

September 13, 2013

International Taxation Working Group
Japan Foreign Trade Council, Inc.

**Requests Concerning the
Draft Handbook on Transfer Pricing Risk Assessment**

The following are the comments of the Accounting & Tax Committee of the Japan Foreign Trade Council, Inc. (JFTC) in response to the invitation to public comments by the OECD regarding the “Draft Handbook on Transfer Pricing Risk Assessment.” The JFTC is a trade-industry association with Japanese trading companies and trading organizations as its core members. One of the main activities of JFTC’s Accounting & Tax Committee is to submit specific policy proposals and requests concerning tax matters. Member companies of the JFTC Accounting & Tax Committee are listed at the end of this document.

General Comments

1. While it is assumed that this Handbook is to be used by tax administrations of both OECD member and nonmember countries, we understand that the Handbook basically extracts the essence of matters covered in the OECD Transfer Pricing Guidelines and thus it has been prepared based on the premise that it is fully consistent with the Guidelines in content. Therefore, we suggest adding to the Handbook an explicit statement to confirm this basic premise. Moreover, we believe that adding to the Handbook explicit references to the relevant paragraph numbers of the Guidelines would be helpful for the users of the Handbook, in gaining a deeper understanding of its contents. Finally, we are concerned that tax administrations in some countries (particularly where the tax administrations have little experience with transfer pricing audits) may extract and use only those sections of the Handbook that could be interpreted favorably to expand their taxing rights. For this reason, we would ask you to add a statement requesting tax administrations to refrain from making such one-sided interpretations that leave taxpayers at a disadvantage.
2. We would ask you to emphasize the point that, in the assessment process, it is necessary to ensure transparency by engaging in a full and open dialogue and communication with taxpayers and appropriately sharing information with them in a timely fashion.

Specific Comments

- In relation to paragraph 18, we believe it is important to ensure objectivity in risk assessment. Therefore, we would ask you to add wording requesting the competent authorities in each jurisdiction to establish a centralized and specialized team for conducting or at least reviewing assessment reports in the transfer pricing area.
- With regard to paragraph 22, we note that the scope of “related parties” for transfer pricing purposes is very broadly defined in some countries (for example, “related parties” may include parties with minor shareholding relationship in which it is substantially impossible for a party to control the other party).

However, in many cases, even if the parties are deemed to be “related parties” under the domestic tax codes (particularly in cases where one party in question does not hold a majority interest in the other party or does not control a majority of the board of directors of the other party), one party would have no substantial control of the other party nor would it have any ability to arbitrarily set transaction prices between the parties. Therefore, we suggest it is addressed in the Handbook that, in performing risk assessment, tax administrations should pay due attention to such circumstances and should consider closely whether substantial and effective controls exist.

- In relation to paragraphs 24 and 39, as addressed in paragraph 57, transfer pricing risks should be assessed based on a thorough review of the functions, risks, and other pertinent factors of the industry and enterprise in question rather than being based only on the size of transactions and other superficial information. Furthermore, the substance of the transactions should be closely reviewed in performing risk assessments as the revenue presented in the income statement might, for example, come merely from brokering transactions in some cases.
- Paragraph 59 indicates that, even if the group as a whole is making losses (so-called “channel losses”), such losses should not be proportionally allocated among all the group members, and the group should include enterprises that are making profits after reflecting risks assumed and/or functions in the group.

The argument that the group should include enterprises that are making profits might be appropriate in a normal economic environment. However, some industries may be experiencing special economic conditions, such as when the market as a whole is shrinking, or when all enterprises in such industries are making losses due to cyclical factors specific to the industries. Therefore, we would ask you to address in the Handbook that assumptions made in a normal economic environment may not necessarily apply to such special

situations (that is, we believe it would not necessarily be correct to allocate income based on only risks and functions, and that due attention should be paid to such special circumstances).

- Paragraph 64 refers to losses recognized by start-up companies. The start-up period needed to enter into a new market may be prolonged due to such factors as the economic environment and circumstances specific to the industry. Therefore, we would ask you to address in the Handbook that it should not be judged that there is automatically a transfer pricing risk simple because of recognized losses extending beyond a certain period.
- With regard to paragraph 69, we would ask you to consider that it should not be uniformly determined that there is a transfer pricing risk, based on a mere fact that an enterprise trades with a related party located in a country where the tax rate is relatively lower than in the other country where the enterprise is a resident. Rather, in performing risk assessment, due attention should be paid to the background and substance of the transactions, including the business reasons that underlie trading with the related party in question.
- Paragraph 74 refers to payments that can be used to erode the local company tax base. We believe that risk factors should not be determined on the basis of category of payment. For instance, tax administrations should avoid making extreme determinations that certain payments are non-deductible expenses simply based on the classification of the payment, e.g. as management fees. In this context, we would ask you to address in the Handbook that economic substance, such as the content and nature of services provided and the level of the payment amounts, should be taken into consideration.
- With regard to paragraph 88, we would ask you to address in the Handbook that factors, such as a high level of taxpayer awareness of tax compliance and the existence and development of appropriate internal control systems over such tax compliance, be included as indications of low risk.
- With regard to paragraph 92, we would ask that you address the situation where tax administrations require the provision of highly detailed information, placing significant burden on the taxpayer, without first considering whether such information is truly critical for the transfer pricing analysis. We believe the Handbook should make it clear that tax administrations should refrain from making such unnecessary and overly burdensome requests.
- Paragraph 129 states that, in certain cases, it is useful for tax administrations to employ information about domestic potentially

comparable businesses that cannot be obtained from commercial databases.

However, taxpayers normally have no alternative but to base the analysis of transfer pricing on disclosed information. We therefore would ask that, in the Handbook, explicit reference be made to the effect that, insofar as actions on transfer pricing are taken based on a proper analysis of disclosed information, the use of undisclosed comparable information (so-called “secret comparables”) is not appropriate.

- In relation to paragraph 136, a transfer pricing risk assessment process may continue throughout the entire period of the tax audit. In this context, we would ask you to address in the Handbook that tax administrations should make efforts to reduce the burden to taxpayers by appropriately monitoring and controlling the progress in the assessment process, and thereby processing the case at hand in an effective and efficient manner.

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