

Financial Services Tax News

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PwC Japan Tax Newsletter

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New Independent Agent Exemption for Discretionary Investment Managers: Background, Release of Reference Cases, Q&A and Joint Presentation by the FSA, NTA and MOF

Earlier Newsletters updated on developments regarding the introduction of the independent agent exemption for dependent agent permanent establishments into Japanese law.

In this special edition August 2008 Financial Services Tax News, we summarize the guidance issued following the Financial Services Agency's ("FSA") press release on June 27, 2008 outlining a collection of "Reference Cases" and a "Q&A" on practical application (together, the "Guidance"), and a subsequent joint presentation titled "Minimizing the 'PE Risk' of Fund Managers" by the FSA, National Tax Agency ("NTA") and the Ministry of Finance ("MOF") held on July 4, 2008.

Background

On December 21, 2007, the FSA announced the basic concepts of a plan for strengthening the competitiveness of Japan's financial and capital markets. Part of the plan called for encouraging foreign fund managers to participate in Japanese markets by removing taxation risk of the fund in carrying out business through independent agents in Japan.

Under Japanese law, a non-Japanese resident may cause a permanent establishment ("PE") to arise where it conducted business through an agent in Japan who acted in a discretionary capacity on its behalf regarding the conclusion or negotiation of contracts ("Agent PE"). For Japanese fund managers, unlike many other jurisdictions and the Organisation for Economic Co-operation and Development ("OECD") Model Tax Convention on Income and on Capital ("Model Tax Convention"), Japan had neither a general independent agent exemption nor the equivalent of a safe harbor trading rule or investment management exemption for the management of foreign registered and domiciled funds ("foreign funds") by Japanese based advisors. Since many foreign funds were not themselves eligible under a double tax treaty with Japan or were not considered qualified for tax exempt status pursuant to Japanese tax principles, this lack of an OECD-standard

independent agent exemption under Japanese law created a PE exposure for funds and their investors where the Japanese based investment advisors acted formally or in practice as decision makers.

The NTA had previously advised that discretionary trading in Japan on behalf of a foreign investor under Japanese tax law in the absence of any relief under a double tax treaty creates an Agent PE because there is no independent agent exemption for trading activity. Moreover, analyzing and reporting this risk to investors in foreign funds became acute with the adoption of FIN 48 "Accounting for uncertainty in income taxes" for US GAAP reporting, which required the accrual of tax liabilities on an assumed full disclosure basis to the relevant tax authorities.

In practice, this risk contributed to the restriction of investment management activities in Japan, and often the location of regional investment managers in Hong Kong and Singapore, with the Japan team acting as nondiscretionary advisors/researchers. By comparison, other major fund management centers have safe harbor rules (in particular, the UK) that allowed investment managers to invest and trade in securities on behalf of foreign funds without subjecting them to the risk of Agent PE taxation.

Change to Japanese tax law

Following policy recognition of the detrimental effect the absence of an exemption was having on the Japanese fund management industry and with active support by the FSA, an independent agent exemption was included in Japanese law in the 2008 Japanese tax reforms, which was passed into law on April 30, 2008 and became retroactively effective from April 1, 2008.

Japanese law was amended upon the issue of Cabinet Orders to the existing Corporate Tax Law Enforcement Order 186, Individual Income Tax Law Enforcement Order 290 and Local Tax Law Enforcement Order 7-3-5, which defined an Agent PE for Japanese tax law purposes. The amendments made by these Cabinet Orders exclude from the definition of an agent:

"...a person who conducts business activities associated with the business of the foreign corporation independently of the foreign corporation....and in the ordinary course of his business"

This exemption is broadly in line with Article 5 of the OECD's Model Tax Convention, and is consistent with many other taxation regimes of OECD member countries. However, the amendment did not contain any language specifically defining the scope of the exception, nor did the change provide a safe harbor for certain activities conducted by an agent in Japan. Rather, a case-by-case analysis as to the independence of each agent is required. Further commentary and the equivalent of a safe harbor rule for foreign funds came with the issuance of the Guidance.

The Guidance: independent agent and the four tests

Independent agent

The Guidance starts with the OECD standard in the Model Tax Convention: for an agent to be considered an independent agent, such agent must be legally and economically independent and must be acting in the ordinary course of its business when providing services as an agent.

Whether an agent is independent is a question of facts and circumstances; however, the Guidance provides the following indications of what facts would be relevant in making this determination:

Legal independence

- The agent must have sufficient discretion to act as an agent, relying on its own special skill and knowledge in carrying out the role of agent, and not be subject to detailed instructions or to comprehensive control by the principal.

- An agent who is a subsidiary of the principal does not, of itself, preclude the agent from being independent of its parent company.

Economical independence

- An element of entrepreneurial risk must be borne by the agent.
- While not determinative, the number of principals represented by the agent is relevant, as is the dependency on a single principal for the agent's income.

Ordinary course of Business

- This is to be considered by examining the business activities that the agent customarily carries out when acting as an agent.

The four tests for a discretionary investment manager

The Reference Cases then clarify the meaning of an independent agent in the context of an investment management business, i.e., restricted to where a foreign general partner ("FGP") or foreign investment manager ("FIM") of a foreign fund enters into a discretionary investment agreement with a Japanese discretionary investment manager ("DIM") registered under the Financial Instruments and Exchange Law, and the DIM conducts certain investment activities.

These four tests are more of a safe harbor rule where the circumstances apply, since meeting the four tests is taken as satisfying the meaning of an independent agent in the context of a discretionary fund management business.

Where applicable, the DIM will be treated as an independent agent of the foreign fund if it satisfies all of the following four tests:

1. "Detailed instruction" test: the FIM may provide broad discretion to the DIM but not detailed instructions; and the DIM must have enough discretion to make decisions when acting as an agent in order to be considered legally independent. The Guidance then states that the DIM should be fully or partly entrusted to make decisions on: the kinds, issues, amounts or process of securities to be invested, including the contents and timing of any derivative transactions to be conducted, as well as whether the securities shall be purchased or sold and by what method and at what timing. The Guidance also provides examples of the application of this test in the areas of risk management, asset allocation, investment restrictions (e.g., negative limits), investment policy, investment approvals, exchange of information and oversight.
2. "Shared officers" test: one half or more officers of the DIM should not concurrently serve as officers or employees of the FGP or the FIM.
3. "Remuneration" test: the DIM receives remuneration that reflects its contributions made; and a DIM will fail this test if it does not receive remuneration which corresponds to the amount of the total assets to be invested under the discretion of the DIM or its investment income.
4. "Diversification capacity" test: the DIM should have capacity to diversify its business or to acquire other clients, without fundamentally altering the way the DIM conducts its business or losing economic rationality for its business where the DIM exclusively or almost exclusively deals with the foreign fund or the FIM (with exceptions for a start up period).

Comments

Scope

The Guidance is prima facie limited to foreign funds that are established as foreign partnerships or foreign corporations without access to any double tax treaty with Japan. This is somewhat intentional as the Guidance is designed to deal with the interpretation of a change in Japanese domestic law. However, the approach to an independent agent in the Guidance will generally assist in the application of the equivalent OECD/treaty based test from the Japanese perspective.

The Guidance only applies to specific investment activities, by which is meant activities of portfolio investment, and these do not extend to the advisory or management of investments particularly of note covering private equity, real estate and non-performing loans, where by comparison with portfolio investment, income is generated through control of the investment.

Flexibility

There are favorable comments and indication that the approach by the NTA as to what is an independent agent and the application of the four tests if applicable will be applied with some degree of flexibility and openness, where for certain reasons a foreign fund or fund manager's circumstances may not strictly met all of the four tests enumerated. This extends to the NTA willing to respond on a disclosure basis to individual enquiries by fund managers, either in the form of advance confirmation (written responses) or confirmation with a relevant tax office (oral response).

Policy changes and final remarks

Overall, the introduction of an independent agent exemption represents a positive step forward for the financial services sector in Japan and in particular the global and local fund management industry. The changes do not eliminate the taxation risks or the need to manage these risks; however, they do generally align Japan's taxation policy in this respect with the OECD and international fund management centers.

The change was also notable for the active involvement of the FSA in framing Japanese tax policy in consultation with MOF and the NTA, and also for the collaborative consultation process that involved discussions amongst government agencies, industry bodies, advisors, asset managers and other interested parties.