

Japan Tax Bulletin

Revision of the Administrative Guidelines on Operation of Transfer Pricing

July 2023

On June 10, 2022, the National Tax Agency revised the Administrative Guidelines on Operation of Transfer Pricing. The revision is intended to clarify Japan's transfer pricing tax treatment of related party transactions in light of the revision of Chapter VIII (Cost contribution arrangement) and Chapter X (Transfer pricing aspects of financial transactions) of the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations.

In particular, the revised Japanese Administrative Guidelines on financial transactions will replace the previous Japan-specific provisions for financial transactions with the global standard (based on OECD transfer pricing guidelines) provisions. This revision will lead to the start of full-fledged scale transfer pricing taxation enforcement for financial transactions between a corporate taxpayer and foreign related parties, and will be applied to investigations for fiscal years beginning on or after July 1, 2022.

First of all, the "Administrative guideline 3-7; Particulars to Note when conducting investigations regarding financial transactions" has been revised to provide basic ideas on considerations regarding money loan transactions, debt guarantee consignment transactions, and cash pooling.

Among the revisions, this commentary focuses on transfer pricing risks related to interest rate setting in the case of loans to foreign affiliates, considerations for debt guarantee consignment transactions, and allocation of mutual benefits in cash pooling in the "Administrative Guideline 3-8; Particulars to Note when conducting an arm's length price study on financial transactions".

The amendment removes the use of methods which were treated as methods equivalent to Comparable Uncontrolled Price Method in the previous Administrative Guidelines when determining arm's length interest rates in monetary loan transactions with made to foreign affiliates. Prior to the revision, it was clearly stated that for money loan transactions, the application of a method equivalent to Comparable Uncontrolled Price Method had been assumed as a matter of course, and the application of the comparable transaction is examined in the order of the borrower's funding interest rates from third party financial institutions, then the lender's funding interest rates from third party financial institutions and finally

the investment interest rate on government bonds and other interest rates. In the revised Administrative Guidelines, the "most appropriate method" prescribed in Article 66-4, paragraph (2) of the Act on Special Measures Concerning Taxation need to be selected in calculating an arm's length price for financial transactions.

Specifically, it can be interpreted that the creditworthiness of the borrowers is assessed, comparable transactions are then selected based on this creditworthiness, and then the arm's length interest rates are calculated.

Since there are very few cases where there are comparable transactions of the same timing and duration in the same currency, it is expected that the calculation of the rate will require some adjustments to the terms, currency, other factors in which the financial transaction is executed.

There was no clear provision for debt guarantee transactions in the previous Administrative Guidelines prior to the revision. When a Japanese parent company provides a debt guarantee to the third party financial institutions for the loan that foreign affiliates obtained from the financial institutions, the foreign affiliates pay guarantee fees to the parent company. The guarantee fees must be set at a rate consistent with the arm's length principle.

The new cash pooling rules also require careful attention to the allocation of common intra-group benefits among parties involved, and broad conditions and circumstances need to be taken into account.

In the Reference Case Studies on Application of Transfer Pricing Taxation, case study 4 was revised in terms of loan transactions and a new case study on consignment of debt guarantees has been added to reflect this revision. A new case study on cash pooling has also been added to case study 7 to reflect this revision.

The amendments were divided and indicated in the following sections:

3-8(1) Use of market interest rates, etc.

It is now clearly stated that so-called "market interest rates" are to be used for comparative transactions.

3-8(2) Policies on credit rating

Credit ratings can be used to evaluate the creditworthiness of borrowers, and specifically, they should be equivalent to ratings published by external rating agencies. Superior credit ratings cannot be guaranteed because the borrower solely belongs to a multinational enterprise group. Meanwhile, it is also stated that incidental benefits based on belonging to a multinational enterprise group should be considered.

3-8(3) and (4) Use of risk-free interest rate

When lenders do not have risk management functions nor perform decision-making functions in lending, notional transactions using risk-free interest rates such as swap rates or government bonds may be used as comparable transactions.

3-8(5) Use of interest rates estimated by financial institutions

The standard also states that interest rate quotations obtained from financial institutions do not correspond to market interest rates. Therefore, interest rates estimated by financial institutions cannot be used as comparable transactions in calculating arm's length prices. The new Administrative Guidelines, however, clearly states that this fact alone does not constitute transfer pricing taxation.

3-8(6) Calculation methods of debt guarantee fees

The "yield approach," the "cost approach," and the "credit default swap approach" are exemplified as approaches to calculate the debt guarantee fees.

3-8(7) Views on allocation methods of common benefits

It is now clarified that common benefits arising from cash pooling should be allocated to the parent companies and foreign related parties in accordance with the arm's length principle.

It may be said that the treatment of interest on loans to foreign affiliates in Japan prior to the revision was quite taxpayer-friendly. However, the amendments require a new type of analysis for setting inter-firm interest rates between foreign related parties, and new calculation approaches might also be required for debt guarantee transactions to set the debt guarantee rates or fees in accordance with the arm's length principle. For loans to loss-making foreign affiliates that have not been performing well, higher interest rates may be required compared to companies with excellent business performance. A change of mindset might be required when analyzing the interest rates setting, and practical responses and approaches with consideration of changing the loan contracts with the foreign affiliate might be needed.