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NERA Breakfast Seminar on Transfer Pricing

Japan Perspectives on Marketing Intangibles

June 15, 2006

Paris

How Markets Work℠

Agenda

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- **Past history concerning NTA disputes related to marketing intangibles**
- **Analysis of different views on marketing intangibles**
- **Some promising developments – cause for some optimism for the future**

Marketing Intangibles
- Japan Perspective

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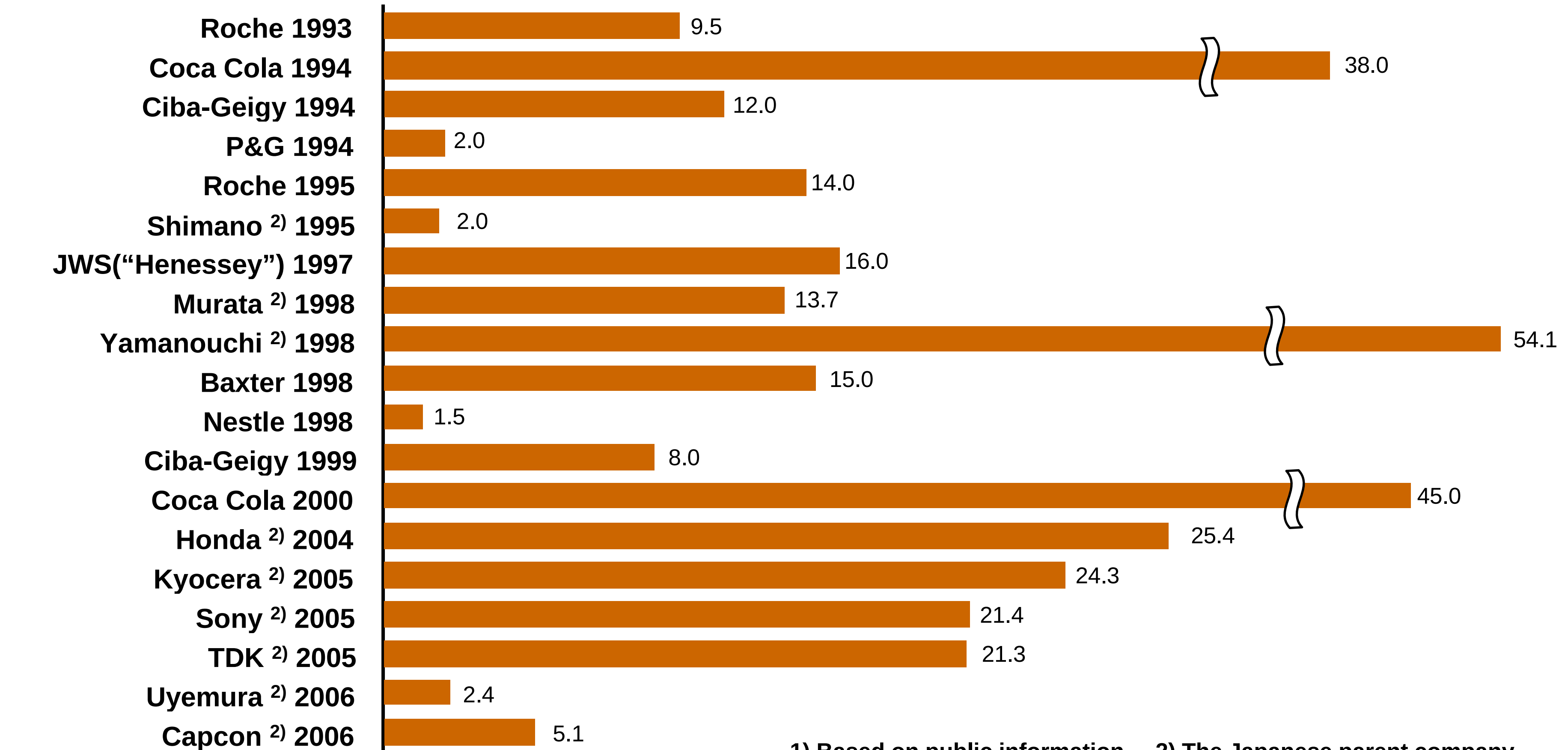
Many Transfer Pricing Assessments in Japan appear to be related with disputes over marketing intangibles

Reported major TP Income Assessment [1] .Unit Billion Yen) .Approx €=.140)



1) Based on public information **2) The Japanese parent company**

Japan Perspectives – Past Experiences

NTA historically argued for higher return for any “marketing intangibles” associated with Japanese market

Case	NTA Possible Arguments
Coca Cola	■ Locally developed products such as “Georgia” coffee should not be subject to “Coca Cola” – level of royalty
Pharmaceutical/Medical equipment	■ Japanese Reimbursement System (or “Yakka”) warrants higher market price in Japan, the price differential should be attributable to Japanese income ■ “Super” sales force should contribute to abnormal profit
High-end Consumer and/or Direct Selling Brands	■ Higher Japanese Market price should warrant more income to Japanese distributors ■ “Super” sales force/distributors special customer’s lists should contribute to abnormal profit

The recently published NTA circular stated that human capital and “organization/network” may be included in valuable intangibles

Marketing Intangibles – Japan "Unique" view?

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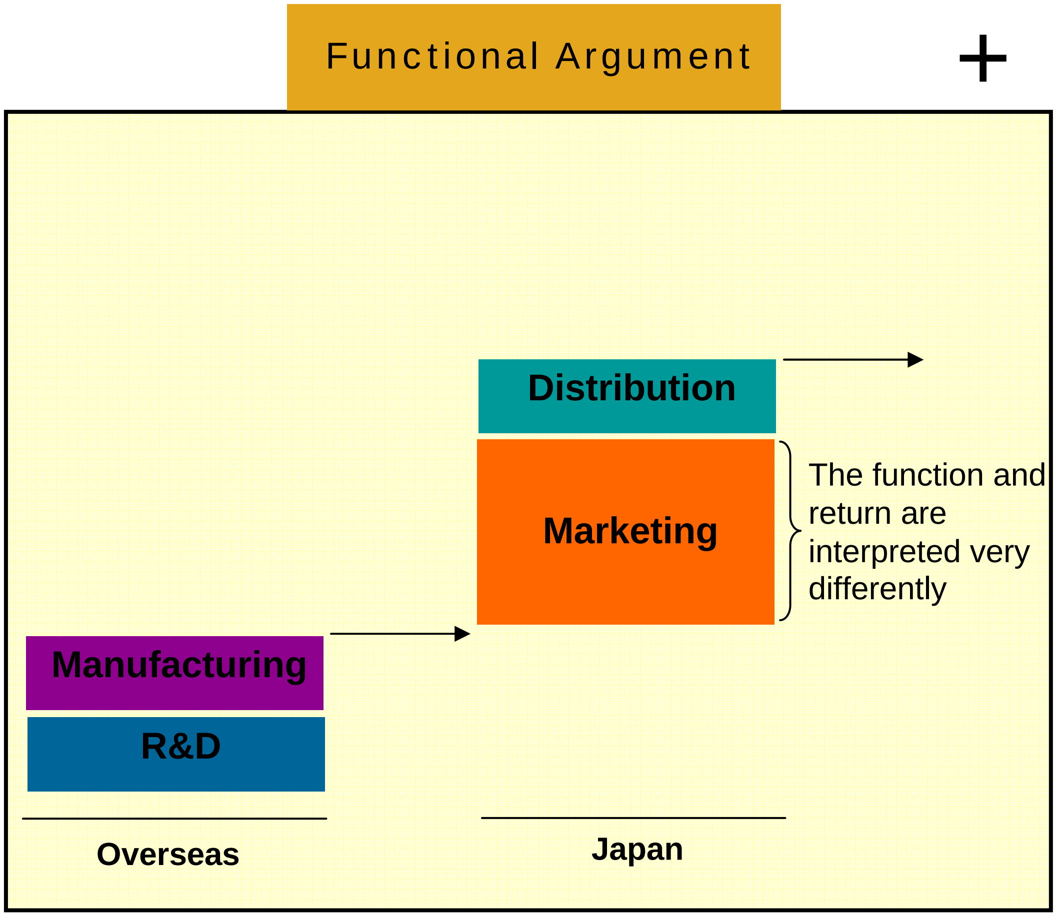
The notion that "marketing" functions by local distributors are generally very significant is not uncommon; it has been also argued that any "market premium" should be attributable to Japan



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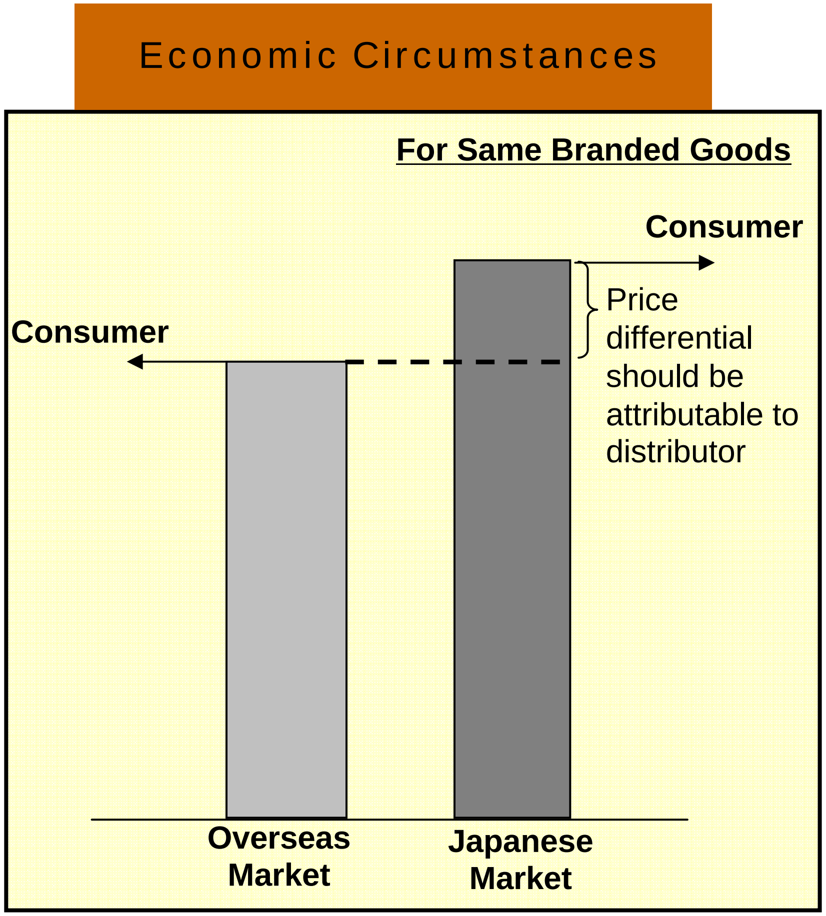

Marketing Intangibles – Scope and Definition

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Relatively loose definition appears to have been adopted by NTA

Functional distinctions	Discussion	Specific example
R&D	■ Local modification to tailor products for Japanese market can be very valuable	■ Locally developed beverage
Manufacturing	■ Any process efficiency due to closeness to market should be captured and associated income should be attributable to Japan ■ An ability to deal with efficient third-party Japanese manufactures (for sourcing) should be highly compensated	■ Significant profit can be assigned to Japan locally assembled products (but for modest amount of raw materials purchased by affiliates and/or modest royalty paid)
Sales and Marketing	■ Any “special” activities for Japan market should not be considered as routine (partly due to lack of suitable comparables), and thus earn a higher, entrepreneurial return ■ Trademarks *per* se may not be as valuable unless “local efforts” are added	■ Functions to deal with Japan-specific distribution channel or Japan-specific ancillary services ■ Sales force with special human resources

Japan Perspectives – Marketing intangibles

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Ex-post interpretation of high profit may yield to confusing discussion

	Possible Argument	Issues
Trademark	The Value of marketing intangibles can go way beyond the value of bare trademark	Legal Ownership vs Economic Ownership
A&P Expense	Advertising and promotion may create substantial value	Income not necessarily proportionate to costs
Some “Unknown” factors (for profit split)	High value chain profit should be sufficiently allocated to the owner of non-R&D (or marketing) intangibles	Cost-based Profit Split or RPSM

Marketing Intangibles – TPM selection

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To capture incremental income from alleged marketing intangibles, peculiar TPMs had been applied

- “**Secret” Comparables**
  - Lack of “exact” publicly available comparables lead to use “secret” comparables
- **Strict Application of Resale Price (RP) Method**
  - Almost mandatory use of Strict Resale price (RP) method made cases much more difficult to resolve
- **Profit Split (per “Contribution Factors”)**
  - Labor Costs and/or SG&A are considered to be split factors

Some Promising Development

Changes in both regulatory and economic circumstances in Japan may create opportunities for more satisfactory solutions

- **Regulatory Aspects . Introduction of TNMM**
  - The recognition of TNMM by the NTA (from 2005) enables more flexible use of external comparables as appropriate benchmarks
  - Marketing intangibles can be captured by the observed returns of selected comparables, and thus no additional analysis should be necessary

- **Improving and more robust financial performances of the Japanese companies**
  - Recent improvement in the Japanese economy, corporate performances, and closer scrutiny of accounting disclosures should result in more appropriate and realistic financial benchmark as comparables

Some Promising Developments (Cont'd)

Developed and recognized Valuation techniques for adjustments and/or profit splits can contribute to satisfactory solutions

- **Valuing Specific intangibles**
  - R&D Regression
  - Internal CUT (Comparable Uncontrolled Transactions)
  - Real Option

- **More Refined Profit Split**
  - RPSM vs OPSM (cost-based allocation)
  - Relative value between R&D and Marketing Intangibles

    (eg. Capitalization by reflecting investment characterstics)