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Accounting & Tax Committee

Japan Foreign Trade Council, Inc.

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Comments on OECD "Interpretation and Application of Article 5 (Permanent Establishment) of the OECD Model Tax Convention"

The following are the comments of the Accounting & Tax Committee of the Japan Foreign Trade Council, Inc. in response to the invitation to public comments by OECD regarding "Interpretation and Application of Article 5 (Permanent Establishment) of the OECD Model Tax Convention." The Japan Foreign Trade Council is a trade-industry association with trading companies and trading organizations as its core members, while one of the main activities of its Accounting & Tax Committee is to develop the trade environment by submitting specific policy proposals and requests to government authorities concerning tax matters. (Member companies of the Accounting & Tax Committee of JFTC are listed at the end of this document.)

I. General Comments

Differences in interpretation and application of the concept of permanent establishment (PE) have frequently been the cause of disputes between tax authorities and taxpayers in various countries. For this reason, we strongly request that greater emphasis be placed in this Commentary on certainty in order to eliminate, to the greatest extent possible, any room for such differences between the two sides.

II. Comments on Specific Issues

Issue 2: Meaning of "at the disposal of"

- ✓ The proposed paragraph 4.2 states: "Whether a location may be considered to be at the disposal of an enterprise in such a way that it may constitute a 'place of business through which the business of [that] enterprise is wholly or partly carried on' will depend on the extent of the presence of an enterprise at that location and the activities that it performs there." We strongly support the inclusion of the following two criteria for determining whether a location is "at the disposal of" an enterprise: (1) the extent of the presence of an enterprise, and (2) the activities that it performs there. However, differences in interpretation may arise between tax authorities and taxpayers on the interpretation of these criteria. While ultimately it would be determined based on the facts and circumstances on a case-by-case basis, we request that detailed explanations be provided in order to eliminate, to the greatest extent possible, room for interpretation. We are also concerned that "wholly or partly carried on" may give rise to problems of interpretation concerning the meaning of "partly." Therefore, we request that this provision be limited to "wholly." In addition, we believe that the duration of activities should be an important factor in determining the "extent of the presence of an enterprise" and hence it is highly important to establish an objective criterion on duration to avoid unnecessary disputes between taxpayers and tax authorities. Therefore, we request the establishment of a minimum time criterion.

- ✓ The proposed paragraph 4.2 states: "This will not be the case, however, where the enterprise's presence at a location is so intermittent or incidental that the location cannot be considered a place of business of the enterprise." We request that the meaning, scope, and/or degree of "presence," "intermittent" and "incidental" be clarified.

- ✓ The proposed paragraph 4.2 states: "Where an enterprise does not have a right to be present at a location and does not, in fact, use that location itself, that location is clearly not at the disposal of the enterprise." In this respect, assuming a situation where an enterprise has a right to be present at a location but it never actually be using that location itself, we understand that such a case does not constitute a PE because the enterprise is not actually

engaged in business activities at that location. We request that this point be clearly stated.

- ✓ Because the criteria for determination of "at the disposal of" are highly important in further ensuring the predictability of PE taxation, we request that this concept be further clarified. In addition to the above-mentioned criteria, we believe it would be useful to present a non-exclusive list of criteria as to what constitutes "at the disposal of," as previously suggested by the Business and Industry Advisory Committee in a note for its meeting with Working Party 1 Delegates in February 2005.

Issue 6: Time requirement for the existence of a permanent establishment

- ✓ From the perspective of avoiding unnecessary disputes between taxpayers and tax authorities, we believe it is highly important to establish a certain rational criteria on time requirements for a location to be considered a PE. Therefore, we request the establishment of a minimum time criterion. While the proposed paragraph 6.2 contains two illustrative examples, in both cases the conclusion is based merely on whether or not it is "the location where the business of that enterprise is wholly carried on." As such, it appears that no consideration has been given to the duration of activities. However, we believe there should not be "permanency" if a place of business exists for a very short period and whether a place of business constitutes a PE should not be determined merely because the business activities are carried on exclusively in that location. Criteria for "permanency" based on duration already exist in the cases of construction sites (12-month rule) and alternative option to services (183-day rule). We believe that time requirement rules compatible with the above should be established.

Issue 7: Presence of foreign enterprise's personnel in the host country

- ✓ In normal cases of secondment, seconded personnel would perform the business activities of the foreign enterprise to which they have been seconded. In principle, it can be said that this does not constitute a PE. On the other hand, while the proposed paragraph 10 refers to seconded personnel and the relationship to the Commentary on Article 15 (Income from employment), it

does not contain explicit criteria for determining whether seconded personnel can constitute a PE. In particular, we request that clear provisions be added to preclude constitution of a PE in the following cases.

- In case of secondment from parent company, regardless of whether or not a formal employment contract has been concluded, it can be said that the economic employer is the actual employer. Therefore, when the receiving enterprise is the economic employer, seconded personnel should not be deemed to constitute a PE.

- In determining the economic (actual) employer, even if the dispatching parent company makes up for the difference in pay, this should not by itself be grounds for determining that seconded personnel constitute a PE of the dispatching parent company.

- Cross-border performance assessment systems and reporting lines of multinational groups as a part of the global management and administration should not by themselves be grounds for determining that seconded personnel constitute a PE of the dispatching parent company.

✓ The proposed paragraph 10 states: "Within a multinational group, it is relatively frequent for employees of one company to be temporarily seconded to another company of the group and to perform business activities that clearly belong to the business of that other company." We request the term "temporarily" be more clearly defined.

Issue 8: Main contractor who subcontracts all aspects of a contract

✓ Regardless of the type of contract, we believe the essential factor for this issue is whether or not the main contractor is actually engaged in onsite supervision and instruction. As referred to in this Discussion Draft, "it would be fairly unlikely that a main contractor would not have some employees on a construction site." We understand that if such employees are engaged in onsite supervision and instruction, this would normally constitute a PE. However, assuming there is the fairly unlikely case where a main contractor has no employees on a construction site, we believe no PE should be constituted merely because the main contractor has responsibilities for the

project. Rather, we believe the most important factor should be whether physical presence of the enterprise exists or not.

- ✓ Under the provisions of the proposed changes, both a main contactor and its subcontractor of a project could be subject to taxation in the same State. In this respect, we think clarification of this section, together with clarification of the treatment of income attributable to PE in the Commentary on Article 7, should be made so that the same income is not taxed in the hands of both the main contractor and the subcontractor (i.e., double taxation).

Issue 9: Application of paragraph 3 to joint venture and partnership activities

- ✓ There may be a case where an unincorporated joint venture is formed by two companies to execute a construction project in a given country and then the companies are separately and severally engaged in their own works but jointly responsible for the execution of the project. In such cases, even if one of the companies is not engaged in the works in the country in question (in other words, the company is exclusively engaged in its works in countries other than the country in question), it might be possible to interpret that a PE of that company exists merely on the grounds that it has contractual responsibilities based on the concept of Issue 8. We believe no PE should be constituted because the company has no physical presence in the country in question. We request that this point be clearly stated.

Issue 10: Meaning of "place of management"

- ✓ We request that it be clearly stated that cross-border performance assessment systems and reporting lines of multinational groups as a part of the global management and administration should not by themselves be grounds for determining the existence of "place of management."

Issue 11: Additional work on a construction site

- ✓ We agree with the conclusion that "work that is undertaken on a site after the construction work has been completed pursuant to a guarantee that requires

an enterprise to make repairs would normally not be included in the original construction period." However, the reality is that, even if the majority of such repair works pursuant to a guarantee is performed without charge, some additional works could be incidentally undertaken with additional charge upon request of the client. In such cases, as long as the majority of the additional works is undertaken without charge pursuant to a guarantee, we understand that it is not necessary to include such works in the original construction period. We request that this point be clarified.

Issue 17: Negotiation of import contracts as an activity of a preparatory or auxiliary activity

- ✓ We do not agree with replacing a part of paragraph 24 by the proposed paragraph 24.2. In particular, it concerns us that "take an active part" and "by participating in" have not been defined. Failure to define these phrases can give rise to differences in interpretation between taxpayers and the tax authorities, which may lead to a broader interpretation and application of the PE definition. We should also point out that the relation between this paragraph and the following sentence of the proposed paragraph 33.1 under Issue 20 is unclear. "The mere fact, however, that a person has attended or even participated in negotiations in a State between an enterprise and a client will not be sufficient, by itself, to conclude that the person has exercised in that State an authority to conclude contracts in the name of the enterprise."

Issue 19: Meaning of "to conclude contracts in the name of the enterprise"

- ✓ While reference is made to the concept of being "economically bound," no explanation is provided on what constitutes being "economically bound." The concept of being "economically bound" is also an important factor in determining "whether or not a person was an agent of an independent status" under Issue 22: "Assumption of entrepreneurial risk as a factor indicating independence." We therefore believe that further clarification of this phrase is needed.

- ✓ Regarding Issue 21, as has been pointed out by the Working Group, the term "general commission agent" used in the English version of paragraph 6 of

Article 5 does not correspond to the term *commissionnaire* used in the French version. In order to avoid differences in interpretation in tax treaties concluded between common law and continental law countries, it will be necessary to provide definitions and interpretations of "a person acting on behalf of the enterprise," which appears in the proposed paragraph 32.1.

- ✓ When a service agreement has been concluded between a parent company domiciled in a Contracting State and a subsidiary domiciled in the other Contracting State, the fact that under the agreement the subsidiary provides services related to other contracts—such as supply of information, communication, and liaison activities related to a contract between the parent company and customers—should not by itself constitute a PE. We request that this point be clearly stated.

Issue 22: Assumption of entrepreneurial risk as a factor indicating independence

- ✓ Paragraph 38.7 proposed by the Working Party in 2002 stated: "the assumption of entrepreneurial risk is a distinguishing feature of the independent agent. The character of the remuneration which an agent receives may provide a useful indication of whether (or to what extent) the agent bears the commercial risk of his activities." However, significant room still remains for interpretation in the recognition of risk. Moreover, we do not believe that independency can necessarily be determined solely on the basis of the assumption of risk. Therefore, we request further clarification of criteria for the determination of independent agents and dependent agents.

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