

# ASG tax news

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**Our news letter provides information on Japanese tax and business which we believe is of interest to international companies doing business in Japan.**

## Transfer Pricing – Introduction of the Transactional Net Margin Method

Until now, the Comparable Uncontrolled Price Method (CUP), the Resale Price Method (RP) the Cost Plus Method (CP), and the Profit Split Method (PS) have been accepted in Japan as a basis for justifying the appropriateness of transfer prices for transactions across national borders between related parties. In 2004, as part of the Japanese Government's 2004 Tax Reform package, the Transactional Net Margin Method (TNMM) was added to this list of acceptable transfer pricing methods. With this change in policy, Japan has come into line with other countries which base their transfer pricing regulations on OECD guidelines.

The impetus behind Japan's acceptance of the TNMM can be found in the new U.S. – Japan Tax Treaty, which came into effect on July 1, 2004. In this treaty, the two parties committed to resolving transfer pricing issues according to OECD guidelines. Japan changed its regulations in order to fulfill its obligations under the tax treaty.

## Overview of the Transactional Net Margin Method

Unlike the CUP, RP, and CP methods of determining appropriate transfer prices, the TNMM looks at the reasonable NET margin that can be expected to be earned from a particular transaction. The appropriate transfer price is considered to be one that results in a net margin that is comparable to that earned on an arm's length transaction of the same goods or services. In order to determine what a "reasonable" net margin is, the net margin earned by the company on sales of its goods or services to unrelated parties is considered the most appropriate comparable, followed by the net margin

earned by other companies on similar transactions. The inclusion of Sales, General, and Administrative Expenses (SGA) in the TNMM analysis means that companies selected to provide net margin comparables should not only sell the same kind or similar products, but should also be similar in structure to the company for which the analysis is being performed.

## Illustration

The following is an illustration of the calculation of an acceptable transfer price in a transaction involving the sale of goods to a related party using the TNMM:

### Variables:

A: Cost of Goods to the tested company	600
B: SGA of the tested company incurred on sales to related parties	400
C: Sales Price to a non-related party by a comparable company	1,000
D: Cost of Goods to the comparable company	500
E: SGA of the comparable company	300



**Acceptable Transfer Price:**

$$= A + \{(A+B) \cdot (C-D-E) / [C - (C-D-E)]\} + B$$

$$= 600 + \{(600+400) \cdot (1,000 - 500 - 300) / [1000 - (1000-500-300)]\} + 400 = 1,250$$

$$\text{Net margin of the comparable company} = (1000-500-300)/1000 = 20\%$$

$$\text{Net margin of the tested company} = (1,250-600-400)/1,250 = 20\%$$



In practice, it is not possible to find one company for comparison with exactly the same structure and costs as the company for which the transfer pricing analysis is being performed. Therefore, the net margins of several companies that meet as much of the comparability

criteria as possible are calculated to create an acceptable net margin range. A transfer price that results in a net margin on related party transactions within this range would be considered acceptable.

**Procedure for Applying for Treaty Benefits Under the New Japan – U.S. Tax Treaty**

The new Japan-U.S. Tax Treaty comes into effect on July 1, 2004 for withholding taxes and on January 1, 2005 for all other taxes covered under the agreement. Some changes have been made as to the eligibility requirements to enjoy the benefits of the treaty. As a result, new application procedures have been established as part of the Japanese government's 2004 tax reforms.

**Proof of Eligibility to Receive Treaty Benefits**

The new treaty contains a clause limiting the application of the treaty benefits to parties that do not meet the eligibility requirements (Article 22). In order to prove eligibility, a new form (Schedule 17) must be submitted to the tax authorities, along with the existing "Tax Treaty Application Form". Schedule 17 requires the applicant to provide details of compliance with the eligibility criteria laid out in the treaty.

**Additional Documentation for Withholding Tax Exemption**

The new treaty provides for exemption from withholding taxes on royalties, as well as certain types of interest and dividend payments. In order to take advantage of these

exemptions, proof of eligibility to receive treaty benefits and/or other supporting documentation must be submitted in addition to Schedule 17. The preferred proof to be submitted is a certificate from the tax authorities certifying eligibility. However, the Internal Revenue Service of the United States does not issue such a certificate and so in practice this certification is difficult to obtain. Alternative proof of eligibility is a certificate of residency for tax purposes issued by the tax authorities, as well as the listing of shareholders in the case of dividends, bank and account number of the investor to which remittances will be made in the case of interest payments, and the royalty contract in the case of royalty payments.

**Retaining the Benefits of the Former Treaty**

Note that in some cases, the tax treatment received under the former Japan – U.S. tax treaty may be more favorable than the tax treatment under the new treaty. According to Article 30 of the new tax treaty, the benefits of the former treaty may be enjoyed for up to 12-months after the new treaty comes into effect. No special application is necessary to have the former tax treaty applied to transactions. The regular application form for treaty benefits should be used, filled out with the terms of the former treaty.

**Gaikei Hyojun Kazei – Guidelines for Foreign Companies**

As detailed in the previous issue of ASG Tax News, the new Gaikei Hyojun Kazei (GHK), or business scale tax, will replace the local Enterprise Tax for companies with paid-in capital exceeding JPY 100,000,000 for tax years beginning on or after April 1, 2004. The government has recently issued guidance on how this tax will be applied to foreign corporations doing business in Japan.

If a foreign corporation has a Permanent Establishment in Japan, then the foreign corporation is subject to national and local taxes on the amount of net income earned from its activities in Japan. The GHK, being a local tax, would similarly apply to foreign corporations. The applicability of the GHK is determined by the paid-in capital of the foreign corporation. What constitutes "paid-in capital" is determined by the legal definition of "paid-in capital" of the country in which the corporation was incorporated. At each fiscal year end, the foreign currency amount of paid-in capital is translated into Japanese Yen using the prevailing central bank exchange rate. If the translated amount is JPY100 million or more, then the GHK will apply for that fiscal year.



## Basis of taxation

The GHK taxes three different “factors” of the company – paid in capital, taxable net income, and “added-value”. As explained in the previous issue of ASG Tax News, the taxable net income amount is the total revenues less deductible expenses arising from operations in Japan. The “added-value” factor is derived from a calculation involving taxable net income in Japan, employee compensation relating to employees performing work for the Japanese entity, net interest paid relating to Japanese activities, and net rents paid in the course of Japanese activities. Whether or not certain revenues or expenses relate to the Japanese activities is determined in line with regulations governing the calculation of taxable income of foreign entities for Japanese corporation tax purposes.



The amount of paid-in capital to use for calculating the capital-based portion of the GHK is based on the pro rata number of employees working in Japan in relation to the number of employees working in the company as a whole at the fiscal year end. While the full amount of the foreign corporation’s paid-in capital is used to determine the *applicability* of the GHK, only the portion of paid-in capital deemed to be related to Japanese activities is taxed as part of the GHK.

March 31, 2005 is the earliest fiscal year end for which the GHK will apply. Foreign corporations with a Permanent Establishment in Japan should determine whether or not their paid-in capital will be greater than JPY 100 million on their first fiscal year end after that date and, if so, ensure that they have procedures in place to collect the information necessary for the filing of the GHK tax return.



## Exemption of Withholding Tax Obligation on Payments to Companies with a Permanent Establishment in Japan – Change in Procedure

Payments to foreign corporations and non-residents for such things as dividends, royalties, rents, and certain services are generally subject to Japanese withholding taxes. The rate of withholding tax depends on the nature of the payment and the terms of any tax treaty that is in effect between Japan and the country in which the foreign corporation or individual is resident. However, a recipient

foreign corporation can apply for a waiver to eliminate the requirement that the payer withhold taxes on certain types of payments if the foreign corporation has a Permanent Establishment in Japan. In order to qualify for the withholding tax exemption, the foreign corporation must be subject to Japanese corporate taxes, and the payments received must be included in the taxable income calculation of the Japanese Permanent Establishment. Also, the Japanese Permanent Establishment must notify the local tax office of the details of any payments received overseas to which the waiver was applied. Similarly, a non-resident individual may also apply for such a waiver, providing that he or she has filed a notice of commencing business in Japan with a local tax office, appointed a tax representative in Japan, and has filed a Final Tax Return in the previous tax year. This waiver is not new, but as part of the 2004 Tax Reforms, the procedure to obtain and exercise this waiver has been simplified.

Up until now, a separate waiver had to be obtained by the foreign corporation or non-resident individual for each customer from whom payments would be received.



For example, if a company had five Japanese customers from whom payments were expected to be received, five different waiver applications had to be made. A certificate would be issued for each waiver approved, and these certificates had to be handed over to the customers and retained in their records. The new process has been simplified considerably. It is no longer required that each customer be issued a separate waiver. A foreign corporation or non-resident individual is now only required to *present* the waiver certificate to each customer, eliminating the need for multiple waiver applications for the same type of payments.

Because customers will no longer receive their own waiver certificate, it will be more difficult for the tax office to track payments to which the waiver has been applied and to ensure that customers have been notified of cancelled waivers. Therefore, the foreign corporation or non-resident individual is now required to keep a record of all customers to which the waiver certificate has been presented, and has a legal obligation to notify all of these customers in the event that the waiver becomes invalid. Failure to live up to these obligations could result in a fine of up to JPY 200,000 and a prison sentence of up to one year. As for companies that have been shown the waiver and so do not withhold taxes on payments made to the foreign corporation or non-resident individual, they are required to record the details of such waivers, including the expiration date, in their records.

## Transition Rules

This change in method of applying the withholding tax waiver rules came into effect on July 1, 2004. Waivers that have already been obtained on an individual customer basis and that have already been given to customers are still valid until their stated expiry dates. However, waiver certificates that were obtained before July 1, 2004 but not yet given to customers are now invalid. A new application using the updated procedure must be made.

## Clarification of the Treatment of Hybrid Entities Under the New Japan – U.S. Tax Treaty

A hybrid entity is one that is taxed on a different level in one jurisdiction compared to another. In the case of Japan and the U.S., Partnerships and Limited Liability Companies (LLC's) have been considered hybrid entities because both types of company structures may be taxed at either the individual investor or company level in the U.S. (using the "check the box" rule), while in Japan Partnerships are taxed at the individual partner level and LLC's are taxed at the company level. In the past, confusion has arisen due to the different treatment of these entities between jurisdictions, and this issue has been addressed in the new Japan – U.S. Tax Treaty.

Under the terms of the new Treaty, the two countries have agreed to tax such hybrid entities on the same basis as the country in which the company itself is resident. Therefore, if an LLC resident in the U.S. opts to be taxed in the U.S. at the company-level rather than the individual investor-level (using the "check the box" rule), then Japan will similarly treat the LLC as a company and not a group of individual investors. If the LLC earns income in Japan that is subject to preferential tax treatment under the Japan-U.S. Tax Treaty, then preferential withholding tax rates available under the treaty will be applied to 100% of such earnings. However, if the LLC opts to be taxed at the individual investor-level in the U.S., then such income would only enjoy the preferential withholding tax rates to the extent that the individual investors in the LLC are U.S. residents. For example, if there were 10 equal investors in the LLC and 6 were resident in the U.S. while the others were resident in other countries, then only 60% of the eligible income of the LLC would be subject to the preferential rates.



## Permanent Establishment and Cost-Plus Service Arrangements

It has been common for foreign companies to conduct operations in Japan by using the services of a Japanese affiliate and paying the affiliate a service fee of cost plus 5%. Up until recently, this type of arrangement has been safe from transfer pricing scrutiny and has allowed foreign companies to limit their exposure to Japanese taxation to the 5% markup on cost instead of the total net income derived from their Japanese business activities. However, the Japanese tax authorities have started to crack down on these types of arrangements. Their argument is that while on the surface the Japanese affiliates are only performing limited services for the foreign corporations and do not have the authority to conclude contracts on behalf of the foreign corporations, the scope of services performed and the involvement of the Japanese affiliates in the activities of the foreign corporations are so extensive that a de facto agency relationship exists. This leads to the judgment that an agency Permanent Establishment exists in Japan for the foreign corporations. The foreign corporations would now be liable to pay Japanese tax on the net income that can be attributed to their activities in Japan.



Last year, Lone Star, a U.S. – based private equity firm, was assessed over 13 billion yen in taxes and penalties relating to income that was related to its activities in Japan over a four-year period. Lone Star had been using a Japanese affiliate to conduct business in Japan and paid that affiliate service fees. However, the Tokyo Regional Tax Bureau deemed that the scope of the services performed by the affiliate created a de facto agency Permanent Establishment for Lone Star in Japan. There have been several other permanent establishment tax cases in the past several months, and this is expected to continue to be an area that the tax authorities look closely at in the future. Foreign companies currently doing business in Japan using a cost-plus service fee arrangement with a Japanese affiliate should reassess the services that are being provided and any risks that are being shouldered by the Japanese affiliate to ensure that a de facto agency relationship cannot be inferred.

Two examples of business structures which can act as alternatives to the cost-plus service fee arrangement and still provide the benefit to foreign corporations of limitation of Japanese tax liabilities are as follows:

1. Commissionaire ("Toiya")
2. Distributor

## Commissionaire

A Commissionaire, or “Toiya” in Japanese, concludes sales in his own name on behalf of a company, but never actually holds title to the goods being sold. Under this business structure, the foreign corporation would import goods to Japan under its own name, while the “Commissionaire” Japanese affiliate would act as the foreign corporation’s Custom Duty Administrator, as required under the Custom Duty Law. The Commissionaire would conclude sales contracts with customers in its own name and collect the amounts due on the contracts. The Commissionaire would then remit to the foreign corporation the monies received from sales, less a commission for its services. The total commissions deducted from the sales proceeds would likely be higher than the amount of fees paid to a service provider under a “cost plus 5%” arrangement.

Because the Commissionaire is party to the sales contracts, not the foreign corporation, it is easier to argue that the Commissionaire is negotiating and concluding contracts on its own behalf, not on behalf of the foreign corporation. Also, because the Commissionaire is party to the sales contracts, it must bear any consequences of non-delivery, damaged goods, uncollectable accounts, etc. If the Commissionaire were truly an agent, it would not bear these risks. For transfer pricing purposes, the commission deducted by the Commissionaire must be equivalent to what would be paid in an arm’s length transaction.


Also, because the foreign corporation holds title to the goods until they are delivered to the Japanese customer, it is responsible for paying Japanese consumption taxes on imports and collecting consumption taxes paid by Japanese customers. The net consumption taxes collected must be remitted annually with the filing of a consumption tax return, and if Japanese sales exceed a certain level then quarterly or monthly consumption tax installment payments will be required.

## Distributor

In a distributor business structure, the foreign corporation sells goods to its Japanese affiliate, and the Japanese affiliate takes ownership of the goods and sells them to customers in Japan. There is no risk of a deemed Permanent Establishment with this business structure, and the foreign corporation will have no obligations relating to Japanese consumption taxes. For transfer pricing purposes, the prices of the goods sold must be equivalent to prices that would be charged in an arms-length transaction.

When choosing the type of business structure to use for business activities in Japan, a foreign corporation must weigh the benefits of reducing exposure to Japanese corporate taxes with the risk of incurring penalties and interest on unpaid taxes if it is deemed that in fact a Permanent Establishment exists in Japan. There are still many foreign corporations which use the “cost plus 5%” type of business structure for their Japanese business activities, despite the recent actions of the Japanese tax authorities to look at these structures harshly. It is highly recommended that such business structures be reviewed and rearranged in order to minimize the risk of incurring significant Japanese tax assessments in the future.



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We welcome your feedback and suggestions.  
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