B.E.P.S. INITIATIVE SPAWNS UNFAVORABLE PERMANENT ESTABLISHMENT COURT DECISIONS

Authors
Taketsugu Osada
Christine Long
Stanley C. Ruchelman

Tags
India
Japan
Permanent Establishment
Principal-Agent

INTRODUCTION

Over the past few months, two court decisions in different parts of the world found that a permanent establishment ("P.E.") existed in structures that appeared to be risk free. These decisions serve as warnings that reliance on the business profits and P.E. articles of an income tax treaty may have to be rethought. The provisions may not provide benefits when most needed: during the course of a tax examination abroad.

TOKYO DISTRICT COURT JUDGED PRODUCT SHIPPING FACILITY FOR ONLINE SHOPPING SERVICES AS A P.E.

Background

Sometimes, it is dangerous to anticipate that a standard provision of an income tax treaty will be applied in a straightforward way to achieve a desired goal. This was recently illustrated by a Tokyo district court case that was asked to apply one of the more prevalent provisions of an income tax treaty.

The case apparently ignored the plain meaning of the of the Japan-U.S. Income Tax Treaty ("the Treaty"), and expanded its interpretation to conclude that a storage facility for inventory could rise to the level of a P.E. The case involved the following fact pattern:

- A U.S. resident operated an online shopping service directed to Japanese customers. It rented an apartment and warehouse in Japan (hereinafter the "Japanese Facilities") in order to store products prior to their shipment to Japanese customers. All orders were placed through the internet.
- The Japanese tax authorities asserted that the U.S. resident was taxable on the resulting business income because the Japanese Facilities qualified as a P.E. under the Treaty.
- The taxpayer asserted that the Japanese Facilities used for storage and delivery purposes could not qualify as a P.E. because they were maintained for preparatory or auxiliary purposes.

The court affirmed the position of the Japanese tax authorities and held that the Japanese Facilities amounted to a P.E. under the Treaty.

Taketsugu Osada is a Certified Tax Accountant in Japan. Mr. Osada specializes in the field of transfer pricing and other aspects of international taxation, including permanent establishments, C.F.C.'s, and individual taxation.

Treaty Provisions

Article 7 (Business Profits) of the Treaty addresses the threshold of contact with Japan that must exist before a U.S. tax resident may be taxed on its business profits. Paragraph 1 provides as follows:

> The profits of an enterprise of a Contracting State shall be taxable only in that Contracting State unless the enterprise carries on business in the other Contracting State through a permanent establishment situated therein. If the enterprise carries on business as aforesaid, the profits of the enterprise may be taxed in that other Contracting State but only so much of them as is attributable to the permanent establishment.
>
> Article 5 (Permanent Establishment) of the Treaty addresses facts that must exist in order for a U.S. resident to be considered to maintain a P.E. in Japan. The starting point is the general rule in paragraph 1: For the purposes of this Convention, the term 'permanent establishment' means a fixed place of business through which the business of an enterprise is wholly or partly carried on.

Paragraph 2 contains specific examples of facts that would be considered to comprise a P.E.:

> The term 'permanent establishment' includes especially
>
> a) a place of management;
>
> b) a branch;
>
> c) an office;
>
> d) a factory;
>
> e) a workshop; and
>
> f) a mine, an oil or gas well, a quarry or any other place of extraction of natural resources.

Paragraph 4 contains express exclusions from P.E. status for certain places of business that are used for preparatory and auxiliary purposes. It provides as follows in pertinent part:

> Notwithstanding the preceding provisions of this Article, the term 'permanent establishment' shall be deemed not to include
>
> a) the use of facilities solely for the purpose of storage, display or delivery of goods or merchandise belonging to the enterprise;
>
> b) the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of storage, display or delivery;
>
> * * *

e) the maintenance of a fixed place of business solely for the purpose of carrying on, for the enterprise, any other activity of a preparatory or auxiliary character;

f) the maintenance of a fixed place of business solely for any combination of activities mentioned in subparagraphs (a) to (e), provided that the overall activity of the fixed place of business resulting from this combination is of a preparatory or auxiliary character.

The Technical Explanation prepared by the Treasury Department in connection with the approval process in the Senate explains the exception in the following way:

> This paragraph contains exceptions to the general rule of paragraph 1, listing specific activities that may be carried on through a fixed place of business, but which nevertheless do not create a permanent establishment. The use of facilities solely to store, display or deliver merchandise belonging to an enterprise does not constitute a permanent establishment of that enterprise. The maintenance of a stock of goods belonging to an enterprise solely for the purpose of storage, display or delivery, or solely for the purpose of processing by another enterprise does not give rise to a permanent establishment of the first-mentioned enterprise. * * * Subparagraph 4(f) provides that a combination of the activities described in the other subparagraphs of paragraph 4 will not give rise to a permanent establishment if the combination results in an overall activity that is of a preparatory or auxiliary character. This combination rule, derived from the OECD Model, differs from that in the U.S. Model. In the U.S. Model, any combination of otherwise excepted activities is deemed not to give rise to a permanent establishment, without the additional requirement that the combination, as distinct from each constituent activity, be preparatory or auxiliary. If preparatory or auxiliary activities are combined, the combination generally also will be of a character that is preparatory or auxiliary. If, however, this is not the case, a permanent establishment may result from a combination of such activities.

Issue Presented

The issue presented to the court was whether the Japanese Facilities have a "preparatory or auxiliary character." Presumably, that was because both a stock of goods and a storage facility were maintained. The court held that the Japanese Facilities were not of a "preparatory or auxiliary character" based on the following facts:

- The U.S. resident conducted sales activities in the Japanese Facilities as sales offices, even though all sales were placed on the U.S. entity's website.
- Employees actually performed important operations of the online shopping service in the Japanese Facilities, such as the storing, wrapping, and shipment of products and the receipt of returned products.[1]

---

1 Judged on May 28, 2015.

Analysis

Critical to the judge's ruling was the fact that the U.S. resident emphasized on its website, which was written entirely in Japanese, that the U.S. business could deliver goods imported from the U.S. soon after a purchase order was placed. The judge acknowledged that such quick delivery was possible because the Japanese Facilities stored goods imported from the U.S. beforehand. In order to fulfill one of the conditions of the service's contract with their customers, *i.e.*, that they would deliver goods quickly, the Japanese Facilities were playing an important role for the online shopping service provided by the U.S. resident, and as such, their character was beyond preparatory or auxiliary.

The logic of the court is somewhat unique. The Treaty does not limit the exclusion for storage facilities that are slow, or that ship goods in unwrapped condition, or only in packages with delivery addresses written in English. Yet the court seemed to distinguish storage facilities that are effective and that store inventory prior to sale to Japanese customers from other storage facilities. Presumably, efficiency is the enemy of preparatory or auxiliary activity. U.S. businesses are cautioned that neither the Japanese tax authorities nor the courts are willing to allow competition from businesses designed to be efficient, and nothing in the Treaty will be applied to the contrary.

BROADCASTER'S TAX LIABILITY IN INDIA BASED ON P.E. RULES

An Indian tax court, the Mumbai Bench of the Income Tax Appellate Tribunal ("I.T.A.T."), held that a U.S. broadcaster owes tax to India on the income generated from the independent sale of advertising airtime by its Indian network subsidiary because such subsidiary is considered a dependent agent and constitutes a P.E. of the broadcaster. Despite the existence of principal-principal contractual provisions and arm's length payments, the court in *NGC Network Asia LLC v. Joint Director of Income Tax*[2] found that the entities had a principal-agent relationship. The tax liability created by this principal-agent characterization is expected to impact how foreign broadcasters enter into contracts and advertise in India.

The case involved NGC Network Asia LLC Co. ("NGC Asia"), which is a Delaware subsidiary of U.S. Fox Entertainment Group, Inc., and the Indian tax authority. NGC Asia owns the television channels National Geographic and Fox International, which the company broadcasts in India as well as other countries. NGC Asia entered into an advertisement sales agreement with one of its subsidiaries, NGC Network (India) Private Limited ("NGC India"), in which NGC Asia sold to NGC India the rights to distribute its two television channels and to sell advertising airtime in exchange for a lump sum. Under the agreement, NGC India made arm's length payments to NGC Asia for the income derived from the distribution rights and from the advertising profits. The agreement provided that NGC India bear all the risks for the sale of advertising airtime as well as determine the terms of the airtime sales to advertisers. NGC Asia and NGC India intended to establish a principal-principal arrangement and viewed NGC India as an independent agent.[3]

---

2 *NGC Network Asia LLC v. Joint Director of Income Tax*, ITA No. 7994/Mum/2011.

3 Amrit Dhillon, "Foreign Broadcasters Risk PE Findings After Indian Ruling," *BNA International Tax Monitor*, January 15, 2016.

“The tax liability created by this principal-agent characterization is expected to impact how foreign broadcasters enter into contracts and advertise in India.”

NGC Asia did not regard NGC India as a P.E. and therefore considered its income from the sale of distribution rights and airtime to NGC India to be excluded from tax. However, the Indian tax authority determined that NGC India is a dependent agent P.E. of NGC Asia and, as such, NGC Asia’s income from the sale of distribution rights and advertising airtime was taxable in India. The tax authority also determined that “advertisement airtime” does not constitute goods that can be sold because “time” cannot be stocked or delivered in advance, or in this case, cannot be separated from the channel airing the advertisement.[4] NGC Asia challenged the determination and the case went up to the I.T.A.T. in Mumbai.

The I.T.A.T. agreed with the Indian tax authority, and on December 16, 2015, it that since the agreements NGC India entered into in India were binding on NGC Asia, NGC India is a dependent agent P.E. of NGC Asia.[5]

The court affirmed that airtime is not capable of sale and that NGC India is an agent dependent on NGC Asia because NGC India cannot use the advertising airtime without NGC Asia’s transfer of rights.[6] Thus, the court held that NGC Asia and NGC India have a principal-agent relationship, despite the fact that the advertising sales agreement intended to establish a principal-principal relationship between the companies.

The I.T.A.T. further refuted NGC Asia’s reliance on *DIT v. Morgan Stanley & Co.*[7] and its argument that the arm’s length payments by NGC India did not trigger a tax obligation for NGC Asia, even if NGC India is a P.E. The I.T.A.T. stated that *DIT v. Morgan Stanley & Co.* is limited to the situation in which a foreign company makes payments to its associated entity or P.E. in India – it does not apply to an entity in India making payments to an associated entity abroad.[8]

NGC Asia will probably appeal the I.T.A.T.’s decision in the Mumbai High Court. In the meantime, however, the tax court’s decision creates uncertainty about tax liability for foreign broadcasters selling advertising airtime in India and concerns that a contractual principal-principal relationship will be viewed as principal-agent with an Indian P.E.

CONCLUSION

Emboldened by the O.E.C.D.’s attack on base erosion and profit shifting (“B.E.P.S.”), tax authorities are looking at new ways to assert the existence of a permanent establishment. In the Japanese case, it was web-based advertising in the Japanese language, combined with a local delivery service. In India, it was furnishing media content to a local subsidiary. Tax advisers who remember the world before the B.E.P.S. initiative are likely surprised by these cases. Nonetheless, in a post-B.E.P.S. world, they may represent the new normal.

---

4 *Id.*

5 *Id.*

6 *Id.*

7 *DIT v. Morgan Stanley & Co.*, (2007) 292 ITR 416 (SC).

8 Dhillon, “Foreign Broadcasters Risk PE Findings After Indian Ruling.”