Japan Tax & Legal Inbound Newsletter

Updated operational guidelines drive a new focus on financial transaction transfer pricing (FTTP)

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Background

For fiscal years starting on or after 14 July 2022, the FTTP guidance used by Japanese tax examiners when they carry out examinations of intercompany finance transactions has been updated.

In 2023, Japan has already seen rising non-Japanese Yen (JPY) interest rates and is likely to see a comprehensive assessment of monetary policies, including the JPY interest rate policy, by the Bank of Japan.

Multinational corporations (MNCs) must be able to plan, price, document, and defend decisions regarding intercompany financial transactions in the expectation of increased scrutiny by tax examiners based on the updated FTTP guidance, and considering the challenges of volatile interest rates.

Key considerations and issues

What are the key aspects of the updated FTTP guidelines?

The updated guidelines align with the OECD guidance on FTTP and emphasize that where the contractual terms and conditions of intercompany financial transactions do not align with the facts, a tax examiner is able to adjust the terms, conditions, and pricing to reflect the reality of the transaction. The guidance provides examiners with a strong foundation from which to recharacterize and reprice transactions.

The pricing of intercompany financial transactions must be based explicitly on the creditworthiness of the intercompany borrower or the beneficiary of a guarantee; if this is enhanced due to the implicit support of the MNC group or parent company, this implicit support is an ancillary benefit for which no payment is due.

The transfer pricing methods for intercompany loans are focused on the Comparable Uncontrolled Price (CUP) method, and only give limited consideration to a method involving a cost of funds plus a mark-up. Loan pricing quotes from third parties do not provide proof of an intercompany loan price being consistent with the arm’s length principle.

For pricing intercompany guarantees, a case in the guidelines notes that the maximum guarantee charge may correspond to a price based on sharing the benefit of interest savings associated with the guarantee (the yield approach), and the minimum guaranteed fee may be based on the probability and the magnitude of the liability that would be transferred, and the cost of covering that liability (the expected loss approach).

Under the guidelines, cash pooling participants are assumed to be better off (with respect to interest rates, sources of funds, liquidity, exposure to banks, etc.) than those without cash pooling. If no benefit is received from cash pooling, other options may need to be considered, otherwise there is a risk that examiners may recharacterize the transaction or adjust the transfer pricing, or both.

How might the changes to Japan's FTTP guidelines affect foreign MNCs and their Japanese affiliates?

Increased focus on FTTP in examinations: Going forward, examiners will apply the updated guidelines and request all relevant documentation. Taxpayers must expect increased scrutiny of FTTP decisions.

FTTP delineation may drive examiners' adjustment arguments: There is an increased risk of recharacterization of intercompany financial transactions due to examiners' potential lack of understanding of complex treasury arrangements, and third-party debt instruments and markets.

Potential disputes with respect to credit ratings: Some academic studies indicate Japanese rating agencies tend to rate entities higher than agencies outside Japan. Disputes may arise if Japanese agency ratings are used by tax examiners.

The focus on the CUP method may lead to lengthy pricing debates: The use of yield bond indices and cost of funds, as opposed to other sources of interest rate data, is likely to be an area of debate in tax examinations given their regular use in global FTTP policies and operations.

Potential challenges in rolling over of short-term loans or cash pooling balances: Short-term intercompany loans are normally rolled over, with the resulting risk of examiners applying long-term rather than short-term deposit or loan rates, and adjusting the interest income from the Japanese related party upwards, and this is expected to be seen as an easy and potentially sizable source of tax adjustments for examiners.

Let's talk

Given the volatile interest rate environment and revisions to the Japanese FTTP guidance, MNC tax and treasury managers may wish to take a more measured approach to the planning and pricing of Japanese intercompany financial transactions than they have applied previously.

For MNCs with large, sophisticated treasury operations, and where the group already relies on an OECD-based approach to FTTP, adapting to the changes in Japan may be comparatively straightforward and involve simply updating existing FTTP process checklists. Groups that have a more ad-hoc approach to FTTP may need to consider addressing any gaps in existing planning and pricing processes, reflecting both the OECD and the new Japanese guidance.

It is important that MNCs use the remainder of fiscal year 2023 to align planning and pricing with the updated FTTP guidance, and mitigate the risks that may arise for the relevant tax examination cycle.

Deloitte can support your company's intercompany financial transactions with FTTP policy planning, documentation, or risk management advice, and benchmarking in line with Japan's updated FTTP guidance and OECD guidance to help bridge the gap between tax and treasury objectives and to defend your company's position under tax examinations.

Please do not hesitate to contact us; we welcome the opportunity to discuss our services with you and to address any questions you may have.

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