On the basis of the introduction of the "Independent Agent Exemption" in the FY2008 Tax Reform, the Financial Services Agency has compiled the document below regarding the determination of whether a domestic investment manager conducting certain investment activities under a discretionary agreement with an offshore fund is treated as an "Independent Agent." In compiling this document, the FSA has closely consulted with the Tax Bureau of the Ministry of Finance in order to confirm the intention and the background of the introduction of this exemption. Regarding this document, the FSA has asked for the National Tax Agency's views, and the NTA notified the FSA that it has no objection to its contents.

Main Text

I The basic concept of applying the provision of an "Independent Agent"

The scope of "Agents, etc." (persons who have authority to conclude contracts on behalf of non-residents and persons equivalent thereto) treated as permanent establishments, which determine the tax basis of a non-resident individual or a foreign corporation, was amended under FY2008 Tax Reform. Accordingly, agents of an independent status are excluded from the scope of "Agents, etc." treated as permanent establishments (Article 290 of the amended Cabinet Order for implementing the Income Tax Act and Article 186 of the amended Cabinet Order for implementing the Corporation Tax Act). The amendment is effective from April 1, 2008 (Article14(1) of the Supplementary Provisions of the amended Cabinet Order for implementing the Income Tax Act and Article 25(1) of the Supplementary Provisions of the amended Cabinet Order for implementing the Corporation Tax Act).

This amendment is to introduce a provision corresponding to the long-established provision of an "Independent Agent" generally provided for in tax conventions, to domestic tax legislations (the Income Tax Act and the Corporation Tax Act). The applications of such "Independent Agent" provision of domestic laws are basically consistent with the following concepts which are shown in the commentaries to the OECD "Model Tax Convention on Income and on Capital" which interpret the provision of the "Independent Agent" under the Convention.).

1 Requirements of an "Independent Agent"

An agent is considered as an Independent Agent conducting his business

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activities associated with the business of a non-resident individual or a foreign corporation independently of the nonresident or foreign corporation and in the ordinary course of business, if and only if he is legally and economically independent of his principal ("Legal Independence" and "Economical Independence") and he acts in the ordinary course of his business when acting on behalf of his principal ("Ordinary Course of Business").

2 Legal Independence

Whether an agent is legally independent of his principal depends on the extent of the obligation which he has vis-à-vis his principal. Where his commercial activities for his principal are subject to detailed instructions or to comprehensive control by it, he cannot be considered as independent of his principal. In determining Legal Independence, it is important that the agent has enough discretion to act as an agent.

An Independent Agent will generally be responsible to his principal for the results of his work but not subject to significant control with respect to how that work is carried out. He will not be subject to detailed instructions from his principal with respect to the manner in which that work is carried out. The fact that the principal is relying on the special skill and knowledge of the agent is an indication of independence.

In determining Legal Independence, the control which a parent company exercises over its subsidiary in its capacity as shareholder is not relevant in a consideration of the independence of subsidiary acting as an agent for its parent company. The fact of being a subsidiary company does not, of itself, preclude it from being independent of its parent company. Even the fact that the trade or business carried out by the subsidiary is managed by the parent company does not preclude the subsidiary company from being independent.

3 Economical Independence

In determining Economical Independence, an important criterion will be whether entrepreneurial risk is borne by the agent. Another factor to be considered is the number of principals represented by the agent, and it is important that the income of the agent does not wholly depend on a single principal. For example, independent status is less likely if the activities of the agent are performed wholly or almost wholly on behalf of only one principal over

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the lifetime of the business or a long period of time. However, this fact is not by itself determinative. All the facts and circumstances must be taken into account to determine whether the agent's activities constitute an autonomous business conducted by him (in which he bears risk and receives remuneration through the use of his entrepreneurial skills and knowledge).

4 Ordinary Course of Business

An agent cannot be said to act in the ordinary course of his business if he performs activities which, economically, belong to the sphere of his principal rather than to that of his own business operations.

In deciding whether or not particular activities fall within or outside the ordinary course of business of an agent, one would examine the business activities that he customarily carries out when acting as an agent.

II The basic concept of applying the provision of an "Independent Agent" to Certain Investment Activities.

According to the aforementioned concept in I, the basic concept in determining whether a domestic investment manager conducting certain investment activities under a discretionary investment agreement with an offshore fund is treated as an "independent Agent" is as follows.

※ See page 4-7 for definitions of the underlined words

When a Foreign General Partner of an offshore fund created under a Partnership Agreement enters into a Discretionary Investment Agreement (DIA) with a domestic Investment Manager (including cases in which a Foreign General Partner indirectly enters into a DIA with a domestic Investment Manager through a Foreign Investment Manager) for other Non-residents partners of the offshore fund, and the domestic Investment Manager conducts Certain Investment Activities in Japan under the DIA on behalf of the Non-resident partners of the offshore fund (or the Foreign Investment Manager), that domestic Investment Manager is considered as an Independent Agent of the partners of the offshore fund (or the Foreign Investment Manager), provided that none of the following exists. (All the facts and circumstances are assumed to be fully reflected in the agreement. It should be noted that this basic concept is not generally applicable to other cases.)

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A) As the investment decisions that the domestic Investment Manager is delegated to make under the DIA are extremely limited, the partners of the offshore fund (or the Foreign Investment Manager) are considered to be directly conducting investment activities in Japan.

B) One half or more officers of the domestic Investment Manager concurrently serve as the officers or the employees of the Foreign General Partner or the Foreign Investment Manager.

C) The domestic Investment Manager does not receive remuneration (being adequate reflecting contributions by those involved) which corresponds to the amount of the total assets to be invested under the DIA or the investment income.

D) The domestic Investment Manager does not have a capacity to diversify its business or acquire other clients without fundamentally altering the way it conducts its business or losing economic rationality for its business, in cases where the domestic Investment Manager exclusively or almost exclusively deals with the offshore fund or the Foreign Investment Manager (except for the initial period for the domestic Investment Managers to start up its business.)

Please note that if the Foreign General Partner or the Foreign Investment Manager aforementioned is the domestic Investment Manager's "Foreign Related Person" prescribed in Article 66-4(1) or 68-88(1) of Act on Special Measures concerning Taxation, the remuneration that the domestic Investment Manager receives may be subject to the transfer pricing taxation.

Please also note that in the case of a domestic Investment Manager having entered into a DIA with an offshore fund established as a corporation under foreign legislation, whether the Domestic Manager is to be treated as an Independent Agent will be determined in the same way.

【Glossary】

Partnership Agreement	The following agreements prescribed in article 291(5) of the Cabinet Order for implementing the Income Tax Act or Article

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	187(5) of the Cabinet Order for implementing Corporation Tax Act : ①A partnership contract (*"Kumiai Keiyaku"*) prescribed in Article 667(1) of the Civil Code ②A limited partnership agreement for investment (*"Toushi Jigyou Yugen Sekinin Keiyaku"*) prescribed in Article 3(1) of the Limited Partnership Act for Investment) ③A limited liability partnership agreement (*"Yugen Sekinin Jigyou Kumiai Keiyaku"*) prescribed in Article 3(1) the Limited Liability Partnership Act ④An Agreement under foreign legislation similar to the one listed in any of the preceding ①～③
Foreign General Partner	A general partner of a Partnership Agreement who is a Non-resident
Non-residents	A non-resident individual prescribed in Article 164(1)(iv) of the Income Tax Act or a foreign corporation prescribed in Article 141(iv) of the Corporation Tax Act
Investment Manager	A person registered under Article 29 of the Financial Instruments and Exchange Act (FIEA) to carry out an invest management business prescribed in Article 28(4) of the FIEA (limited to business in respect to the Discretionary Investment Agreement (Article 2(8)(xii)(b) of the FIEA))

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Discretionary Investment Agreement	A discretionary investment agreement prescribed in Article 2(8)(xii)(b) of the FIEA), i.e. an agreement wherein one of the parties is fully or partly entrusted by the other party with the discretion in making Investment Decisions based on analysis of Values, etc. of Financial Instruments (*) and is also entrusted with the authorities necessary for making investments on behalf of the other party based on such investment decisions, and other similar agreements * Values, etc. of Financial Instruments (Article 2(8)(xi)(b) of the FIEA) value of financial instruments, amount receivable for options, or movement of financial indicators
Investment Decisions	Decisions on the kinds, issues, amounts or prices of securities to be invested as well as whether the securities shall be purchased or sold, by what method and at what timing, or decision on contents and timing of derivative transactions to be conducted (including other similar decisions) (Article 2(8)(xi)(b) of the FIEA)
Foreign Investment Manager	A Non-resident conducting as its business acts similar to the investment management business prescribed in Article 28(4) of the FIEA (limited to business in respect to the Discretionary Investment Agreement (Article 2(8)(xii)(b) of the FIEA)) under foreign legislation
Certain Investment Activities	The following activities : ① Investment (including instructions of investment; the same shall apply hereinafter) of money or other assets in securities (including deemed securities) or rights pertaining to derivative transactions, carried out based on Investment Decisions which are made based on analysis of Value, etc. of Financial Instruments ② Investment of money or other assets in the Specified Assets (*"Tokuteishisan"*) prescribed in Article 2(1) of the Act

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	concerning Investment Trust and Investment Corporation (excluding land for housing and buildings) which is similar to the investment prescribed in the preceding ① ③ Activities incidental to investments listed in preceding ①and②
Independent Agent	A person conducting his business activities independently of non-residents and in the ordinary course of his business who is to be excluded from agents treated as permanent establishments under the provision of Article 290 of the Cabinet Order for implementing the Income Tax Act or Article 186 of the Cabinet Order for implementing the Corporation Tax Act.

III Cases

Individual applications of the basic concept aforementioned in II to particular hypothetical cases are shown below.

【Points to Note】

1. All the facts and circumstances are assumed to be fully reflected in the agreement
2. The treatments may differ if the actual facts and circumstances differ from the assumption.
3. Application of tax conventions is not taken into consideration.
4. Even in such cases where a domestic Investment Manager is determined not to be an "Agent, etc." treated as a permanent establishment:
   (1) Partners (the Foreign General Partner and other non-resident partners) of the offshore funds have to file income tax returns in Japan with respect to income, etc. prescribed in Article 291(1)(iii) or (iv) of the Cabinet Order for implementing the Income Tax Act or Article 187(1) (iii) or (iv) for implementing the Cabinet Order of Corporation Tax Act
   (2) If the Foreign General Partner or the Foreign Investment Manager is the domestic Investment Manager's "Foreign Related Person", prescribed in Article 66-4(1) or 68-88(1) of Act on Special Measures concerning Taxation, the remuneration that the domestic Investment Manager receives may be subject to transfer pricing taxation.

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【Case1】

(Facts)

An outline of Fund A

Fund A is a limited partnership (LPS) set up by Company A (an investment management company in Country A) in Country A for the purpose of global investment in financial capital markets. Company A executes the business of Fund A as the general partner (GP) of Fund A, and many other investors within and outside Country A participate in Fund A as limited partners (LP). Fund A is not considered as a corporation for the purpose of Japanese tax legislation.

Conditions of management entrustment

Company A, on behalf of Fund A, enters into a DIA with Company B, an Investment Manager in Japan, and Company B is entrusted with the discretion for investment of assets under management of Fund A in Japanese financial capital markets. There is no capital relation between Company A and B.

Terms and Conditions of the DIA

Under the DIA between Company A and B, no instruction is given by Company A to Company B except for

- asset allocation (ratio of bonds and securities)
- limitation of risk amount, and
- periodical reporting on the investment situation

Remuneration

Company B receives management fee corresponding to the assets under management and incentive/performance fee corresponding to the annual investment income under the DIA as a compensation of management activities.

Company B receives substantial income from Company A, but also enters into DIA with other clients from whom Company B receives considerable income.

Fully considering the facts described above, Company B is considered as an Independent Agent of the partners of Fund A in this case.

Company B is considered legally independent from Company A, as Company B has enough discretion to act as an agent, without detailed instructions or comprehensive control from Company A. Instructions of broad asset allocation or limitation of risk

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amount as in Case1, which do not negate enough discretion of Company B as an agent, are not considered detailed instructions. Moreover, periodic reporting on the investment situation itself does not deny independence of Company B, unless the reporting is conducted in the course of seeking approval from Company A for the manner in which the business is to be carried out.

Company B is considered economically independent from Company A, as Company B receives remuneration corresponding to the assets under management and annual investment income, as well as receiving considerable income from other clients. The fact that Company B receives remuneration corresponding to the assets under management and annual investment income indicates that Company B bears entrepreneurial risks. Also, the fact that Company B receives considerable income from other clients indicates that Company B is economically independent from Company A.

Company B is considered as acting in the ordinary course of its business, because Company B enters into a DIA with Company A as part of its business as an Investment Manager.

【Case 2】

(Facts)

The facts are basically the same as Case 1, except that Company C (an investment management company in Country C) stands between Company A and Company B. The details of a DIA and remuneration between Company A and Company C and those of Company C and Company B are the same as those of Company A and Company B in Case 1 respectively.

Conditions of management entrustment

Company A, on behalf of Fund A, enters into a DIA with Company C, an investment management company in country C, and Company C is entrusted with the discretion for investment in assets under management of Fund A in global financial capital markets. There is no capital relation between Company A and C.

Company C enters into a DIA with Company B, an Investment Manager in Japan, and Company B is entrusted with the discretion for investment assets under management of Fund A in Japanese financial capital markets. There is no capital relation between Company C and B nor Company A and B.

Fully considering the facts described above, Company B is considered as an Independent Agent of Company C and the partners of Fund A in this case.

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In Case2, as three parties – a principal (Fund A), an agent (Company C) and a subagent (Company B) – are involved, for Company B to be considered as an Independent Agent of Company C and the partners of Fund A,

- whether a subagent (Company B) is considered as an Independent Agent of an agent (Company C), and
- whether an agent (Company C) is considered as an Independent Agent of a principal (the partners of Fund A)

shall respectively be examined, unlike Case1.

Company B is considered as an Independent Agent of Company C, and Company C is considered as an Independent Agent of the partners of Fund A, as the examinations of Case 1 apply for either relation of Company B and Company C and Company C and Company A. Even if Company C is not considered as an Independent Agent of the partners of Fund A, Company B is considered as an Independent Agent of the partners of Fund A because Company B is considered as an Independent Agent of Company C.

In cases in which Company B is not considered as an Independent Agent of Company C,

- Company B is considered as an Independent Agent of the partners of Fund A if Company C is considered as an Independent Agent of the partners of Fund A.
- Company B is not considered as an Independent Agent of the partners of Fund A if Company C is not considered as an Independent Agent of the partners of Fund A.

【Case 3】

(Facts)

The facts are basically the same as Case 1, except that Company A may give instructions concerning the selection of or timing of purchasing/disposal of individual investment.

Terms and Conditions of the DIA

Under DIA between Company A and B, Company A may give and is actually giving instructions to Company B concerning the selections of or timing of The purchase/disposal of individual investment other than asset allocations, limitation of risk amount and periodic reporting on the investment situation.

Fully considering the facts described above, Company B is <u>not</u> considered as an

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Independent Agent of the partners of Fund A in this case.

Partial entrustment in making investment decisions is allowed under a DIA, but the instructions which are given by Company A to Company B in case 3 concerning the selection of or timing of the purchase/disposal of individual investment negate enough discretion of Company B as an agent and are considered as detailed instructions. Therefore, Company B is not legally independent from Company A.

【Case 4】

(Facts)

The facts are basically the same as Case 1, except that Company B is a 100% subsidiary of Company A.

Conditions of management entrustment

Company A, on behalf of Fund A, enters into a DIA with Company B, an Investment Manager in Japan and Company B is entrusted with the discretion for investment of assets under management of Fund A in Japanese financial capital markets. Company B is a 100% subsidiary of Company A.

Fully considering the facts described above, Company B is considered as an Independent Agent of the partners of Fund A in this case.

In determining Legal Independence, the control which a parent company exercises over its subsidiary in its capacity as shareholder is not relevant in a consideration of the independence of subsidiary acting as an agent for its parent company. The fact of being a subsidiary company does not, of itself, preclude it from being independent of its parent company. Even the fact that the trade or business carried out by the subsidiary is managed by the parent company does not preclude the subsidiary company from being independent.

Company B is considered as an Independent Agent of the partners of Fund A, as the examinations of Case 1 apply for relations of Company B and A.

【Case 5】

(Facts)

The facts are basically the same as Case 4, except that Company B is exclusively (or almost exclusively) dealing with Company A.

Remuneration

Company B receives management fee corresponding to the assets under

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management and incentive/performance fee corresponding to the annual investment income under the DIA as a compensation of management activities.
Company B is exclusively (or almost exclusively) dealing with Company A.

In determining Economical Independence, the number of principals represented by the agent is to be considered. Independent status is less likely if the activities of the agent are performed wholly or almost wholly on behalf of only one principal over the lifetime of the business or a long period of time. However, this fact is not by itself determinative. All the facts and circumstances must be taken into account to determine whether the agent's activities constitute an autonomous business conducted by him (in which he bears risk and receives remuneration through the use of his entrepreneurial skills and knowledge).

Company B should have at least special skills and knowledge as well as bearing the entrepreneurial risks to be considered economically independent even though it is exclusively (or almost exclusively) dealing with Company A. The fact that Company B has the capacity to diversify its business or acquire other customers without fundamentally altering the way it conducts its business or losing economic rationality of its business shows that Company B has a special skills or knowledge. The fact that Company B receives remuneration corresponding to the assets under management and annual investment income indicates that Company B bears entrepreneurial risks. Also, the remuneration has to be a sufficient amount (not less than arm's length price). The fact that Company B receives sufficient remuneration as an agent is an important factor that indirectly shows Company B is an Independent Agent.

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