Partial revision of the Commissioner’s Directive on the Operation of Transfer Pricing relating to Financial Transactions

August 2022

In brief

Effective June 10, 2022, the National Tax Agency (‘NTA’) has partially revised the Commissioner’s Directive on the Operation of Transfer Pricing (Administrative Guidelines) (the ‘Revised Guidelines’). According to the NTA, the revision is intended to ‘implement necessary improvements relating to the treatment of financial transactions and cost contribution arrangements, etc.’

Many Japanese affiliates of foreign MNEs (inbound companies) receive monetary loans from their overseas global headquarters or regional headquarters in Asia. This newsletter outlines the specific revisions made in the Revised Guidelines in relation to ‘financial transactions,’ focusing on such monetary loan transactions, as these revisions will have a significant impact on Japanese affiliates of foreign MNEs that engage in such transactions.

In detail

1. Overview of the revisions (financial transactions)

The Revised Guidelines mainly revise Chapter 3, ‘Examination.’ Revisions to the introductory clause to Chapter 3-1 have been made to reflect the new guidance for applying the arm's length principle that was added to the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (the ‘OECD Transfer Pricing Guidelines’) in 2017, such as the ‘accurate delineation of actual transactions’ and the ‘commercial rationality criteria.’ Also, substantial revisions have been made to the introductory clause to Chapter 3-7, ‘Financial Transactions,’ to more specifically describe the examination policies for financial transactions, consistent with the outline of the examination policies presented in the introductory clause to Chapter 3-1.

Additionally, in Chapter 3-8, the section entitled ‘Investigation of Monetary Loan Transactions by the Method Equivalent to the Method Similar to the Comparable Uncontrolled Price Method’ has been entirely deleted, and a new section entitled ‘Matters to Be Noted in the Examination of Arm’s Length Prices relating to Financial Transactions’ has been newly added. Previously, the guidelines provided the following priority for application of a ‘method equivalent to a method similar to the comparable uncontrolled price method,’ particularly in selecting comparable transactions for monetary loan transactions:

(1) Debtor's funding rate → (2) Lender's funding rate → (3) Interest rate on government bonds, etc.

The revision has deleted this priority requirement, and has added instead the stipulation that the ‘most appropriate method,’ as provided for in paragraph 2, Article 66-4 of the Act on Special Measures Concerning Taxation (the ‘ASMT’), be used.

2. Impact on transactions to obtain monetary loans from foreign affiliates

For Japanese affiliates of foreign MNEs, these revisions are expected to have a significant impact on their monetary loan transactions with their foreign affiliates. Previously, assuming the application of a method equivalent to a method similar to the comparable uncontrolled price method, it was explicitly stated in Chapter 3-8 that, in selecting comparable transactions, the following order should be followed: (1) debtor's funding rate, (2) lender's funding rate and (3) interest rate on government bonds, etc.

Therefore, when asked in a tax examination about interest rates on monetary loan transactions with foreign affiliates, many taxpayers explained by saying, for example, ‘interest has been charged to the Japanese affiliates after adding a small markup on the funding rate of the lender (e.g., the foreign parent company).’ That was an explanation based on the ‘lender's funding rate,’ which was the second priority among the applicable comparable transactions listed in Chapter 3-8. However, under the Revised Guidelines, which now require the tax examiners to examine whether the amount of consideration (e.g., the interest rate) in a financial transaction was calculated using the ‘most appropriate method,’ when a taxpayer provides an explanation solely based on the ‘lender's funding rate,’ the tax examiners would not be able to determine, based on that explanation, whether that is the most appropriate method, and the explanation is therefore more likely to be judged as insufficient.

3. Measures required for local files

(1) Necessity of documenting financial transactions

Although Japanese affiliates of foreign MNEs typically prepare a transfer pricing local file, the majority document only intangible asset transactions, inventory transactions and service transactions relating to their main businesses, and financial transactions (such as monetary loans from their global parent company or regional headquarters in Asia) are out of the scope of their documentation. This may be at least partly due to the fact that the Japanese tax examiners did not often focus on financial transactions in the past. However, as the Revised Guidelines have aligned the transfer pricing methods for financial transactions with the OECD Transfer Pricing Guidelines, it is expected that financial transactions with foreign affiliates will be carefully examined in an increasing number of tax examination cases. As a practical matter, it is difficult for taxpayers to prepare, after the commencement of a tax examination, documents that accurately delineate their transactions and document and support that their interest rates are set in accordance with the arm's length principle. Therefore, it will become more necessary than ever to include such documentation for financial transactions in the local file, which should be prepared well in advance of the commencement of a tax examination.

(2) Necessity of delineating transactions accurately

The Revised Guidelines reflect the guidance for applying the arm’s length principle that was added to the OECD Transfer Pricing Guidelines in 2017 (Section D, Chapter I). In particular, the guidelines position a ‘comparability analysis’ as the heart of the application of the arm's length principle. In addition, in order to conduct a comparability analysis, transactions between affiliates must be accurately delineated, and in order to do this, commercial and/or financial relationships between the affiliates (contract terms, functions and risks, characteristics of assets and services, economic conditions, business strategies) must be identified (paragraph 1.33). The guidelines also provide that, when evaluating the terms of a potential transaction, independent enterprises would compare the transaction to the other options realistically available to them. Therefore, it is necessary to accurately delineate the controlled transaction in consideration of such commercial rationality criteria as well (paragraph 1.38).

Similar to the introductory clause to Chapter 3-1, the introductory clause to Chapter 3-7 stipulates that, in an examination of financial transactions, the tax examiners ‘shall examine whether there are any transfer pricing tax issues by accurately understanding the currency, timing, period, and other details of the financial transactions based on the factors listed in ASMT Directive 66-4(3)-3.’[1] For financial transactions as well, the ‘ accurate delineation of transactions’ is emphasized, in order to ensure the reasonable conduct of a comparability analysis and verification of comparability between the foreign affiliated transaction and the transaction between non-affiliated persons.

The objective of the ‘accurate delineation of transactions’ is to understand the contents and characteristics of transactions in a multifaceted and accurate manner from the perspective of the contract terms, the functions and risks of the parties, the characteristics of assets and services (for financial transactions, the characteristics of the financial instruments), economic conditions, and business strategies, for use in the comparability analysis. Therefore, it shall be based on the substance of the transaction, and the transaction should not be unnecessarily recharacterized. Care must be taken when, for example, a financial transaction conducted between foreign related parties contains terms that are not seen, or that might seem significantly unreasonable, between unrelated parties (e.g., a loan period that is inconsistent with funding requirements, a loan period where repayments are not feasible based on projected future cash flows, or various conditions including scheduled repayment) because these terms may be changed to appropriate terms to calculate an arm's length price.

(3) Necessity of selecting comparable transactions

With the revision of the guidelines, it is highly likely that the tax authorities will no longer accept traditional explanations (e.g., a small markup on the lender's funding rate) without sufficient analysis about the arm’s length nature of interest rates on monetary loans from foreign related parties. In the future, taxpayers may be increasingly required to explain the arm’s length nature of interest rates based on a comparables analysis. In such an analysis, the concept of the creditworthiness of a party to the transaction (e.g., the lender) will be important. The Revised Guidelines clarify the concept of creditworthiness as follows.

Regarding creditworthiness (of the debtor), Revised Guidelines Chapter 3-8(2) lists, as one of the comparability factors to be considered in the analysis of transfer pricing of a financial transaction, ‘an indicator showing the results of an evaluation of the credit conditions of the party, such as a credit rating.’ Basically, a certain credit rating made available to the public by an external credit rating agency is expected to be used. However, it is extremely rare that a foreign affiliate (other than the head office) of a corporate group has a credit rating assigned by an external rating agency. Therefore, the taxpayer needs to reasonably derive a credit rating by some method. Among potential solutions, the following approaches are expected to be applicable in practice. In reality, as methodology 2 is difficult for operating companies, methodologies 1 and 3 (or some combination of both) can be considered.

1. A methodology that derives credit ratings by using a financial tool of a credit rating agency to calculate the debtor's probability of default;
2. A methodology that derives credit ratings by independently conducting a qualitative and quantitative analysis based on a credit rating methodology made available to the public by a credit rating agency;

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[1] Under ASMT Directive 66-4(3)-3, ‘For the purpose of application of Article 66-4, it should be noted that, in determining the degree of similarity between a foreign affiliated transaction and a transaction between non-affiliated persons as to whether or not it falls under the category of a comparable transaction, the contents or the like of the businesses of the corporation, the foreign affiliated person and the non-affiliated person, and the similarity of the factors listed as follows, for example, shall be taken into consideration.

(1) Type of inventory assets, contents of services, or the like;
(2) Functions performed by the seller or the buyer;
(3) Contract terms;
(4) Market situation;
(5) Business strategies of the seller or the buyer;’

3. A methodology that qualitatively derives credit ratings based on a group credit rating methodology made available to the public by a credit rating agency, etc.

Following the above, under the Revised Guidelines, Chapter 3-8(2), a party (such as the debtor) may have a higher credit rating because of the fact that the party belongs to a corporate group. However, no compensation is required for ancillary benefits that inure to the party as a result of membership in the corporate group. However, under the Revised Guidelines, when the arm's length nature of a party's credit rating will be judged, it is necessary to do so based on the higher credit rating resulting from belonging to a corporate group.

These basic guidelines for evaluating debtors' credit ratings are consistent with the OECD Transfer Pricing Guidelines (paragraphs 7.13 and 10.62) and are considered reasonable. On the other hand, from a practical point of view, when using a comparable transaction between unrelated parties, for example, it is difficult for the taxpayer to know how these parties evaluate additional creditworthiness resulting from belonging to a corporate group.

Therefore, in practice, reliance must be placed on the group rating methodologies made available to the public by credit rating agencies. For example, a possible approach is that, after reasonably deriving a single credit rating, the credit rating is revised upward based on one of these credit rating methodologies or revised downward based on the group-wide credit rating as the starting point.

Going forward, where a relatively high interest rate has been paid by a Japanese taxpayer to a foreign related party, without the taxpayer having given consideration to the credit rating of the parent company in the MNE group based on the above-discussed concepts of the Revised Guidelines and the OECD Transfer Pricing Guidelines, the transaction is likely to be closely scrutinized in a tax examination. This will also be the case where the creditworthiness of a Japanese subsidiary debtor is set at a very low level on a non-consolidated basis without consideration having been given to additional creditworthiness that may exist due to being a member of the corporate group.

The takeaway

As expected, the contents of the Revised Guidelines as a whole follow those of the revised OECD Transfer Pricing Guidelines. They will directly affect foreign affiliated Japanese companies, particularly in their monetary loan transactions, and financial transactions are expected to be examined carefully in an increasing number of tax examination cases. Therefore, taxpayer documentation measures will be necessary to avoid undue risk.

This revision is effective for corporation tax and advance pricing arrangement ('APA') examinations of fiscal years beginning on or after July 1, 2022. For corporation tax or APA examinations of fiscal years beginning before that date, the previous version of the guidelines will continue to apply. Therefore, the revision will be effective from the fiscal year ending March 31, 2024 for corporations with a fiscal year ending in March, and from the fiscal year ending December 31, 2023 for corporations with a fiscal year ending in December.

Let's talk

For more information or a deeper discussion of how this issue might affect your business, please contact:

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