique inspection techniques and testing equipment, it checks quality and production lines at each of the key stages of production, and any problems that do occur during manufacturing are immediately rectified based on such know-how.

This unique quality control setup dramatically increases inspection efficiency, and also reduces the cost of manufacture by reducing spoilage at company S and reduces product complaints from end users concerning product A, which has consequently acquired a reputation for reliability. As a result, a superior sales position has been achieved.

**Treatment for transfer pricing taxation purposes**

Regarding the foreign-related transaction in this case, it was found that the attainment of high sales through the global distribution channels created by company P (resulting in higher profits as sales increase due to the high proportion of fixed costs in the cost of manufacture) and the establishment of a superior sales position (as a result of reduced loss due to spoilage in the cost of manufacture and the lower incidence of faults due to company S's original quality control know-how) served as a source of income in company P and company S's foreign-related transactions compared with in the cases of a corporation engaging solely in routine activities.

**Explanation**

Regarding the transfer pricing taxation treatment of intangible properties, see the "Explanation" to Case 10.

Corporations ordinarily have some kind of distribution channels (even those engaging solely in routine activities), and also engage in some form of quality control in manufacturing, and so the existence of distribution channels and engagement in quality control cannot be immediately deemed to serve as a source of income in a foreign-related transaction compared with in the cases of a corporation engaging solely in routine activities. However, they may serve as a source of income in a foreign-related transaction if the distribution channels are broader and unique or quality control know-how is more unique than with corporations engaging solely in routine activities.

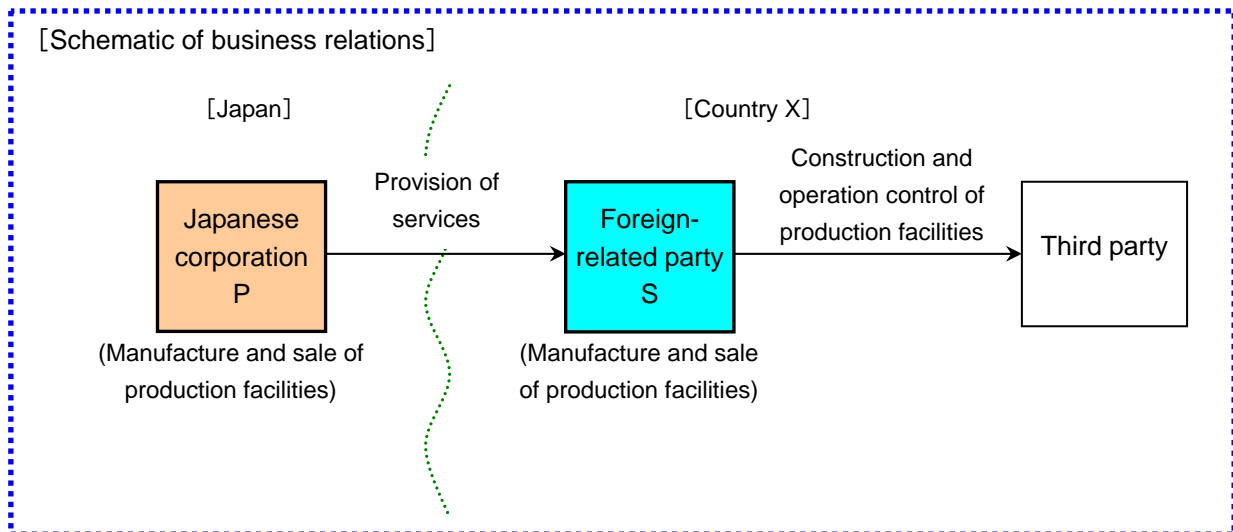


## Case 12: Intangible properties such as know-how accumulated by enterprises through human resources' business activities

### Key point

This case illustrates the treatment of intangible properties such as know-how accumulated by enterprises through the business activities of employees and other human resources.

### Preconditions



### (Summary of business of corporation and foreign-related party)

Japanese corporation P is a manufacturer and distributor of production facilities, and since its establishment it has engaged in the planning, design, procurement, structure, and maintenance of various kinds of production equipment in Japan and around the world. 10 years previously, it established company S in country X as a subsidiary to enter contracts for and implement construction facilities in country X, and, with company P's support, company S won an order for a large-scale production facility. Company S's business has steadily grown, and it now operates and maintains this facility, which was completed five years ago, under contract.

### (Summary of foreign-related transaction)

Company P provides services to company S such as management guidance.

### (Functions and activities of corporation and foreign-related party)

#### (1) Functions and activities regarding information gathering and receipt of orders

Company P has information gathering operations, including branches and offices, all over the world, allowing it to gather and accumulate information for planning the construction of production facilities around the world. These enabled it to learn of plans for construction of a large-scale production facility in country X ahead of other companies. Its overseas sales representatives have also developed good relations with clients and know-how on sales negotiations and analysis of project profitability through the company's production and sale of production facilities to date.

Company S makes maximum use of company P's advantages and know-how, and, working in collaboration with staff involved in design, equipment procurement, and construction at company P, ultimately won an order after intensive negotiations with a client in country X.

(2) Functions and activities relating to construction, operation control of production facilities

Use is made of original know-how and trading networks developed to date by company P's staff in various departments in regard to the production and sale of production facilities in making decisions on the design of production facilities, selection and procurement of equipment, formulation of construction plans, selection of construction contractors, construction management, and so forth. Company P has also assisted company S with operation control and maintenance since the completion of facilities, using know-how accumulated by company P through its experience to date in providing after-sales service.

(3) Details of business decisions, etc. made by company P with respect to company S

Company S communicates with staff at company P involved in overseas business, design, equipment procurement, construction, and operation control, and takes orders from clients after obtaining company P's advice. It also receives necessary instructions, responds to inquiries, and obtains materials from company P regarding construction work.

#### Treatment for transfer pricing taxation purposes

Company P provides company S with services relating to information gathering and sales negotiations for construction of major production facilities by company S in country X, and business decisions and risk management concerning the design, construction, and operation control of such facilities, and it was found that these services affect company S's business profitability and that company S depends on them in order to do business independently.

In engaging in business related to large-scale production facilities in country X, the company has the business judgment and risk management know-how (regarding the production facility business) acquired to date by employees in the course of company P's production and sale of production facilities around the world, along with company P's information network, negotiating procedures, and trading network (for receipt of orders, placement of orders for equipment, construction, and control, etc.). These strengths are furnished as an integrated whole in conjunction with the above services to enable company S's pursuit of the above project.

In light of the above, it was found that the know-how developed by company P's employees from past business experience, company P's information network, negotiation procedures, trading network, and so forth serve as a source of income in company S's foreign-related transaction.

#### Explanation

1. In the cases of service provision transactions, consideration for use of intangible properties needs to be taken into account if use is made of intangible properties in the provision of services (see main clause of Administrative Guidelines 2-8(1)).

If, as in the present case, an investigation is made into whether use is made of intangible properties in the provision of services, such as when know-how, etc. accumulated by an enterprise through its

employees' business activities are furnished as an integral part of the provision of services or services are provided through or using the trading network, negotiation procedures, etc. created in an organization, certain points shall be noted: That the provision of services and use of intangible properties are conceptually distinct, and that consideration shall be given to what kind of intangible properties are used by the service provider when services are provided, and what impact the provision of such services has on the activities and functions of the corporation receiving the services (see Administrative Guidelines 2-8(1) Note).

When investigating transactions involving intangible properties, wide-ranging consideration shall also be given to intangible properties' contribution to income (Administrative Guidelines 2-11).

(Reference) Administrative Guidelines 2-11 (extract)

When determining, in examinations, how intangible properties contribute to the income of the corporation or foreign-related parties, properties such as the following that have material value and serve as a source of income shall be comprehensively considered:

- (a) Patents and trade secrets derived from technical innovation.
- (b) Know-how derived from experience by employees and other human resources through business activities such as management, front-office operations, production, research and development, and sales promotion.
- (c) Production process, negotiation procedures and development, distribution, and financing networks.

(Note) Regarding the relationship between provision of services and intangible properties in cases where intangible properties are used when providing services, 2-8(1) Note shall be noted.

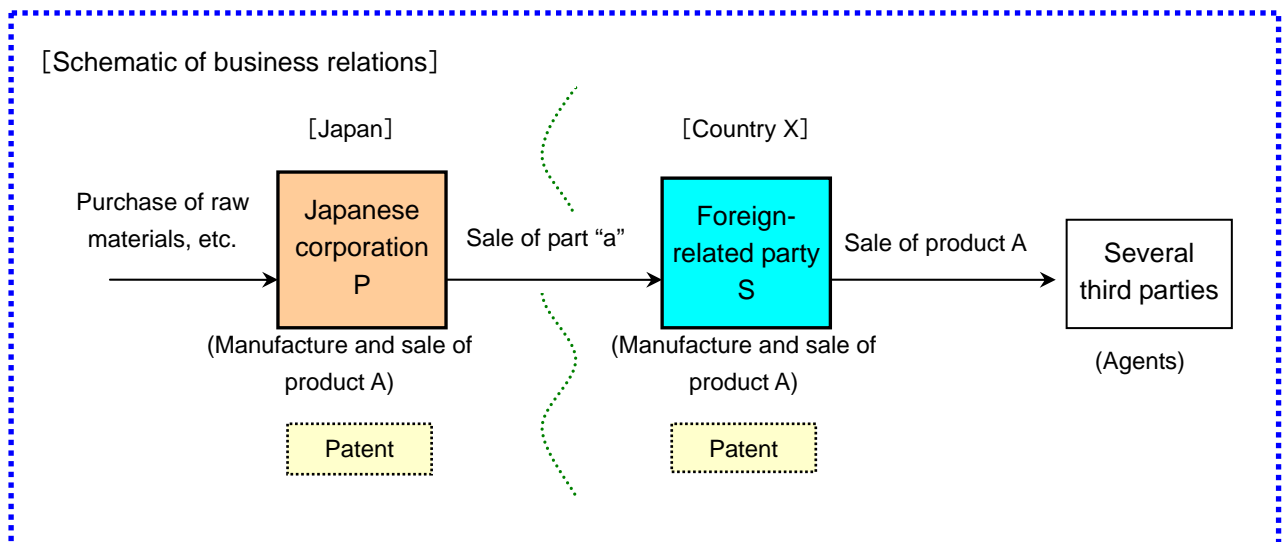
2. If it is thus found that if the know-how accumulated by a corporation through its employees' business activities is furnished organizationally by a corporation to a foreign-related party, functions as a material element in the foreign-related party's business activities, and serves as a source of income in the foreign-related transaction compared with in the cases of a corporation that engages solely in routine activities, it is regarded as a material intangible property.

### Case 13: Contribution to creation, maintenance, and development of intangible properties

#### Key point

This case illustrates the extent of the contribution of a corporation and a foreign-related party to the creation, maintenance, and development of intangible properties.

#### Preconditions



#### (Summary of business of corporation and foreign-related party)

Japanese corporation P is a manufacturer and distributor of product A, and 10 years previously it established company S in country X as a subsidiary to manufacture and distribute product A.

Product A is made using original technologies resulting from R&D activities led by company P.

#### (Summary of foreign-related transaction)

Company P sells part “a” (a core part that aggregates company P’s original technologies) for product A to company S. Company S combines part “a” with other parts to produce product A, which it sells to several third-party agents in country X.

#### (Functions and activities of corporation and foreign-related party)

Development of product A was undertaken mostly by company P’s R&D division. However, company S also has a product development division with around 10 researchers, and some of the development work was undertaken by this division. Company P and company S have continued to pursue R&D since the product’s launch so as to improve performance.

At company P and company S, formulation of R&D strategy in R&D, allocation of specific fields of responsibility, management of progress on R&D, decisions on continuation (or discontinuation), and assessment of researchers’ performance are undertaken entirely under the supervision of company P’s R&D managers, and company S’s product development operations are supervised by R&D staff at company P.

Product A has seen sales increase due to its unique technical performance, and it has achieved a certain

market share in country X, where it sells for a largely stable price.

**(Acquisition of patents)**

Product A aggregates original technologies resulting from R&D at company P and company S. These are patented in company P's name in Japan, and company S's name in country X.

**Treatment for transfer pricing taxation purposes**

In this case, the patents are the result of R&D undertaken by both company P and company S, and, compared with in the cases of a corporation engaging solely in routine activities, the product A's resulting unique technical performance is found to be a source of income in company P's and company S's foreign-related transactions.

Although in the present case the patents for product A were registered in both company P's and company S's names, differences in the extent of the contribution of the two in the activities involved in their creation, maintenance, and development exist; company P undertook the greater part of R&D activity, decision-making on development, and risk management, and company S performed only some of the R&D work.

Accordingly, it is considered appropriate to take into account the extent of the contribution to the income focusing on these activities and functions to create, maintain and develop patents for product A undertaken by company P and company S (Administrative Guidelines 2-12).

**Explanation**

Regarding the transfer pricing taxation treatment of intangible properties, see the "Explanation" to Case 10.

As there are cases where the legal owner of intangible properties and the parties contributing to their creation, maintenance, and development are not necessarily the same, there is a need to consider not only the legal ownership of the intangible properties, but also the extent of contribution to their creation, maintenance, and development when considering the extent of contribution to the income from intangible properties.

It is also necessary to take into overall account the functions and so forth performed by the corporation or foreign-related party in decision-making and risk management in R&D, as well as the actual provision of services and burden of costs (Administrative Guidelines 2-12)

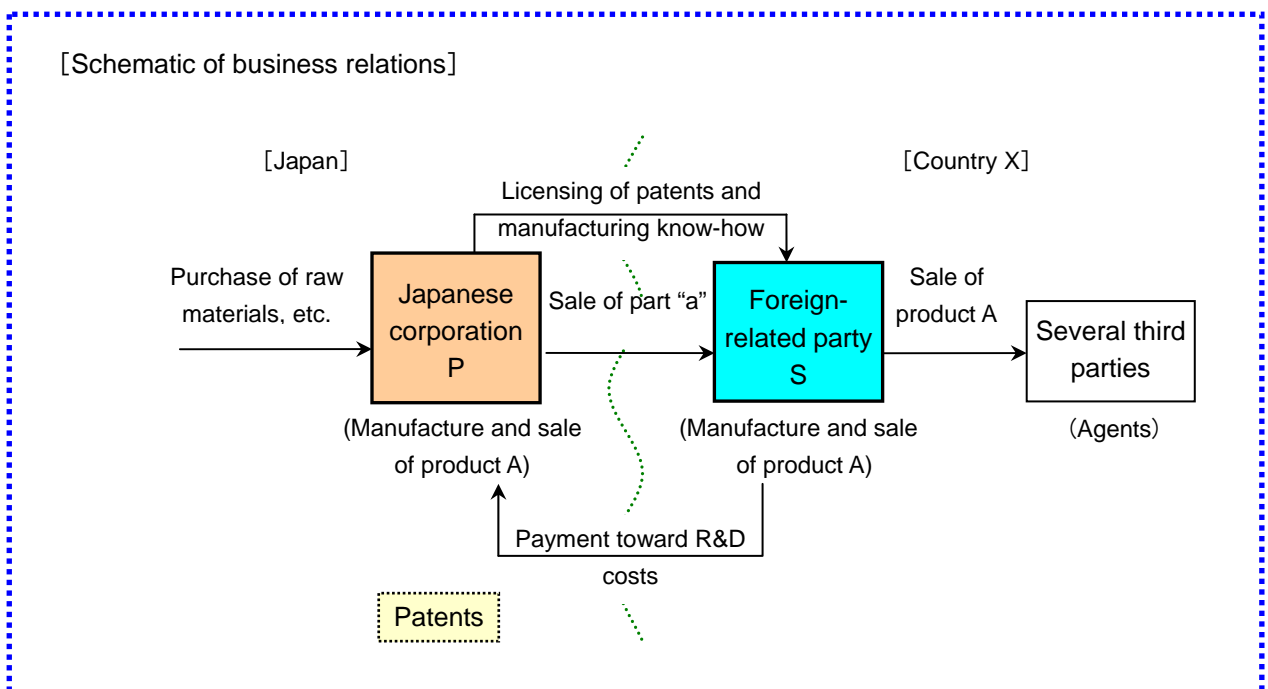
("Decision-making" refers to judgmental and decision-making elements including the formulation and direction of concrete development strategy and preparatory work, such as information gathering, for decision-making. "Risk management" consists of the comprehensive identification of risks inherent in activities such as the creation of intangible properties, and the management of these risks in an integrated fashion through overall and continued control of progress.)

## Case 14: Treatment in the case that a company only bears the cost of creation of intangible properties

### Key points

This case illustrates the relationship between the burden of costs and the contribution to creation, maintenance, and development of intangible properties in the case that a foreign-related party bears a portion of the cost of R&D by a corporation.

### Preconditions



### (Summary of business of corporation and foreign-related party)

Japanese corporation P is a manufacturer and distributor of product A, and 10 years previously it established company S in country X as a subsidiary to manufacture and distribute product A. Product A is made using original technologies resulting from company P's R&D activities.

### (Summary of foreign-related transaction)

Company P sells part "a" (a core part that aggregates company P's original technologies) for product A to company S, and also licenses patents and manufacturing know-how (original technologies resulting from R&D by company P) to company S for the production of product A.

Company S combines part "a" with other parts to manufacture product A, which it sells to several third-party agents in country X.

### (Functions and activities of corporation and foreign-related party)

Product A, which is an outcome of company P's R&D activities, has seen sales increase due to its unique technical performance, and it has secured a certain market share in country X, where it sells for a largely stable price.

Product A is produced by company S based on original technologies originating from and provided by company P.

Company S has no R&D operations and does not engage in R&D activity. However, it does bear part of the cost of R&D undertaken by company P to raise the quality of product A and improve the production line. However, decisions on R&D strategy and risk management are undertaken entirely by company P without company S's involvement. Patents resulting from R&D are also all registered by company P, and company S has no patents.

#### Treatment for transfer pricing taxation purposes

Product A is made using original technologies resulting from company P's R&D activities, and, compared with in the cases of a corporation engaging solely in routine activities, its original technical performance was found to serve as a source of income in the company P and company S's foreign-related transaction.

In this case, although company S bears part of the cost of R&D to raise the quality of product A (which is produced using previously created original technologies) and to improve the production line, it has no divisions involved in R&D and plays no role in the R&D.

Thus while company P's R&D activities contribute to the creation, maintenance, and development of intangible properties, company S's contribution to the creation, maintenance, and development of these assets is found to be low.

#### Explanation

Regarding the transfer pricing taxation treatment of intangible properties, see the "Explanation" to Case 10.

When considering the extent of the contribution to the creation, maintenance, and development of intangible properties, it is necessary to take account of the roles played and functions performed in decision-making, service provision, funding of costs, and risk control toward the creation, maintenance, and development of the intangible properties (Administrative Guidelines 2-12).

In this case, as the parties involved in R&D activity and the parties bearing the cost do not coincide, it is not possible to simply treat the cost borne by company S as its contribution to the creation, maintenance, and development of intangible properties. If only the bearing of the cost of creation, maintenance, and development of intangible properties that are highly likely to serve as a source of income is considered, the level of contribution is low (Administrative Guidelines 2-12).

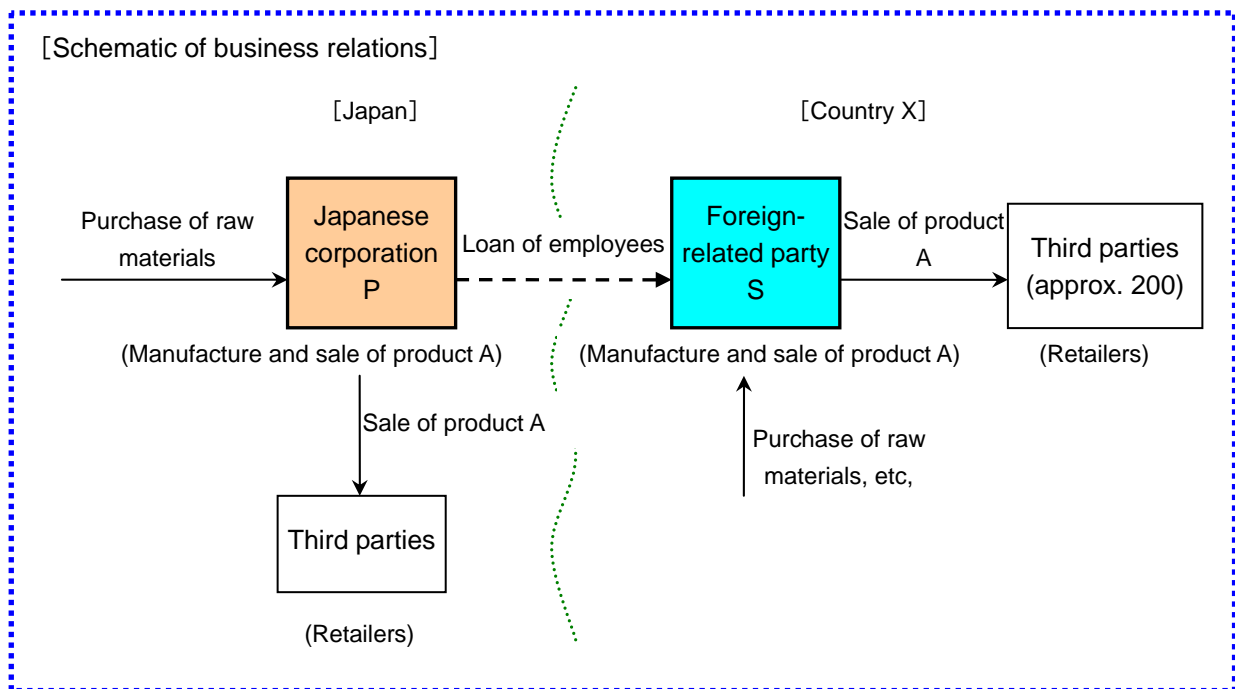
It shall be noted that even if in this case it was found to be appropriate to apply a method consistent with the residual PS method assuming company S to have separate material intangible properties, the simple bearing of costs without performing an R&D function would not constitute a factor for splitting residual profits, and would be taken into consideration in the calculation of routine profit in the same manner as other general expenses. (Regarding the factors for splitting residual profits, see Case 22.)

## Case 15: Intangible properties of a corporation used by employees on loan

### Key point

This case illustrates the contribution of a corporation in the case that it loans employees to a foreign-related party and its intangible properties are used in business.

### Preconditions



### (Summary of business of corporation and foreign-related party)

Japanese corporation P is a manufacturer and distributor of product A, and 10 years previously it established company S in country X as a subsidiary to manufacture and distribute product A. Product A is made using original technologies resulting from company P's R&D activities.

### (Functions and activities of corporation and foreign-related party)

Although company P used to sell parts for product A to company S, company S presently manufactures product A by sourcing all its raw materials and other supplies locally within country X, and sells product A to approximately 200 retailers in country X. However, supplies of product A for the Japanese market are manufactured and sold by company P itself.

Company P loans 10 employees to company S, five of whom are responsible for production engineering, and five for marketing and sales promotion.

The production engineering loan employees are all employed in fields such as development of production technologies in company P's technology development division, and have advanced knowledge and experience of technology development. They are loaned to company S to provide access to company P's production know-how.

As a result of improvements made to the production line in the production engineering division of



company S under the guidance of employees on loan from company P and employing company P's manufacturing know-how, company S has achieved a low cost of manufacture through more efficient manufacturing.

As well as the five loan employees from company P, company S's production engineering division also employs local employees. These perform only auxiliary work, and do not have a particularly high level of technical knowledge.

Company P's employees loaned to company S's production engineering division communicate frequently with company P by email and fax in the course of their work to request materials from fellow researchers in company P's technology development division and to obtain advice.

The employees on loan who are involved in marketing and sales promotion do not have advanced marketing or sales knowledge, and perform routine work under the direction of local employees in company S's marketing and sales promotion division.

#### Treatment for transfer pricing taxation purposes

As in this case company S is able to engage in more efficient manufacturing and achieve a lower cost of manufacture as a result of guidance received by its employees from production engineers on loan from company P, it was found that company P's manufacturing know-how serves as a source of income in company S's foreign-related transaction compared with in the cases of a corporation engaging solely in routine activities. In this case, it was found that this manufacturing know-how resulted from company P's past activities in developing production technologies, and that this was furnished by company P to company S via the employees on loan.

On the other hand, the loan employees responsible for marketing and sales promotion have yet to acquire advanced ability and knowledge of sales and marketing through their work at company P, and so intangible properties such as marketing know-how created by company P were not found to be furnished to company S.

#### Explanation

Regarding the transfer pricing taxation treatment of intangible properties, see the "Explanation" to Case 10.

If it is found that a parent company loans its own employees to an overseas subsidiary, that intangible properties created, maintained, and developed by the parent company are furnished to a foreign-related party via these employees, and that the intangible properties furnished serve as a source of income in comparison with a corporation engaging solely in routine activities, then the contribution to the creation, maintenance, and development of these intangible properties is on the side of the parent company.

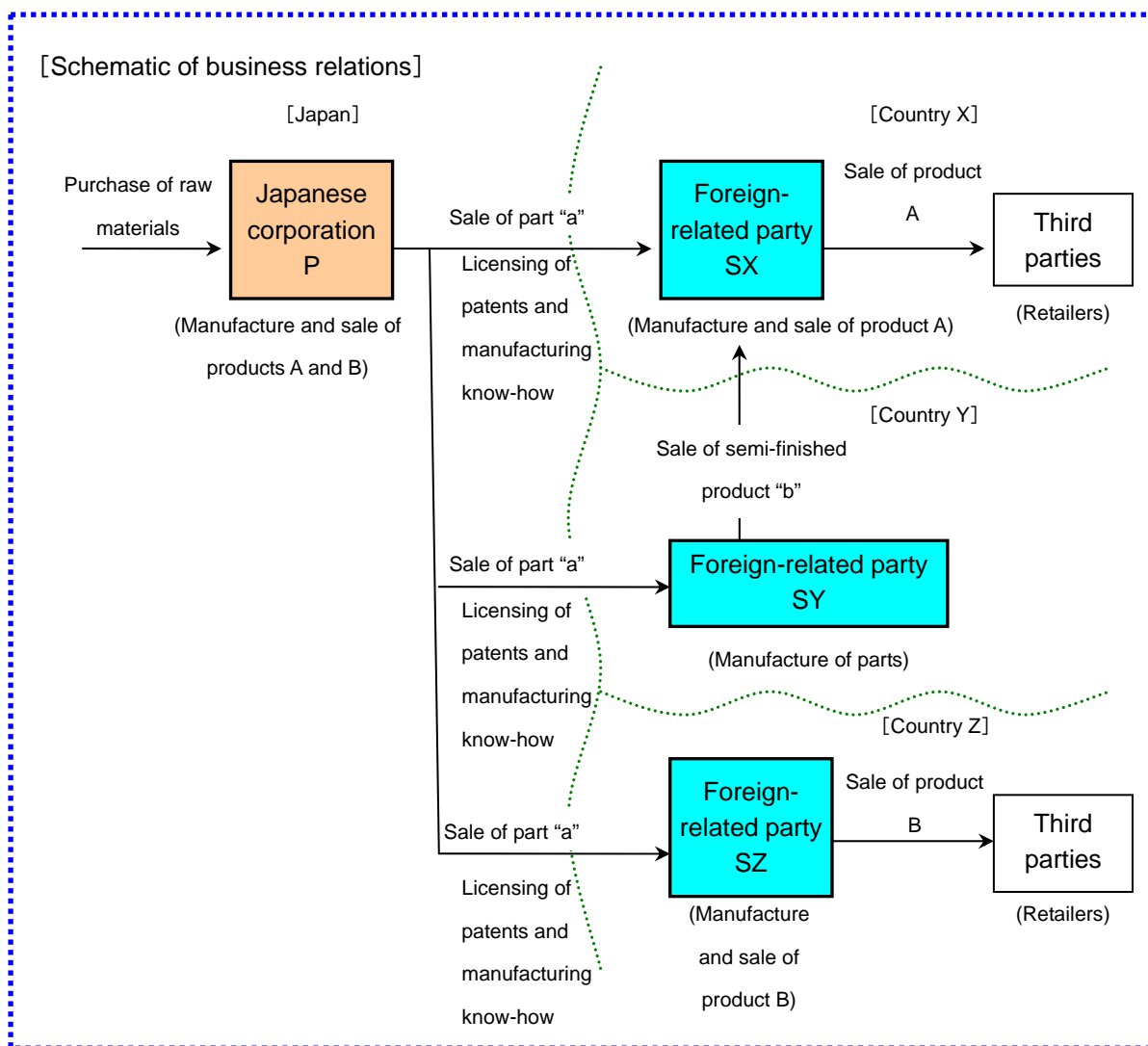
**(2) Cases illustrating general points to note when applying profit split method**

**Case 16: Scope of application of profit split method in a series of foreign-related transactions**

**Key points**

This case illustrates a series of foreign-related transactions situations in which it is found to be appropriate to aggregate multiple foreign-related parties within the scope of application of the profit split method.

**Preconditions**



**(Summary of business of corporation and foreign-related parties)**

Japanese corporation P is a manufacturer and distributor of products A and B. It has a number of subsidiaries: companies SX and SY, which manufacture and distribute product A in country X and country Y respectively, and company SZ, which manufactures and distributes product B in country Z. Product A and product B are manufactured using original technologies resulting from company P's

R&D activities.

**(Summary of foreign-related transactions)**

Company SX in country X purchases part “a” (a core part that aggregates company P’s original technologies), and also manufactures product A using licensed patents and manufacturing know-how (original technologies created as a result of company P’s R&D activities). As it has insufficient production capacity, however, it also purchases semi-finished product “b” from company SY (described below) to process into product A. Company SX sells product A to third-party retailers in country X through its own sales division.

Company SY in country Y similarly purchases part “a” from company P and, using licensed patents and manufacturing know-how, manufactures semi-finished product “b”, which is required to manufacture product A and is sold entirely to related party SX.

Company SZ in country Z similarly purchases part “a” from company P and, using licensed patents and manufacturing know-how, manufactures product B, which it sells to third-party retailers in country Z through its own sales division. (Product B differs from product A in several respects, including shape, use, and sales channel.)

**(Functions and activities of corporation and foreign-related parties)**

Product A and product B have seen sales rise owing to their original technical performance, and have acquired a certain market share in country X and country Z, where they sell for a largely stable price.

Companies SX, SY, and SZ have no R&D operations, and product A, semi-finished product “b”, and product B are manufactured based on technology originating from and furnished by company P.

On the other hand, companies SX and SZ each have numerous sales representatives and actively engage in sales activities, and they also engage in large-scale advertising and sales promotion activities, putting them in a superior sales position compared with corporations engaging solely in routine activities in each of these countries.

Company SY sells its entire output of semi-finished product “b” to company SX, and does not engage in any sales activities.

**Treatment for transfer pricing taxation purposes**

Regarding the sales transaction of parts “a” and licensing of patents, etc. between company P and company SX, as the result of comparability analysis, no comparable transaction was found. However, the following results were obtained from the analysis.

Company P and company SX, compared to a corporation which conducts only routine activities, possess intangible assets which are the source of income associated with foreign-related transaction, and the unique and valuable contribution by company P and company SX is recognized in the relevant foreign-related transaction. Therefore, in this case, it is recognized to be appropriate to apply a method consistent to the residual PS method to the transactions between company P and company SX. (Similarly, no comparable transactions can be found for each transaction between company P and company SY and company SZ.)

It was also considered reasonable to consider the sale of product “a” and licensing of patents and know-how between company P and company SY, and the sale of semi-finished product “b” between

company SY and company SX, as a single unit owing to their constituting a series of foreign-related transactions relating to the manufacture of product A sold by company SX.

Given the above circumstances, it was found to be appropriate to select a method consistent with the residual PS method as the most appropriate method to split profits of company P, company SX, and company SY from transactions between the three companies, and calculate the arm's length price in this case.

When applying a method consistent with the residual PS method here, only routine profit was allocated to company SY, as it was found that company SY did not make unique and valuable contribution.

On the other hand, the sale of part "a" between company P and company SZ and licensing of patents and know-how are transactions involving product B, which, being a different product from product A, makes it necessary to consider the transaction separately from transactions between company P and company SX. As company P's and company SZ's intangible properties were found to be a source of income in the foreign-related transactions between company P and company SZ compared with in the cases of a corporation engaging solely in routine activities, the unique and valuable contribution by company P and company SZ are recognized in the foreign-related transaction, and it was found to be appropriate to select a method consistent with the residual PS method to the transactions between the two companies as the most appropriate method, and calculate the arm's length price.

(Regarding the points to note when selecting the method of calculation of arm's length price and making a comparability study, see the "Explanation" to Case 1.)

### Explanation

Whether a series of transactions (i.e., chain transactions) between multiple foreign-related parties should be included within the scope of application of the PS method when applying this method is determined according to whether, for instance, they constitute a series of transactions involving a single product. If it is found that a series of foreign-related transactions are not conducted at the arm's length price, this will affect the calculation of profits to be split that is arising from foreign-related transactions. As a rule, therefore, it is necessary to consider also related transactions as a whole that are sandwiched between uncontrolled transactions. (For an exception, see Case 17.)

If transactions in a series of foreign-related transactions are all included in the scope of application of the PS method and these include related parties that do not make the unique and valuable contribution, only the routine profit is allocated to these related parties according to the functions performed by them.

### (Reference)

Although calculations of the arm's length price, as a rule, are performed for each individual transaction, it is possible to calculate the arm's length price by treating foreign-related transactions as a single transaction if, for instance, prices are set taking into consideration transactions belonging to the same product group and it is deemed reasonable to calculate the arm's length price for these same units, or if the sale of a part for production and licensing of related manufacturing know-how are

undertaken as a single package and it is deemed reasonable to calculate the arm's length price as a single unit as well (ASMT Directive 66-4(4)-1). This treatment states that multiple foreign-related transactions may be treated as a single transaction unit where it is deemed reasonable from the point of view of calculating the arm's length price.

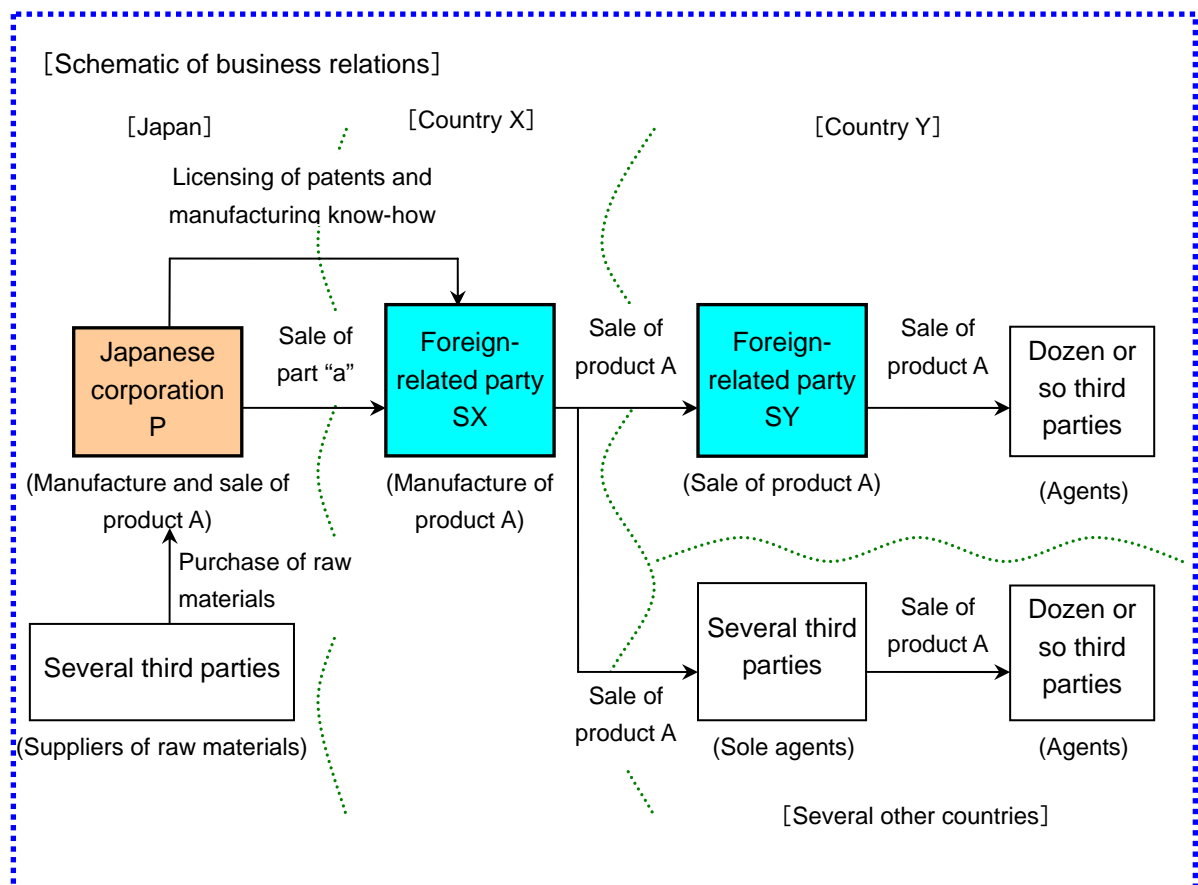
Regarding each of the transaction units that it is judged may reasonably be used as units to calculate the arm's length price in accordance with this treatment, which method of calculation of arm's length price to use is considered as prescribed by law. If, as a result, the profit split method is applied due to the absence of comparable transactions, the scope of application of the profit split method is determined taking note of the above "Explanation."

## Case 17: Transactions that may be excluded from scope of profit split method

### Key point

This case illustrates how a foreign-related transaction found to have occurred at the ordinary transaction price can be excluded from the scope of application of the profit split method where there is a series of foreign-related transactions.

### Preconditions



### (Summary of business of corporation and foreign-related parties)

Japanese corporation P is a manufacturer and distributor of product A, and it has established two subsidiaries: company SX in country X to manufacture product A in country X, and company SY in country Y to distribute product A in country Y.

Product A is made using original technology resulting from R&D activities led by company P.

### (Summary of foreign-related transactions)

Company P sells part "a" (a core part that aggregates company P's original technologies) for product A to company SX, to which it also licenses patents and manufacturing know-how (original technologies created as a result of company P's R&D activities) for the manufacture of product A.

Company SX combines part "a" with other parts to manufacture product A, which it exports to company SY in country Y and also third-party sole agents in several other countries. (This product is

not sold in country X.)

Company SY sells product A, which it imports from company SX as company SX's sole agent, to a dozen or so third-party agents in country Y.

The volume of product A sold by company SX does not differ markedly from that sold to company SY and to the sole agents in the other countries. The selling price is largely set in the same way, and there is no marked difference in the retail price between country Y and the other countries.

**(Functions and activities of corporation and foreign-related parties)**

Product A, which is an outcome of company P's R&D activities, has seen sales increase due to its original technical performance, and it has secured a certain market share in country Y and other countries, where it sells for a largely stable price.

Company SX, too, has a technology development division of around 10 engineers, and performs some of the development for product A and contributes to achieving the original technologies and performance of product A in conjunction with R&D at company P.

Company SX's sales function consists simply of marketing directed at sole agents in each country.

Company SY's sales function is simply that of resale.

**(Profit and loss situation at company SY)**

In the region in which country Y and the several other countries are located, economic levels are comparatively similar.

Company SY and the sole agents in other countries are almost the same in terms of scale and category of business, and their profit margins are also all around 3-4%. This is about the same level (4%) as among other enterprises in the same industry in these countries.

**Treatment for transfer pricing taxation purposes**

As the result of comparability analysis, no comparable transaction was found, but the following results were obtained from the analysis (Regarding the points to note when selecting the method of calculation of arm's length price and making a comparability study, see the "Explanation" to Case 1.)

Compared with a corporation engaging solely in routine activities, company P and company SX were found to have intangible properties serving as a source of income in their foreign-related transactions and to make the unique and valuable contribution in the foreign-related transaction. Regarding transactions between company P and company SX, therefore, it was found to be appropriate to select a method consistent with the residual PS method as the most appropriate method, and calculate the arm's length price. Regarding the treatment of transactions between related parties of company SX and company SY, there were not found to be any problems from the point of transfer pricing taxation owing to:

- (1) Prices being set similarly to transactions engaged in by company SX with unrelated parties (sole agents) in other countries; and
- (2) Company SY's profit level being the same as the industry average, and around the same as that of unrelated parties in other countries in which company SX engages in similar transactions.

It is therefore possible to apply a method consistent with the residual PS method to only company P and company SX, and to exclude transactions between company SX and company SY from the scope

of application of the PS method.

#### Explanation

If, when applying the PS method, a series of foreign-related transactions between related parties does not occur at the arm's length price, this will affect calculation of the profits to be split arising from foreign-related transactions, therefore making it necessary in principle to consider also transactions between the corporation and foreign-related party and between foreign-related parties sandwiched between uncontrolled transactions.

Even in the cases of a series of foreign-related transactions, however, such transactions need not be included within the scope of the profit split method if, for instance, there are not found to be any transfer pricing taxation problems in light of a comparison of average profit levels in the industry or if transactions are of low value and so would have little impact on the calculation of the profits to be split that is arising from the foreign-related transaction. A decision on what to do in such cases is made on the basis of Administrative Guidelines 2-1 and 2-2, and other relevant provisions.

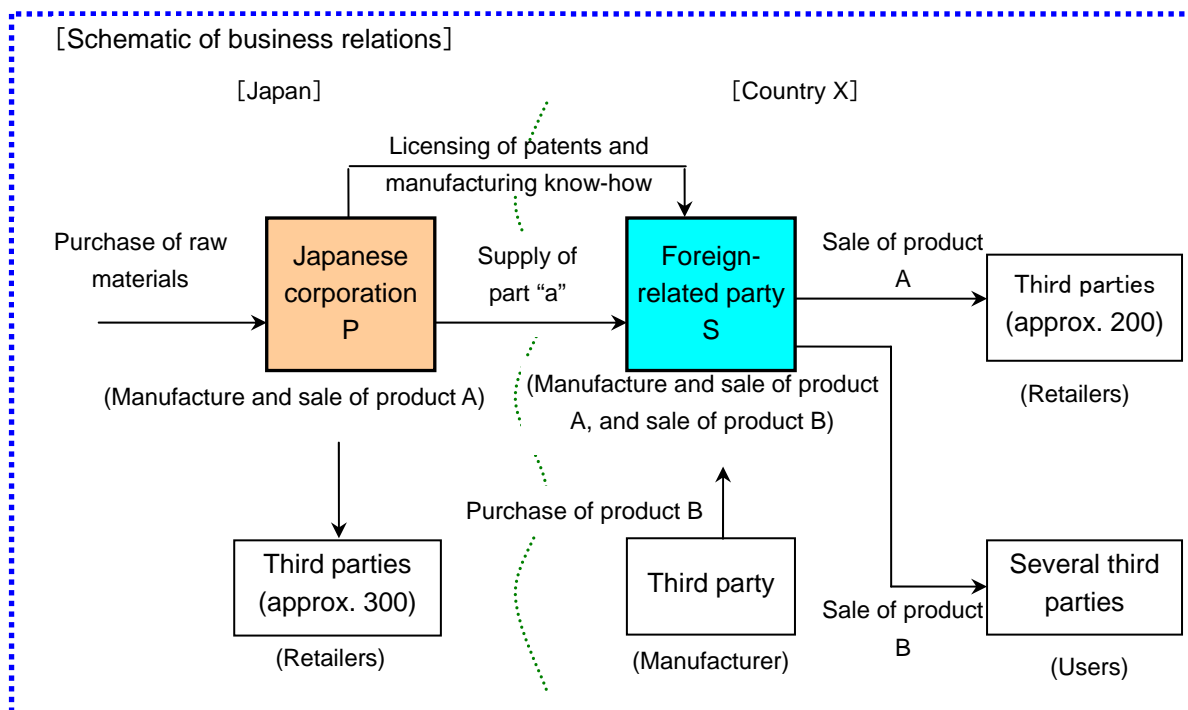


## Case 18: Calculation of profits to be split

### Key points

This case illustrates the calculation of profits to be split when using the profit split method.

### Preconditions



### (Summary of business of corporation and foreign-related party)

Japanese corporation P is a manufacturer and distributor of product A, which it sells in Japan. 10 years previously, it established company S in country X as a subsidiary to manufacture and distribute product A.

In addition to manufacturing and selling product A, company S purchases inventories of product B from a manufacturer in country X, which it sells to users in country X.

Product A is made using original technologies resulting from company P's R&D activities.

### (Summary of foreign-related transactions)

In addition to selling part "a" (a core part that aggregates company P's original technologies) for product A to company S, company P licenses to company S patents and manufacturing know-how (created as a result of company P's R&D activities) for manufacturing product A.

### (Functions and activities of corporation and foreign-related party)

Company S engages in various sales promotion activities employing numerous sales representatives, and also advertises on a large scale in country X.

Product A has secured a certain market share in country X thanks to the unique technical performance of the product itself, along with its strong product recognition and the well-developed retail store network through which it is sold (built up through advertising and sales promotion activities) and thus

it sells for a largely stable price.

**(Other conditions)**

Internally, company P is organized into a production division that manufactures part a and product A, together with an R&D division, a sales division responsible for marketing product A domestically, and a general administration division.

Profit and loss data for company P and company S are as follows:

Company P profit and loss data		Company S profit and loss data	
Sales of product A	200	Sales of product A	110
Sales of part "a"	35	Sales of product B	500
Royalties received	5	<b>Total sales</b>	<b>610</b>
<b>Total sales</b>	<b>240</b>	Purchases of part "a"	35
Cost of sales of product A	95	Other costs of product A	10
Cost of sales of part "a"	25	Purchases of product B	480
<b>Total cost of sales</b>	<b>120</b>	Royalties paid	5
<b>Gross profit on sales</b>	<b>120</b>	<b>Total cost of sales</b>	<b>530</b>
Product A selling expenses	48	<b>Gross profit on sales</b>	<b>80</b>
Part "a" selling expenses	2	Product A selling expenses	15
R&D cost	25	Product B selling expenses	5
Administrative expenses	15	Administrative expenses	10
<b>Total selling and administrative expenses</b>	<b>90</b>	<b>Total selling and administrative expenses</b>	<b>30</b>
<b>Operating profit</b>	<b>30</b>	<b>Operating profit</b>	<b>50</b>

**Treatment for transfer pricing taxation purposes**

As the result of comparability analysis, no comparable transaction was found for any of foreign-related transactions (sales transactions of parts "a" and licensing of patents). The following results were obtained from the analysis. (Regarding the points to note when selecting the method of calculation of arm's length price and making a comparability study, see the "Explanation" to Case 1.) Compared with a corporation engaging solely in routine activities, company P and company S were found to have intangible properties serving as a source of income in foreign-related transactions and to make the unique and valuable contribution in the foreign-related transaction. In the present case, therefore, it was deemed appropriate to select a method consistent with the residual PS method as the most appropriate method, and calculate the arm's length price.

The amount of operating income was therefore calculated by extracting profit and loss on foreign-related transactions from the overall profit and loss of company P and company S respectively, and the profits to be split necessary for application of a method consistent with the residual PS method was calculated as follows:

**(Company P's profit and loss from foreign-related transactions between company P and company S)**

In order to calculate the profit and loss on foreign-related transactions from company P's entire profit and loss, gross profit on sales of company P's manufacturing division was divided into (1) gross profit relating to part "a" destined for company S (sales of part "a" 35 – cost of sales of part "a" 25 = 10) and (2) gross profit relating to product A destined for domestic sale (sales of product A 200 – cost of sales of product A 95 = 105) based on cost accounting data, and so forth.

The expenses of company P's R&D division need to be allocated proportionally to (1) or (2) based on appropriate criteria, excluding expenses that are allocated directly. However, it is not appropriate to use sales of part "a" to company S (35), which is a controlled transaction; rather, it is appropriate to use, for instance, sales of product A to Japan (200) and to country X (110) as criteria.

Regarding operating expenses, it is appropriate that those linked individually to (1) or (2) are first allocated individually (product A selling expenses (48) and part "a" selling expenses (2)), while shared expenses are allocated proportionally on the basis of reasonable criteria, such as company P's cost of sales for part "a" destined for company S (25), and company P's cost of sales for product A destined for the domestic market in Japan (95).

Company P's profit and loss on foreign-related transactions thus work out as follows:

(Sales of part "a"	35)	
– (Part "a" cost of sales	25)	
+ (Royalties received	5)	
– (R&D costs after allocation	9 [=total R&D cost 25 × {110/(110+200)}])	)
– (Part "a" selling expenses	2)	
– (Administrative expenses after allocation	3 [=total administrative expenses	
15 × {25/(25+95)}])		
		= Company P's operating income from foreign-related transactions 1

**(Company S's profit and loss on foreign-related transactions between company P and company S)**

As application of the profit split method to company S's foreign-related transactions requires the calculation of profit and loss of the product A business division, any expenses paid jointly with the product B business division (administrative expenses 10) need to be allocated to the product A business division according to reasonable criteria. Using the ratio of purchases by company S (35+10=45:480) as the criterion for allocation in this case would be inappropriate, as it would include consideration for controlled transactions. It is therefore necessary to use a variable such as the ratio of selling expenses specific to each business division (15:5).

Company S's profit and loss on foreign-related transactions consequently work out as follows:

(Sales of product A	110)	
– (Purchases of part "a"	35)	
– (Other costs of product A	10)	
– (Royalties paid	5)	
– (Product A selling expenses	15)	
– (Administrative expenses after allocation	8 [=total administrative expenses 10 × {15/(15+5)}])	

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=Company S's operating income from foreign-related transactions 37

#### Explanation

When calculating the profits to be split, it is necessary to calculate the expenses linked directly to revenue (cost of sales and some of selling and administrative expenses) broken down as far as possible into individual items, and to calculate indirect expenses (shared expenses) by allocating them proportionately based on what are considered to be the most reasonable criteria based on Administrative Guidelines 3-6. However, items that include consideration in controlled transactions, such as the cost of sales of a subsidiary that purchases from its parent company, and expenses whose proportionate allocation are subject to arbitrary change are considered inappropriate. (It shall be noted that if the accounting categories used for profit and loss by the corporation and foreign-related party differ, as a rule, adjustments need to be made for this.)

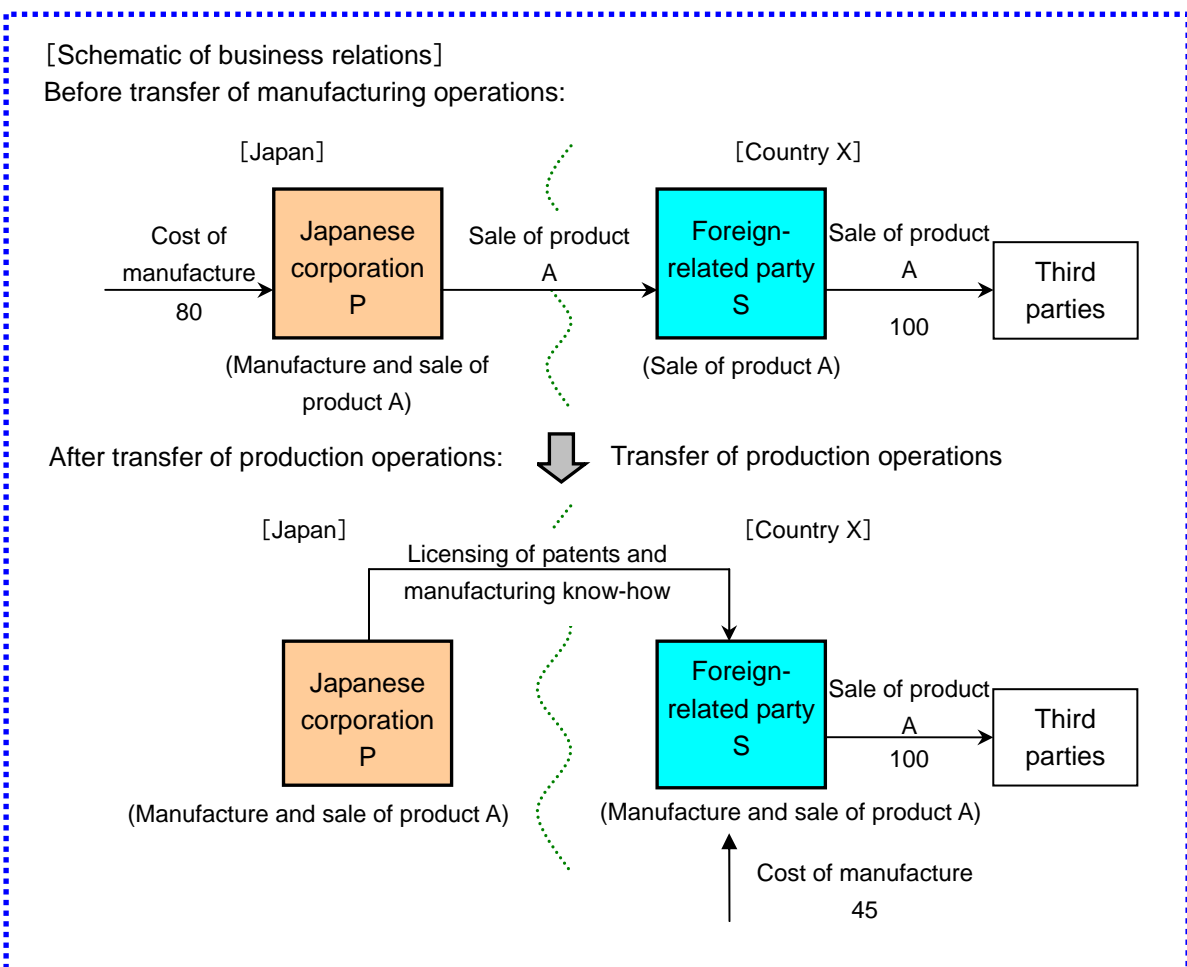
### (3) Cases illustrating points to note when applying residual profit split method

#### Case 19: Treatment of profits due to differences in labor costs

##### Key points

This case illustrates the application of the residual PS method when the cost of manufacture is lower than in the cases of domestic manufacturing, due to the transfer of production operations to a foreign country with lower labor costs.

##### Preconditions



##### (Summary of business of corporation and foreign-related party)

Japanese corporation P is a manufacturer and distributor of product A, and 10 years previously it established company S in country X as a subsidiary to distribute product A. Although it used to sell product A manufactured domestically to third parties in country X via company S, it decided to switch to local production in country X five years ago due to lower labor costs and other expenses in country X, and production operations in Japan were transferred to company S.

Product A is made using original technologies resulting from company P's R&D activities.

##### (Summary of foreign-related transaction)

Since transferring its production operations overseas, company P has licensed to company S patents and manufacturing know-how (original technologies created as a result of company P's R&D activities) for manufacturing product A.

Company S procures raw materials locally in country X to produce product A based on technologies originating from and furnished by company P. It then sells its output of product A to third parties in country X.

**(Functions and activities of corporation and foreign-related party)**

Product A, which is an outcome of company P's R&D activities, has seen sales increase due to its original technical performance, and it has achieved a certain market share in country X, where it sells for a largely stable price.

Company S has no R&D operations, and manufacturing of product A by company S is based on technologies originating from and furnished by company P. On the other hand, company S has traditionally engaged in large-scale advertising and sales promotion activities as a distributor, resulting in a more competitive sales position due to strong product recognition and a large distribution channels.

**(Change in profit/loss situation before and after transfer of production operations)**

Company P's cost of manufacture before the transfer of production operations was 80. Company S's cost of manufacture after the transfer, however, came down to 45, and the combined profits of company P and company S increased from 20 before the transfer to 55 afterwards. (There was no change in the selling price of product A in country X before and after the transfer of production operations, and there were also no other changes.)

**Treatment for transfer pricing taxation purposes**

As the result of comparability analysis, no comparable transaction was found for any of foreign-related transactions. The following results were obtained from the analysis. (Regarding the points to note when selecting the method of calculation of arm's length price and making a comparability study, see the "Explanation" to Case 1.) As it was found that company P's and company S's intangible properties (i.e. the unique technical performance of the product A founded on company P's technical capabilities, and the strong product recognition and distribution channels built up through company S's advertising and sales promotion activities) serve as a source of income in company P's and company S's respective foreign-related transactions compared with in the cases of a corporation engaging solely in routine activities, and the unique and valuable contribution by company P and company S is found in the foreign-related transaction. It was deemed appropriate in this case to select a method equivalent to the residual PS method (or a method equivalent to a method consistent with this method) as the most appropriate method, and calculate the arm's length price. While one factor having an impact on company S's operating profit is the low level of labor costs in country X, this is taken into account by selecting a routine transaction for company S based on the financial information of corporations that similarly receive the benefit of low labor costs as company S in country X in the process of calculating company S's routine profit when applying a method equivalent to the residual PS method.

## Explanation

Although the cost of manufacture falls compared with domestic production when production operations are transferred to the foreign-related party's country, where labor costs and other expenses are lower, this is an externality generated by company P's business group as a result of company P's business decision. If, as in the present case, a product of the same quality and brand as before the transfer of production operations can be sold in approximately the same volume and at approximately the same price, profit after the transfer of operations will increase by the amount that the cost of manufacture was reduced. However, as activities are normally undertaken and know-how employed to maintain quality, brand, selling price, and volume, and to improve production efficiency, profit associated with the transfer of production operations will be affected by an interrelated combination of internal factors and external factors, such as differences in labor costs. When applying the profit split method, therefore, it can be difficult to distinguish these factors from the profits to be split.

In the cases of uncontrolled transactions, if a corporation engages only in routine manufacturing operations in a country with relatively low labor costs, then normally a transaction price is assigned that enables profit commensurate with function to be secured, and the benefits of low labor costs are similarly enjoyed by other corporations in similar markets and categories of business. Thus, even if the benefit of lower labor costs is enjoyed as a result of transferring production operations, the level of profit commensurate with routine manufacturing activities will be the same as that enjoyed by unrelated parties performing the same manufacturing functions under the same economic conditions, and so the difference in labor costs before and after transfer of production operations can be taken into account by selecting a routine transaction based on financial information of appropriate corporations when applying the residual PS method.

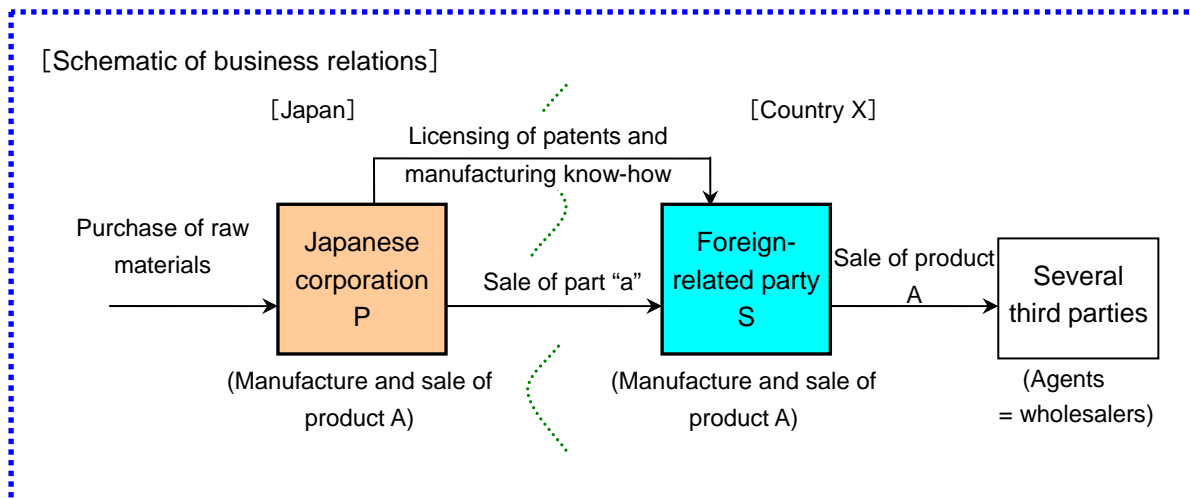
In this case, the residual profits, which are the difference between the profits to be split and the sum of the routine profits, are to be allocated to the corporation and the foreign-related party, respectively, in accordance with the extent of unique and valuable contribution to the acquisition of the relevant residual profits (extent of contribution through intangible assets).

## Case 20: Treatment of profits affected by market features and market fluctuations

### Key point

This case illustrates the application of the residual PS method when factors such as market features and market fluctuations are deemed to have an impact on the profits of the corporation or foreign-related party.

### Preconditions



### (Summary of business of corporation and foreign-related party)

Japanese corporation P is a manufacturer and distributor of product A, and 10 years previously it established corporation S in country X as a subsidiary to manufacture and distribute product A.

Product A is produced using original technologies resulting from R&D led by company P.

### (Summary of foreign-related transactions)

Company P sells part “a” (a core part that aggregates company P’s original technologies) to company S, and also licenses to company S patents and manufacturing know-how (original technologies created as a result of company P’s R&D activities) for the manufacture of product A.

Company S combines part “a” with other parts to manufacture product A, which it sells to a number of third-party agents in country X.

### (Functions and activities of corporation and foreign-related party)

Product A, which is the outcome of R&D led by company P, has seen sales increase due to its unique technical performance, and it has achieved a certain market share in country X.

Company S also has a technology development division consisting of about 10 engineers and performed some of the development for product A, contributing to achieving product A’s unique technical performance in conjunction with R&D by company P. Company S does not engage in original advertising or sales promotion activities, and it does not use its own trademark in marketing.

### (Market conditions)

The product A industry to which company P’s business group belongs is known for being subject to



severe fluctuations globally, and fluctuations in demand are considered to give rise to a regular cycle in companies' profits.

In practice, company S's actual operating margin and the operating margins of corporations in the same industry in Japan, the world, and country X according to databases of corporate data have exhibited largely the same cycle over the past 10 years.

While the industry's average level of profit in country X is higher than the world average, this is due to the market price for product A in country X being kept somewhat higher than the international average on account of government price regulation.

#### Treatment for transfer pricing taxation purposes

As the result of comparability analysis, no comparable transaction was found for any of foreign-related transactions (sales transactions of parts "a" and licensing of patents). The following results were obtained from the analysis. (Regarding the points to note when selecting the method of calculation of arm's length price and making a comparability study, see the "Explanation" to Case 1.)

As company P and company S were found to have intangible properties serving as a source of income in their respective foreign-related transactions compared with in the cases of a corporation engaging solely in routine activities, and to make the unique and valuable contribution in the foreign-related transaction, it was deemed appropriate in this case to select a consistent with the residual PS method as the most appropriate method, and to calculate the arm's length price.

Three factors that could potentially affect company S's operating margin are: (1) intangible properties created by company P and company S's R&D activities; (2) fluctuations in demand arising from cyclical changes in market conditions; and (3) the level of the market prices in country X.

Regarding (2), however, the average profit margin in the industry follows the same trend in Japan, country X, and the world, and corporations belonging to the same industry typically enjoy the same margin, while regarding (3), the industry's average profit margin in country X is comparatively high compared with the global level, and is thought to be enjoyed uniformly throughout the industry in country X.

When applying a method consistent with the residual PS method, therefore, the impact of fluctuations in demand and the level of the market prices is reflected in the calculation of company S's routine profit by selecting a routine transaction based on financial information of appropriate corporation in country X considered to experience similar effects.

#### Explanation

Fluctuations in demand and market prices and the effect on price levels arising from peculiarities of the market would have a similar impact on corporations doing business in the same market.

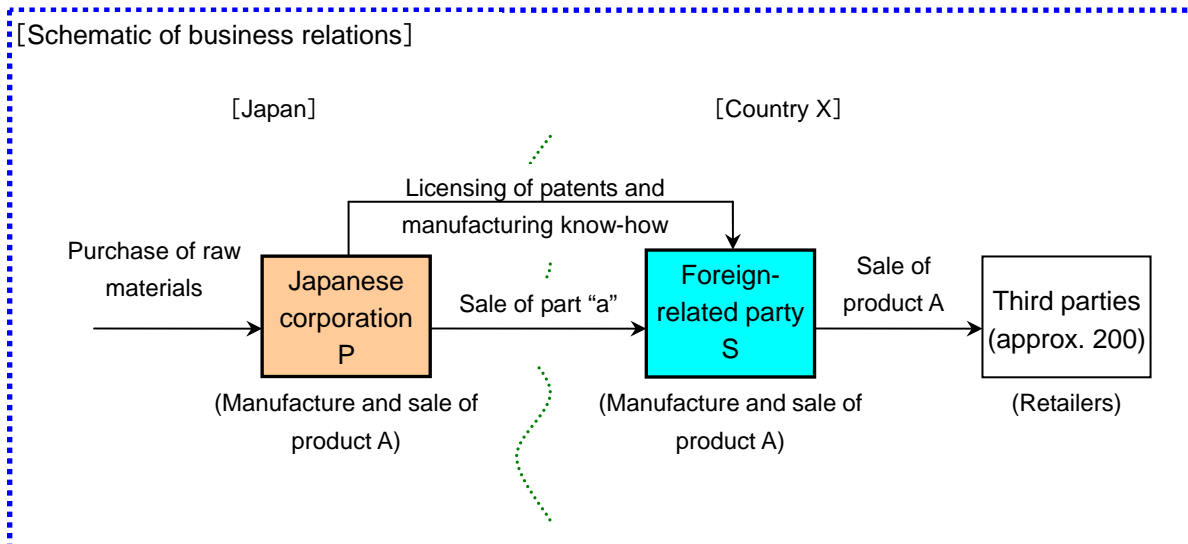
When applying the residual PS method, therefore, the impact on prices of fluctuations in demand and market prices and features of the market (such as customer preferences and government price regulation) is reflected in calculations of routine profit provided that a routine transaction is selected based on financial information of appropriate corporation and that the financial data for the same period is used.

## Case 21: Calculation of routine profit

### Key point

This case illustrates the selection of a corporation used to calculate the routine profit normally earned between unrelated parties without material intangible properties.

### Preconditions



### (Summary of business of corporation and foreign-related party)

Japanese corporation P is a manufacturer and distributor of product A, and 10 years previously it established company S in country X as a subsidiary to manufacture and distribute product A.

Product A is made using original technologies resulting from company P's R&D activities.

### (Summary of foreign-related transaction)

Company P sells part "a" (a core part that aggregates company P's original technologies) for product A to company S, and also licenses to company S patents and manufacturing know-how (original technologies created as a result of company P's R&D activities) for the manufacture of product A.

Company S combines part "a" with other parts to manufacture product A, which it sells to around 200 third-party retailers in country X.

### (Functions and activities of corporation and foreign-related party)

Product A, which is an outcome of company P's R&D, has seen sales increase due to its unique technical performance, and it has acquired a certain market share in country X, where it sells for a largely stable price.

While company S has no R&D operations and depends on original technology furnished by company P, it enjoys a superior sales position thanks to its strong product recognition and large distribution channels created by large-scale original advertising and sales promotion activities.

### Treatment for transfer pricing taxation purposes

As the result of comparability analysis, no comparable transaction was found for any of foreign-related transactions. Compared with a company engaging solely in routine activities, the intangible properties of company P and company S were found to be a source of income in company P's and company S's respective foreign-related transactions and the unique and valuable contribution by company P and company S is recognized in the foreign-related transaction. In the present case, therefore, it was deemed appropriate to select a consistent with the residual PS method as the most appropriate method, and calculate the arm's length price. (Regarding the points to note when selecting the method of calculation of arm's length price and making a comparability study, see the "Explanation" to Case 1.)

In this case, the routine profits to be allocated to company P and company S, within the profits to be split associated with the foreign-related transaction, shall be first calculated. Then, the routine profits shall be deducted from the profits to be split to calculate the profits generated from the unique and valuable contribution (the residual profits). The routine profits shall be calculated by selecting the most appropriate profit level indicator among the ratios prescribed in the Article 39-12(8)-1(c-1) of the Cabinet Order for Enforcement of the ASMT as "in the case where the necessary adjustment prescribed under Paragraph 6, the previous Paragraph, or the following Item to Item 5 is not to be conducted, use the ratio in accordance with these provisions" (Administrative Guidelines 3-7).

Furthermore, for the above ratio, the ratio after addition of necessary adjustment prescribed in the parentheses of the Item (c-1) shall be used (Administrative Guidelines 3-7 (Note)).

### Explanation

The routine profits deducted from the profits to be split in the case of application of the residual PS method shall be calculated on the most appropriate profit level indicator associated with the routine profits (Gross margin on sales, gross margin on sales costs, operating margin on sales, operating margin on total costs, or gross margin on operating expenses). For example, in the application of the residual PS method under which the total operating profit of the corporation and the foreign-related party is subject to the profit allocation, operating margin on sales or operating margin on total costs, which are indicators associated with operating profit, shall be used. (In the case where there exists more than one routine transaction, the mean shall be used in principle. (Administrative Guidelines 3-7 (Notes)))

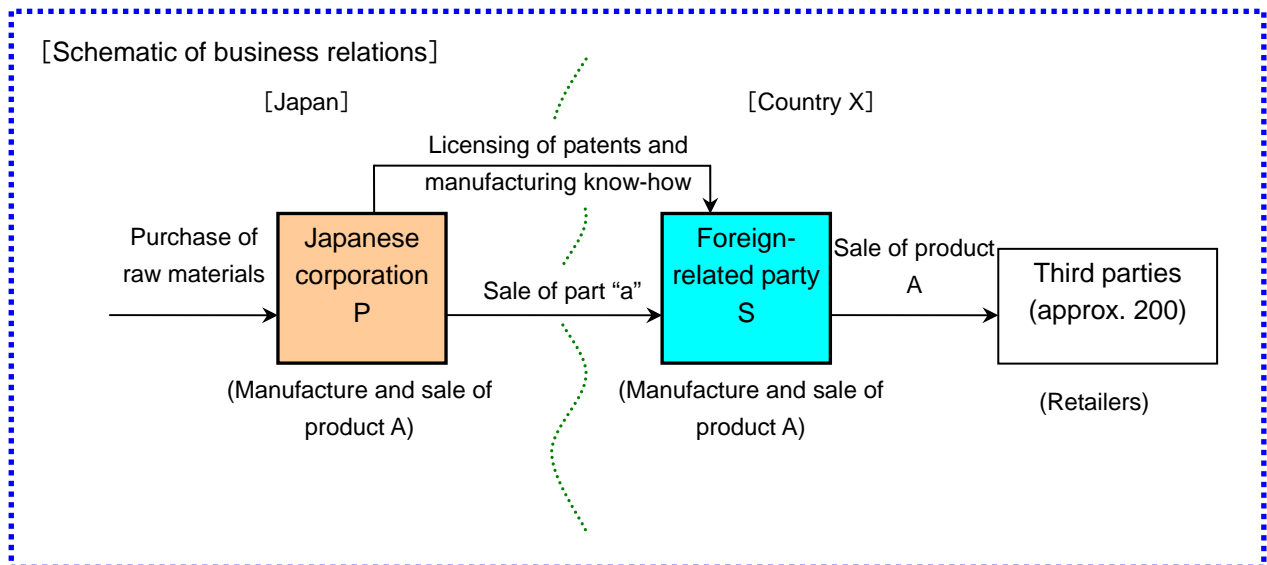
Furthermore, the routine transaction shall be selected from transactions between unrelated parties in which the parties thereof do not perform unique function. Therefore, it shall be noted that the selection shall be based on financial information of the corporation which conducts relatively simple manufacturing/sales activities. (For an example of screening of potential comparable transactions, see Figure 3 of "Explanation" to Case 1.)

## Case 22: Factors for splitting residual profits

### Key points

This case illustrates an instance in which expenditures in each period on the creation, maintenance, and development of intangible properties may reasonably be used as factors for splitting residual profits.

### Preconditions



### (Summary of business of corporation and foreign-related party)

Japanese corporation P is a manufacturer and distributor of product A, and 10 years previously it established company S in country X as a subsidiary to manufacture and distribute product A. Product A is made using original technologies resulting from company P's R&D activities.

### (Summary of foreign-related transaction)

Company P sells part "a" (a core part that aggregates company P's original technologies) for product A to company S, to which it also licenses patents and manufacturing know-how (original technologies created by company P's R&D) for manufacture of product A.

Company S combines part "a" with other parts to manufacture product A, which it sells to around 200 third-party retailers in country X. Company S also engages in large-scale advertising through television commercials, magazine advertisements, and other media in country X.

### (Functions and activities of corporation and foreign-related party)

Product A has acquired a certain market share in country X due to its strong product recognition, etc. thanks to its unique technical performance and company S's advertising activities, and it sells for a largely stable price.

The information relevant to the creation of these intangible properties is as follows:

- Company P's R&D division continues to engage in R&D on product A (including R&D that did not ultimately lead to deliverables), but R&D expenditures on development of individual

- patents and manufacturing know-how are not kept separate in management accounting.
- Company S's advertising activities all concern product A, and are deemed to contribute to the creation of intangible properties in company S's marketing.
  - According to company P's past profit-and-loss statements, company P's expenditures on R&D activities are generally around a constant 7% of sales each period.
  - According to company S's past profit-and-loss statements, company S's advertising costs are generally around a constant 8% of sales each period.

#### Treatment for transfer pricing taxation purposes

As the result of comparability analysis, no comparable transaction was found for any of foreign-related transactions.

Compared with a corporation engaging solely in routine activities, the intangible properties created by company P's R&D activities and company S's advertising activities were found to serve as a source of income in company P's and company S's foreign-related transactions, and the unique and valuable contribution by company P and company S is recognized in the foreign-related transaction, so it was deemed appropriate in this case to select a consistent with the residual PS method as the most appropriate method, and calculate the arm's length price. (Regarding the points to note when selecting the method of calculation of arm's length price and making a comparability study, see the "Explanation" to Case 1.)

While residual profits could be allocated to company P and company S by using the amount of expenses expended by the two companies on development of intangible properties, the amount of expenses expended in each fiscal year was deemed to be the appropriate factor for splitting residual profits. This was due to the fact that the expense of creation of individual patents, manufacturing know-how, and intangible properties employed in marketing could not be identified, and that the amount of expenses expended on activities to create intangible properties are largely constant in each term.

#### Explanation

1. The residual profits shall be allocated to the corporation and the foreign-related party in accordance with the extent of unique and valuable contribution to the residual profits. In the case where the contribution is given through intangible assets, the extent of contribution of the intangible assets which is the source of income shall be used as the factors for splitting the residual profits (ASMT Directive 66-4(5)-4).

However, in order to measure the extent of the contribution of intangible properties, the absolute value of intangible properties possessed by the corporation or foreign-related party do not necessarily have to be determined; as the proportions of the relative values of the respective parties' intangible properties can suffice,. Other possibilities include use of the expenses expended in each period that reflect the creation, maintenance, and development of intangible properties, as well as the acquisition cost of intangible properties.

2. In cases where the acquisition cost of intangible properties is used as the split factor, it is frequently difficult to individually identify the expenses relating to creation, maintenance, and development of patents and manufacturing know-how through R&D activities. Furthermore, if the value of intangible properties declines with the passage of time, it is necessary to estimate in a reasonable and objective manner the period during which individual intangible properties are likely to retain their value.

3. If the focus is on, for instance, activities to create, maintain, and develop intangible properties, then in situations where such activities are performed continuously and expenses in each period that are associated with these activities are comparatively stable, it is considered reasonable for residual profits to be allocated using the amount of the expenses in each period that are associated with these activities as the split factor.

It shall be noted that if it would be detrimental to use the expenses in each period as the split factor due to, for instance, large fluctuations in the amount of expenditures on activities to create, maintain, or develop intangible properties in each period, it is possible to use the average amount of expenditures during a reasonable period, or the sum of expenditures in a reasonable period allocated according to a certain number of years.

(Note) If, in cases where the amount of expenditures in each period is used as the split factor, the split factor has been reasonably determined, and the proportions of the relative values of material intangible properties have been appropriately calculated, application of the residual PS method is deemed appropriate even if the amount of the split factor is relatively small in proportion to the amount of the residual profits.

4. If the amount of expenses expended to create material intangible properties is used as the factor for splitting residual profits, related expenses are identified from among expenses such as the following, which are closely connected to activities to create material intangible properties:

- (1) Intangible properties used in manufacturing activities, such as patents and manufacturing know-how: expenses related to R&D division and manufacturing division, etc.
- (2) Intangible properties used in marketing activities, e.g. brands, trademarks, distribution channels, and customer lists: expenses related to advertising, sales promotion, and marketing divisions, etc.
- (3) Intangible properties used for business activities other than (1) and (2) above, e.g. know-how regarding business judgments, risk management, financing, and marketing: expenses related to planning, operations, finance, and front-office divisions, and other divisions that perform such activities.

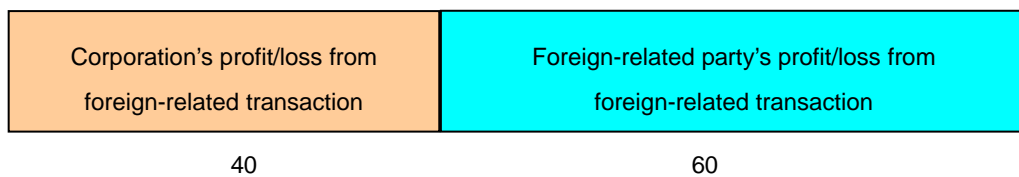
5. The calculation process used for the residual PS method is illustrated in the diagram below:

[Example of calculations for the residual PS method]

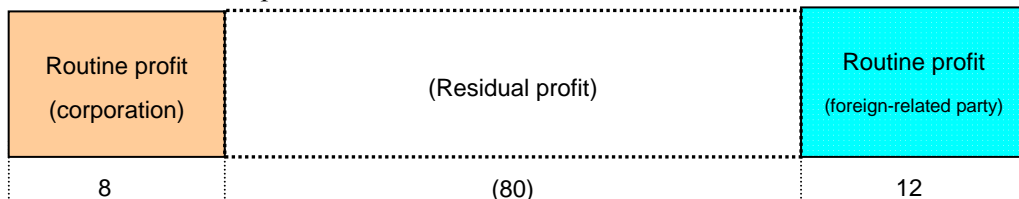
Preconditions

- Corporation's profit/loss from foreign-related transaction: 40
- Foreign-related party's profit/loss from foreign-related transaction: 60
- Corporation's routine profit (after calculation): 8
- Foreign-related party's routine profit (after calculation): 12
- Factors for splitting residual profits
  - Split factor for corporation: R&D activities: 80%
  - Split factor for foreign-related party: Advertising activities: 20%

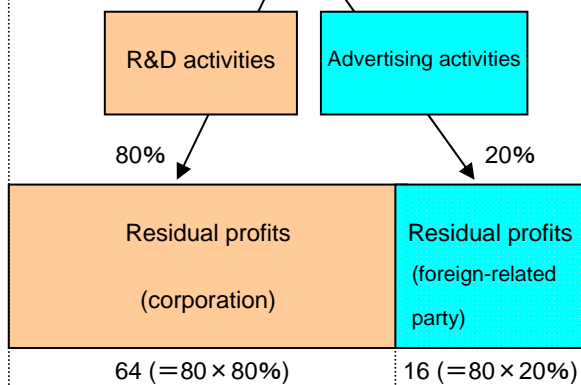
① Calculation of profits to be split



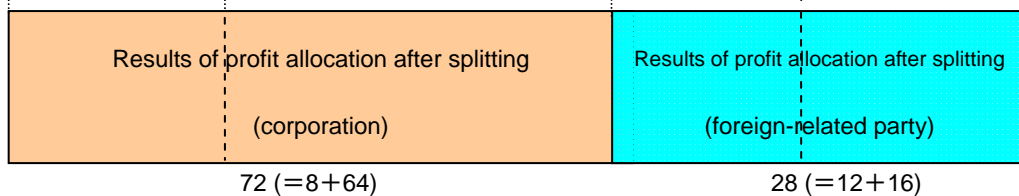
② Allocation of routine profit



③ Allocation of residual profits



④ Results of profit allocation



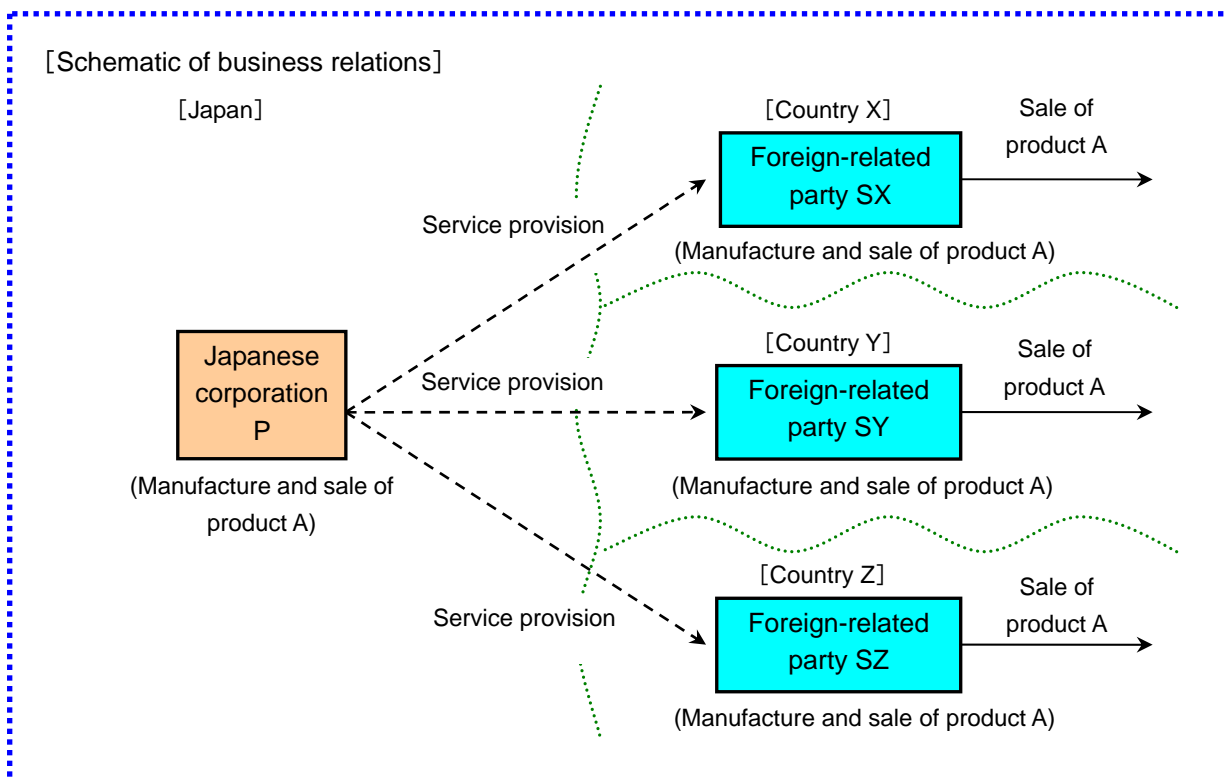
**(4) Other cases**

**Case 23: Intra-group services**

**Key point**

This case illustrates whether the activities of management, finance, business operation, and administration by the corporation for its foreign-related party fall under the provision of services or not.

**Preconditions**



**(Summary of business of corporation and foreign-related parties)**

Japanese corporation P is a manufacturer and distributor of product A, and 10 years previously it established company SX in country X, company SY in country Y, and company SZ in country Z as subsidiaries to manufacture and distribute product A. (These three companies are hereinafter referred to as “company S”).

**(Summary of foreign-related transactions)**

Company S procures all parts and raw materials locally to produce product A, which it sells in the respective countries.

Company P has a unit with responsibility for the various operations concerning company S, and it conducts the following activities for company S:

(Note) Company S does not conduct any activity which overlaps the activity done by company P for company S, and any other entity does not provide such service to company S.



- A. In order to improve the management efficiency of company S and to increase its profitability, company P determines the personnel policies of company S, and interviews the candidates for executives. It also changes executives of company S and revises their remunerations, as necessary. (Changes of executives of company S, revisions of their remunerations are not conducted as the result of execution of the company's rights as shareholder through the company's general meeting of shareholders.)
- B. In order to manage the business operations of company S, company P gives instructions on day-to-day matters of operations by writing, and gives instructions on the operation policies of company S through regular TV meeting held once a week.
- C. Company P checks the draft of budget prepared by company S, and instructs an amendment if it finds a problem on the annual business plan. Company S prepares its annual budget based on it.
- D. Company P itself gathers company S's monthly financial and management data (on production and sales) necessary for preparation of documents to organize the company P's general meeting of shareholders.
- E. In the purpose of preparing its securities report under the Financial Instruments and Exchange Act, company P checks the data for consolidated settlement transferred from company S, and instructs the amendment to company S for any slight error of figures.
- F. Company P witnesses the business audit of company S so that the business audit of company S is held properly. In cases where improper processing is found, company P prepares a document instructing business improvement.
- G. Company P dispatches its personnel in charge of finance to the audit of company S held by an external audit corporation conducted for the audit of company P's consolidated financial statements. (Company S requests the audit to another audit corporation in accordance with the law of the country of location.)
- H. Company P audits company S's operations for the compliance with local laws of its country of location. In cases where a problem is found, company P instructs company S to improve the compliance.
- I. Company P checks the contents of contract through its legal staff in order to reduce the risk involved in a mistake of business judgment concerning a contract that company S enters into with unrelated party under the advice of its consulting lawyer.
- J. In order to reduce the cost of company S, company P collectively develops, and maintains the computer system (which connects company P with company S online) to immediately respond to product claims.
- K. To ensure smooth finance activities of company S, company P judges and analyzes risks on the investment in new facilities of company S, and arranges for procurement including cash and deposit management.
- L. In order to improve the business efficiency of company S, company P has a communication and support system in place in company P in order to immediately respond to business consultations (response to emergency) from company S.
- M. For smooth development of company S's business, company P builds good relationship with

company S's main customers, and gives support in the negotiation of transaction terms of company S with its main customers.

- N. To ensure the conclusion of important contracts of company S with its customers, company P negotiates for conclusion of contract of company S, makes determination thereon, fulfills the contract terms (including guarantee of fulfillment by company P on behalf of company S), or otherwise.

#### Treatment for transfer pricing taxation purposes

In this case, activities under Items D, E, and G constitute the activities concerning the execution of legal rights or fulfillment of legal obligation as shareholder of which company P has its status of company S's shareholder, and which it conducts exclusively for itself. However, the activities related to other Items than D, E, or G are not deemed to be those concerning the execution of legal rights or fulfillment of legal obligation as shareholder which company P conducts exclusively for itself, and these activities do not fall under the shareholder's activities.

Therefore, items other than D, E, and G shall be reviewed under specific judgment standards such as Administrative Guidelines 2-9 (1). However, since company S obtains benefits such as enhancement of management efficiency, improvement of business operation, reduction of risk, and decrease in costs, it is considered that the activities concerning the said items are highly probable to fall under the provision of services.

#### Explanation

1. In cases where a corporation conducts activities of management, finance, business operation, and administration to its foreign-related party, whether these activities fall under the provision of services and whether the corporation should receive the compensation shall be judged by whether the activities have economic or commercial values for the foreign-related party. Specifically, it shall be judged by whether an unrelated party in the same condition as the foreign-related party will pay the compensation in cases where it receives the same activities from another unrelated party, or whether the foreign-related party itself is deemed to be required to conduct the same activities in cases where the corporation does not conduct these activities. (Administrative Guidelines 2-9 (1))

Furthermore, if a corporation routinely maintains personnel, facilities and similar resources capable of providing services as necessary in response to requests by foreign-related party, the maintenance of them in an available state falls under the provision of services (Administrative Guidelines 2-9 (2)).

In cases where a corporation conducts an activity that overlaps the provision of services by a unrelated party to the foreign-related party, or an activity conducted by the foreign-related party for itself, the overlapped activity does not fall, in principle, under the provision of services. However, where the overlapping is deemed temporary, or where the overlapping activities are deemed to be checks to be conducted as procedures in parallel in order to reduce the risks involved in a mistake of business judgment, these overlapping activities shall fall under the provision of services (Administrative Guidelines 2-9 (3) A.)

2. In cases where the activities conducted by a corporation for a foreign-related party are, for example, the activities to hold a general meeting of shareholders organized by the parent company, or to prepare Securities Report of the parent company under the Financial Instruments and Exchange Act, and activities concerning the execution of legal rights or the fulfillment of legal obligation as shareholder conducted by the party having the status of shareholder exclusively for itself (Shareholder's Activities), these activities are not deemed to have economic or commercial values for the foreign-related party, and they do not fall under the provision of services (Administrative Guidelines 2-9 (3) B.)

(Note) The execution of legal rights or the fulfillment of legal obligations mentioned above includes the cases under foreign laws.

Planning concerning specific business, management in emergency, technical advice, support concerning day-to-day management, etc conducted by the parent company for subsidiaries are not deemed as activities conducted by a party having the status of shareholder exclusively for itself, and these do not fall under the shareholder's activities. (Administrative Guidelines 2-9 (3) B. (Note))

The activities that were conducted by the parent company in the purpose of preservation of investment into subsidiaries and that have economical or commercial values for the subsidiaries fall under the provision of services (Administrative Guidelines 2-9 (3) B (Note)).

3. When calculating the arm's length price of Intra-Group service provision transactions under Administrative Guidelines 2-9, selecting the most appropriate method of calculation for each case is required. In case where a method equivalent to the CP method is the most appropriated method, the amount of expenses for provision of the services are required to be marked up.

Even if traditional method may not applied, it may be possible to use the amount of total cost of the provision of services (sum of the relevant direct and indirect costs to the provision of services that are calculated reasonably) as the arm's length price if the provision of services provided is incidental or related to the core operations of the corporation or the foreign-related party, (Administrative Guidelines 2-10 (1)). (See Case 5.)

In cases where the provision of service is not incidental or related to the core operations of the corporation or the foreign-related party, if all the requirements listed in the Table of 5 below are satisfied, it may be possible to use the amount of the total cost of the provision of services (sum of the direct and indirect costs related to the provision of the services that are calculated reasonably) as the arm's length price (Administrative Guidelines 2-10 (2)).

4. When examining whether the amount of compensation for the provision of services payable by a corporation to a foreign-related party is appropriate or not, it is necessary to request the corporation to present or submit the documents describing the contents of services provided by the foreign-related party, and to examine the documents (Administrative Guidelines 2-9 (5) and 2-4). For example, the contents of contract concerning the service provision transaction to be examined, method of setting the compensation amount, process of price negotiations, employees engaging in the service provision transactions of the foreign-related party, assets used, the amount of total costs, etc shall be confirmed.

As the result of examination of the documents, in cases where the real status of service provision purported to have been conducted by the foreign-related party, or specific calculation basis of the amount of compensation cannot be confirmed, it is necessary to examine whether the requirements for the application under the provisions of ASMT Article 66-4 (3) (Exclusion of Contribution to Foreign-related party from Deductible expenses) or those for inclusion in deductible expenses under the provisions of ASMT Article 22-3 are satisfied for the amount calculated as the amount of compensation for the provision of services by the corporation.

In cases where the service provision by a corporation for a foreign-related party is conducted by using intangible properties of the corporation, it is necessary to examine whether the amount of compensation for the service provision includes a portion related to the use of the intangible properties or not (Administrative Guidelines 2-8). As the result, in cases where the portion related to the intangible properties is not included in the compensation notwithstanding the service is provided by using the intangible properties of the corporation, it is necessary to identify the business activities of the foreign-related party to which the used intangible properties contribute, including the viewpoint of the core operations of the corporation, and to calculate the compensation to realize an appropriate result of income distribution

5. Requirements concerning the Treatment of Administrative Guidelines 2-10 (2)

Requirement	Description of business	Examples of concrete tasks or points to note
(A) The content of service falls under one of the tasks listed in the following.	(a) Preparation and management of budget	<ul style="list-style-type: none"> <li>• Management of documents necessary for preparation of annual budget, business plan of foreign-related party</li> <li>• Check of execution status of annual budget of foreign-related party</li> </ul>
	(b) Accounting, tax filing or legal work	<ul style="list-style-type: none"> <li>• Check of accounting records necessary for preparation of financial statements of foreign-related party</li> <li>• Preparation of tax filing documents of foreign-related party</li> <li>• Check of submission of report, and compliance status of foreign-related party under the provisions of laws and regulations concerning permits and approvals</li> </ul>
	(c) Management or collection of credits	<ul style="list-style-type: none"> <li>• Management of balance of accounts receivable of foreign-related party</li> <li>• Preparation of invoices issued by foreign-related party</li> <li>• Business to recover accounts receivables of foreign-related party</li> <li>• Demand of payment to clients of foreign-related party</li> <li>• Collection and analysis of credit information concerning clients of foreign-related party</li> </ul>
	(d) Operation, maintenance or management of telecommunication systems	<ul style="list-style-type: none"> <li>• Response to technical problems, and inquiries concerning the operation of telecommunication system of foreign-related party</li> <li>• Maintenance and check of telecommunication systems of foreign-related party</li> </ul>
	(e) Management of cash flow or payment capacity	<ul style="list-style-type: none"> <li>• Cash management of foreign-related party</li> <li>• Management of balance of accounts payable of foreign-related party</li> <li>• Payment operation concerning the accounts payable of foreign-related party</li> </ul>
	(f) Fund operation or procurement (limited to administrative procedures)	<ul style="list-style-type: none"> <li>• Management of bank accounts of foreign-related party</li> </ul>
	(g) Recruitment, positioning or training of employees	<ul style="list-style-type: none"> <li>• Production of notice concerning recruitment activities of foreign-related party</li> <li>• Personnel-related tasks concerning recruitment, positioning, etc. of employees of foreign-related party</li> <li>• Preparation and execution of recruitment plan of foreign-related party, and training for newly recruited persons (including preparation and execution of training plan)</li> </ul>
	(h) Clerical work related to salaries and insurances of employees	<ul style="list-style-type: none"> <li>• Calculation, payment and book-keeping concerning salaries of employees of foreign-related party (including clerical work concerning health-care insurance, pensions, etc. of employees)</li> </ul>
	(i) Advertisement and promotion (except for support to marketing listed in 2-9(1)-(i))	<ul style="list-style-type: none"> <li>• Production of website of foreign-related party</li> </ul>
	(j) Other general administration	<ul style="list-style-type: none"> <li>• Input operation of various data handled by foreign-related party</li> <li>• Compilation of documents/electronic information and management of furniture/fixings handled by foreign-related party</li> </ul>

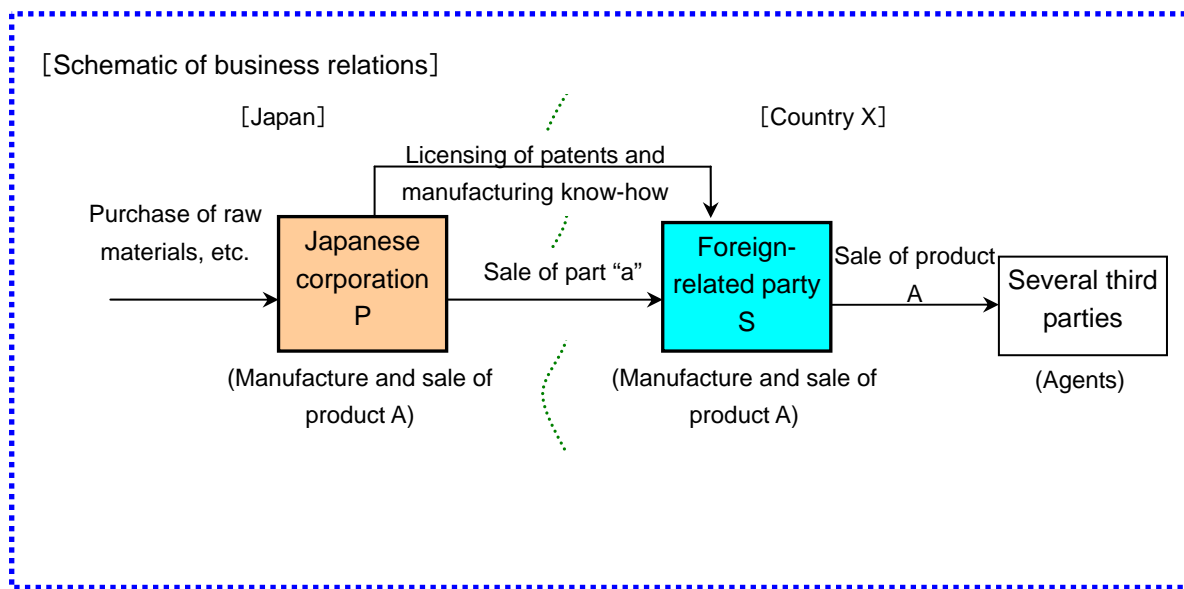
(B) The relevant service provision is not related to the substantial part of the business activities of the corporation or the foreign related party.	“Substantial part of the business activities” means such activities that contributes substantially to the acquisition of profits or that determines the success of business of the corporation or the foreign-related party.
(C) The expenses required for the relevant service provision do not occupy a considerable part of the costs or expenses of the business year in which the relevant services were provided.	“Substantial part” means approximately 50% or over of the amount of costs or expenses of the side which provided the services.
(D) Its own intangible assets are not used in the provision of the services.	For examination of whether the intangible assets of the service provider are used in the service provision, Administrative Guidelines 2-8(1) (Note) shall be noted.
(E) The calculation of direct expenses and indirect expenses related to the relevant service provision is consistent with reasonable allocation ratios, such as ratio of engagement of employees, ratio of employment of assets used, concerning the relevant service provision.	The criteria for allocation of expenses required for the service provision shall be verified to be reasonable by the business diary, daily business report, etc.

## Case 24: Consideration of multiple years

### Key points

This case illustrates the calculation of arm's length price in individual years after consideration of market conditions in multiple years.

### Preconditions



### (Summary of business of corporation and foreign-related party)

Japanese corporation P is a manufacturer and distributor of product A, and 10 years previously it established company S in country X as a subsidiary to manufacture and distribute product A.

Product A is manufactured using original technologies resulting from company P's R&D activities.

### (Summary of foreign-related transaction)

Company P sells part "a" (a core part that aggregates company P's original technologies) for product A to company S, and also licenses to company S patents and manufacturing know-how (created as a result of company P's R&D activities) for the manufacture of product A.

Company S combines part "a" with other parts to manufacture product A, which it sells to several third-party agents in country X.

### (Functions and activities of corporation and foreign-related party)

Product A, which is a result of company P's R&D, has seen sales increase due to its unique technical performance, and it has acquired a certain market share in country X.

Company S has no R&D functions, and does not engage in original advertising or sales promotion activities.

### (Market conditions for product)

The product A industry to which company P's group belongs is known for its large global swings in demand, and company profits reportedly follow a regular cyclical pattern subject to fluctuations in demand. Company S's actual operating margins and the operating margins of corporations in the

product A industry according to a database of corporate data in country X have exhibited a regular cycle over the past 10 years. A comparison of company S's operating margin and the average operating margin of corporations in the product A industry shows that, on a single-year basis, company S's operating margin is generally higher than the industry average in each year, and company S's margin is similarly higher than the industry average for the past 10 years.

**(Other conditions)**

Cost items are not required to be entered under the financial data disclosure system for corporations in country X. (However, an item corresponding to operating income in Japan is disclosed in reports.)

**Treatment for transfer pricing taxation purposes**

As company S's operating margin generally exceeded the level in the industry as a whole in individual years, and the average for multiple years, over the past 10 years, despite being affected by cyclical fluctuations in market demand, this was found to present problems from the point of view of transfer pricing taxation of foreign-related transactions between company P and company S (Administrative Guidelines 2-2(2)).

When selecting the method of calculation of arm's length price, as a result of comparability analysis, potential comparable transactions for the application of one of the traditional transaction methods and a method consistent with those (including methods equivalent to those methods) cannot be found.

As it is possible to find comparable transactions using the operating margin of company S, which has comparatively simple functions, from publicly available information, it was deemed appropriate in this case to select the TNMM (including a method equivalent to the TNMM) as the most appropriate method. (Regarding the points to note when selecting the method of calculation of arm's length price and making a comparability study, see the "Explanation" to Case 1.)

As in this case corporations in the same industry and market in country X are also found to experience the same demand cycle, it is not necessary to take special account of the demand cycle in the market when applying the TNMM, and the arm's length price may be calculated for each year provided that appropriate comparable transactions are chosen and financial data for the same period are used.

**Explanation**

When considering possible problems from the point of view of transfer pricing taxation, their existence or otherwise is determined from multiple perspectives according to the specific circumstances of individual transactions, while mindful of the items listed in Administrative Guidelines 2-1 (State of Allocation of Profits between Corporation and Foreign-Related Party), to ensure that examinations are conducted efficiently (main clause of Administrative Guidelines 2-2). For instance, take a case where it is considered inappropriate to examine foreign-related transactions considering only information on individual taxable years or consolidated taxable years owing to considerable fluctuations in prices of inventory assets (such as due to commonly occurring changes in demand or the product lifecycle): In such a case, then the average consideration for, or profit margin on, the foreign-related transaction or transactions deemed comparable with the foreign-related transaction during a reasonable period before and after the taxable year or consolidated taxable year is



considered as a base and taken into account when considering whether there are any transfer pricing taxation problems (Administrative Guidelines 2-2(2)). The same applies in the cases of the treatment set forth in the provisions of Administrative Guidelines 2-2(1).

If there are found to occur considerable price fluctuations in a foreign-related transactions but when prices of transactions deemed comparable with the foreign-related transaction remain at a constant level, or those prices fluctuate in a different manner compared with the foreign-related transaction, it is necessary to consider whether there are any transfer pricing taxation problems by using a variable such as the average consideration or profit margin for the foreign-related transaction and transactions deemed comparable with the foreign-related transaction in multiple years.

If, as in the present case, multiple transactions deemed comparable with the foreign-related transaction exhibit largely the same price fluctuations as the foreign-related transaction, no special consideration need be given to the market cycle for the foreign-related transaction.

The lifecycle of the product involved in a foreign-related transaction and the lifecycle of products involved in the transactions deemed comparable with the foreign-related transaction are also taken into consideration if they can be identified from publicly available information.

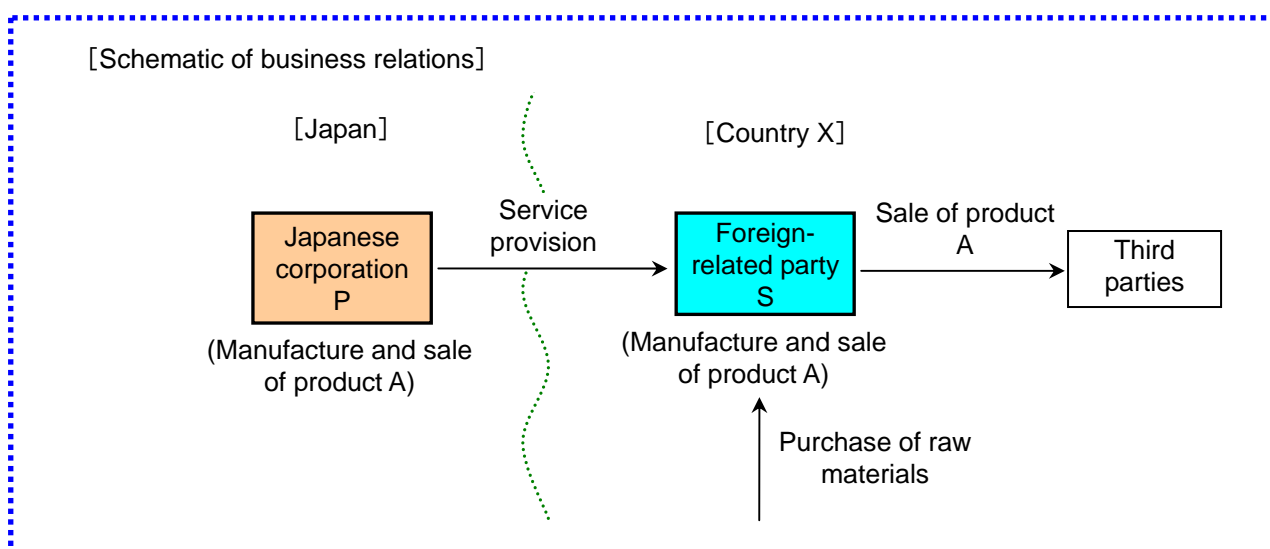
It shall be noted that even in the cases where use is made of the average consideration or profit margin in multiple years, in order to help determine whether there are any transfer pricing taxation problems, the arm's length price is calculated (tax assessed) only for those taxable years found to be problematic in view of transfer pricing taxation as prescribed in Article 66-4 of the ASMT if there are found to be problems.

## Case 25: Contribution to foreign-related party

### Key point

This case illustrates the treatment of case where a corporation does not receive the compensation of transaction from a foreign-related party (Precondition 1 illustrates the case where the provisions of ASMT Article 66-4-3 (Exclusion of Contribution to Foreign-related Party from Deductible Expenses) shall apply. Precondition 2 illustrates the case to be examined as taxable contribution under the transfer pricing taxation system.)

Precondition 1: In the case where the provision of exclusion from deductible expenses is applied for contribution to foreign-related party



### (Summary of business of corporation and foreign-related party)

Japanese corporation P is a manufacturer and distributor of product A, and three years ago, it established corporation S in X country as a subsidiary to manufacture and distribute product A. Just from after the establishment, company S started to construct manufacturing factory of product A. The factory was completed one year after the start of the construction works, but the original production plan has not been achieved due to the poor skill level of machine operation of locally employed staff.

### (Summary of foreign-related transactions)

After the completion of manufacturing factory of company S, company P dispatches its employees to company S for such operations as maintenance and inspection of manufacturing facilities of product A and education/training of employees of company S. (Any intangible property of company P is not used for the operations.)

Company P does not receive any compensation for the services provided to company S concerning these operations.

### (Contents of agreement between company P and company S concerning the dispatch of company P's employees)

Company P estimated the performance of company S. The cash flow of company S remains in severe conditions until the manufacturing and distributing business of product A goes on a track and the management of company S is stabilized. Company P and company S have exchanged agreements to receive the compensation of service provision concerning the business operation conducted by company P's employees. However, company P determined not to receive that compensation under the agreement of both companies in the purpose of supporting company S financially.

Furthermore, company S is not in such a poor performance that may result in a bankruptcy.

#### Treatment for Transfer pricing Taxation Purposes

Company P supports company S by dispatching company P's employees for indispensable operations of company S to achieve the business in country X, and is deemed to be providing services to company S.

In this case, since company P does not receive the compensation of service provision from company S, the above case falls under the gratuitous provision of services. Since company P agreed with company S not to receive the compensation for provision of services in order to support company S financially, that provision of services is deemed to fall under the "gratuitous provision of economic interests" to company S. Furthermore, company S is not in such a poor situation that may result in a bankruptcy, so company P's support of providing such services to company S is not deemed to have a considerable reason described in CTA Directive 9-4-2 (Interest-free Loans in the Reconstruction of Subsidiary).

Judging from the above, since the provisions of ASMT Article 66-4-3 (Exclusion of Contribution to Foreign-related Party from Deductible Expenses) are applicable to the service provision transactions in the above case (Administrative Guidelines 2-19), this case is not taxable under the transfer pricing taxation.

Precondition 2: In the case where the case is assessed as taxable under the transfer pricing taxation

#### **[Schematic of business relations]**

It is same as in the Case 1

#### **(Summary of business of corporation and foreign-related party)**

It is same as in the Case 1

#### **(Summary of foreign-related transactions)**

It is same as in the Case 1

#### **(Contents of agreement between company P and company S concerning the dispatch of company P's Employees)**

Company P has not entered into a contract with company S concerning the service provision transactions, since it purports that these operations are conducted as the responsibility of the parent company to the subsidiary.

### Treatment for Transfer pricing Taxation Purposes

Since company P supports company S in the operations essential to perform business in country X by dispatching company P's employees, it is deemed to service provision to company S.

In this case, since company P does not receive the compensation for service provision from company S, the above case falls under the gratuitous provision of services, but only the fact that company P does not receive a compensation for provision of services does not mean that the operations conducted by company P for company S are not onerous, and it cannot be deemed that "gratuitous provision of economic interests" was made done concerning those operations between company P and company S. Judging from the above, the provisions of ASMT Article 66-4(3) (Exclusion of Contribution to Foreign-related Party from Deductible Expenses) may not be applicable to the service provision transactions in the above case and this case shall be examined as taxable based on the transfer pricing taxation.

### Explanation

In cases where a corporation conducted other transactions than capital transactions or similar transactions, unless otherwise provided for, the income amount concerning sales of assets, onerous or gratuitous transfer of assets or provision of services or gratuitous takeover of assets is to be included into taxable revenues (ASMT Article 22-2). For this reason, in cases where a corporation has not recognized an amount to be included in the revenue although it sold assets, lent money, or provided services, or effected similar transactions to a foreign-related party, it is necessary to examine whether the provisions of ASMT 66-4(3) (Exclusion of Contribution related to Foreign-related Party from Deductible Expenses) shall apply or it is taxable under the transfer pricing taxation, and to treat the amount properly.

In other words, in cases where a corporation has not recognized an amount as income concerning a transaction with a foreign-related party, and where the fact that falls under the "donation or gratuitous transfer of money and other assets, or economic interests" concerning that transaction is found, the amount to be recognized as income by the corporation shall be a contribution to the foreign-related party, and provisions of ASMT Article 66-4(3) ("Exclusion of Contribution to Foreign-related Party from the Deductible Expenses" shall apply (Administrative Guidelines 2-19 A).

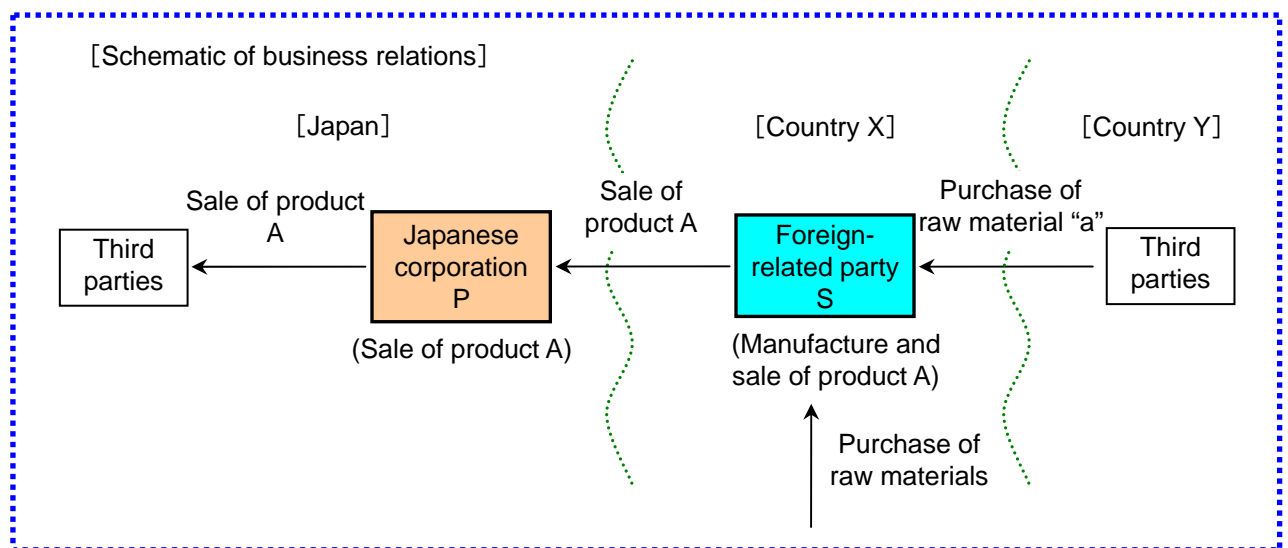
On the other hand, in cases where a fact that falls under the "donation or gratuitous transfer of money and other assets, or economic interests" concerning that transaction is not found, the transaction shall be treated as taxable under the transfer pricing taxation.

## Case 26: Treatment of price adjustment

### Key point

This case illustrates the treatment of the case where a corporation revises the transaction price retroactively after starting the foreign-related transactions and pays price adjustment to the foreign-related party. (Precondition 1 illustrates the case in which the payment of similar price adjustment is made in the transaction between unrelated parties. Precondition 2 illustrates the case in which price adjustment are paid based on the prior agreement between the corporation and the foreign-related party.)

Precondition 1: In the case where similar price adjustments are paid in the transaction between unrelated parties



### (Summary of business of corporation and foreign-related party)

Japanese corporation P is a manufacturer and distributor of product A, and ten years ago, it established corporation S in X country as a subsidiary to manufacture and distribute product A.

### (Summary of foreign-related transactions)

Company S purchases raw material "a" from a third party in country Y, and procures other raw materials in country X to manufacture the product A and sells it to company P. Company P sells product A imported from company S to a third party in Japan.

### (Content of payment of price adjustment)

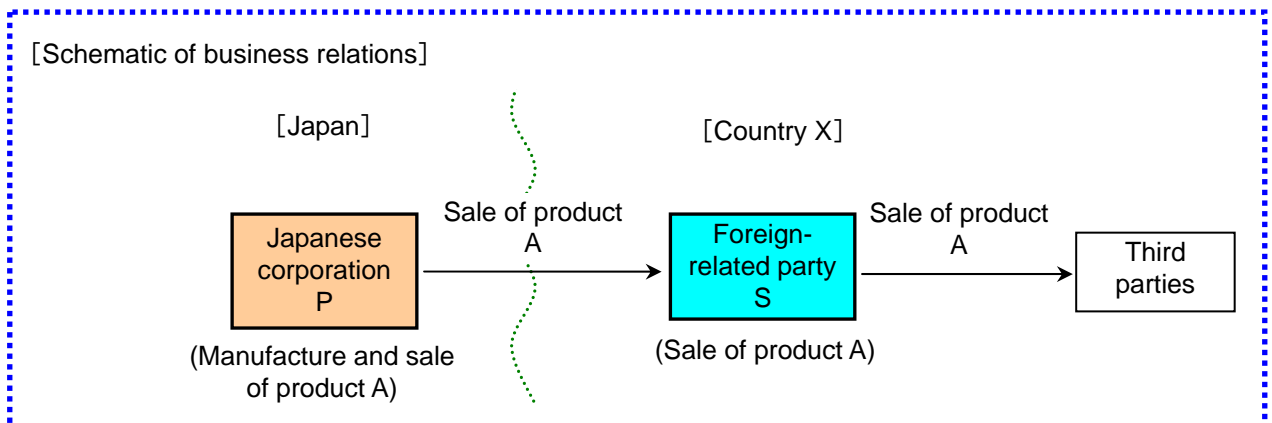
The transaction price of raw material "a" that company S purchases from a third party in country Y soared due to the stop of supply from other major production countries, which caused a substantial raise in the price. Company S partially passed the raised portion of the price of raw material "a" on the sales price of product A. However, the increase in the price of raw material "a" was beyond expectation, which resulted in the reverse-spread transactions. For this reason, company S determined to revise (raise) the transaction price with company P retroactively for the portion of transactions

effected after the price of raw material “a” had skyrocketed for which company S could not fully passed the increased portion on the transaction price. Company P paid the price adjustment associated with this revision in a lump sum to company S. After the price of raw material “a” had skyrocketed, the amounts of transaction price were retroactively changed by post-factum agreements between unrelated parties for the products using the raw material “a”, and price adjustment were delivered accordingly. The content of above-mentioned revision of price between company P and company S was similar to such a revision.

### Treatment for Transfer pricing Taxation Purposes

Company P and company S changed the price amount concerning the foreign-related transactions retroactively without being based on a prior agreement. However, since similar changes were made for transactions between unrelated parties similar to the foreign-related transaction, the price adjustment that company P paid to company S is deemed to be the result of revision of transaction price based on reasonable grounds.

Precondition 2: In the case where price adjustments are paid based on the prior arrangement between the corporation and the foreign-related party



#### (Summary of business of corporation and foreign-related party)

Japanese corporation P is a manufacturer and distributor of product A, and ten years ago, it established corporation S in X country which is a subsidiary to distribute product A.

#### (Summary of foreign-related transactions)

Company P sells product A to company S, and company S distributes the purchased product A to a third party agency in Country X.

While any comparable transaction for application of Traditional Methods could not be found, comparable transaction for application of the TNMM could be found from public information of country X. Company P and company S set the sales price of product A for company S based on the TNMM applicable to company S.

#### (Content of payment of price adjustment)

Company P and company S set the operating margin of the comparable transaction concerning application of the TNMM as the indicator for calculation of arm's length price, and determined to bring the operating margin of import and sales transaction of product A by company S to this level. They agreed and exchanged memorandums to revise the price of transactions effected during the period, at the end of the accounting period of company S in order to adjust the results to that indicator level, in cases where the result of operating margin of import and sales transaction of product A in each business year is gapped from that indicator.

Since the result of operating margin of import and sales transaction of product A for a business year was lower than that indicator, company S intended to adjust the purchase price of the business year by decreasing it at the end of the accounting period and sent a statement of amount to be adjusted by this revision to company P. Company P recorded a price adjustment of that amount as account payable on the last date of the business year, and transferred the amount to company S in the following business year.

#### Treatment for Transfer pricing Taxation Purposes

Company P and company S, based on the memorandum exchanged between them, set the transaction price of product A by the TNMM applicable to company S. For this reason, the price adjustment to be paid by company P to company S in the above case means a change of the transaction price of product A based on the legal method of calculation of arm's length price under pre-determined terms. The necessity of change of transaction price cannot be judged until the result of operating margin of import and sales transactions of product A by company S is established. Furthermore, company P cannot record the price adjustment unless it receives a statement concerning the adjustment of transaction price from company S.

Based on the above, the price adjustment recorded as account payable at the end of a business year by company P is deemed to be a change of transaction price under reasonable grounds, in the light of reason for record, content of prior agreement with foreign-related party, method of calculation, calculation basis, date on which the recording was determined, date of recording, etc (Administrative Guidelines 2-20).

(Note) The precondition is that the method of calculation of arm's length price used by company P and company S, selection of comparable transaction made by them, etc are all conformed to the provisions of law.

#### Explanation

1. A corporation and a foreign-related party may change, establish, or otherwise determine the price, for example, of the time of transaction concerning a foreign-related transaction, and adjust retroactively the amount of price concerning the foreign-related transaction, deliver the amount concerning that adjustment in the context of price adjustment, or record it as expense or income concerning the foreign-related transaction.

In cases where a delivery or recording of such price adjustment is made under reasonable grounds, it falls under an ordinary amendment of transaction price, and the price adjustment shall be examined for

the purpose of transfer pricing taxation by including it in the amount of price concerning the foreign-related transaction, and judged whether it is appropriate or not.

Furthermore, the retroactive change of the amount of price concerning the foreign-related transaction is conducted in a similar manner in a transaction between unrelated parties similar to that foreign-related transaction, the change shall be treated as an amendment of transaction price based on reasonable grounds.

2. In cases where a fact of payment of price adjustment to a foreign related party or recording it as expense (hereinafter referred to as “payment”), is found, note that retroactive change of transaction price in the transaction between unrelated parties shall not be conducted without a prior agreement except for special cases. The reasonability shall be determined in a comprehensive consideration of the reason concerning the payment, the content of prior agreement with the foreign-related party, the method of calculation and calculation basis, the date on which the payment was determined, the date on which the payment was made, and so on. In cases where the payment is judged as unreasonable, it shall be examined for application of provisions of ASMT Article 66-4(3) (Exclusion of Contribution to Foreign-related Party from Deductible Expenses) (Administrative Guidelines 2-20).

For example, in cases where the payment aims to financially support the foreign-related party, where the conditions to retroactively revise the transaction amount are not determined in advance with the foreign-related party, where the calculation of payment amount is not based on the legal method of calculation of arm’s length price, or where specific calculation basis of payment amount does not exist, and other similar cases, the payment of price adjustment is not usually deemed reasonable, and it requires examination.

In a condition where the actual status of payment of the price adjustment cannot be confirmed, for example, because the documents required for examination of payment of the price adjustment are not submitted by the corporation, note that it cannot be treated as the amount of price concerning the foreign-related transaction.



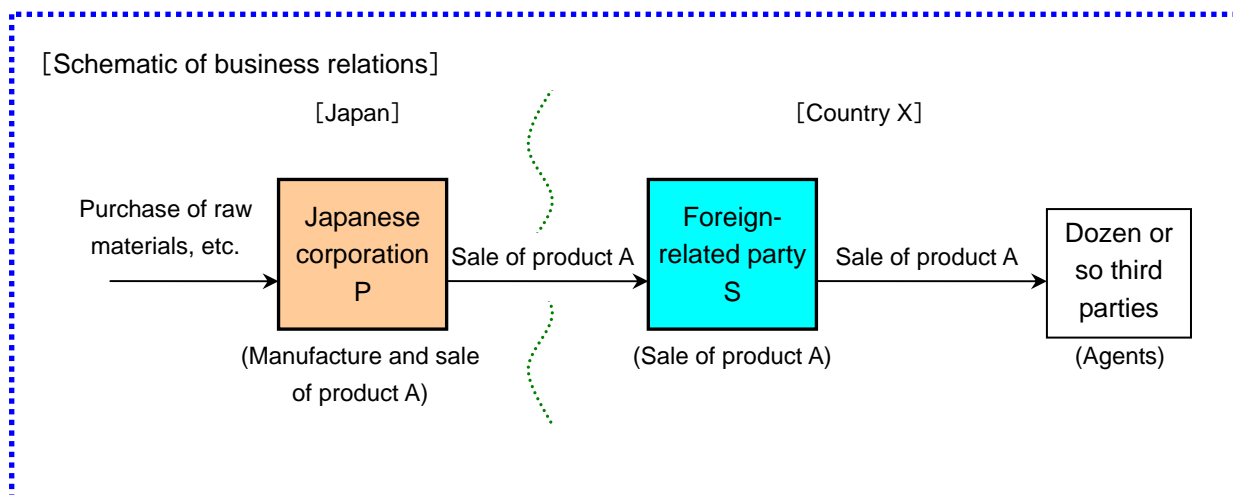
### Section 3. Cases of advance pricing arrangement

#### Case 27: Case of establishment of given range for target profit margin

##### Key point

This case illustrates the setting of a given range for the profit margin that an APA applicant adopts as its target in the taxable year to be confirmed.

##### Preconditions



##### (Summary of business of corporation and foreign-related party)

Japanese corporation P is a manufacturer and distributor of product A, and 10 years previously it established company S in country X as a subsidiary to distribute product A.

Product A is made using original technologies resulting from company P's R&D activities.

##### (Summary of foreign-related transaction)

Company P sells product A to company S, which sells it to a dozen or so third-party agents.

##### (Functions and activities of corporation and foreign-related party)

Product A, which is an outcome of R&D by company P, has seen sales increase due to its unique technical performance, and it has acquired a certain market share in country X.

Company S does not engage in original advertising or sales promotion activities.

##### (Market conditions)

The product A industry to which company P's business group belongs is known for being subject to major global swings in demand, causing large cyclical fluctuations in companies' profit situations.

##### (State of APA application)

Company P and company S file APA applications with mutual agreement to the tax authorities in both countries.

In these applications, the TNMM is applied to company S as the method of calculation of arm's length price, four enterprises in country X that are comparable with company S are selected from a corporate database, and a fixed range defined by these enterprises' average ratio of operating profit to net sales (fixed throughout the taxable years to be confirmed) over the past five years is adopted as the profit

margin employed by company S as its target.

All four enterprises for comparison are distributors with only one business segment, and they were found to be comparable with company S in terms of goods traded, market, sales functions, and so forth.

#### Treatment for transfer pricing taxation purposes

As the result of comparability analysis, the following results were obtained (Regarding the points to note when selecting the method of calculation of arm's length price and making a comparability study, see the "Explanation" to Case 1.)

Product A is manufactured by using unique technology of company P by its R&D activities, and no potential comparable transaction can be found for application of the CUP method. And no potential comparable transaction can be found for application of a method consistent with the CUP method.

Company S, which only sells products, performs a simpler function than company P, which engages in manufacturing and sales as its business, therefore, it is deemed more appropriate to select company S as the tested party.

From openly accessible information, no potential comparable transaction can be found in applying the RP method under which company S is the tested party. However, potential comparable transactions can be found in applying the TNMM under which company S is the tested party, and a comparable transaction can be selected from those potential comparables.

In view of the above, application of the TNMM to company S (due to its having relatively simple functions) and the selected comparable transactions employed by company P in its APA application were found to be appropriate.

Due to the large cyclical fluctuation in profits among companies in the product A industry to which company P's business group belongs, it is appropriate in this case to incorporate the effects of this cycle in the range of the target profit margin.

It is also necessary to attach critical assumptions in cases of extreme changes in market conditions, such as those exceeding normal fluctuations in the product A industry. (Regarding the setting of critical assumptions, see Case 28.)

#### Explanation

1. Advance pricing arrangements (APAs) consist of the advance confirmation by a district tax office director or similar official of the method of calculation of arm's length price used for foreign-related transactions, and are performed in response to applications by taxpayers in order to ensure the predictability of transfer pricing taxation for taxpayers. Japan was one of the first countries in the world to adopt such a system in 1987.

If a corporation that has received confirmation files a return that corresponds to the content of the APA in the taxable year confirmed, the transaction to be confirmed is treated as having occurred at the arm's length price. In addition, in cases where a taxable year to be confirmed has already elapsed at the time of the APA, the amended return submitted by the confirmed corporation to make the return filed for the taxable year in question comply with the content of the APA is not treated as

corresponding to a “return filed foreknowing that corrections should be made” prescribed in Article 65(5) (Additional Tax for Deficient Returns) of the Law on General Rules for National Taxes (Administrative Guidelines 5-16).

It shall be noted that in cases where a return is filed for the taxable year in question due to the arrival of the due date for filing for the taxable year to be confirmed during the period from the application for APA to notification of APA, transactions to be confirmed relating to the return are not subject to transfer pricing examination.

2. In calculating the arm’s length price in APA, the arm’s length price is calculated using information obtainable by the corporation—i.e. information on internal comparable transactions engaged in by the corporation or foreign-related party, or external comparable transactions based on publicly available information from sources such as databases of corporate data—or applying the profit split method using internal information from the corporation and foreign-related party. Regarding external comparable transactions, comparability must be ensured by considering other data available, as well as information from databases of corporate data. In APA evaluations, too, consideration is to be given to the matters set forth in Administrative Guidelines 2-1 (Administrative Guidelines 5-11(2)). At such time, it should be borne in mind that there are cases in which the submission of materials enabling confirmation of the state of allocation of income between the corporation and foreign-related party may be requested even where an APA application is not premised on application of the profit split method.

When the RTB division-in-charge has finished its evaluation of an APA application with mutual agreement, the RTB division-in-charge’s opinion is communicated to the Office of Mutual Agreement Procedures through the NTA division-in-charge, and conveyed to the APA applicant corporation.

3. An APA is a means of forecasting the APA applicant’s future profit from a foreign-related transaction, and there are cases in which an APA can be set up using a fixed range of profit margin (such as an interquartile range), rather than a specific level (i.e. a specific point) in order to ensure the predictability of transfer pricing taxation for taxpayers.

This point shall be treated differently from examination which uses specific point for determination of income amount of the past business year, in the case where the price the corporation receives from the foreign-related party does not reach the arm’s length price, or in the case where the price the corporation pays to the foreign-related party exceeds the arm’s length price.

It is to be noted that when a certain range is established, there are also cases in which it is deemed appropriate to use a range consisting of all comparable transactions, as well as a range determined by the interquartile method (See the “Explanation” 5 to Case 1).

(Note) In cases of an APA set up by Japan alone without mutual agreement, confirmation is performed using only the upper or lower limits of the respective ranges according to whether the corporation to be verified is a foreign-related party or the APA applicant.

4. The data used to establish the range of the target profit margin can be utilized in two ways:

- (1) When verifying each taxable year to be confirmed, progressively updating the data on the profit margins of comparable transactions using the most up-to-date data to establish the range of the target profit.

This is a method of establishing the range of the target profit margin using the average of the profit margins on the comparable transactions in each taxable year to be confirmed. These profit margins are updated to include data for the latest period by adding data for the corresponding taxable year to be confirmed, and removing the data for the oldest period.

This method enables the use of data corresponding to the year of the foreign-related transaction and comparable transactions used for the APA, and allows fluctuations in market conditions to be incorporated into the range of the target profit.

If this method is used, however, it is necessary to take into consideration the fact that the target profit margin is not determined until the profit margin data for the comparable transactions to be updated becomes available. There also exists the possibility of the range of the target profit margin becoming skewed if the comparable transactions used at the time of the APA cease to exist.

- (2) Using data for a fixed period relating to comparable transactions to establish the target profit margin

This is a method of establishing the range of the profit margin adopted as the target based on the average profit margin during a past fixed period for comparable transactions, and fixing and applying this range over the entire period of the taxable years to be confirmed.

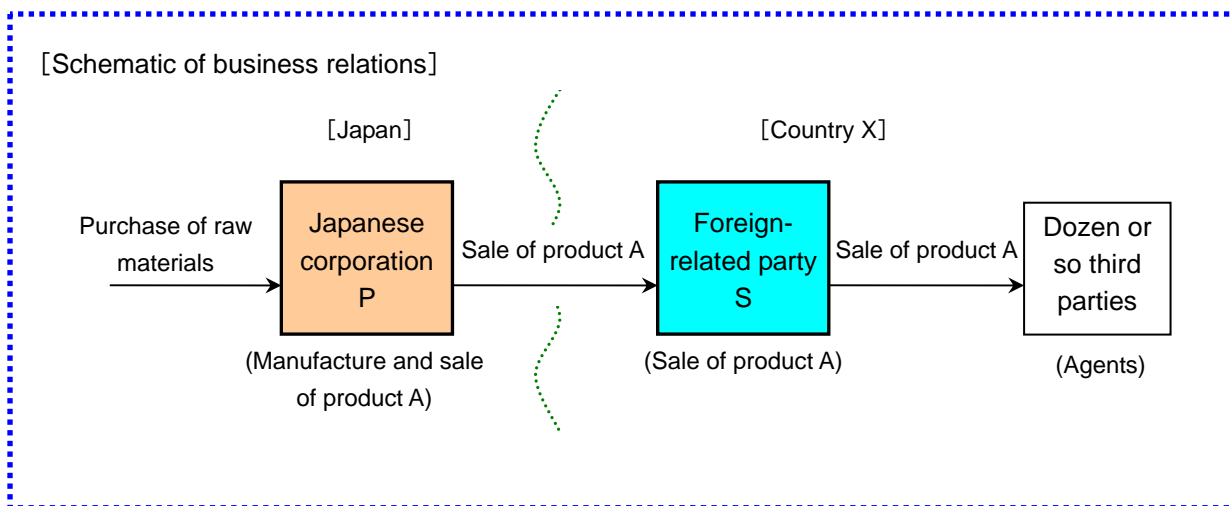
This is the method that is generally used when fluctuations in business conditions are not particularly great, and the range of the target profit margin is predetermined.

## Case 28: Critical assumptions

### Key point

In this case, it is deemed appropriate to attach material commercial or economic conditions to the APA.

### Preconditions



### (Summary of business of corporation and foreign-related party)

Japanese corporation P is a manufacturer and distributor of product A, and 10 years previously it established company S in country X as a subsidiary to distribute product A.

Product A is manufactured using original technologies resulting from company P's R&D activities.

### (Summary of foreign-related transaction)

Company P sells product A to company S, and company S sells its purchases of product A to about a dozen third-party agents.

### (Functions and activities of corporation and foreign-related party)

Product A, which is a result of R&D by company P, has seen sales increase due to its unique technical performance, and it has secured a certain market share in country X.

Company S does not engage in original advertising or sales promotion activities.

### (Market conditions)

Product A and similar products are susceptible to sharp fluctuations in market prices worldwide, and companies' profits fluctuate considerably depending on fluctuations in market prices. The specifications of the best-selling products also often change rapidly in this industry.

The accounting system in country X is currently undergoing major revision, and extensive amendments are expected in the future.

### (State of APA application)

Company P and company S apply to the tax authorities in the two countries for an APA, together with applications for mutual agreement procedures, using the TNMM applied to company S as the method

of calculation of the arm's length price. These applications were deemed appropriate in content (in terms of their selection of method of calculation of the arm's length price, choice of comparable transactions, etc.).

#### Treatment for transfer pricing taxation purposes

In the present case, there is a possibility of substantial fluctuations in company S's actual profit margin at some point in the future in the event of large fluctuations in market prices or changes in the specifications of products traded. In such event, it is considered inappropriate to use the method of calculation of the arm's length price confirmed on the basis of the present situation in unmodified form. Moreover, if the method used to calculate company S's profit margin undergoes change as a result of changes to the accounting system, company S's actual profit margin and the results calculated based on the details submitted for the APA request could diverge, creating the risk that it could no longer be determined whether the actual values conformed to the content of the APA.

In the present case, therefore, business or economic conditions need to be attached as preconditions for the APA and continued confirmation in order to guard against such a situation occurring in the taxable year to be confirmed. Such conditions might include the following: (1) company S's sales shall not diverge substantially from present circumstances, (2) the portfolio of goods traded by company S shall not change substantially, and (3) there shall occur no substantial changes in country X's accounting system.

#### Explanation

An APA is concluded in the cases where it is found that the methodologies are reasonable as the method of calculation of arm's length price in future years in the light of the business situation concerning past and present foreign-related transactions.

Should unforeseeable changes arise in material circumstances in the taxable year to be confirmed, such as substantial changes in market prices, the conditions upon which the APA is premised will change, rendering it no longer appropriate to continue the APA in unmodified form. For this reason, "material business and economic conditions essential to the APA and its continuation (hereinafter referred to as "critical assumptions")" shall be set up and documents describing these conditions shall be attached with the APA request (Administrative Guidelines 5-3(c)).

Due to the difficulty of exhaustively predetermining the factors that might affect the continuation of an APA, it is common to attach generic conditions, such as the requirement that there shall occur "no material changes in business or economic conditions" or "no fundamental changes in the functions performed by related parties or the assets used." However, more specific conditions may be attached in some cases, such as "no change beyond a certain range in the exchange rate," in order to make it clearly predictable whether a situation corresponds to the conditions established as the critical assumptions.

In the event of a change in circumstances prescribed in the critical assumptions, it is necessary to reconsider the method of calculation of the arm's length price under the situation in question, and the confirmed corporation will, as a rule, have to apply for amendment of the APA (Administrative

Guidelines 5-20). If the confirmed corporation does not make such an application, the APA is invalidated from the taxable years in which the situation arose (Administrative Guidelines 5-21(1)(a)). (Note) In the cases of an APA with mutual agreement, a mutual agreement procedure must be initiated between the tax authorities and an agreement reached on a method of calculation of the arm's length price differing from the initial method.

It shall be noted that the confirmed corporation shall enter and submit in a report in each confirmed taxable year a "statement of any changes to business or economic conditions based on which the APA is given" (Administrative Guidelines 5-17(c)).