

Japan Tax Bulletin

Impact of BEPS Action 7 Preventing the Artificial Avoidance of PE Status on Japan inbound investments

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The Discussion Draft on BEPS Action 7 released on October 31, 2014 discusses the artificial avoidance of Permanent Establishment (PE) status through commissionaire and similar arrangements. Commissionaire arrangements and similar strategies are frequently utilized by foreign companies to sell their products to Japanese customers.

1. *Commissionaire*

Under Japan law a commissionaire is called Toiya. A Toiya is a person who engages in the business of selling or purchasing goods on behalf of another person. The Toiya acquires the rights and assumes obligations in relation to the other party as they arise from the sales or purchases that the Toiya has engaged in on behalf of another person. In relation to these sales or purchases, where the other party to the transaction does not fulfill its obligation, the Toiya is responsible for fulfilling the other party's obligation. Under a Toiya contract, the Toiya enters into a sales/purchase contract with customers in its name, but the economic effect of the transactions is attributable to the principal.

For Japan inbound sales transactions, a foreign company and its Japan subsidiary enter into a commissionaire contract where the Japanese subsidiary enters into sales contracts with Japanese customers and the foreign principal records sales revenue in its books and compensates the Japanese subsidiary with commission. In the early 2000's, there were many restructuring transactions which changed the contract between a foreign parent and its Japanese subsidiary from a buy/sell contract to a commissionaire contract. Even now it appears that there are still many Japanese subsidiaries acting as commissionaire on behalf of a foreign parent.

2. *Cost plus service company*

A cost plus service company is commonly used for Japan inbound sales by foreign companies. Under the cost plus service company arrangement, the foreign company enters into sales contracts with Japanese customers directly and its Japanese subsidiary acts as a liaison between the foreign company and Japanese customers. In return the subsidiary is compensated with a commission which is computed as total operating expenses plus a 5~10% mark up. Therefore, the tax exposure of the Japanese subsidiary is minimized. The Japanese subsidiary's activities are restricted to providing product information to customers, providing customers' order forecasts and customers' needs to the foreign parent, correspondence support to the foreign parent and customers, providing technical support to customers etc. However, sometimes the activities of a Japanese subsidiary end up not being limited to support functions but are expanded to sales negotiation, taking orders etc. In this case, the question of PE creation arises.

3. *Agent PE under Japan Law*

Under Japan law, an agent having and habitually exercising authority to conclude contracts in Japan on behalf of a foreign corporation or non-resident principal is a PE, unless such authority is limited to the purchase of goods or merchandise for the foreign principal. However, the Japanese definition excludes persons who conduct the same or similar business with a foreign corporation or a non-resident and conclude such contracts for the foreign corporation or non-resident based on inevitable necessity because of the character of the business (i.e. an independent agent).

A contracting agent is therefore an agent who concludes contracts on behalf of and in the name of a foreign corporation or a non-resident individual. The authority to act on behalf of the principal 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.

4. *BEPS 7 Discussion Draft*

The BEPS 7 Discussion Draft discussed Options A, B, C and D below to address artificial avoidance of PE status through commissionaire and similar strategies by changing paragraphs 5 and 6 of Article 5 of the OECD Model Tax Convention as follows:

- A. Add a reference to contracts for the provision of property or services by the enterprise; replace "conclude contracts" by "engages with specific persons in a way that results in the conclusion of contracts"; strengthen the requirement of "independence".
- B. Add a reference to contracts for the provision of property or services by the enterprise; replace "conclude contracts" by "concludes contracts, or negotiates the material elements of contracts"; strengthen the requirement of "independence".



- C. Replace “contracts in the name of the enterprise” by “contracts which, by virtue of the legal relationship between that person and the enterprise, are on the account and risk of the enterprise”; replace “conclude contracts” by “engages with specific persons in a way that results in the conclusion of contracts” ; strengthen the requirement of “independence”.
- D. Replace the phrase “contracts in the name of the enterprise” by “contracts which, by virtue of the legal relationship between that person and the enterprise, are on the account and risk of the enterprise”; replace “conclude contracts” by “concludes contracts, or negotiates the material elements of contracts” ; strengthen the requirement of “independence”.

Each option enlarges the scope of a contracting agent PE. Further to the 2014 October Discussion Draft, the majority of public comments preferred Option B. A new Discussion Draft was released May 15, 2015 where the proposal to change paragraph 5 and 6 in the following way was made :

“5. Notwithstanding the provisions of paragraphs 1 and 2 but subject to the provisions of paragraph 6, where a person is acting in a Contracting State on behalf of an enterprise and, in doing so, habitually concludes contracts, or negotiates the material elements of

- contracts, that are
- a) in the name of the enterprise, or
 - b) for the transfer of the ownership of, or for the granting of the right to use, property owned by that enterprise or that the enterprise has the right to use, or
 - c) for the provision of services by that enterprise, that enterprise shall be deemed to have a permanent establishment in that State in respect of any activities which that person undertakes for the enterprise, unless the activities of such person are limited to those mentioned in paragraph 4 which, if exercised through a fixed place of business, would not make this fixed place of business a permanent establishment under the provisions of that paragraph.

6. a) Paragraph 5 shall not apply where the person acting in a Contracting State on behalf of an enterprise of the other Contracting State carries on business in the first-mentioned State as an independent agent acting on behalf of various persons and acts for the enterprise in the ordinary course of that business. Where, however, a person acts exclusively or almost exclusively on behalf of one or more enterprises to which it is connected one enterprise or associated enterprises, that person shall not be considered to be an independent agent within the meaning of this paragraph with respect to any such enterprise.

b) For the purpose of this Article, a person shall be connected to an

enterprise if one possesses at least 50 per cent of the beneficial interests in the other (or, in the case of a company, at least 50 per cent of the aggregate vote and value of the company’s shares or of

the beneficial equity interest in the company) or if another person possesses at least 50 per cent of the beneficial interest (or, in the case of a company, at least 50 per cent of the aggregate voting power and value of the company’s shares or of the beneficial equity interest in the company) in the person and the enterprise. In any case, a person shall be considered to be connected to an enterprise if, based on all the relevant facts and circumstances, one has control of the other or both are under the control of the same persons or enterprises.”

The final report is expected to be released in October 2015 and so attention should be paid to any changes in the version.

5. *Reform of domestic tax law and tax treaties*

The Japanese government has incorporated BEPS Actions into domestic tax law. As tax treaty provisions override domestic tax law provisions in the Japanese legal system, tax treaties will need to be updated to necessary to incorporate Action 7. As such, it is recommended that taxpayers pay close attention to domestic tax law and future tax treaty reforms in relation to this.



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