

J-TaD contents

Commissionaire structures in Japan

The purpose of this article is to highlight the issues to be considered when establishing a commissionaire (“toiya”) structure in Japan. A commissionaire structure is specifically provided for under the Japanese Commercial Code (“JCC”) and is a business structure that is becoming increasingly popular for multinational companies (“MNCs”) selling into Japan.

:::INTRODUCTION:::

Traditionally, MNCs have established distribution networks on a country-by-country basis. Typically, this involves the incorporation of a local subsidiary that buys product from its parent company for resale into the local market. This model is commonly referred to as a “buy-sell model”. The subsidiary has its own management structure responsible for business decisions (such as pricing, marketing and product development) relating to sales of the product in the local market.

Alternatively, MNCs may enter into distribution agreements with third parties. Typically, these arrangements involve the MNC granting a third party distributor distribution rights (exclusive or non-exclusive) for a specified territory and term. Although the MNC may retain control over some aspects of the local distribution of its product the third party distributor will generally have significant discretion with respect to how it markets the product.

Irrespective of whether the MNC distributes through a local subsidiary or third party distributor, the common element is that control of the distribution of the MNC’s product occurs on a country-by-country basis. In many cases, this leads to a duplication of functions and costs (e.g. separate marketing teams in each country), inconsistent policies (e.g. relating to pricing and discounts) and contradictory brand images.

With the advent of globalization and increased competitive pressures, MNCs are now focusing on gaining sustainable competitive advantage through supply chain management. With this new focus, MNCs are realizing that traditional distribution models may no longer be appropriate and are looking for alternative structures to achieve a better sharing of services, technology, and commercialization of products. It is against this background that so-called “regional principal” (“RP”) structures were developed.

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:::DESCRIPTION OF REGIONAL PRINCIPAL STRUCTURES:::

Although the legal and commercial form of a RP structure may vary from country to country, the common features are (i) the centralization of sales, marketing, and other functions in one entity (the RP company) for a particular region, (ii) the use of commissionaire or stripped risk distributor entities (“SRDs”), and (iii) the use of shared services support companies. The RP company usually bears the principal risks of operating in the region and has overall responsibility for profitability, marketing strategy, and key operational and strategic decisions. Accordingly, the retention of the majority of profits by the RP company (which may be established in a low cost / low tax jurisdiction) can be justified for transfer pricing purposes.

The local commissionaires or SRDs are responsible for sales, business development, and collection of market information for each of their respective territories and generally do not bear the commercial risks that a full entrepreneurial entity would otherwise bear. Accordingly, a lower remuneration for the commissionaires or SRDs can be justified for transfer pricing purposes, thereby minimizing local country tax costs.

:::DESCRIPTION OF COMMISSIONAIRE STRUCTURE:::

In Japan, a RP structure is usually implemented by way of a commissionaire (or *toiya*) arrangement under the JCC. Articles 551-558 of the JCC defines a *toiya* as a person who makes it his business to effect sales or purchases of goods in his own name for another person (the foreign principal.) The commissionaire acquires rights and incurs obligations with regard to the local customer to the transaction. If the customer does not perform its obligation in connection with the sale that the commissionaire has effected for the principal, the commissionaire is liable for the performance thereof to the principal (unless the parties agree otherwise.)

Although the commissionaire is an agent for the foreign principal, it differs from an ordinary commission agent (who acts as an agent for a disclosed principal) in that it acts for an undisclosed principal. An ordinary commission agent sells in the name of the principal and its contracts with customers will legally bind the principal. A commissionaire, however, sells under its own name, albeit

for the account of the principal. The contracts with customers will not bind the principal legally (i.e. customers are not able to claim their rights or obligations under the contracts directly with the principal.)

Often, a commissionaire structure replaces an existing buy-sell model, with the local Japanese subsidiary converting from a fully-fledged distributor to a commissionaire. A major advantage of a commissionaire structure is that there is no disruption to existing customer relationships since, practically, there should be no change to the day-to-day activities performed by the commissionaire in relation to its customers. Customers will continue to believe they are dealing with and buying from the commissionaire although legal title to products now passes from the principal to the customer.

Alternatively, a commissionaire model can be used to replace (or supplement) an existing service fee model whereby a foreign corporation sells direct to customers in Japan with the assistance of a local subsidiary that performs sales support services. Usually, this service entity is reimbursed its costs plus a certain mark-up. However, it is not uncommon that over time, the activities of the sales support entity gradually extend beyond mere liaison or auxiliary services, thereby creating a substantial permanent establishment (PE) risk for the foreign corporation. In these cases, a commissionaire structure can allow the foreign corporation to continue making direct sales to Japanese customers while at the same time recognizing that sale activities are taking place in Japan.

:::PERMANENT ESTABLISHMENT ISSUES ARISING FROM COMMISSIONAIRE STRUCTURE:::

Under Japanese domestic law, the taxable income of a foreign corporation depends upon the degree of its presence in Japan; in particular, whether it has a PE in Japan. A PE means a fixed place of business through which the business of the enterprise is partly or wholly carried on. Corporation Tax Law (“CTL”), Article 141(1) specifically includes a branch, factory, and other fixed places of business in the definition of PE. Corporation Tax Law Enforcement Order (“CTLEO”), Article 185(1) extends the definition of PE to include an office, warehouse and branch.

CTL Article 141(3) provides that a foreign corporation that has in Japan a person with authority to conclude contracts

on the foreign corporation's behalf will be deemed to be a PE of the foreign corporation. CTLEO Article 186(i) to (iii) provides that the "person" identified in CTL Article 141(3) includes the following:

(i) a person who has an authority to conclude contracts in Japan on behalf of a foreign corporation (excluding contracts to purchase assets for the foreign corporation) and exercises such authority continuously (i.e. "contracting agent");

(ii) a person who maintains in Japan sufficient goods to meet the normal requirements of a foreign corporation's customers and delivers the goods to the customers on behalf of the foreign corporation to meet such requirements (i.e. "fills order agent"); and

(iii) a person who exclusively or principally on behalf of a foreign corporation performs an important part in the solicitation of orders, negotiations, and other acts leading up to the conclusion of contracts with respect to the business of the foreign corporation (i.e. "negotiation agent").

If the principal in a commissionaire structure is resident in a country with which Japan has not concluded a tax treaty, the PE implications will be determined under Japanese domestic tax law. In principle, it appears the commissionaire could be considered a PE of the principal under (i) above. However, at very least, there appears to be uncertainty within the Japanese tax authorities with respect to whether commissionaires should generally be characterized as PEs. The authors' understanding is that the authorities may be awaiting the results of work being undertaken by the OECD before considering this point. Certainly it seems that MNCs continue to establish principals in (non-treaty) jurisdictions such as Hong Kong and that PE concerns do not appear to feature highly in such cases.

If the principal is a United States ("US") resident, the Japanese PE issues arising from a commissionaire structure will be determined under the provisions of the 2003 Income Tax Agreement between Japan and the US (the "Japan-US Treaty").

Article 7(1) of the Japan-US Treaty provides that the profits of a US enterprise shall be taxable only in the US unless the US enterprise carries on business in Japan through a PE situated therein. In such case, the profits of the US

enterprise may be taxed in Japan to the extent that they are attributable to the PE. Article 5(5) provides that, where a person in Japan, other than an agent of independent status (as defined in Article 5(6) – see discussion below), acts on behalf of a US enterprise and has, and habitually exercises in Japan, an authority to conclude contracts in the name of the US enterprise, the US enterprise will be deemed to have a PE in Japan unless the activities of such person are limited to those defined under Article 5(4) (e.g., purchasing goods for the US enterprise, etc.) Based on these provisions, it seems likely that the commissionaire could be considered a PE of its US principal as it concludes sale contracts on behalf of the latter.

:::INDEPENDENT COMMISSIONAIRES:::

In addition to commissionaire arrangements that involve a commissionaire and principal that are related parties, it is also possible for the foreign principal to deal with a non-related entity on a commissionaire basis. In such cases, where a tax treaty is in place, the PE implications may be determined by way of reference to the independent agent provisions of the relevant treaty. For example, Article 5(6) of the Japan-US Treaty indicates that a US enterprise will not have a PE in Japan merely because it carries on business in Japan through a broker, general commission agent, or any other agent of an independent status, provided that such persons are acting in the ordinary course of their business. PE risk is likely to be very low in such cases.

:::CURRENT APPROACH OF JAPANESE TAX AUTHORITIES TO COMMISSIONAIRE STRUCTURES:::

As noted above, as the commissionaire will be negotiating and concluding sales contracts on behalf of its foreign principal, it is possible that the Japanese tax authorities ("NTA") will review the commissionaire structure from a PE perspective. However, if it can be demonstrated that the structure has commercial substance, under its current practice, the NTA is more likely to focus on whether:

- there are commercial reasons for implementing the commissionaire structure;
- the principal has sufficient substance to act as such; and
- the commission paid by the principal to the commissionaire represents an arm's length commission taking into account the functions performed by it,

rather than seeking to assess the existence of a PE and determining the profits attributable to such PE.

If the NTA believes that the commissionaire structure does not have commercial substance, it is likely to adopt a "substance over form" approach and disregard the existence of the commissionaire structure. In the case where the commissionaire was formerly a distributor, the previous buy-sell model could be deemed to continue to be in place with the result that it would be assessed additional tax and late payment penalties and interest for the understatement of taxable income for corporate tax purposes and taxable sales for consumption tax purposes.

:::TRANSFER PRICING:::

Under the Japanese transfer pricing rules, transactions between a Japanese company and foreign related parties must be conducted on an arm's length basis. Arms length is generally defined as being on the same terms and conditions that would apply if the transaction were undertaken between unrelated parties. Generally, a commissionaire should be reimbursed its expenses plus a commission based on a percentage of sales made on behalf of the principal. In the case where the commissionaire and the principal are related parties, the appropriate commission rate would depend upon a functional analysis of the activities performed by the commissionaire.

:::CONSUMPTION TAX:::

• General

Consumption tax is a VAT style tax that applies to the supply of goods or services in Japan (except where the supply is specifically exempted.) The current rate of consumption tax is 5%. A taxable enterprise is required to charge consumption tax on its supply of goods or services (output consumption tax), but can pass this tax on to its customer. Conversely, a purchaser of goods or services is required to pay consumption tax on (i) its purchases of goods or services from suppliers in Japan, or (ii) imports from outside Japan if it is the importer of record (input consumption tax). In determining its consumption tax liability, a taxable enterprise can subtract input consumption tax paid from output consumption tax charged. If output consumption tax exceeds input consumption tax, the net amount is payable to the tax office. Conversely, if input consumption tax exceeds

output consumption tax, the net amount is refundable to the taxable enterprise.

• Implications for commissionaire

Generally, the commissionaire will act as the importer of record and, accordingly, will pay consumption tax on the value of the imported products. As noted above, the commissionaire can offset the consumption tax paid against its own output consumption tax.

• Implications for principal

As title to goods will transfer from the principal to the customer while the products are physically located in Japan, the sale will be treated as a taxable transaction for consumption tax purposes. Accordingly, the commissionaire is required to charge consumption tax on its invoices to the customer. However, as the commissionaire makes sales for the account of its principal, the output consumption tax charged is deemed to belong to the principal. This means that the principal is required to file a Japanese consumption tax return to report the output consumption tax charged, unless it is exempted from filing.

A corporation with taxable transactions for consumption tax purposes of less than JPY 10 million during the "Base Period" (defined as the fiscal year two years prior to the current year) for a fiscal year is treated as a tax-exempt enterprise, unless it elects to become a taxable enterprise. An exception to this rule relates to a corporation established on or after April 1, 1997 with a paid-in capital of Yen 10 million or more. Such a corporation is automatically treated as a consumption taxpayer for its first two fiscal years. Accordingly, if the principal is treated as an exempt enterprise for the first two fiscal years after the commissionaire structure is implemented, it will be exempt from paying net consumption tax collected from customers to the tax office.

:::IMPLEMENTATION ISSUES:::

Commercial reasons for implementing commissionaire structure

Due to the potential revenue benefit that can be obtained by the principal relating to its exemption from filing consumption tax returns in the first two fiscal years after the commissionaire structure is implemented, the NTA has a concern regarding abusive use of such structures.

Accordingly, it is important that the economic and commercial reasons for implementing the commissionaire structure can be substantiated.

:::COMMERCIAL SUBSTANCE OF PRINCIPAL:::

The documentation of the business activities of the principal after the implementation of the commissionaire structure will play a critical role in any audit defense of the structure. In particular, it is important that the principal can be demonstrated as being a “real” company that actually performs substantive functions and undertakes real risks that are consistent with its role as the principal in the commissionaire structure. For example, the principal manages inventories and sales and distribution networks, controls accounts receivable, takes responsibility for warranty risk, foreign exchange risk, etc. for the Japanese operations.

:::CONSUMPTION TAX – ATTITUDE OF CUSTOMERS:::

As discussed above, Japanese tax law requires that the principal charge consumption tax on sales. Where the principal is a tax-exempt enterprise, it may be able to keep consumption tax collected. If the principal loses its tax-exempt enterprise status (often after two fiscal years) it will be required to pay consumption tax collected thereafter to the Japanese authorities. However, in spite of the principal’s clear obligation, difficulties may arise if Japanese customers become aware that consumption tax is being charged for the account of the (foreign) principal and that such collected consumption tax may not be paid to the authorities. In such cases, customers may challenge payment of consumption tax and / or seek a reduction in price to the extent of the (temporary) windfall experienced by the principal. In order to avoid such complications, commissionaires may endeavor to ensure that customers focus upon the transaction with the commissionaire.

:::TRANSFER OF INVENTORY FROM COMMISSIONAIRE TO PRINCIPAL:::

In the case where the implementation of a commissionaire structure replaces an existing buy-sell model, with the local Japanese subsidiary converting from a fully-fledged distributor to a commissionaire, existing inventory owned by the commissionaire must be transferred to the principal. This transfer will be subject to consumption tax at the rate of 5% and the commissionaire must report the

consumption tax collected from the principal on its consumption tax return for the fiscal year in which the transfer occurs. However, if the principal is exempt from filing consumption tax returns in its first 2 fiscal years, the consumption tax paid to the commissionaire cannot be recovered. Accordingly, in order to minimize adverse cash flow implications, before the commencement of the commissionaire structure, the commissionaire should seek to minimize the amount of inventory that must be transferred to the principal.

:::SYSTEMS CHANGES:::

The implementation of a commissionaire structure will require changes to accounting systems of the commissionaire if it is converting from a distributor model. This is because sales revenue and consumption tax charged to customers should be recorded for the account of the principal.

:::CUSTOMS DUTY ISSUES:::

The implementation of a commissionaire structure may require a change to the valuation of imported products for Japanese customs duty purposes, which could present customs duty planning opportunities.

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