

A Global Survey on the Application Of the Control of Risk and DEMPE Frameworks: Japan

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In this article, the seventh in a series, the authors summarize their findings from a KPMG member firm survey of how tax authorities around the world are applying the OECD control of risk framework and the transfer pricing guidelines on development, enhancement, maintenance, protection, and exploitation of intangibles. This installment is focused on Japan.

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In 2015 the OECD reached an agreement on revised guidance regarding transfer pricing as part of base erosion and profit-shifting actions 8-10. It can be difficult to get a comprehensive global view of how different tax authorities are applying this guidance. KPMG has surveyed its member firms from around the world to better understand how local tax authorities are approaching the control of risk and development, enhancement, maintenance, protection, and

exploitation (DEMPE) frameworks. In this article, the seventh in a series, we focus on Japan.¹

Japan

The Japanese National Tax Agency (NTA) followed a framework similar to DEMPE well before the start of the OECD's BEPS initiative.² In 2019 the NTA updated its regulations and rules to explicitly incorporate the changes made as part of BEPS actions 8-10 in respect of intangible property transactions. Whether auditing issues related to marketing, distribution, manufacturing, or research and development, the NTA and regional tax bureaus (collectively referenced as the "Japanese taxing authorities" or JTAs) adopt a strict interpretation of the control of risk and DEMPE guidance and tend to be particularly focused on transfer pricing issues related to IP.

The NTA defines IP broadly, as follows: "in addition to intellectual property rights such as industrial property rights and copyrights, laws and regulations should make it clear that intangible assets for transfer pricing taxation include brands and marketing intangibles." Tax auditors carefully examine the functions

¹For previous installments in this series, see Mark R. Martin et al., "A Global Survey on the Application of the Control of Risk and DEMPE Frameworks: The U.S. and U.K.," *Tax Notes Int'l*, May 8, 2023, p. 705; Olivier Kiet et al., "A Global Survey on the Application of the Control of Risk and DEMPE Frameworks: France, Italy, and Spain," *Tax Notes Int'l*, June 5, 2023, p. 1327; Julia Bürkle et al., "A Global Survey on the Application of the Control of Risk and DEMPE Frameworks: Germany, the Netherlands, and Sweden," *Tax Notes Int'l*, June 26, 2023, p. 1743; Carlos Pérez Gómez et al., "A Global Survey on the Application of the Control of Risk and DEMPE Frameworks: Mexico and Canada," *Tax Notes Int'l*, July 17, 2023, p. 251; Sophie Lewis et al., "A Global Survey on the Application of the Control of Risk and DEMPE Frameworks: Australia and China," *Tax Notes Int'l*, Aug. 28, 2023, p. 1083; and Tai-Joon Kim et al., "A Global Survey on the Application of the Control of Risk and DEMPE Frameworks: India and South Korea," *Tax Notes Int'l*, Aug. 12, 2024, p. 973.

²This section was written in conversation with Koichiro Fujimori and Nicolas Karolewicz of KPMG Japan.

performed by both parties to the transaction to understand which affiliate assumes the main roles in development, enhancement, maintenance, protection, and exploitation of IP. Legal and economic ownership are two distinct notions under the Japanese tax regime, and both are separately addressed in the Japanese guidelines. If subsidiaries participate in the creation of IP in addition to the parent company that legally owns the IP, the parent company cannot remain the only beneficiary as the legal owner. Thus, the aforementioned subsidiaries are considered economic owners who should also benefit from the IP in proportion to their contribution. In audits, the JTAs occasionally claim that the legal ownership of IP doesn't necessarily reflect the economic ownership, especially for Japan inbound companies, for which the burden of proof is on the taxpayer to prove that legal and economic ownership are aligned.

Audits around the control of risk and DEMPE-related issues are common in Japan, although few of those cases advance to the courts. In one audit, a chemical company parented outside Japan licensed IP to the Japanese entity relating to the manufacture of chemical substances for semiconductors. The JTAs claimed that although the parent company had developed the core formula, because the Japanese entity tailored the manufactured substances for each of the Japanese customers, the IP had been enhanced and exploited through Japanese engineering activities and made an assessment on this basis. The case was ultimately settled through an appeal process based on the residual profit-split method.

In another audit of a foreign-owned automobile parts manufacturer, the JTAs asserted that the Japanese affiliate was creating marketing IP in connection with the company's customers outside Japan. The JTAs acknowledged the important functions performed and the investment made by the foreign parent in originally developing the brand (and the related marketing IP), but the JTAs insisted that the Japanese subsidiary had undertaken significant activities to enhance, maintain, and exploit the brand — specifically related to customer relationships outside Japan — and that these activities created marketing IP. The JTAs and the taxpayer compromised; based on a year-by-year

study, it was demonstrated that for some years, some of the affiliates outside Japan benefited from the Japanese affiliate's marketing and customer relationships, while there was no benefit in other years.

When examining IP transactions, the JTAs also focus on the price-setting mechanisms/logics with considerations for economic substance and business models/structures, rather than simply debating the comparables used to establish an arm's-length range. JTAs typically do not consider the discounted cash flow (DCF) to be a reliable approach because of the critical nature of the underlying assumptions. In 2019 the NTA adopted the OECD's hard-to-value-intangible approach in line with the OECD guidelines.

For example, a foreign-headquartered computer parts company had a Japanese subsidiary that owned technology IP. The parent company acquired the Japanese IP and used the income approach or DCF method to value the IP. After the transfer of IP, the Japanese affiliate paid a royalty to the parent for the license of the IP. The company filed a unilateral advance pricing arrangement in Japan that covered the royalties, but the JTAs disagreed on the valuation of the outbound IP transfer (based on the DCF approach) and the proposed royalty rate. The JTAs claimed that the facts and forecasts used as basis for the royalty calculation were inconsistent with those used as the basis for the DCF, which assumed that the IP transferred would only generate a small incremental return on a go-forward basis. However, the transaction net margin method used to calculate the implied royalty rate assumed that the IP would generate a higher return after the transfer. The company was unsuccessful in the unilateral APA process and moved to a bilateral process. Of note, this case happened before the OECD updates for BEPS actions 8-10 were incorporated into Japanese regulations and rules — emphasizing that IP has been a long-standing focus area for the JTAs.

Under audit, companies that undertake a deep dive into the specific facts of each affiliate's operations and understand the control of risk and DEMPE considerations are typically much more successful in rebutting the questions and challenges of the JTAs. Unless defined clearly in written documents, the JTAs have discretion to

determine which entity owns IP. Thus, detailed and contemporaneous intercompany agreements and other transfer pricing documentation focusing on fact-based pricing mechanisms can materially help to strengthen a taxpayer's position. The JTAs believe that documentation prepared before any potential audit is a gage of objectivity. Recording its transfer pricing in advance is crucial to lowering transfer pricing

exposures, especially on IP related transactions in Japan.³ ■

³The foregoing information is not intended to be "written advice concerning one or more Federal tax matters" subject to the requirements of section 10.37(a)(2) of Treasury Department Circular 230. The information contained herein is of a general nature and based on authorities that are subject to change. Applicability of the information to specific situations should be determined through consultation with your tax adviser. This article represents the views of the author(s) only, and does not necessarily represent the views or professional advice of KPMG LLP.

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