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Recent Developments in Japan's International Taxation¹

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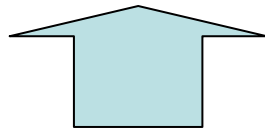
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Background - Domestic Economy

- Demographic changes
 - Decreasing population
 - Rapidly-aging society
- Diversification
 - Family structure & work patterns
 - Corporate structure
 - Investment activities
- Macro-Fiscal conditions
 - Contracting labor force
 - Lowering household saving rate
 - Large fiscal deficit

Background – Globalization

- Widening & deepening interdependence
 - With respect to goods, capital, know-how, etc
 - With rest of the world, in particular, Asia



- Liberalization in trade & capital movement
- Revolutionary IT progress
- End of the Cold War

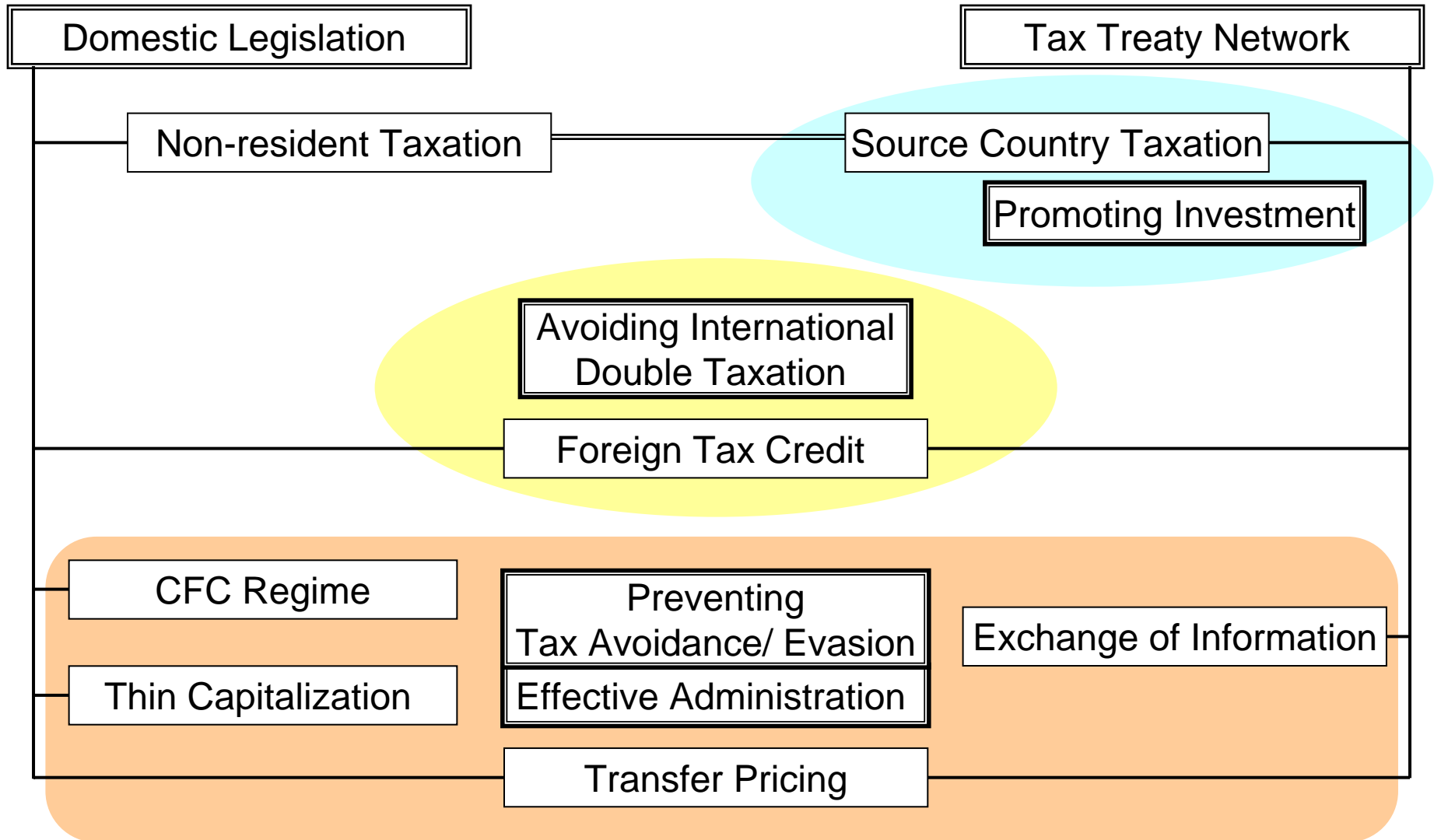
Background – Globalization

- Growth in cross-border transaction
 - E-commerce
 - Services and intangibles
 - Innovative schemes
- Tax competition/ harmonization
 - CIT rate reductions (w/ base broadening)
 - Taxing capital differently from labor?
 - Greater chance of tax evasion and avoidance

Challenges for International Taxation

- Economic revitalization (Japan & Asia)
 - Facilitate mutual investment flows
 - Promote technology transfers
- Fair and neutral taxation
 - Avoid double/ no taxation
 - Properly respond to diversifying business structure & investment activities
- Prevent tax evasion
 - Tax haven/ preferential regime issues
 - Cope with tax shelter, treaty shopping, etc

Japan's International Taxation



History of International Taxation Policy

Japan

- 1953 : Foreign Tax Credit
- 1955 : First Tax Treaty (Japan-US)
- 1962 : Indirect Foreign Tax Credit
- 1978 : CFC rules
- 1986 : Transfer Pricing rules
- 1992 : Thin Capitalization rules

OECD

- 1963 : OECD Model Tax Convention
- 1979 : “Transfer Pricing and Multinational Enterprises” report
- 1987 : “Thin Capitalization” report
- 1995 : Transfer Pricing Guideline
- 1998 : “Harmful Tax Competition” report

Topics for Today's Seminar

- Transfer Pricing: FY2007 measures
 1. Grace of tax payment during MAP
 2. Clarification of TP application
 3. APA

Transfer Pricing : Background

- Increase of cross-border intra-group transactions under globalization of business activities
 - Involvement of intangibles
 - Intra-group services
- Increasing number of TP cases and corresponding income assessed for the cases

	2001	2002	2003	2004	2005
TP cases	43	62	62	82	119
Assessed income (billion yen)	85.7	72.5	75.8	216.8	283.6

Topics for Today's Seminar

- Transfer Pricing: FY2007 measures

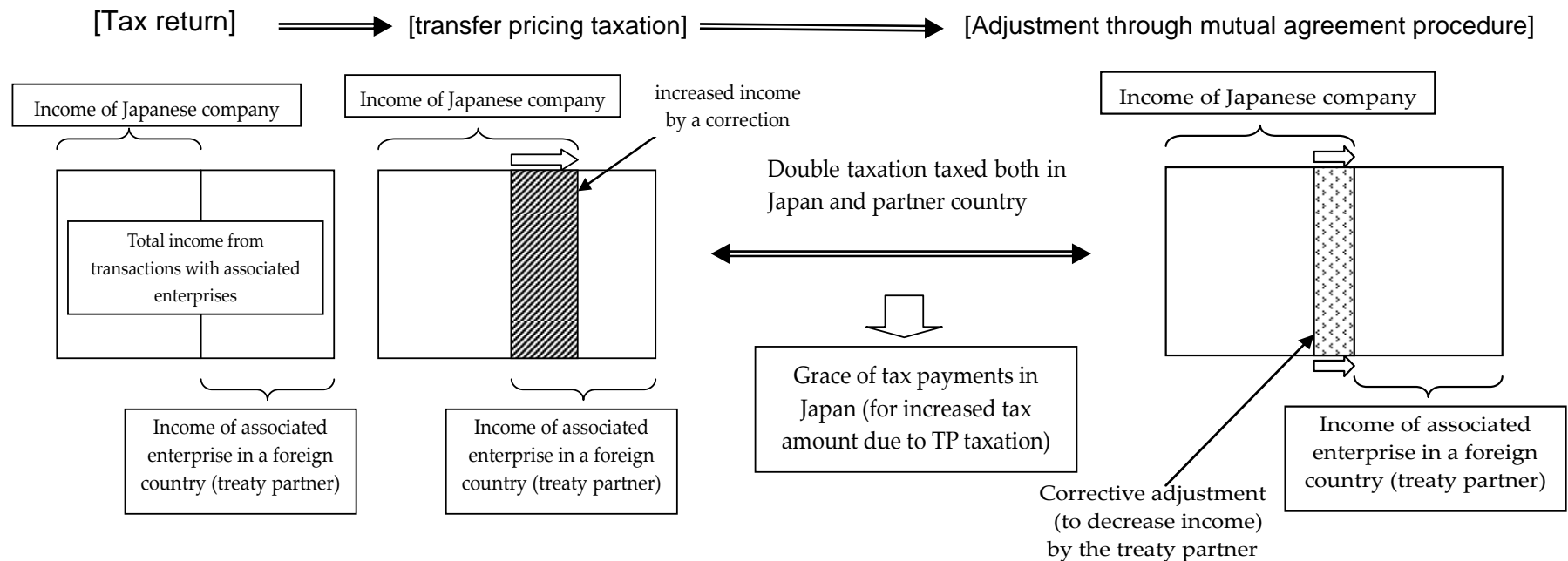
1. Grace of tax payment during MAP

2. Clarification of TP application

3. APA

1. Grace of tax payment during MAP

- To alleviate double-taxation burden on business
 - Introduced grace of tax payments in the course of mutual agreement procedures with treaty partners
 - No delinquent tax for the grace period



Topics for Today's Seminar

- Transfer Pricing: FY2007 measures
 1. Grace of tax payment during MAP
 - 2. Clarification of TP application**
 3. APA

2. Clarification of TP application

- Revised NTA Administrative Guideline on TP application
- Clarified applicability criteria
 - On transactions involving **intangibles**
 - To determine whether intangible properties served as the source of income
 - To select comparative transaction
 - On rendering of **services**

2. Clarification of TP application

- Compiled Reference Cases
- As its annex, illustrate key points of the Administrative Guidelines
 - Drawing on past experience, these cases clarify TP application under individually specified set of assumptions (26 cases in total)
 - Selection of ALP calculation method (9 cases)
 - Points to note in applying ALP calculation method (15 cases)
 - Advance Pricing Agreement (2 cases)

2. Clarification of TP application

- Illustration of Reference Cases

Case 1: CUP (and Overview)
Case 8: Residual Profit Split Method

- When to use residual PS method

– Case 18: Residual Profit Split Method

- How to calculate profit to be split

– Case 22: Residual Profit Split Method

- Split factors for splitting residual profit

– Case 23: Intra-group provision of services

Overview (cf. Case 1)

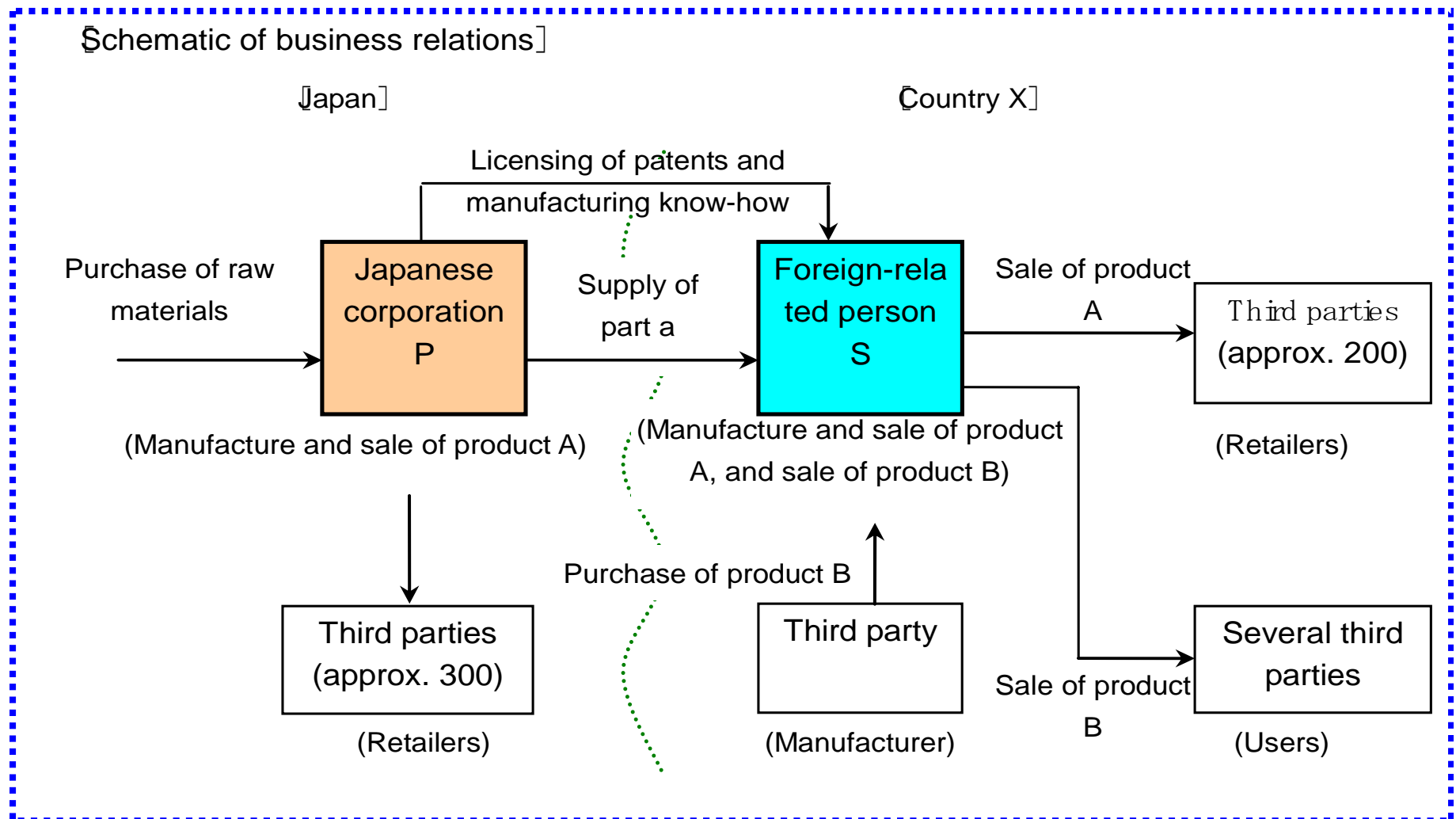
- Traditional Transaction Methods:
 - CUP (Comparable Uncontrolled Price)
 - RP (Resale Price)
 - CP (Cost Plus)
- Transactional Profit Methods:
 - TNMM (Transactional Net Margin Method)
 - PS (Profit Split)
 - Contribution Profit Split
 - Comparable Profit Split
 - Residual Profit Split

Overview (cf. Case 1)

- Priority in applying TP methods
 - Applicability of traditional transaction methods to be examined first
 - OECD 1995 TP Guideline
 - “**Last resort**” status of **transactional profit methods**
 - Their use should be limited to those exceptional situations where there are **no data** available or where the available data are **not of sufficient quality** to rely solely or at all on the traditional transaction methods

Reference Cases (Case 18)

- Calculation of profit to be split (residual profit split method)



Reference Cases (Case 18)

- Assumptions
 - Company P
 - A manufacturer and distributor of Product A, which is made of Part a, a core part that intensively utilizes company P's original technologies
 - Established Company S in Country X
 - In addition to selling part a to company S, licenses related patent and manufacturing know-how

Reference Cases (Case 18)

- Assumptions
 - Company S
 - In addition to manufacturing and selling product A, purchases stocks of product B from a manufacturer in country X and sells them to users in country X.
 - Engages in various sales promotion activities employing numerous sales representatives
 - advertises on a large scale in country X

Reference Cases (Case 18)

- Assumptions

- Product A has secured a certain market share in country X thanks to:

- the unique technical performance of the product itself
 - its strong product recognition and the well-developed retail store network through which it is sold built up through advertising and sales promotion activities

Reference Cases (Case 18)

- Assumptions

Company P profit and loss data

Sales of product A	200
Sales of part a	35
Royalties received	5
Total sales	240
Cost of sales of product A	95
Cost of sales of part a	25
Total cost of sales	120
Gross profit on sales	120
Product A selling expenses	48
Part a selling expenses	2
R&D cost	25
Administrative expenses	15
Total selling and administrative expenses	90
Operating profit	30

Company S profit and loss data

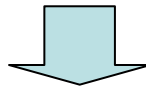
Sales of product A	110
Sales of product B	500
Total sales	610
Purchases of part a	35
Other costs of product A	10
Purchases of product B	480
Royalties paid	5
Total cost of sales	530
Gross profit on sales	80
Product A selling expenses	15
Product B selling expenses	5
Administrative expenses	10
Total selling and administrative expenses	30
Operating profit	50

Reference Cases (Case 18)

- Application of TP

- No comparable transactions for any of the foreign-related transactions

- sale of part a
 - licensing of patents and know-how

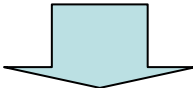


Traditional Transaction Methods not applicable

- Which of the Transactional Profit Method to use?

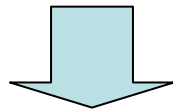
- Explanation in Case 8 clarifies the selection criteria

Use of Residual PS (cf. Case 8)

- Operation of Company P
 - The 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
 - Part a that company P sells is also manufactured using these original technologies
- 
- Intangible properties served as a source of income, compared to a “corporation engaging solely in basic activities”

Use of Residual PS (cf. Case 8)

- Operation of Company S
 - engages in various sales promotion activities employing numerous sales representatives
 - advertises on a large scale in country X



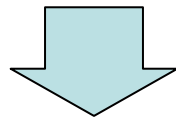
- Employing a better developed network of retailers and enjoying higher product recognition than a “corporation engaging solely in basic activities”

Use of Residual PS (cf. Case 8)

- “Corporation engaging solely in basic activities”:
 - engaging in the same category of business
 - of a similar scale
 - active in a similar market
 - holding **no intangible properties** that contribute to profit that cannot be generated from basic activities such as manufacturing and sales activities alone

Use of Residual PS (cf. Case 8)

- Intangible properties served as sources of income, compared to a “corporation engaging solely in basic activities”, for **both** Company P and Company S
 - Company P: unique technology
 - Company S: sales promotion / advertising



deemed appropriate to apply Residual Profit Split method

Reference Cases (Case 18)

- Calculating profit to be split
 - Needs to extract profit and loss on foreign-related transactions from the overall profit and loss of company P and company S
 - Company P
 - (1) P/L for part a destined for company S
 - (2) P/L for product A destined for domestic sale
 - Company S
 - (1) P/L for product A
 - (2) P/L for product B

Reference Cases (Case 18)

- Assumptions

Company P profit and loss data

Sales of product A	200
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Administrative expenses	10
Total selling and administrative expenses	30
Operating profit	50

Reference Cases (Case 18)

- Company P: R&D expenses
 - R&D expenses need to be allocated to (1) or (2) based on appropriate criteria
 - excluding expenses that are allocated directly
 - Not appropriate to use sales of part a to company S (35), which is a controlled transaction
 - Appropriate to use, for example, sales of product A to Japan (200) and to country X (110) as allocation factor

Reference Cases (Case 18)

- Company P: SGA expenses
 - Selling, general and administrative expenses linked individually to (1) or (2) should first be allocated individually
 - product A selling expenses (48)
 - part a selling expenses (2)
 - Shared expenses need to be allocated based on reasonable criteria, for example:
 - cost of sales for part a destined for company S (25)
 - cost of sales for product A destined for the domestic market in Japan (95).

Reference Cases (Case 18)

- Calculating profit to be split: Company P

Sales of part a	35	
– Part a cost of sales	25	
+ Royalties received	5	
– R&D costs after allocation	9	$\left(= \text{total R\&D cost } 25 \times \frac{110}{110+200} \right)$
– Part a selling expenses	2	
– SGA after allocation	3	$\left(= \text{total SGA exp. } 15 \times \frac{25}{25+95} \right)$
<hr/>		
= Operating profit for foreign-related transactions	1	

Reference Cases (Case 18)

- Company S: SGA expenses
 - any common expenses for Product A division and Product B division (SGA expenses 10) needs to be allocated based on reasonable criteria
 - Using the ratio of purchases (45:480) would be inappropriate, as it includes controlled transactions
 - Purchase of part a 35 + Other costs of Product A 10 = 45
 - Purchase of Product B = 480
 - Appropriate to use a variable such as the ratio of selling expenses specific to each division (15:5)
 - Product A selling expenses 15
 - Product B selling expenses 5

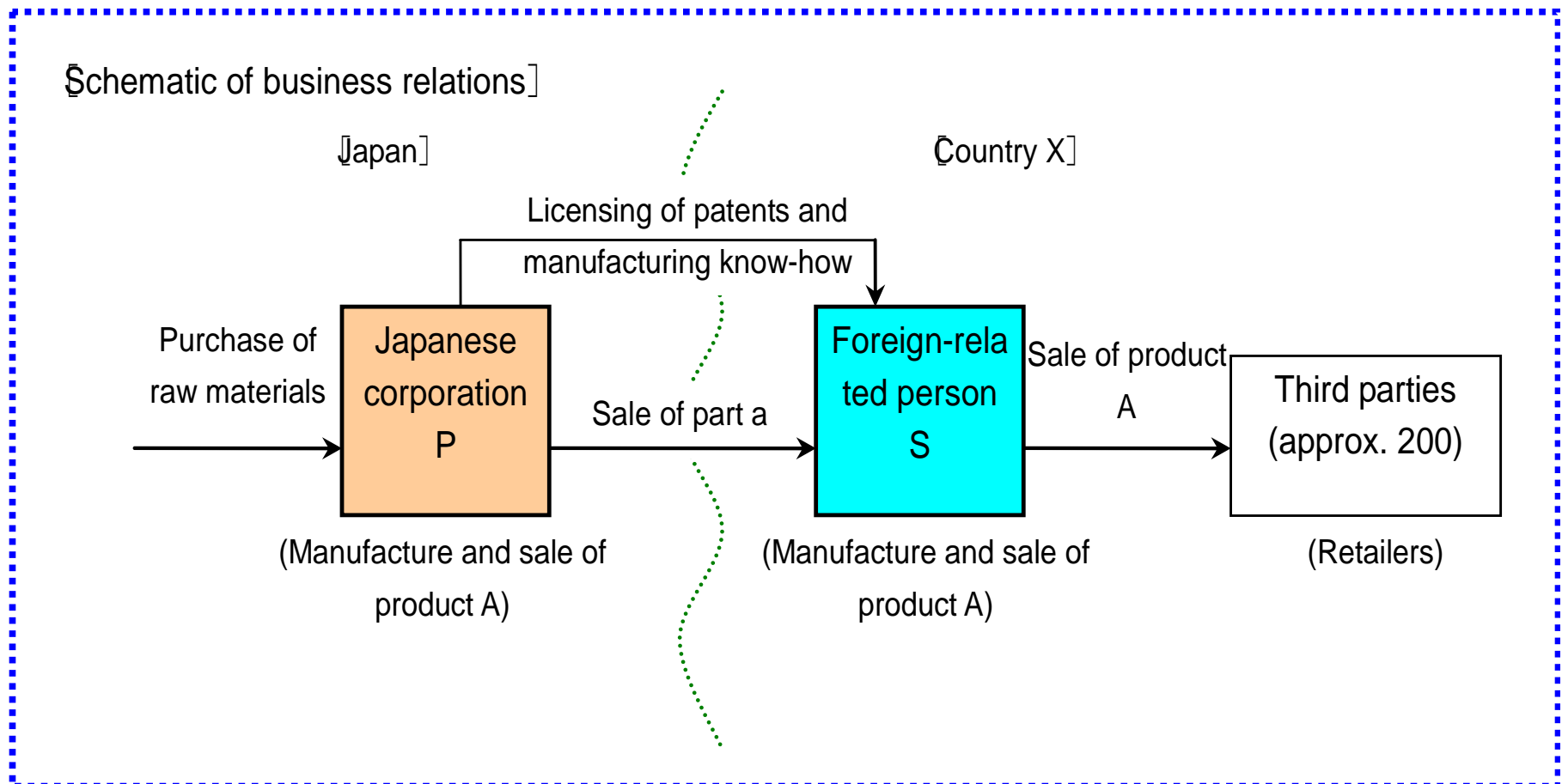
Reference Cases (Case 18)

- Calculating profit to be split: Company S

Sales of product A	110	
— Purchases of part a	35	
— Other costs of product A	10	
— Royalties paid	5	
— Product A selling expenses	15	
— SGA exp. after allocation	8	$\left(= \text{total SGA exp. } 10 \times \underline{15 / (15+5)} \right)$
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= operating profit for foreign-related transactions	37	

Reference Cases (Case 22)

- Split factors for splitting residual profit



Reference Cases (Case 22)

- Assumptions
 - Company P
 - A manufacturer and distributor of Product A, which is made of Part a, a core part that intensively utilizes company P's original technologies
 - Established Company S in Country X
 - In addition to selling part a to company S, licenses related patent and manufacturing know-how
 - Company S
 - Manufactures product A and sells them to third parties in country X
 - Engages in various sales promotion activities employing numerous sales representatives
 - advertises on a large scale in country X

Reference Cases (Case 22)

- Assumptions

- Company P

- continuously engages in R&D on developing product A, including R&D that did not ultimately lead to final products
 - No separate account for individual patents and manufacturing know-how
 - R&D expenditures have been generally constant at around 7% of sales

Reference Cases (Case 22)

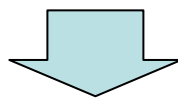
- Assumptions
 - Company S
 - advertising activities all concern product A, contributing to the creation of intangible properties in marketing
 - advertising costs have been generally constant at around 8% of sales

Reference Cases (Case 22)

- Splitting factor for residual profit split method
 - Residual profit needs to be allocated to company P and company S according to an appropriate splitting factor
 - The amounts of expenses on development of material intangible properties serving as sources of income are to be used as the splitting factor
 - However, expenses for individual intangibles (patents, manufacturing know-how, and marketing intangibles) cannot be identified

Reference Cases (Case 22)

- Splitting factor for residual profit split method
 - Absolute values of intangibles do not need to be determined
 - The proportion of relative values of respective parties' intangibles may suffice



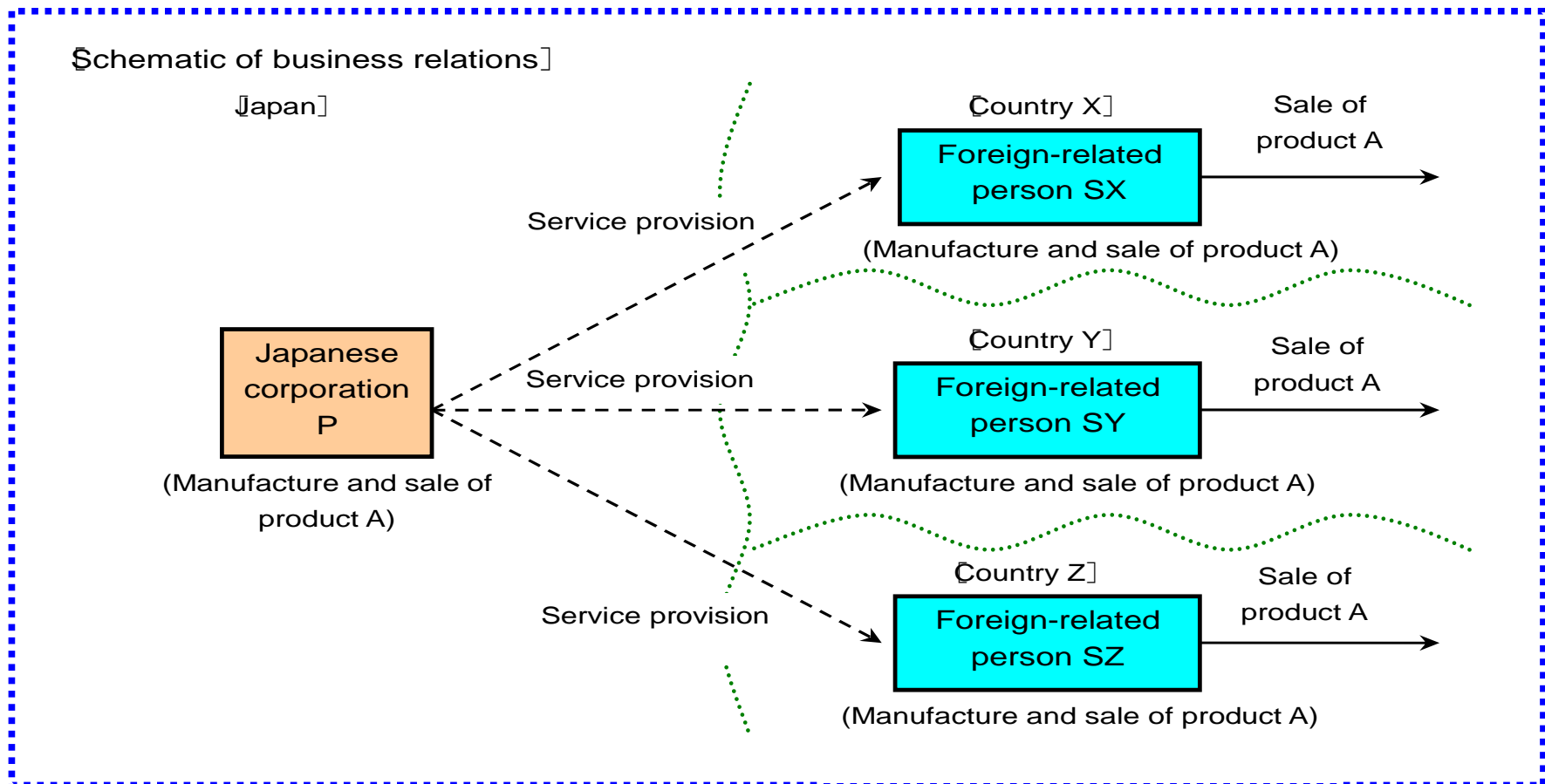
- Splitting factor could be determined on, e.g.,:
 - Expenses in each period that reflect the creation, maintenance, and development of intangibles
 - Acquisition cost of intangibles

Reference Cases (Case 22)

- Splitting factor for residual profit split method
 - Expenses in each period can be used as splitting factor, if:
 - Activities to create, maintain, and develop intangible properties are performed continuously
 - Associated expenses in each period are comparatively stable
 - NB: In cases of large fluctuations in such expenses, it is possible to use:
 - Average amount of expenditures during a reasonable period; or
 - The sum of expenditures in a reasonable period allocated to a certain number of years

Reference Cases (Case 23)

- Intra-group provision of services



Reference Cases (Case 23)

- Assumptions
 - Company P
 - A manufacture and distributor of Product A
 - Established company SX in country X, company SY in country Y, and company SZ in country Z
 - Company S (SX, SY, and SZ)
 - Procures all parts and raw materials locally to produce product A to be sold locally

Reference Cases (Case 23)

- Assumptions

- As intra-group services, Company P:

- (a) Determines human resource policy of Company S

- (b) Manages business operations of Company S through weekly teleconference

- (c) Checks draft budgets prepared by Company S

- (d) Compiles monthly financial and management data of Company S for reporting within Company P

- (e) Checks data from Company S for consolidated financial statement

- (f) Accompanies company P's internal auditors in audit of Company S

- (g) Accompanies outside accounting firm in audit of company S

Reference Cases (Case 23)

- (h) Audits Company S's observance of environmental legislation
- (i) Checks contracts, and answers legal queries by Company S
- (j) Develops and maintains computer system linking Company P and Company S to promptly deal with product complaints
- (k) Makes investment decision, analyses risks and arranges financing for Company S
- (l) liaise consultations on operational matters from company S
- (m) Supports Company S in relationship-building and negotiations with key clients
- (n) Negotiates and makes decision on key contracts of Company S, and implements them

Reference Cases (Case 23)

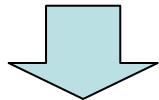
- All intra-group services that have **commercial value** are to be treated as “foreign-related transactions” (i.e., subject to TP rules)
- How to determine whether each of the intra-group services has commercial value?
Without such IGS, it would have had to:
 - Obtain such services from an unrelated person by paying their prices; or
 - Undertake such services itself

Reference Cases (Case 23)

- A corporation routinely maintains personnel, facilities, and similar resources capable of providing services as and when necessary in response to requests by foreign-related persons
- The maintenance of such a state is considered as provision of services

Reference Cases (Case 23)

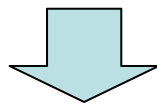
- A subsidiary receives services from an unrelated person or engages in such services itself
- Its parent company provides services to the subsidiary, i.e., duplicating such services



- No commercial value
 - Unless such duplication is considered temporary; or
 - The duplicated services are deemed to be procedural double-checks to reduce risks

Reference Cases (Case 23)

- Services are “shareholder activities”
 - Performed by the parent company in its capacity as a shareholder in the subsidiary
 - e.g.,
 - activities by the parent company for its shareholders meeting
 - activities by the parent company for its financial reports



- No commercial value
 - (d), (e), and (g) do not have commercial value

Topics for Today's Seminar

- Transfer Pricing: FY2007 measures
 1. Grace of tax payment during MAP
 2. Clarification of TP application

3. APA

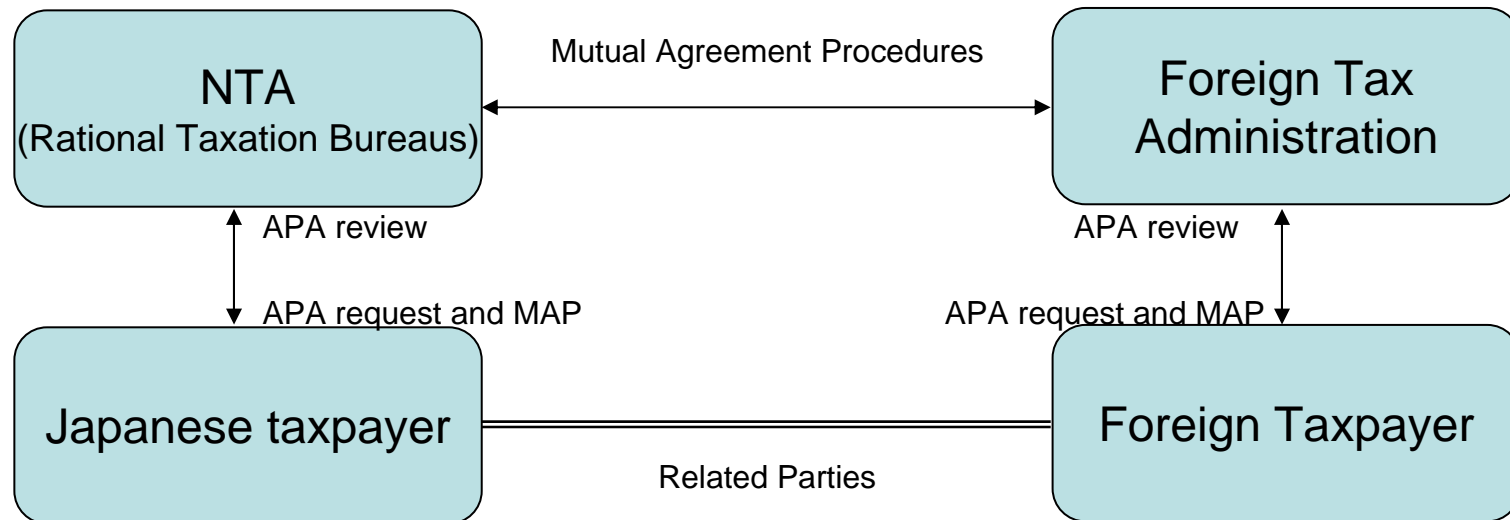
3. APA

- Advance pricing agreement (APA)
 - Confirmation made by tax authorities with regard to the method of calculating ALP
 - APAs were first created in Japan in 1987

Number of cases	2001	2002	2003	2004	2005
Received	25	49	65	51	76
Settled	18	28	28	34	32
Carried over	85	106	143	160	204

3. APA

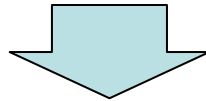
- Bilateral APA
 - APA by related CA (competent authorities) through MAP (Mutual Agreement Procedure)



3. APA

- Pre-filing consultation

- Taxpayers can consult with tax authorities before applying for an APA



- Established a dedicated pre-filing consultation office in each Rational Taxation Bureau
- Provides related information in NTA website to familiarize taxpayers with the pre-filing consultation system

Regarding APA

- Shorten examination time for APA
 - Strengthened administrative organization
 - increased the number of persons in charge of APA

(number of persons)

	2001		2006		2007
Persons assigned to APAs	15	➡	34	➡	68
Persons assigned to MAPs	9	➡	19	➡	19

- Continue to improve efficiency of APA process, and enhance close cooperation with treaty partners in mutual agreement procedures

3. APA

- Revised related Administrative Guidelines
 - Described explicitly on pre-filing consultation
 - Declared explicitly to make efforts to shorten examination time of APA