Japan Tax Newsletter

Deloitte Tohmatsu Tax Co.

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Applying the New Japanese Transfer Pricing Guidelines regarding Intra-group Financial Transactions in a Dynamic and Higher Interest Rate Environment

Executive Summary

- On 10 June 2022, the National Tax Agency released an update to the Commissioner's Directive on the Operation of Transfer Pricing ("Administrative Guidelines") with significant amendments to the guidelines concerning financial transactions. The new guidelines will be applied to corporate tax examinations of fiscal years beginning on or after 1 July 2022. For December and March year-ended companies, the first years impacted by the update are December 2023 and March 2024, respectively.
- The rise in market interest rates has led to an increase in arm's length ranges of interest rates and corresponding interest income and expense transaction amounts. This necessitates revisiting existing financial transaction pricing that may no longer reflect current market rates or transaction risk profiles.
- As examinations into Transfer Pricing for intra-group financial transactions are expected to intensify, it is necessary to review and update policies and documentation to adhere to the new guidelines on intra-group financial transactions and reflect current market conditions. Close attention must be paid to the growing importance of intra-group financial transactions especially where pricing adhered to the old Administrative Guidelines.

1. Major revisions

On 10 June 2022, the National Tax Agency (hereinafter the "NTA") released an update to the "Commissioner's Directive on the Operation of Transfer Pricing (Administrative Guidelines)" (NTA website). The new guidelines will be applied to corporate tax examinations of fiscal years beginning on or after 1 July 2022. For December and March year-ended companies, the first years impacted by the update of the Administrative Guidelines are December 2023 and March 2024, respectively. With the revisions, the new guidelines on intra-group financial transactions were brought into alignment with the OECD Transfer Pricing Guidelines (2022). The table below shows the major revisions to the Administrative Guidelines which did not previously cover guarantees or cash pooling transactions.

	Summary of the updated Administrative Guidelines
Loan	• Eliminates the heirarchy of methods under the old Administrative Guidelines specifically abolishing the provision for pricing loans based on funding rates of the lenders and government bond yields • Replaces the old guidelines and stipulates that, in principle, interest rates should be set based on a borrower's creditworthiness • Provides new guidelines for the process of determining a borrower's creditworthiness, selecting comparable transactions based on that creditworthiness, and calculating an arm's length range of interest rates • Provides new guidelines for the terms and conditions of a loan that should be considered in a loan's pricing including the timing of its issuance, its currency and its lending period
Guarantee	• Establishes new guidelines for renumeration of a cash pool leader and the allocation of pooling benefits and compensation to cash pool participants
Cash Pooling	• Establishes new guidelines to determine under what conditions it is necessary to remunerate guarantee fees, how such remuneration of guarantee fees should be priced, and the scope of guarantees covered by the new guidelines (i.e., performance guarantees and acts similar to guarantees are also covered)

For companies with intra-group financial transactions, the following are the main issues and corresponding analyses necessary to establish Transfer Pricing policies in accordance with the new Administrative Guidelines.

- **Determination of the creditworthiness of the borrower**

  If a borrower does not have a credit rating, it is necessary to evaluate the creditworthiness of the borrower using appropriate methods. Also, when there are many borrowers, it may be advantageous to analyse these borrowers in reasonably constructed groupings.

- **Interest rate (guarantee fees) benchmarking analysis using comparable transactions**

  The new Administrative Guidelines assume an analysis using comparable instruments issued by entities with the same creditworthiness as the intra-group borrowers (internal and external comparable transactions) is appropriate. As the number of comparable instruments issued in the same currency, at the same time, and for the same duration as a transaction under analysis are generally limited, it is commonly necessary to make adjustments for differences in the currency, execution date, duration.

- **Cash pooling analysis**

  After evaluating the structure of a cash pooling arrangement, it is necessary to establish an appropriate renumeration for the cash pooling leader based on its functional profile and to set interest rates gin accordance with the pooling benefits and incentive for participating in the pooling.

2. The rise in market interest rates and its effect on Transfer Pricing

The rise in market interest rates is leading to a corresponding rise in arm's length interest rates and transaction amounts. As such, determining the materiality of and risk associated with a financial transaction should be based on the current higher interest rate environment.

Below we first explain what the components of an interest rate are and then how those components are changing.

(1) Composition of interest rates

- As illustrated below, an interest rate is composed of a base (or "risk-free") rate and a spread which accounts for differences in credit risk.

  - Interest Rate = Base Rate + Spread

    e.g., 1Y USD Swap Rate: 5.0% e.g., 1.0%

- Interest rates can be either fixed or floating. Fixed interest rates are rates which remain constant for the duration of a borrowing period whereas floating interest rates are rates that fluctuate during a borrowing period.

  - For a fixed base rate, a swap rate[1] in the currency of the loan corresponding to the tenor of the loan is commonly used. For example, for a loan issued in U.S. dollars having a tenor of one year, it is

[1] I.e., A floating to fixed swap rate

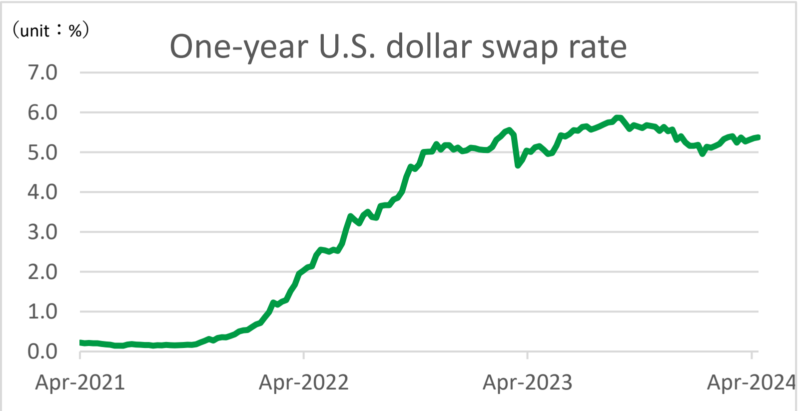
common to use one-year U.S. dollar (floating to fixed) swap rates.

- For a floating base rate, short term interest rates corresponding to the interest payment period (e.g., interbank rates such as TIBOR and EURIBOR) are commonly used.[2]
- The currency of the loan should be used to determine the appropriate base rate. A base rate in a currency other than the currency of the loan is not appropriate.

■ As the creditworthiness of the borrower is embedded in the spread, the spread is generally the component of the interest rate that is analysed assuming the base rate is appropriately selected.

(2) **Market interest rates trends**

■ U.S. dollar interest rates have been rising since 2022. For example, the one-year U.S. dollar swap rate is shown in the figure below. The one-year U.S. dollar swap rate stood above 5% as of April 2024, a significant increase from approximately 0.2% as of April 2021.



(Source: LSEG)

■ The rise in base rates due to higher market interest rates and a widening of the spread due to reflecting borrower’s creditworthiness, respectively, could lead to a significant rise in arm's length interest rates.

3. Frequently asked questions

Our clients are asking various questions regarding the new guidelines on Transfer Pricing for intra-group financial transactions. Below are some of the frequently asked questions.

Q1: Is it required to prepare local files for intra-group financial transactions?

The rules regarding local file preparation are the same as for tangible and intangible asset transactions. Therefore, in principle, if contemporaneous documentation is required for a foreign related party, a local file should also be prepared for intra-group financial transactions with that foreign related party.

Q2: Is it required to collect guarantee fees?

Regardless of whether there is a written contract or not, it will be necessary to assess whether a guarantee should be remunerated based on the new guidelines, and if so, it will be necessary to make payment or take receipt. As the new guidelines have clarified the methods for pricing guarantee fees, it is assumed that Japanese tax authorities will test the arm’s length nature of guarantee fees in the future.

Q3: Will intra-group financial transactions be subject to tax examinations?

Even in corporate tax examinations conducted for fiscal years prior to the revision, intra-group financial transactions were subject to examination. Examinations of financial transactions will likely be conducted more commonly and with greater scrutiny for the fiscal years after the revision.

Q4: Is it necessary to analyse cash pooling?

Cash pooling transactions falls under the category of “financial activities related to financial transactions” in the new

[2] The publication of USD LIBOR ceased in June 2023.

guidelines, and cash pooling transactions have already been subject to tax examinations. It is prudent to establish and implement cash pooling policies in accordance with the new guidelines to reduce risk of assessment in examination.

Q5: Are licenses and databases required?

It should be noted that the use of databases and payment of license fees may be necessary to obtain specific interest rate information.

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Contacts

Deloitte Tohmatsu Tax Co.

Tokyo Office

Address	Marunouchi Nijubashi Building 3-2-3 Marunouchi, Chiyoda-ku, Tokyo, 100-0005
Tel	03-6213-3800

Osaka Office

Address	Yodoyabashi Mitsui Building, 4-1-1 Imabashi, Chuo-ku Osaka, Osaka 541-0042
Tel	06-4560-8000

Nagoya Office

Address	1-1-1,Meieki, Nakamura-ku JP Tower Nagoya, Aichi 450-8503
Tel	03-6213-3800

Email	tax.cs@tohmatsu.co.jp
About us	www.deloitte.com/jp/tax
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