

On the basis of the introduction of the "Independent Agent Exemption" in the FY2008 Tax Reform and its partial revision in the FY2018 Tax Reform, the Financial Services Agency (FSA) has issued the following document 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 preparing 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. Moreover, the FSA has asked for the National Tax Agency's (NTA) views, and the NTA has notified the FSA that it has no objection to its contents.

Main Text

I The basic concept of the provision of an Independent Agent

Regarding taxation on non-residents or foreign corporations, Independent Agents are excluded from the scope of agents (i.e., persons who have authority to conclude contracts on behalf of non-residents and persons equivalent thereto) treated as permanent establishments, which determine their taxation basis (ex-Article 1-2 (3) of the Cabinet Order for implementing the Income Tax Act and ex-Article 4-4 (3) of the Cabinet Order for implementing the Corporation Tax Act before the FY2018 Tax Reform).

The FY2018 Tax Reform excluded a person exclusively or almost exclusively acting on behalf of one or more persons who are in a special relationship with himself (person in ① a relationship in which one person directly or indirectly controls the other, such as a relationship in which one directly or indirectly owns over 50% of the outstanding shares, etc., in the other in terms of their number or value, or ② a relationship between two persons in which the two persons are directly or indirectly controlled by the same person, such as in a relationship between two corporations where the same single person directly or indirectly owns over 50% of the outstanding shares, etc., in both corporations (excluding the relationship in ①; "Specially Related Person" hereinafter) from the scope of Independent Agents (Article 1-2 (8) and (9) of the Cabinet Order for implementing the Income Tax Act, Article 1-2 of Ordinance for Enforcement of the Income Tax Act, Article 4-4 (8) and (9) of the Cabinet Order for implementing the Corporation Tax Act, and Article 3-4 of the Ordinance for Enforcement of the Corporation Tax Act).

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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 legislation (the Income Tax Act and the Corporation Tax Act). The applications of the Independent Agent provision of domestic laws are basically consistent with the 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 said Convention.

The OECD “Model Tax Convention on Income and on Capital” and the commentaries stipulate that if an agent is conducting his business activities associated with the business of a non-resident individual or a foreign corporation independently of the non-resident or foreign corporation and in the ordinary course of business, such an agent does not constitute a permanent establishment of the non-resident individual or a foreign corporation. They however state that an agent exclusively or almost exclusively acting on behalf of closely related enterprises is excluded from the scope of Independent Agent.

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

According to the commentaries to the OECD “Model Tax Convention on Income and on Capital,” 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:

※ Refer pages 4–6 for definitions of 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

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noted that this basic concept is not generally applicable to other cases.)

- A) Where the Investment Decisions that the domestic Investment Manager is delegated 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 adequately 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.)
- E) Partners of an offshore fund are considered to be Specially Related Persons of a domestic Investment Manager, and the domestic Investment Manager is exclusively or almost exclusively acting on behalf of the partners of the offshore fund.

Note that if the Foreign General Partner of an offshore fund enters into a DIA with the domestic Investment Manager (agent), based on the cooperative nature of the Partnership Agreement business, whether the partners of the fund have a permanent establishment (agent PE) in Japan will be determined for each of the partners. As such, in considering requirements for E), it is appropriate to determine whether the domestic Investment Manager is judged to be exclusively or almost exclusively acting on behalf of Specially Related

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Persons between the domestic Investment Manager and the partners of the offshore fund.

If the Foreign General Partner or the Foreign Investment Manager aforementioned is the domestic Investment Manager's "Foreign Related Person" as 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 would be subject to the arm's length transfer pricing rules.

【Glossary】

<p>Partnership Agreement</p>	<p>The following agreements prescribed in Article 281 (5) of the Cabinet Order for implementing the Income Tax Act or Article 178 (5) of the Cabinet Order for implementing the Corporation Tax Act :</p> <p>① A partnership contract (<i>"Kumiai Keiyaku"</i>) prescribed in Article 667 (1) of the Civil Code</p> <p>② A limited partnership agreement for investment (<i>"Toushi Jigyuu Yugen Sekinin Kumiai Keiyaku"</i>) prescribed in Article 3 (1) of the Limited Partnership Act for Investment)</p> <p>③ A limited liability partnership agreement (<i>"Yugen Sekinin Jigyuu Kumiai Keiyaku"</i>) prescribed in Article 3 (1) the Limited Liability Partnership Act</p> <p>④ An Agreement under foreign legislation similar to the one listed in any of the preceding ①~③</p>
<p>Foreign General Partner</p>	<p>A general partner of a Partnership Agreement who is a Non-resident</p>
<p>Non-residents</p>	<p>A non-resident individual prescribed in Article 164 (1) (ii) of the Income Tax Act or a foreign corporation prescribed in Article 141 (ii) of the Corporation Tax Act</p>
<p>Investment Manager</p>	<p>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</p>

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	business in respect to the Discretionary Investment Agreement (Article 2 (8) (x ii) (b) of the FIEA)
Discretionary Investment Agreement	<p>A discretionary investment agreement prescribed in Article 2 (8) (x ii) (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 <u>Values, etc. of Financial Instruments</u> (*) 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</p> <p>* Values, etc. of Financial Instruments (Article 2 (8) (x i) (b) of the FIEA) value of financial instruments, amount receivable for options, or movement of financial indicators</p>
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) (x i) (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) (x ii) (b) of the FIEA) under foreign legislation
Certain Investment Activities	<p>The following activities :</p> <p>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</p>

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	<p>Instruments</p> <p>② Investment of money or other assets in the Specified Assets (“<i>Tokuteishisan</i>”) prescribed in Article 2 (1) of the Act concerning Investment Trust and Investment Corporation (excluding land for housing and buildings) which is similar to the investment prescribed in the preceding ①</p> <p>③ Activities incidental to investments listed in preceding ① and ②</p>
Independent Agent	<p>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 1-2 (8) of the Cabinet Order for implementing the Income Tax Act or Article 4-4 (8) of the Cabinet Order for implementing the Corporation Tax Act</p>
Specially Related Person	<p>A person who is in a special relationship, specified in Article 1-2 (9) of the Cabinet Order for implementing the Income Tax Act or Article 4-4 (9) of the Cabinet Order for implementing the Corporation Tax Act (① a relationship in which one person directly or indirectly controls the other, such as a relationship in which one directly or indirectly owns over 50% of the outstanding shares, etc., in the other in terms of their number or value, or ② a relationship between two persons in which the two persons are directly or indirectly controlled by the same person, such as the relationship between two corporations in a situation in which the same single person directly or indirectly owns over 50% of the outstanding shares, etc., in both corporations (excluding the relationship in ①)), with the agent</p> <p>(Same as “closely related enterprises” in the OECD “Model Tax Convention on Income and on Capital” and its commentaries)</p>

III Cases

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

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【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 are not taken into consideration.**
- 4. Even in such cases where a domestic Investment Manager is determined not to be an agent 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 281 (1) (iv) or (v) of the Cabinet Order for implementing the Income Tax Act or Article 178 (1) (iv) or (v) of the Cabinet Order for implementing the 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 would be subject to arm's length transfer pricing rules.**

【Case1】

(Facts)

Outline of Fund A

Fund A is a limited partnership (LPS) formed 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 its general partner (GP), and many other investors within and outside of Country A participate in Fund A as limited partners (LP). Fund A is not considered as a corporation for Japanese tax purposes. The share of Company A's investment in Fund A is about 5%.

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

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for investment of assets under management of Fund A in Japanese financial capital markets. Neither Company A nor other partners of Fund A are considered to be a Specially Related Person of Company 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 for management activities.

Company B receives substantial income from Company A, but also enters into DIA with other clients (not Specially Related Persons of Company B) 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.

Company B has sufficient discretion to act as an agent, without detailed instructions or comprehensive control from Company A. Instructions of broad asset allocation or limitation of risk amount as in Case1, which do not negate sufficient discretion of Company B acting 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 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.

Considering the above, Company B can be regarded as being 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

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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. Company A is not considered to be a Specially Related Person of Company 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. Company C and Company B are not considered to be Specially Related Persons of Company 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 Case 2, 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 Case 1.

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

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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 investments.

Terms and Conditions of the DIA

Under DIA between Company A and B, Company A may and does issue instructions to Company B concerning the selection of or timing of the purchase/disposal of individual investments other than asset allocations, limitation of risk amount and periodic reporting on the investment situation.

Fully considering the facts described above, Company B is not considered as an Independent Agent of the partners of Fund A.

Partial entrustment in making investment decisions is allowed under a DIA, however 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 investments negate sufficient discretion of Company B as an agent and are considered as detailed instructions. Accordingly, Company B is not 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

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investment of assets under management of Fund A in Japanese financial capital markets. Company B is a 100% subsidiary of Company A. Company B has entered into DIAs with other clients (not Specially Related Persons), and the activities Company B performs on behalf of other clients represent a significant part of its business.

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

For Company B, Company A, which is its parent, is considered to be a Specially Related Person. However, as Company B earns considerable income from other clients (not Specially Related Persons of B) (see "Facts" in Case 1) and the activities Company B performs on behalf of other clients represent a significant part of its business, it cannot be considered to be acting exclusively or almost exclusively on behalf of a Specially Related Person.

In determining independence in such a case, 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, and in principle, the despite 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 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, but 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.

Fully considering the facts described above, Company B is considered as an

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Independent Agent of the partners of Fund A in this case as long as Company B fulfills the independence requirement and is not exclusively or almost exclusively acting on behalf of Company A.

(1) Independence

In determining 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 application 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 independent from Company A and other partners of Fund A 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 such 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. The remuneration should be sufficient (and not less than an arm's length price). The fact that Company B receives sufficient remuneration as an agent is an important factor that indirectly supports that Company B is an Independent Agent.

(2) Persons who act exclusively or almost exclusively on behalf of Specially Related Persons

As Company A, the parent of Company B, is regarded as a Specially Related Person of the latter, it is necessary to determine whether Company B is considered a person who acts exclusively or almost exclusively on behalf of Company A.

If the Foreign General Partner of offshore fund enters into a DIA with the domestic Investment Manager (agent), based on the cooperative nature of the Partnership Agreement business, whether the partners of the fund have a permanent establishment (agent PE) in Japan will be determined for each of its partners. As such, in considering the requirements for being an Independent Agent, it is appropriate to determine whether Company B is judged to be acting exclusively or

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almost exclusively on behalf of its Specially Related Person (Company A), between Company B and the partners of Fund A.

If the sales that Company B concludes for partners of Fund A other than Company A (not Specially Related Persons) is 10% or more of all the sales that it concludes as an agent, Company B is not considered to be acting exclusively or almost exclusively on behalf of a Specially Related Person. As Company B receives asset management fees corresponding to Fund A's total assets under management and annual investment income in Japan, partners of Fund A are considered to be bearing the asset management fees according to the percentage of their respective invested amount in Fund A. Therefore, it is appropriate to look at the percentage share of partners in the invested amount in Fund A in determining the ratio of sales.

As the ratio of investment by Fund A's partners other than Company A (about 95%) exceeds 10% of the total investment in Fund A (see "Facts" in Case 1), Company B is not considered to be acting exclusively or almost exclusively on behalf of a Specially Related Person.

【Case 6】

(Facts)

Outline of Fund A'

Fund A' is a limited liability company (LLC) established in Country A for the purpose of global investment in financial capital markets. Unit holders of Fund A' are comprised of a number of investors within and outside Country A. Fund A' is treated as a corporation under Japanese Tax Law.

Conditions of management entrustment

Fund A' entered into a DIA with Company B, an Investment Manager in Japan, where Company B is entrusted with the discretion for investment of assets under management of Fund A' in Japanese financial capital market. Fund A' is not considered to be a Specially Related Person of Company B.

Terms and Conditions of the DIA

While the above-mentioned DIA specifies asset allocation and limitation of risk amount, and requires periodical reporting on the investment situation, Company B is given a significant discretion in the other respects.

Company B has a special skills or knowledge related to investment, and bears entrepreneurial risks.

Remuneration

Based on the DIA, Company B receives management fee corresponding to the

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

Company B is exclusively (or almost exclusively) dealing with Fund A'.

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

As Fund A' is treated as a corporation under Japanese Tax Law, an examination to determine whether Company B is considered as an Independent Agent of Fund A' should start with looking into the relationship between Company B and Fund A'.

As Company B is granted, based on the DIA, sufficient discretion as an agent by Fund A', has a special skills or knowledge and bears entrepreneurial risk, it is regarded as being independent of Fund A'.

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