

Japanese tax treatment of Keepwell agreement

I. Introduction

When a parent company guarantees its subsidiary's loan payable or concludes a Keepwell agreement on the debts, it does not always charge a guarantee fee to its subsidiary. Referring to the recent decision made by the National Tax Tribunal on the guarantee fee, it would be necessary to reconsider such commercial practice. For this purpose, the decision is introduced in this article.

According to the decision, the common guarantee, concluding a Keepwell agreement and providing a letter of management service can generally be referred to as "guarantee". The Tax Tribunal's decision in this article does not focus on whether a guarantee fee should be charged in a common guarantee transaction, but raises the issue of whether the guarantee fee should be charged under the Keepwell agreements. It was concluded that the legal effectiveness of the Keepwell agreement is equivalent to that of the common guarantee agreement so there must be a guarantee fee charge in the Keepwell agreement as well. The legal effectiveness, in this context, means that a parent company may be requested to assume the legal liability of repayment for the subsidiary. In contrast, no such legal effectiveness was recognized for a management service letter.

It was decided that the arm's length price of the fee (the 0.1% p.a. guarantee fee charge by the banks in this case) for the guarantee transactions should be used to determine the arm's length price of the fee for a Keepwell agreement, since they are comparable transactions.

On May 24, 2002, the National Tax Tribunal issued their decision on the Keepwell agreement. This decision deals with (i) similarity of Keepwell agreement and "common" guarantee agreement, and (ii) transfer pricing methodology for guarantee fee charged under the Keepwell agreement. It can be seen as a kind of transfer pricing guideline for multinational companies engaging in various kinds of credit enhancing transactions with affiliate companies raising fund from outside parties. The decision is summarized in this article, focusing on the above two points.

II. Background

A Japanese company, ACo, has its 100% subsidiary of XCo in the Netherlands. XCo is engaging in fund management whereby funds raised through issuing bonds and borrowings from banks are used to purchase high-ranked bonds or to extend loans. ACo entered into guarantee agreements and other forms of credit enhancing transactions with XCo, including Keepwell agreements. ACo charges to XCo a guarantee fee of 0.1% p.a. on the guaranteed debts, but does not charge any fee for other forms of credit enhancing transactions. When issuing bonds, XCo discloses the existence and content of the Keepwell agreement in its bond prospectus as a part of its effort to obtain higher credit ratings and lower interest rate than it would without a Keepwell agreement.

III. Details of the decision

1. Similarity between Keepwell agreement and “common” guarantee agreement

The decision includes the following description of the terms of the Keepwell agreement:

- (1) ACo holds 100% shares of XCo
- (2) ACo maintains XCo's net assets valued at US\$10,000 or more
- (3) ACo promises to provide sufficient funds to XCo if XCo's current assets are not sufficient to repay its debts.

In connection with (3) above, XCo discloses the existence and details of the Keepwell agreement in the bond prospectus. By doing this, XCo informs bondholders that XCo may exercise the right granted therein if it becomes unable to fully redeem the bonds. According to the decision, the actions of (i) concluding the Keepwell agreement, and (ii) disclosing the existence and contents of the Keepwell agreement in the bond prospectus, are seen collectively as one guarantee transaction (“guarantee based on the Keepwell agreement”), by mentioning that, under the common guarantee arrangement, a guarantor gives principal creditors the right to directly claim that the guarantor pay the principal debt in case of the principal debtor's defaults. As for the guarantee based on the Keepwell agreement, the Tax Tribunal has recognized (i) ACo bears the legal obligation similar to the one under the common guarantee agreement, and (ii) XCo is able to raise the fund with conditions similar to the case where common guarantee is provided by ACo, although the Keepwell agreement differs in form from a common guarantee agreement. It further concluded that the economic effect of the Keepwell

agreement is equivalent to that of a common guarantee agreement so the guarantee fee normally charged under the common guarantee agreement is comparable to the guarantee fee to be charged under the Keepwell agreement.

The National Tax Tribunal has concluded that the economic substance of the Keepwell agreement and that of the common guarantee agreement are the same provided that (i) there is a clearly identifiable relationship between the Keepwell agreement and the principal debt it covers, (ii) the existence and details of the Keepwell agreement are made known to the bondholders (or creditors) of XCo, and (iii) in case of default of XCo, the bondholders (or creditors) may ultimately obtain the redemption.

Further, it is noteworthy that the mere act of concluding the Keepwell agreement in itself is not recognized as having the same economic effect as the common guarantee transactions.

2. Calculation method of arm's length price of the guarantee fee

Further to the above, the decision discusses the arm's length guarantee fee calculation. To calculate the arm's length guarantee fee charged under the Keepwell agreement, it adopts (1) the Comparable Uncontrolled Pricing Method as the transfer pricing method, and (2) the guarantee fee charged by banks for its guarantee transactions as the Comparable Uncontrolled Price. Specifically, arm's length guarantee fee charged under the Keepwell agreement is calculated by multiplying the guarantee fee rate used by banks and the amount of principal debts covered by the Keepwell agreement together.

It is interesting to note that the Tax Tribunal concludes that the arm's length guarantee fee cannot be calculated if the banks employ a variety of guarantee fee rates at the time of conclusion of the Keepwell agreement in question and consequently, the Tax Tribunal rejected the transfer pricing methodology (or formula) employed by the tax office for the tax assessment and the tax office's tax assessment itself.

IV. Conclusion

The following points in the decision raised our interest:

- (1) The mere conclusion of the Keepwell agreement in itself does not cause the consideration of the agreement; the same economic effectiveness as the common guarantee transaction can only be recognized because the creditors know about the

Keepwell agreement.

- (2) Since the conclusion of the Keepwell agreement and disclosing the existence and the contents of the Keepwell agreement is recognized collectively as the equivalent of a common guarantee transaction, the common guarantee transaction is an appropriate comparable transaction to such Keepwell transaction.
- (3) The arm's length guarantee fee must be calculated based on the guarantee fee rate applied in the comparable uncontrolled transactions (bank guarantee transaction, in this case).

Supplementary – The arm's length price cannot be calculated

According to the survey by the Tax Tribunal on the banks' common guarantee transaction, the guaranteed fee ratio of 0.1% per annum is employed for the guarantee of the bonds issued in the Euro market from August 1989 to November 1990 (there were 16 bond issues). However, the guarantee fee ratios employed in the bank's common guarantee transactions conducted from 1991 onwards varied widely, showing double to triple divergence. The Tax Tribunal could not determine any guarantee transaction by the banks which may be used as a basis to arrive at the arm's length guarantee fee for those years. The appropriate adjustment required under the transfer pricing tax legislation could not be identified with the data obtained by the Tax Tribunal. The Tax Tribunal has concluded that the arm's length guarantee fee cannot be calculated in such circumstances.

Guarantee fee ratio employed by banks

2nd quarter, 1991

Total number of data =	38
Minimum:	0.2%
Maximum:	0.6%
Average:	0.36%