

The TNMM is only available for fiscal years beginning on or after 1 April 2004, as the method was added to the Japanese transfer pricing rules in the 2004 tax reform.

The following paragraphs explain each of the permitted methods in greater detail.

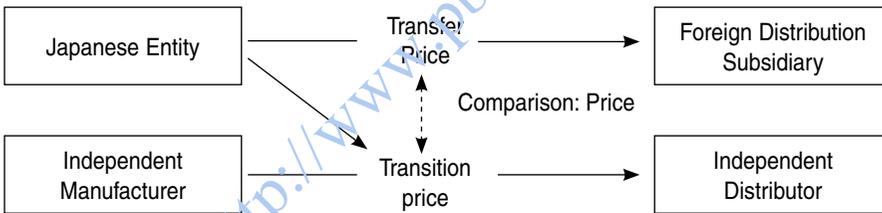
Law: Art 66-4 of the *Special Taxation Measures Law*.

JPN ¶3-860 Transaction methods

(1) CUP Method

The CUP method uses tangible property transactions between unrelated parties to determine the arm's length consideration for tangible property transacted between related parties. This method evaluates whether the amount charged in a foreign related transaction is arm's length by reference to the amount charged in a comparable uncontrolled transaction. This is illustrated below:

Figure 4: CUP Method



In the above example, the Japanese entity which has transactions with its foreign related party (the foreign distribution subsidiary above) may also have similar transactions with an unrelated party (the independent distributor above). Such transactions may provide a comparable uncontrolled price. Alternatively, in the absence of such transactions, there may be similar transactions between two third parties unrelated either to the Japanese entity or to its foreign related party. If such transactions exist, and data on the prices used in those transactions are available, then those transactions may provide a comparable uncontrolled price.

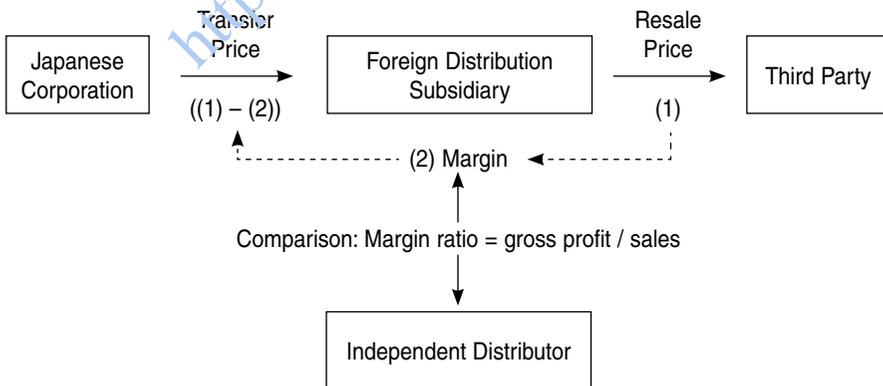
In making this evaluation, it is important that comparable transactions to be used under the CUP method substantially involve the same products as the

foreign related transaction because similarity of products generally will have the greatest effect on price under this method. In addition, the transaction conditions, terms, volume, and other factors which may affect the price also must be identical or highly similar. If there are material product differences or differences in transaction conditions, terms, volume, etc, between the foreign related transaction and comparable uncontrolled transaction which may affect the transaction price, it is necessary to quantify the impact of those differences and adjust the comparable uncontrolled price accordingly. If accurate adjustments for such differences cannot be computed, the CUP method ordinarily will not provide a reliable measure of an arm’s length result. (STML Art 66-4 para 2(i)(a))

(2) RP Method

The RP method can be employed to determine the arm’s length consideration to be earned by the purchaser in a foreign related transaction when it, in turn, resells to unrelated parties. The RP method evaluates whether the amount charged in a controlled transaction is arm’s length by reference to the gross profit margin realised in comparable uncontrolled transactions. More specifically, the arm’s length price in a foreign related transaction is computed by deducting from the third party sales price a “normal” (ie arm’s length) gross profit margin. The normal gross profit margin is determined by reference to gross profit margins earned in comparable uncontrolled transactions. This is illustrated in the following example:

Figure 5: RP Method



examiners will generally continue to visit the taxpayer once every one to three weeks to receive the taxpayer's answers to the questions and to ask additional questions or to ask for clarifications of the taxpayer's responses.

The number and timing of meetings, number and types of questions asked, and length of time required by this stage varies from case to case. A complex case involving multiple types of transactions with multiple foreign related parties could last up to a year or even longer. A relatively simple case could finish after only a few months. The time required will also be influenced by the arguments made by the taxpayer. For example, if a taxpayer produces extensive new transfer pricing analysis in defense of its transfer prices, the presentation and discussion of the analysis could require additional time.

JPN ¶11-310 *Examiner's opinion*

After obtaining additional information from the taxpayer over a series of meetings and questionnaires, the examiners may conduct their own transfer pricing analysis and reach a preliminary conclusion. If they decide that the taxpayer's transfer pricing is not arm's length and warrants adjustment, they may express their opinions (orally or in writing) to the taxpayer during the course of the examination.

The examiner may make a statement to the effect that they have decided that the taxpayer's transfer pricing is problematic and that they have conducted their own analysis. If they use secret comparables, they may also include a statement to the effect that the taxpayer did not answer their requests in a timely manner, triggering their legal authority to collect non-public comparable transaction data (ie secret comparable data). (The legal authority of the examiners to use secret comparables is described in greater detail in the section titled "Authority of tax examiners to use secret comparables" JPN ¶11-560) They may explain their analysis, including how they decided to segment the taxpayer's transactions for analysis, which fiscal years they chose to analyse, how they identified their comparables, any adjustments made to the results of the comparables, and the calculation of a preliminary adjustment to the taxpayer's transfer prices based on the comparison with the comparables. The comparables used may be secret comparables, in which case the examiners will only disclose limited information on their methodology and on the comparables (ie information that will not disclose the comparables' identity). (See section titled "Secret

comparables” JPN ¶11-760 for additional information on how secret comparables are used in an examination.)

JPN ¶11-360 Debate and discussion

After the examiners begin expressing their opinion and preliminary conclusions, the examination typically enters a debate and discussion stage. Over the course of one or more meetings, the taxpayer may ask questions about the examiners’ methodology, comparables, adjustments, etc. The taxpayer is also free to make extensive counter-arguments if it so chooses. These counter-arguments may take the form of position papers containing criticisms of the examiners’ approach as well as transfer pricing analysis performed by the taxpayer which supports the arm’s length nature of its transfer prices. The examiners will answer the taxpayer’s questions to the extent that they feel is appropriate and permitted (since they are legally restricted in the amount of information they can disclose on secret comparables) and will usually provide responses to individual counter-arguments made by the taxpayer.

As with other stages of the examination, the number and timing of meetings and length of time required by this stage varies from case to case and depends on the number of counter-arguments the taxpayer wishes to make as well as how quickly the examiners wish to conclude the examination. This stage could require anywhere from one to six (or more) months.

The outcome of this stage, of course, depends on the individual case. There are cases where the examiners do not agree with any of the taxpayer’s counter-arguments and therefore decide not to modify their conclusions. In other cases, the examiners may be persuaded by the taxpayer that the transfer prices were in fact arm’s length or that there were unique circumstances or special reasons for the taxpayer’s low profitability besides transfer pricing. In such cases, the examiners may be willing to modify their conclusions and to reduce the adjustment to the taxpayer’s transfer pricing initially presented in their interim opinion.

JPN ¶11-410 Final negotiations

Following the debate and discussion over the interim opinion, transfer pricing examinations often enter a negotiation stage. In a case where the

description of some of the major publicly reported transfer pricing assessments since 2005.

In 2007, companies reporting transfer pricing assessments included Daikin Industries, Ltd; Denso Corporation; and Aderans Co, Ltd. In addition, Honda Motor Co, Ltd, reported that it was under examination for transfer pricing. According to media reports, the likely adjustment to Honda's income is approximately ¥140 billion. Honda also announced that it was recognising a liability and tax expense in its consolidated USGAAP financial statements in connection with this transfer pricing examination as required by Financial Accounting Standards Board Interpretation No. 48 ("FIN 48"). Media reports placed the amount of the tax expense related to this particular transfer pricing examination at approximately ¥80 billion.

JPN ¶14-160 Increasing Focus on Intangible and Service Transactions

Several indications have emerged that the NTA is devoting more attention to intercompany services and intangible transactions. This is especially apparent in the recent regulatory changes, as many of the significant changes to the Japanese transfer pricing regulations over the past several years have involved expansions of the rules on intangible and service transactions.

For example, as described previously in JPN ¶2-610, guidelines on the pricing of intercompany services were added in 2002. Prior to this the Japanese transfer pricing rules contained very little guidance on such transactions, and it was not until 2002 that Japan had a system of rules for intercompany services that mirrored the OECD Guidelines. (See section titled "Service transactions" in JPN ¶4-060 for more information on the guidelines regarding intercompany services.)

In addition, the NTA released additional guidance regarding intangible transactions in 2006. The previous guidance regarding intangible transactions was very limited, and it was not until 2006 that the rules defined intangible property to include not only patents, trade secrets, and technology but also know-how, processes, and networks of relationships resulting from taxpayers' sales efforts, R&D, production, etc. It was also from 2006 that the rules stated that all intangible-producing activities and contributions made by a taxpayer and its foreign related parties (ie activities and contributions

beyond the simple bearing of costs) would be scrutinised in determining who is the economic owner of intangible property. (For additional detail on the treatment of intangible transactions, see section titled “Intangible transactions” in JPN ¶4-010.)

The 2006 revisions to the transfer pricing rules also included the publication of Japan’s first guidelines regarding CCAs. (See section titled “Cost contribution arrangements” in JPN ¶8-060 for more explanation of Japan’s CCA guidelines.)

That the NTA is devoting considerable attention to intangible transactions and service transactions is also apparent from some of the transfer pricing cases that have emerged in recent years. Among the recent assessments that have been publicly disclosed in the past two years are several that involve royalty transactions and one that involves financial derivatives.

None of this is to say, however, that tangible inventory transactions, which were historically the focus of most transfer pricing scrutiny, are now somehow receiving less attention than before. Recently announced transfer pricing cases include several that involve transactions of tangible inventories. This indicates that the NTA is casting a wide net and examining a wide range of transactions, industries, and taxpayers.

JPN ¶14-210 Widening Geographic Focus

It is also apparent from the above companies’ public statements and media reports that the NTA is examining and adjusting transactions with foreign related parties in a wider variety of countries. In particular, there appears to be a greater emphasis on transactions with countries in East and Southeast Asia. The increased scrutiny on such transactions could prove to be a difficult development for MNEs, as many Asian countries do not have much experience or expertise with transfer pricing and would thus not be well-equipped to conduct a MAP negotiation with Japan to resolve double taxation. Even more difficult are cases involving transactions with Hong Kong, because there is no double taxation treaty between Japan and Hong Kong and thus no means for requesting a MAP to obtain relief from double taxation.