

# Financial Services Tax News

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## PwC Japan Tax Newsletter

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## OECD- Draft Update to Model Tax Convention

On April 21, 2008 the Organisation for Economic Co-operation and Development ('OECD') released for comments the draft contents of the 2008 update to the Model Tax Convention, which the Committee on Fiscal Affairs intends to finalize in June 2008.

The key changes are outlined below:

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## Article 5: Permanent Establishments

The changes to the commentary on this Article are based on the 2006 discussion draft released by OECD on Tax Treaty Treatment of Services (December 2006).

The suggested changes represent a significant policy shift in regard to source State taxation of services and now OECD has suggested inclusion of the Service Permanent Establishment ('PE') clause within scope of Article 5.

However, since the OECD Model Tax Convention ('OECD MC') itself has not been changed, the effect of this clause can only arise if the treaty partners agree to amend or draft their tax treaties accordingly. There is no automatic application of this change on existing tax treaties which otherwise do not have this particular clause incorporated.

### Taxation of services and Service PE

At the onset, OECD reinforces the principle that for source State taxation of services, the normal PE threshold should ideally apply and be treated similar to taxation of other business activities.

OECD considers that a source rule for the taxation of services (i.e., taxing services without existence of PE) may have administrative and compliance difficulties, as compared to a classical 'fixed place of business' PE. In OECD's view, pure source based taxation is not considered as optimal tax treaty policy and non-residents cannot be taxed on services rendered outside the source State merely because the recipient/payer is resident of that State or those services are commercially utilized in that State. Further, only profits derived from the service should be taxed rather than the whole payment and services rendered for very short period within a State should not be taxed.

OECD has recognized that some OECD Member States, as a matter of pure domestic law policy on taxing services rendered within a State, still maintain taxing rights on services even before the classical PE threshold (i.e., fixed place of business) is reached.

Based on this consideration, OECD has now suggested the 'Service PE' clause in the commentary, which OECD Member States can incorporate in their bilateral treaties. The basic tenets adopted for taxing services are – (i) only services performed within a State should be taxed, (ii) tax should be imposed only on profits (not gross payment), and (iii) service provider should pass a permanence test.

The new suggested Service PE clause has two parts:

- where services are provided through an individual (whether self employed or employees/dependent of another enterprise) –
  - (a) such individual must be present in the source State for at least 183 days in any twelve month period, and
  - (b) more than 50 per cent of the gross revenues attributable to active business activities of the enterprise during this period or periods are derived from the services performed in that other State through that individual.
- where services relate to projects (i.e., multiple individuals may be involved) –
  - (a) services are performed for at least 183 days in any twelve month period, and
  - (b) these services are performed for the same project or for connected projects through one or more individuals who are present and performing such services in the source State.

OECD has clarified that the Service PE clause only creates alternative / supplementary definition of PE, but does not affect the basic PE principles underlying fixed place of business or construction activities. Various other technical aspects have been clarified in the new commentary with regard to Service PE.

## Article 7: Business Profits

The changes to the commentary on this Article arise from OECD's Report on the Attribution of Profits to Permanent Establishment (December 2006) and the public discussion draft on Revised Commentary to Article 7 (April 2007).

The issue of profit attribution has undergone significant debate and discussion in OECD's public forum. As OECD had explained in the earlier reports, the current version represents changes to the commentary which are not inconsistent with the present language and principles underlying Article 7. As part of the broader project on modernizing profit attribution principles, OECD intends to subsequently introduce a new version of Article 7 (along with commentary).

**Functionally separate entity approach:** In the new commentary OECD has confirmed the 'functionally separate entity approach' as the authorized approach for attribution of profits to a PE. Under this approach, the PE may be attributed profits even if the enterprise has not made overall profits and conversely, the PE may not be attributed profits even if the enterprise has earned profits on the whole.

**Importance of documentation:** OECD has reinforced the fact that the accounting records of the PE are the starting point for attributing profits and records and documentation must reflect the true facts of the PE's transactions and its functional and risk profile. The new commentary encourages taxpayers to prepare such documentation to reduce risk of controversies.

**2-step approach for attribution:** The 2008 update refers to the 2-step approach for attributing profits to a PE which was explained in detail on the December 2006 PE Attribution Report. The steps are:

- Step 1 - Identification of functions & risks of the PE as a separate and distinct enterprise, including:
  - Attribution of rights & obligations to PE arising out of external transactions of the enterprise:
  - Determination of functions of hypothesized distinct & separate entity
  - Attribution of risks based on significant people function
  - Attribution of economic ownership of assets based on significant people function
  - Attribution of capital (free & debt) based on assets & risks attributed to PE
  - Recognition & determination of nature of dealings between PE & head office
- Step 2 - Determining the arm's length remuneration for the PE based on its functions, risks and assets and comparability analysis.

The OECD refers to the arm's length principle and usage of the OECD Transfer Pricing Guidelines for application of both these steps.

**Construction PEs:** In relation to attributing profits to a Construction PE, OECD has clarified that the supply of goods and services from other parts of the enterprise (i.e. overseas/offshore supply) to the PE should not lead to attributing profits embedded in such overseas supply.

**Dependent Agent PEs:** In relation to attributing profits to a Dependent Agent PE, OECD has clarified that the dependent agent & the PE are distinct entities (and separate taxpayers) with different functions, assets and risks. While the dependent agent's remuneration will depend on its own functions and risks, the asset and risk attributed to the PE is based on the functions of the dependent agent on behalf of the enterprise.

Thus, depending upon whether the dependent agent would perform significant people functions for assumption of risks and ownership of assets, there could be attribution of profits to the PE over and above the arm's length remuneration received by the dependent agent from the principal company. The attribution of profits in such case is not automatic and requires an extensive functional & factual analysis of the activities of the agent under a transfer pricing study, i.e., whether or not the agent performs significant people functions for assumption of risks & ownership of assets.

**Deduction of expenses:** On the issue of deductibility of expenses for computing profits of a PE, the OECD commentary clarifies that normally only actual expenses (and not profits thereon) shall be deductible. For example, if the head office provides intangibles or marketing services to the PE, no deduction would be allowed for a royalty or marketing fee, but only the costs thereof. The only exception would be where goods or

services are provided which are directly meant for sales through the PE.

This treatment creates an inherent difference between the allowance of expenses of a PE and a subsidiary company.

**Deduction of interest cost:** On the issue of deductibility of interest by the PE on debts actually incurred by the enterprise (deduction of interest on internal debts is restricted), OECD has adopted the concept of 'free' capital attribution to the PE, rather than direct or indirect apportionment of interest costs to the PE. This approach is based on the premise that the PE's funding is comprised of 'free' capital and debt.

## Article 10 – Dividend

The provisions of Article 10 dealing with dividend income are proposed to be applied to the distribution made by Real Estate Investment Trusts ('REITs') to small investors. Large investors would not be entitled to the reduced rates on dividends<sup>1</sup> contained in Article 10. For this purpose 'small investors' are investors owning less than 10% of the REIT company. The rationale of extending the benefit of Article 10 to small investors is that these investors are not in a position to exercise control over the immovable property and it may be appropriate to treat such income as portfolio dividend. Large investors, on the other hand, may be seen as having invested in the immovable property and hence the beneficial rates contained in Article 10 on dividend income should not be extended to such investors.

Further, where the REIT does not qualify as a company resident of a Contracting State, then appropriate changes are proposed to ensure that the income earned by small investors from REITs organized under the laws of that Contracting State qualifies for the beneficial treatment under Article 10. Further, where the REIT is not organized in the form of a company but is in the form of trust or as a contractual or fiduciary arrangement, the income distributed by such REIT should be treated as a dividend from a company for the purpose of Article 10.

## Article 12 – Royalty

The interpretation and application of the definition of 'Royalties' raises various practical questions. The draft update has issued certain clarifications which are as follows:

- Where there is an alienation / transfer of ownership of a right as referred to in the definition of royalty, consideration received for acquiring the ownership cannot be for the 'use of' such a right, and therefore not 'royalty'. Such consideration is likely to be income which is governed by either Article 7 (Business Profits) or Article 13 (Capital Gains).
- Payments for obtaining exclusive distribution rights of a product or service in a given territory would not constitute royalties as they are not made in consideration for the 'use of or the right to use' a property, intended in the definition of a royalty. Such payment would usually fall under Article 7 only.
- For a payment to qualify as being 'for the use of, or right to use' a design, model or plan (and hence covered within the royalty definition), it is essential that such design and model should already be in existence (viz. previously developed). Payment for development of a new design, model or plan (i.e. one that does not already exist) would not constitute a 'Royalty' but would instead be in consideration of 'services' rendered by the developer of the designs etc. and would fall under Article 7 (Business Profits), unless a specific Article / Treaty deals with services.
- The draft update clarifies that payments for information concerning industrial, commercial or scientific experience would constitute a Royalty only if such information is concerning previous experience. The Article does not apply to payments for new information obtained as a result of performing services at the request of the payer. Such payments would qualify as 'Service Fee' and accordingly be subject to other appropriate provisions of the double tax agreement ('DTA').
- The scope of term royalty appears to have been widened by re-defining the phrase 'industrial, commercial or scientific experience'. As per the prevailing Commentary, the words 'payments received as

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<sup>1</sup> 5% / 15% as per the OECD Model

consideration for information concerning industrial, commercial or scientific experience' were defined to cover only technical information necessary for the industrial reproduction of a product or process. Whereas, under the proposed amendment, the above phrase corresponds to information of an industrial, commercial or scientific nature, which has practical application in the operation of an enterprise and from the disclosure of which an economic benefit can be gained.

- Arrangements between a software copyright holder and a distributor granting him the right to distribute copies of the program but without the right to reproduce that program, would not constitute 'Royalty'. Such payment, since what the distributor gets is only a right to acquire and sell copies of software and not to exploit any right in the software copyright, would instead be dealt with as Business income in accordance with Article 7.

### Article 13 - Capital Gains

Article 13 of the OECD MC provides that gains derived by a resident of a Contracting State from alienation of shares deriving more than 50% of their value from immovable property, situated in another Contracting State may be taxed in such other State. The Draft Update recommends exempting the above tax in relation to alienation of shares (and similar interests) in a REIT for small investors (for this purpose 'small investors' are investors holding less than 10% of the REIT company), since their interest in the REIT takes the form of security rather than an indirect holding in immovable property. Further, since REIT (unlike other entities deriving their value primarily from immovable property) are required to distribute most of their profits, there would not be significant residual profits to which capital gains tax would apply.

### Article 15 - Income from Employment

Under Article 15 of the OECD MC, salary earned by a resident of a Contracting State shall be taxable only in that State unless the employment is exercised in the Other Contracting State. Under Article 15 of the OECD MC, to decide whether an individual is taxable in the Other State, it has to be proved that he is physically present in the Other State for more than 183 days in a 12 month period. The draft update seeks to clarify that only those days of physical presence in the Other State will be taken into consideration during which the individual is a "resident" of the first State (under Article 4). In other words, the days of physical presence in the Other State should be excluded while computing the 183 days period.

### Article 24 - Non-discrimination

The changes to the commentary on this Article arise from OECD's public discussion draft on Application and Interpretation of Article 24 (May 2007). The changes reflect the present day differences and complexities in interpretation and application of non-discrimination principles. Further, various countries or Courts take divergent views on non-discrimination clauses, which makes it important to clarify areas of dispute within the OECD MC to the extent possible.

OECD has clarified that Article 24 is not meant to cover 'indirect' or covert discrimination. The Articles should be applied in their direct purpose and intention. The European Court of Justice (ECJ) has dealt with a number of cases on the subject of overt and covert discrimination (cases like *Schumaker*, *Arnoud Gerritse*) and has also held that differing treatment of residents and non-residents does not per se constitute discrimination.

Further, OECD suggests that non-discrimination provisions cannot be extended into most-favoured-nation treatment. Thus, tax benefits offered in a particular bilateral tax treaty will not be automatically applicable for a third State on basis of non-discrimination. A similar judgment was given by the ECJ in *D's* case.

It is also clarified that measures that are mandated or authorized by other Articles of the OECD MC cannot be held to be discriminative even if they apply to one class of taxpayers (for example, transfer pricing provisions which apply only on transactions with non-residents or withholding tax imposed only on payments to non-residents).

### Article 25 - Mutual Agreement Procedure ('MAP')

- MAP is a special procedure outside the domestic law for resolving difficulties of tax payers arising out of the application of the convention entered into by two contracting states on behalf of the tax payers. It seeks to resolve issues of tax payers subject to taxation which are not in accordance with the provisions of the convention.

- MAP is required to be initiated within a period of 3 years of the first notification of the action which gives rise to taxation.
- While the tax payer has the right to present a case as soon as he considers that he will be taxed not in accordance with the convention, the three year time limit only begins when that result has materialized (i.e., date of notification of individual action). It is clarified that the provisions should be interpreted in the way most favorable to the tax payer.
- The fact that a charge of tax is made under an avoidance provision of domestic law should not be a reason to deny access to MAP. Circumstance in which a state would deny access to MAP should be made clear in the convention.
- In case a tax payer has brought a suit for the same purpose in the Court of either contracting state and the suit is still pending, the approach adopted by most countries as regards MAP is as under:
  - A person cannot pursue simultaneously the MAP and domestic legal remedies. Where domestic legal remedies are still available, the competent authorities will generally either require that the tax payer agree to the suspension of these remedies or if the tax payer does not agree will delay the MAP until these remedies are exhausted.
  - Where the MAP is first pursued and a mutual agreement has been reached, the taxpayer and other persons directly affected by the case are offered the possibility to reject the agreement and pursue the domestic remedies that had been suspended; conversely, if these persons prefer to have the agreement apply, they will have to renounce the exercise of domestic legal remedies as regards the issues covered by the agreement.
  - Where the domestic legal remedies are first pursued and are exhausted in a State, a person may only pursue the MAP in order to obtain relief of double taxation in the other State. Indeed, once a legal decision has been rendered in a particular case, most countries consider that it is impossible to override that decision through the mutual agreement procedure and would therefore restrict the subsequent application of the mutual agreement procedure to trying to obtain relief in the other State.
- In cases where there is an ongoing suit on an issue, but the suit has been taken by another taxpayer than the one who is seeking to initiate MAP, the competent authorities should not unduly delay the agreement pending a general clarification of law at the instance of the other taxpayer. Competent Authorities may however do so if the tax payer seeking MAP agrees to the delay if the clarification is likely to be favorable to him. In other cases, delaying discussion as part of MAP should not put the tax payer seeking MAP at a disadvantage. The tax payer should be allowed to defer payment of the amount outstanding during the course of the delay or at least during that part of the delay which is beyond his control.
- As a minimum, payment of outstanding tax should not be a requirement to initiate the MAP if it is not a requirement before initiating domestic law review. If MAP is initiated before the tax payer is charged to tax, a payment should be required once that charge has occurred. Alternatively, a bank guarantee provided by the tax payer's bank could be sufficient to meet the requirement of the competent authorities.
- Paragraph 5 has been added to Article 25 which provides that in cases where the competent authorities are unable to reach an agreement within 2 years, the unresolved issues will, at the request of the person who presented the case, be solved through an arbitration process.
- Awaiting a court decision or otherwise holding a MAP procedure in abeyance, whilst formalized domestic recourse proceedings are underway will not infringe upon, or cause time to expire from the two year period.
- Recourse to arbitration is not automatic. The person who presented the case may prefer to wait beyond the end of the two year period or simply not pursue the case.

- Only unresolved issues can be brought up to arbitration. The arbitration process is not an alternative or additional recourse. Arbitration cannot be resorted to merely because the person who made the MAP request does not consider that the agreement reached by the competent authorities provides a correct solution to the case.
- Where the treaty between two contracting States does not have an arbitration clause but they wish to implement an arbitration process for general application or to deal with a specific case, the commentary suggests that the Contracting States may still do so by mutual agreement.
- The commentary clarifies that for arbitration process to be effective and to avoid the risk of conflicting decisions, a person should not be allowed to pursue the arbitration process if the issues submitted to arbitration have already been resolved through the domestic litigation process of either States.
- Unless a person directly affected by the case does not accept the mutual agreement that implements the arbitration decision, that decision shall be binding on both states. If a person to whom the mutual agreement that implements the arbitration decision has been presented does not agree to renounce the exercise of domestic legal remedies, that person must be considered not to have accepted the agreement.
- Sample Mutual agreement on arbitration has been provided.
- The commentary also suggests adoption of a supplementary dispute resolution mechanism other than arbitration e.g., mediation between two parties or reference to an expert in case of purely factual matters.

## Conclusion

The update also includes a number of technical changes to the Commentary on the Model Tax Convention that have not been previously released for comments and on which comments are now invited

These changes deal with the following topics:

- The concept of “place of effective management”
- The situation of dual-resident persons who are treaty non-residents under the tie-breaker rule.
- Minor drafting change to paragraph 32.6 of the Commentary on Articles 23 A and 23 B.
- Minor updating of paragraph 12 of the Commentary on Article 21.

There are significant changes being proposed to the Articles and the commentary and the OECD has invited comments to the proposed changes by 31 May 2008.

**For more detailed information, please do not hesitate to your financial tax services representative or any of the following members:**

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