

Japan Tax Bulletin

PE Risks When Employees of a Foreign Corporation Work Remotely from Japan

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In recent years, with the spread of teleworking and the diversification of international work styles, there has been an increasing number of cases where employees of foreign corporations stay in Japan and continue working remotely. While such work arrangements allow companies to utilize human resources more flexibly, they may also give rise to Permanent Establishment (PE) risks in Japan. The determination of a PE directly affects the attribution of taxing rights in Japan, making proper analysis and appropriate responses essential.

1. Definition of PE

A Permanent Establishment (PE) means a fixed place of business through which the business of an enterprise is wholly or partly carried on.

Even if a non-resident or a foreign corporation conducts business in Japan, if it does not have a PE in Japan, its business profits are taxable only in its home country and are not subject to taxation in Japan. This “no taxation without PE” principle has become the international rule for the taxation of business profits. If a PE exists in Japan, the income attributable to the PE is subject to taxation in Japan. Conversely, if there is no PE, business profits are not taxed in Japan; however, certain categories of income may still be subject to withholding taxation.

1-1. PE under domestic rules

Under Japanese domestic tax law there are three types of PE; “branch PE”, “construction activity PE” or “agency PE”.

1) Branch PE

Where a foreign enterprise has a fixed place of business in Japan through which the business of the enterprise is carried on, it may be regarded as a branch PE.

The essential conditions are generally summarized as follows:

- (a) The place must constitute a place of business at the disposal of the enterprise;
- (b) The place must have a degree of permanence (i.e., it must exist for a certain period of time);
- (c) The business of the enterprise is carried on through that place.

A branch PE is not formed if the activities are preparatory or auxiliary in nature.

2) Construction activity PE

A building site, construction, installation or assembly project, or supervisory activities in connection therewith carried on in Japan by a non-resident or a foreign enterprise constitutes a construction PE if such site or project lasts for more than twelve months.

For the purpose of applying this time threshold, where contracts are divided or split up with the principal purpose of avoiding the twelve-month test, the periods of such projects shall be aggregated to determine whether the threshold is exceeded.

As with a branch permanent establishment, an exemption exists for activities of a preparatory or auxiliary character.

3) Agency PE

An agency PE consists of “contracting” agents or “negotiating” (or “secures orders”) agents.

A contracting agent is an agent who concludes contracts on behalf of and in the name of a foreign corporation or a non-resident individual. The authority may be given by a power of attorney, but more often it arises out of an employment, partnership or other underlying contract between the agent and the principal. A person who is authorized to negotiate all elements and details of a contract in a way that is binding on the foreign enterprise would be said to exercise sufficient authority even though the contract is formally signed by another person outside Japan.

A negotiating agent is an agent who exclusively or principally on behalf of a foreign corporation or non-resident “secures orders, negotiates, or performs other important acts leading toward the conclusion of contracts” in connection with the business of the foreign corporation or non-resident.

Independent agent: An exemption applies if an agent carries on business activities in connection with the foreign enterprise independently and in the ordinary course of their own business. However, this shall not apply where the agent acts exclusively or almost exclusively on behalf of one or more enterprises with which it has a special relationship.

1-2. PE under tax treaties

Where a tax treaty concluded by Japan provides a definition of a PE that differs from that under domestic law, the treaty definition shall prevail to the extent it is more favorable to the taxpayer. Accordingly, for non-residents or foreign corporations eligible for treaty benefits, the concept of a PE under the treaty is used

instead of the domestic definition.

2. *Analysis of PE Risks Arising from Remote Work*

The remote work of employees of a foreign corporation in Japan gives rise to debate as to whether it falls within the scope of a “branch PE” or an “agency PE.”

2-1. *Branch PE*

The main factors in determining whether a PE exists are the functions performed and the role of the fixed place, as well as the length of term. Although there is no defined time period under domestic law whereby a fixed place becomes a PE, the OECD commentary on the model tax convention suggests that 6 months is the threshold for establishing a fixed place of business.

If the activities of the employee are considered to be critical to the foreign corporation as a whole, the place through which those activities are conducted will form a branch PE for the foreign corporation. Therefore, if an employee’s home or an office space is used on a continuous basis for the employer’s business it is considered that a branch PE may be formed.

2-2. *Agency PE*

If the employee has the authority to conclude contracts on behalf of a foreign corporation, or effectively determines the key terms of contracts, an agency PE may be formed.

2-3. *Exception for Preparatory or Auxiliary Activities*

Activities limited to a preparatory or auxiliary nature - such as the storage of goods, information gathering, or internal administrative functions - may be excluded from PE recognition. However, the scope of “auxiliary activities” is interpreted narrowly, and activities related to sales, business development, or marketing are generally not regarded as auxiliary.

From a practical standpoint, in order to avoid PE recognition, it is important to limit the scope of duties in job descriptions and employment contracts strictly to auxiliary activities, explicitly stating that the employee will not engage in sales activities or contract negotiations. Clarifying the nature of work in this manner is essential. Furthermore, it is advisable to establish mechanisms that prevent contracts from being executed in Japan - for example, requiring that all contracts receive final approval by the headquarters or another foreign group entity - so that contracting authority is not exercised in Japan.

3. *Conclusion*

When employees of a foreign corporation work remotely from Japan, the determination of whether a PE is constituted depends on factors such as the permanency of the workplace, the nature

of the activities performed, and the existence of the authority to conclude contracts.

If the employee’s duties are limited to auxiliary activities and they are not granted authority to conclude contracts, PE risks can be effectively mitigated. However, where the employee engages in sales activities or contract negotiations, the likelihood of PE recognition is high, which may trigger corporate tax filing obligations as well as transfer pricing documentation requirements.

Ultimately, the determination of PE status depends on the specific facts and circumstances of each case, and a case-by-case analysis is strongly recommended.