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Supervisory Activities as Permanent Establishments : The Australia/Japan Treaty

Abstract

What are 'supervisory activities'? When will such activities constitute a permanent establishment of a corporation in an overseas country? What tax planning opportunities are available? These issues, which are often of great importance when planning international commercial operations, are explored in this article with particular reference to the Australia/Japan Treaty.

Keywords

supervisory activities, Australia/Japan Treaty

SUPERVISORY ACTIVITIES AS PERMANENT ESTABLISHMENTS: THE AUSTRALIA/JAPAN TREATY

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What are "supervisory activities"? When will such activities constitute a permanent establishment of a corporation in an overseas country? What tax planning opportunities are available? These issues, which are often of great importance when planning international commercial operations, are explored in this article with particular reference to the Australia/Japan treaty.

Introduction

The presence of a permanent establishment in a country will generally result in an entity being exposed to tax in that country under the international tax treaties. The definition of "permanent establishment" is, therefore, crucial in the planning of any international commercial operations.

One of the more difficult situations to grapple with is that in which an entity undertakes "supervisory activities" in another country. Every Australian tax treaty deems an entity carrying out supervisory activities in another country in connection with a building site, or construction, installation or assembly project to have a permanent establishment in that country if certain criteria are met.

This paper will attempt to throw some light on the types of supervisory activities which will generally result in a corporation having a permanent establishment in an overseas country. Specific reference will be made to the Japanese Treaty since the Japanese domestic law is modelled on similar provisions. In addition, the scale of construction and other similar activities carried out by Japanese corporations in Australia over recent years makes this Treaty of particular interest. The paper will initially review supervisory activities and permanent establishments under the domestic laws of Japan and Australia. The Treaty provisions and their impact on the domestic laws will then be examined.

Japanese domestic tax position

Foreign corporations operating in Japan through a permanent establishment are liable to Japanese corporate income tax on Japanese source

business profits. In the absence of such a taxing nexus, no liability to Japanese tax arises in respect of such profits.¹

Construction project nexus

Article 141(2) of the Japanese Corporation Tax Law provides that a foreign corporation will have a Japanese taxing nexus where, among other things, there exists a:

Construction, installation or assembly project or similar activity or services in the supervising or superintending of such project or activities in Japan, which a foreign corporation carries on for a period over one year.

Thus, where a foreign corporation actively engages in a construction project for a period of more than twelve months in Japan, a taxing nexus will arise. In these circumstances, the total income derived from the activities will prima facie be liable to tax in Japan.

The operation of Article 141(2)

The Japanese tax authorities have issued several pronouncements regarding the operation of Article 141(2) of the Corporation Tax Law, and the similar provisions in the income tax law which are of some assistance in determining its application.

Meaning of construction, installation or assembly activities

There is no definition in the legislation of the types of activities which will constitute construction, installation or assembly activities. Basic Circular CTL 20-2-3 states only that "construction activities" include installation work, if installation of equipment requires the one year period.² This appears to be so even in a situation where the installation is incidental to the sale of the machinery or equipment. Some further guidance may be obtained from Huston, Miyatake and Way, who advise that the construction project,

... may occur at one or several geographic points. It may involve the operation of very heavy machinery owned or leased by the foreigner for appreciable periods of time. Also involved may be the installation of other items of personal property ranging in size from merely large to utterly gigantic. And such projects almost always have offices.³

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- 1 *Hōjinzeihō* (Corporation Tax Law) Law no 34 of 1965, art 141, items (2) and (3). English translation in Huston, Miyatake and Way, *Japanese International Taxation* (1988) at 5-10, 59.
 - 2 Basic Circulars are a form of administrative regulation that have the purpose of expanding upon the primary set of regulations, called the Enforcement Orders (or the Cabinet Orders).
 - 3 Huston, Miyatake and Way, *Japanese International Taxation* (1988) 2.02[3].

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Meaning of supervising or superintending

The provision reads: “or services in the supervising or superintending” of such a project. This indicates that these activities are different from the carrying out of a project. Again, however, there is no definition in the legislation and there are no pronouncements by the Japanese tax authorities to guide us as to the meanings of these expressions.

One year period

A determination whether or not an activity exceeds one year is made by reference to each contract. If there are several contracts involving the same parties and related projects, then the periods will be aggregated to determine whether the one year is exceeded.⁴ Other Basic Circulars⁵ indicate that where an entity enters Japan to carry out a project which is intended to last more than one year, the entity will immediately acquire a tax nexus. This is of some assistance as far as it goes. However, in practice there are many more issues which may need to be addressed. For instance:

- what is the situation if the project is delayed because of bad weather or labour disputes?
- when will the projects be related?
- will the Japanese tax authorities seek to aggregate activities carried out in prior years with current projects?
- will the activities be a permanent establishment in any event due to the operation of another provision, for example on the establishment of an office?

There is no indication of how these or similar matters should be dealt with in the Japanese tax law.

Tax burden

Japan is a relatively high tax country. Foreign corporations with a construction project nexus will generally be liable to three taxes on Japanese source income – national corporation tax of 42%, local inhabitants tax at a maximum rate of 20.7% of corporate tax, and local business tax at a maximum rate of 13.2%. The local business tax is tax deductible. In the case of small corporations (paid-in capital of 100 million yen or less), the first 8 million yen of taxable income is taxed at a reduced national corporation tax rate of 30% and the excess is taxed at 42%.⁶ The effective tax rate for large corporations is therefore approximately 56%, although due to non-allowable expenses such as entertainment, the actual tax burden may exceed this. Accordingly, Australian corporations will generally seek to avoid exposure to Japanese tax.

4 Basic Circular ITL 164-4, translation in Huston, Miyatake and Way at p R-38.

5 Basic Circular ITL 164-4 and CTL 20-2-2.

6 Kuboi Takashi, *Business Practices and Taxation in Japan* (1988) 7.

Exemptions

The Japanese Corporation Tax Law Enforcement Order provides, by Article 185(2), an exemption where a fixed place of business exists solely for the purpose of activities having an auxiliary function in carrying on the business of the enterprise, for example, supply of information. It is considered, however, that supervisory activities which would be seen as falling within Article 141(2) would not normally be subsidiary activities of the entity as the provisions are directed towards foreign corporations carrying on an active business in Japan. If this is so, this exemption would not generally be applicable.

There are also other exemptions available for the purchase and storage of goods in Japan but these are not relevant here.

Australian domestic tax position

A non-resident of Australia will be subject to Australian income tax on gross income derived from Australian sources.⁷ Except in a very few cases, the source of the income is determined according to the common law rules. In the case of supervisory activities, the source of the income from these activities can be expected to be the place where the activities are carried out.⁸ Therefore, it will generally be the case that, where supervisory activities are carried out in Australia in connection with a construction, installation or assembly project located here, the foreign corporation will be liable to Australian tax on any income derived from those activities.

The term "permanent establishment" is defined in the Australian income tax legislation and specifically includes a place where a person is engaged in a construction project in Australia but makes no mention of supervisory activities.⁹ Whether a foreign corporation has a permanent establishment in Australia does not generally determine the corporation's liability to income tax under the domestic law. A permanent establishment is, however, relevant to the withholding tax provisions (Division 11A), the taxation of royalties (s 6c), capital gains tax (s 150T) and transfer pricing provisions (Division 13).

Double tax treaty

The domestic tax law in both Australia and Japan is generally subject to the Australia/Japan Double Tax Treaty. In regard to Australia, the Income Tax (International Agreements) Act 1953 states at Article 4(2) that the Treaties have effect notwithstanding anything inconsistent with those provisions contained in the Income Tax Assessment Act 1936 ("the Act") (other than s 160AO and Part IVA) or in an Act imposing Australian tax.

Consistent with other Treaties, the Australia/Japan Treaty relieves a foreign corporation from tax on industrial or commercial profits unless the corporation is carrying on business in another country through a permanent

7 Income Tax Assessment Act 1936 (hereinafter referred to in the footnotes as "ITAA"), s 25(1).

8 *Cliffs International Inc v FC of T* (1985) 85 ATC 4374.

establishment situated therein.¹⁰ Permanent establishment is defined in Article 3 at paragraph 4 to include “supervisory activities”:

[A]n enterprise of one of the Contracting States shall be deemed to have a permanent establishment in the other Contracting State if it carries on supervisory activities in that other Contracting State for more than six months in connection with a building site, or a construction, installation or assembly project which is being undertaken in that other Contracting State.

Interpretation of the Treaty provisions

The expressions “supervisory activities” and “in connection with a building site, or a construction, installation or assembly project” are not defined in the Treaty. In such a case, the Treaty states that reference should be made to the meaning under the laws in force in the relevant country.¹¹ While this is accepted, it is also considered that some universal meaning of these expressions will need to be arrived at if the Treaty is to achieve its purpose of avoiding double taxation.

The Australian courts have had few opportunities to consider the operation of the Treaties. In 1988, Hamilton and Deutsch commented that “despite some passing acknowledgement of the purposes of the double tax agreements and the need to pay regard to them, there has not been a great deal of effort to make them work according to what might be termed their spirit”.¹² A review of the few cases that have come before the Australian courts in the past also indicates a reluctance to refer to international views, such as those expressed in the commentary on the OECD Model Convention, to assist them in the interpretation of the Treaties. Despite this, a significant change in approach may have been heralded by the recent High Court case of *Thiel v FC of T*.¹³ In *Thiel's* case McHugh J found an opportunity to express some general guidelines on the interpretation of Treaties when considering Article 7 of the Australia/Swiss Treaty. McHugh J stated:

... none of the relevant terms or expressions in the Agreement has any particular or settled meaning in Australian income tax law. The meaning of those terms and expressions must be ascertained from the Agreement.

The Agreement is a treaty and is to be interpreted in accordance with the rules of interpretation recognised by international lawyers. Those rules have now been codified by the Vienna Convention on the Law of Treaties to which Australia ... is a party.¹⁴

9 ITAA, s 6(1).

10 Australia/Japan Treaty, art 4(1).

11 Australia/Japan Treaty, Art 2(4) and Income Tax (International Agreements) Act, Art 3(9).

12 Hamilton and Deutsch, *Understanding Australian International Tax* (1988) 223.

13 (1990) 90 ATC 4717.

14 *Ibid* at 4727 per McHugh J.

And later, in regard to the object of the Treaty, McHugh J supported the view that the Treaty was for the avoidance of tax and it is necessary to interpret its words with that particular purpose in mind.¹⁵

The Vienna Convention provides that in interpreting Treaties, recourse may be had not only to the text, but to preambles, annexes, other agreements between the parties, the subsequent application of the provisions and so on.¹⁶ The High Court in *Thiel's* case, relying on these provisions in the Vienna Convention, showed no hesitation in making reference to the 1977 OECD Model Convention and Commentary in regard to the business profits article, Article 7 of the Australia/Swiss Treaty. The OECD Model Convention was considered to fall within the supplementary documents referred to in the Vienna Convention. The Convention was the model for the Agreement and also reflected the customary rules relevant to the interpretation of an international agreement.

In the following discussion on the meaning of the expressions "supervisory activities" and "in connection with a building site, or a construction, installation or assembly project" for the purposes of the Treaty, references will therefore be made to both domestic law, as required by the Treaty, and to the OECD Model Convention and Commentary.

While the Australia/Japan Treaty is modelled on the 1963 OECD Model Convention, it is considered acceptable to refer to both the 1977 and 1963 OECD Conventions on the basis that the provisions for supervisory activities and permanent establishments are almost identical under both Conventions.

Meanings of expressions in the Treaty

Meaning of "supervisory activities"

There is no definition of "supervisory activities" in either the Australian or Japanese tax legislation and no evidence has been found of the expression being examined by the Australian courts. Supervisory activities in this context are also absent from both the 1963 and 1977 OECD Model Conventions. It is generally considered, however, that where such activities are carried out by the contractor also carrying out the construction, that supervisory activities are within the scope of the Convention.¹⁷ The *Oxford Dictionary* defines "supervise" as to "oversee, watch or direct the carrying on of work ...".

It is also probably pertinent to note that the test is a physical presence test. The supervisory activities must be carried on in the foreign country before the provisions are attracted. It may therefore be possible to avoid the operation of the provisions by performing some part of the activities outside the foreign country so that the six-month time limit is not breached. Great care would need to be taken, however, to ensure that some other provision in Article 3 did not operate to treat the activities as establishing a permanent establishment in any case.

15 Ibid.

16 Vienna Convention on the Law of Treaties 23 May 1969, Arts 31 and 32.

17 1977 OECD Model Commentary, Art 3 at 16.

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Meaning of "in connection with"

Comment was made on the meaning of "in connection with" in a recent stamp duties case, *Efira Services Pty Ltd v Commissioner of Stamps (SA)*, where Prior J stated "in connection with" is a phrase of wide meaning extending to something having substantial relation in a practical business sense".¹⁸

Meaning of "building site, or a construction, installation or assembly project"

As we have already seen, the Japanese domestic law and pronouncements provide very little assistance in interpreting the similar expression appearing in Article 141(2) of the Japanese Corporation Tax Law.

The Commissioner of Taxation in Australia has, however, provided some valuable comments on the word "construction" used in its "normal and accepted sense" in Income Tax Ruling IT 2450, which deals with profit recognition on long-term construction contracts. In that ruling it is stated:

- 11 The word construction is used in its normal accepted sense. Income from long-term construction contracts would include: income from construction of buildings, bridges, dams, pipelines, tunnels and other civil engineering projects; income from related activities such as demolition, dredging, heavy earthmoving projects etc; and income from the construction of major plant items including ships and transport vessels. It would also include income from similar contracts in associated fields, eg air-conditioning contracts, major electrical wiring or rewiring contracts, major refurbishment of hotels, stores, etc, major construction management contracts, etc.
- 12 A long-term construction contract does not include a contract for the sale and supply over time of what may ordinarily be regarded as the sale of trading stock, eg, it does not include a contract for the supply and installation of office furniture in a new building even though the furniture may need to be assembled upon delivery.¹⁹

The types of activities that the Commissioner considers fall within the ordinary meaning of "construction" are therefore wide-ranging. It is interesting to note that the term includes not only activities which involve the creation of a new structure but also the refurbishment and demolition of existing structures. The term also appears to include supervisory activities such as management contracts.

Regarding the exception for the supply of trading stock, it should be borne in mind that, while contracts for the supply of trading stock may fall outside the definition of "construction", Article 3(4) of the Treaty also extends to "installation and assembly projects" and it is possible that such activities could fall within one of these terms. Despite this, it is worthwhile noting that such activities could fall outside Article 3(4) and IT 2450 may provide some support for a taxpayer wishing to pursue this argument.

18 *Efira Services Pty Ltd v Commissioner of Stamps (SA)* (1990) 90 ATC 362.

19 Income Tax Ruling IT 2450, paras 11 and 12.

The Australian income tax legislation does not give a general definition of building site, construction, installation or assembly project. However, "construction project" is comprehensively defined in s 221YHA(1) of the Act for the purposes of the prescribed payments system. For prescribed payments purposes, "construction project" means any work or similar activity usually associated with building, construction, modification or demolition of any structure. It also includes certain peripheral activities such as painting or decorating, the installing of heating, lighting or security, and landscape gardening. Interesting additions to this definition are earthworks and landscape gardening. While it is recognised that this definition is specific to Division 3A of the Act, it is interesting to note that "installation" activities are included in the meaning of "construction" activities. One could question, therefore, whether the inclusion of installation and assembly projects in the Treaty in fact extends the activities covered beyond those which would otherwise fall within the ordinary meaning of construction.²⁰

Certain commentators have thought that the inclusion of "installation" projects in the Treaty may not be meaningless. Bissell comments that the inclusion of installation projects may "offer protection for start-up services provided for a service fee to a foreign buyer of heavy equipment who, without this exception, could be deemed to have a permanent establishment".²¹ Start-up services could include initial installation, operation, and staff training services provided by the vendor to the foreign buyer on site in the foreign country. Such start-up services may fall within the meaning of "installation" but not within the meaning of "construction". If so, the six month period permitted under Article 3(4) of the Treaty before such activities are treated as permanent establishments could offer some protection for these activities.

Article 5 of the 1977 OECD Model Convention states that a "building site or construction or installation project constitutes a permanent establishment only if it lasts more than twelve months". In this context, the term "building site or construction or installation project" includes not only the construction of buildings but also the construction of roads, bridges or canals, the laying of pipe lines and excavating and dredging. Planning and supervision of the erection of a building are covered by this term, if carried out by the building contractor.²² This list is, of course, not exhaustive, particularly as the OECD provision does not extend to assembly projects which are included in the Australia/Japan Treaty.

The Commentary also does not elaborate on the difference between a building site, a construction project and an installation project. In the Australia/Japan Treaty building sites, construction projects and installation

20 On this point, it is also of interest to note that "installation project" was a term rejected as "meaningless" in the 1963 OECD Model Convention and was replaced with "assembly" (1963 OECD Model Convention, Art 5 at 8). In the 1977 OECD Model Convention "assembly" was again replaced by "installation".

21 Bissell T, "The Treasury's Model Income Tax Treaty - An Analysis and Appraisal" (1976-77) 3 International Tax Journal 16.

22 1977 OECD Model Convention, Art 5 at 16.

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projects are subject to the same time requirement of six months. Therefore any distinction is unlikely to be of significance for this Treaty. However, it is interesting to note that other Treaties have different time requirements for the different types of projects. This indicates that a distinction does exist and in some circumstances may be important. In several of the Canadian Treaties, for example the Canada/Philippines Treaty, different time limits apply for construction projects to those that apply for assembly projects to determine whether the project is a permanent establishment. In this context, Larter states that "construction normally refers to building of real property. Assembly connotes the 'fitting together' of component parts"²³

The above discussion on the meaning of "building site or construction, installation or assembly project" indicates that these terms can be expected to be interpreted very broadly. They encompass not only the building of new structures but also the refurbishment or demolition of existing structures. In addition, management contracts and peripheral activities such as landscape gardening may be included. Whether the inclusion of "installation and assembly" projects expands the activities caught beyond those that would fall within the ordinary meaning of "construction" is open to question.

Six month time period

The OECD commentators also discuss the calculation of the time period when discussing Article 5(3) of the OECD Model Convention. This Article specifically includes a building site or construction or installation project in the definition of "permanent establishment" if it lasts more than 12 months. The OECD commentators' views are directly relevant to the six month time limit on supervisory activities under Article 3(4) of the Australia/Japan Treaty.

When do the activities commence?

The activities will be taken to commence from the date on which work, including preparatory work, begins in the country and to continue until the work is completed or permanently abandoned. A temporary cessation of activity will not be treated as the cessation of the activity.²⁴ It could therefore be advantageous if preparatory work, where possible, were to be carried out prior to entering the country.

Do projects have to be aggregated?

The OECD Commentary states that the test applies to each individual site or project:

In determining how long the site or project has existed, no account should be taken of the time previously spent by the contractor concerned on other sites or projects which are totally unconnected with it. A building site should be regarded

23 Larter RW, "Permanent Establishment (Article 5)" IFA Canadian Branch Special Seminar on Analysis of Canada's Tax Conventions and Comparison to the OECD Model Double Taxation Convention 1979, 73.

as a single unit, even if it is based on several contracts, provided that it forms a coherent whole commercially and geographically.²⁵

It is reasonable to assume that these guidelines should also apply for supervisory activities. If so, it means a foreign corporation could be present in a country for more than six months working on unconnected projects and not be treated as having a permanent establishment in that country. The OECD position could therefore differ from the Japanese domestic position, which calculates the time period based on contracts. Separate contracts are aggregated under Japanese domestic law if the same parties are involved and the projects are related.²⁶ For example, where a contractor enters into separate contracts with different parties in relation to a project, the contracts would appear to be aggregated for Treaty purposes but not for the purposes of the Japanese domestic law.

Does the project have to remain on the same site?

Even though the permanent establishment provisions refer to a “fixed place of business”, if the nature of the project is such that the activities must be relocated continuously, or from time to time as the project progresses, it appears that this is immaterial and the clock will continue to tick.²⁷

Can the provision be avoided by subcontracting the work?

It appears that if an entity undertakes the performance of a project and then subcontracts parts of the project to others, the period spent by the subcontractors must be considered as being time spent by the general contractor.²⁸

Must the six month period be exceeded before a permanent establishment is found to exist?

Article 3(4) of the Australia/Japan Treaty provides an alternative test to that in Article 3(1), which provides the general definition of “permanent establishment” for the purposes of the Treaty. Article 3(4) deems an entity carrying out supervisory activities to have a permanent establishment when those activities are carried out for more than six months. However, this Article may not provide a six-month immunity where an activity would otherwise be a permanent establishment under the general definition or under another provision contained in Article 3 of the Treaty. This can be contrasted with Article 5(3) of the 1977 OECD Model Convention, where the expiration of the relevant time period is a condition precedent to a building site or construction or installation project being taken to constitute a permanent establishment. Article 5(3) of the 1977 OECD Model Convention

²⁴ Above n 22 at 18.

²⁵ Ibid.

²⁶ Basic Circular ITL 164-4.

²⁷ Above n 22 at 19.

²⁸ Ibid at 18.

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states that “a building site or construction or installation project constitutes a permanent establishment *only* if it lasts more than twelve months”. It is also interesting to note that the relevant time period in the OECD Model Convention for a construction project permanent establishment is 12 months not six months.

The six-month period in the Australia/Japan Treaty is consistent with the United Nations' Double Tax Convention For Use Between Developed and Developing Countries. The purpose of the reduction in the time period in the United Nations' Convention seems to be to give developing countries a greater opportunity to tax the often substantial supervisory activities undertaken in their countries by developed countries. While the United Nations' Convention was drafted after the signing of the Australia/Japan Treaty, maybe our Australian leaders showed some foresight. If we compare the scale of Japanese investment in Australia to the scale of Australian investment in Japan, the reduction to six months should, in theory, benefit the Australian coffers.

The majority of Australia's treaties with countries in the Asia-Pacific region also adopt the six-month period. In the case of Papua-New Guinea, the period is reduced further to three months, which the United Nations advises may be adopted in special circumstances. In contrast, the treaties with most European countries adopt a 12-month period.

These variations in time periods may create a window of opportunity for the tax planner. Corporations intending to carry out supervisory activities in Australia, for example, could establish an entity to carry out the activities which is resident in a country where the 12 month period applies. Care would again need to be taken to ensure that another provision in Article 3 is not attracted.

Exemptions

Similar to the Japanese law, the Treaty provides an exemption from treatment as a permanent establishment where a fixed place of business exists solely for the purpose of activities having an auxiliary function. Again, however, it is not considered that activities within Article 3(4) would generally be activities of an auxiliary nature. Other exemptions for the purchase and storage of goods are also not relevant here.

Supervisory activities and the Treaty

It is interesting to consider the impact that the absence of supervisory activities from the OECD agreement has on the taxation of these activities when compared to the Australia/Japan Treaty. Would such activities, for instance, escape taxation under the United States/Japan Treaty, which is modelled on the OECD Model Convention in this respect?

The OECD Model Commentary states that:

Planning and supervision is not included if carried out by another enterprise whose activities in connection with the construction concerned are restricted to planning and supervising the work. If that other enterprise has an office which it

uses only for planning or supervision activities relating to the site or project which does not constitute a permanent establishment, such office does not constitute a fixed place of business within the meaning of para 1, because its existence has not a certain degree of permanence.²⁹

In reference to the current United States/Japan Treaty, which deletes any reference to supervisory activities, Huston, Miyatake and Way refer to comments by a principal Japanese author writing in a major international tax journal that supervisory activities are "entirely safe". "Even if carried on for more than 12 months supervisory activities in connection with a construction, installation or assembly project no longer constitute a permanent establishment."³⁰ These comments are understood to reflect the views of the Japanese tax authorities and obviously favour the Australian taxpayer. However, there is no evidence to suggest that the Australian tax authorities accept this liberal interpretation.

It must be borne in mind that the test in Article 3(4) is an alternative test of whether a permanent establishment exists. Where an entity is carrying out supervisory activities in another country for periods of up to six months, it would not be unlikely that the entity would have a "fixed place of business" in that country. This fixed place of business could be an on-site office or hotel room, from which the entity is operating. In such a case, the entity would be caught by the general definition of permanent establishment in Article 3(1). It is immaterial whether the premises are owned or rented by, or are otherwise at the disposal of, the entity.³¹

This view is supported by the extract from the OECD Model Commentary related above.³² The OECD Commentary is saying that an on-site office used only for planning and supervising activities is not a permanent establishment when the site or project is not a permanent establishment. It is not saying that an entity carrying out *only* planning and supervisory activities in connection with a site or project in another country will never have a permanent establishment in that country. In fact, the entity could well have a permanent establishment where the entity has use of an on-site office and the site is a permanent establishment.

There is further indication from the OECD Model Commentary on Article 5(1) that supervisory activities are not *entirely safe*. In discussing the general definition of "permanent establishment", the Commentary provides advice on a situation where a lessor leases equipment to a party in another country and also provides personnel after installation to operate the leased equipment in that other country. If the personnel's responsibilities are limited solely to operation and maintenance of the equipment under the direction of the lessee, no permanent establishment will be taken to exist.³³ If, however, the personnel have wider responsibilities, such as participating in decisions

29 Ibid at 16.

30 Above n 3 at 2.03[4].

31 Above n 22 at 4.

32 Ibid at n 16.

33 Reference may also be made to United States' Revenue Ruling 77-45, 1977-1 CB 413, which supports this.

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regarding the work for which the equipment is used, a permanent establishment could be deemed to exist. "When such an activity is connected with, or is similar in character to, those mentioned in paragraph 3, the time limit of 12 months applies."³⁴ In the latter case, the personnel would appear to be carrying out activities generally thought of as "supervisory activities" and these are interpreted as falling within the general definition of "permanent establishment". Where these activities are connected with a building site or construction or installation project, the commentary advises that the activities will constitute a permanent establishment if carried on for more than 12 months. In this case, then, even though supervisory activities are not mentioned in the OECD Model Convention, the provisions appear to apply to these activities in the same manner as it is expected that Article 3(4) of the Australia/Japan Treaty would apply. If this were indeed the case, the effect of Article 3(4) would then be to confirm that such a building site or construction, installation or assembly project being carried out by another party, may also be the permanent establishment of an entity carrying out only supervisory activities in relation to that project. The Article may only deem a permanent establishment to exist in practice in circumstances where a permanent establishment could also be found to exist under the OECD Model Convention.

Splitting the project

The express mention of a time limit leaves open the possibility of splitting the project into separate phases, each to be undertaken by a different entity. Provided each phase has a duration of less than six months, the activities might not be treated as constituting a permanent establishment. While this is a possibility, the test under Article 3(4) is an alternative test and the general definition or one of the other provisions of Article 3 could still apply to treat the activities as a permanent establishment, even though the six month period is not exceeded. Another possibility is that one entity, for example the parent company of a group of companies, could still be treated as carrying out supervisory activities for the entire period. Activities carried out by other entities could be treated as a subcontract arrangement.

Impact of the Treaty on the domestic law

Finally it is necessary to revisit the domestic tax position and consider how the Treaty may effect this, since domestic tax law in both Australia and Japan is generally subject to the Treaty.

Japan

The effect of a Treaty article cannot be to charge tax on income which would not otherwise be chargeable to tax under the domestic tax legislation. It will be recalled that, for a liability to exist under Japanese domestic tax law, the supervisory activities are generally required to be carried on for

³⁴ Above n 22 at 8.

more than 12 months. This being the case, no liability to Japanese tax should, *prima facie*, arise where such activities are carried out for 12 months or less, regardless of the six-month period in the Treaty. It is pertinent here, however, to refer to comments by Huston, Miyatake and Way, who warn that it would be "unwise to indulge in the assumption that the Japanese construction nexus and the OECD building site or construction or installation project permanent establishment are conceptually co-extensive. It is quite likely that they are not."³⁵ In fact, it should be noted that the Japanese construction nexus appears to be broader than the Treaty in two respects:

- it covers "supervising or superintending" activities, whereas the Treaty only covers supervisory activities; and
- it extends to activities *similar* to construction, installation or assembly projects.

It is difficult to determine the effect of these variations between the provisions in the Japanese domestic law and the Treaty. The differences may in fact arise only on translation and have little impact in practice. On this point, however, it should also be remembered that the Japanese calculation of the relevant time period may differ from the method used under the Treaty (if the OECD interpretation is adopted). Under the Japanese approach, separate contracts may be aggregated where the parties are the same and the projects are related.

Where separate contracts are aggregated for Japanese domestic tax purposes, the Treaty provisions may provide additional protection if those activities relate to separate projects and each project is for six or fewer months.

Australia

As discussed previously, a Japanese corporation carrying out supervisory activities in Australia in connection with a building site, or construction, installation or assembly project, would be liable to tax in Australia in respect of these activities under the domestic law. The Treaty will, therefore, generally relieve the Japanese corporation of this liability, where such activities are carried on for a period of six months or less. This assumes, of course, that none of the other provisions in Article 3 of the Treaty operate to treat the relevant activities as constituting a permanent establishment.

Conclusion

The great difficulty in interpreting Treaty provisions is in finding a universal meaning in the face of the complexities of commercial practices and the countries' varying tax laws. This is particularly the case where the domestic laws, the Treaty and the OECD Model Convention provide little

³⁵ Above n 3 at 2.02[4].

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guidance, as is the case with supervisory activities and permanent establishments. While reliance has been placed on the OECD Model Convention on the basis that it is a standard pattern for the negotiation of tax treaties, it must also always be borne in mind that each agreement is peculiar to itself, being freely negotiated between the relevant countries. This aside, it may be concluded from the above discussion that the provisions relating to supervisory activities and permanent establishments under both the Japanese law and the Treaty should be interpreted very broadly and that they should not be treated as necessarily being consistent.

Some tax planning opportunities may exist where preparatory activities are performed outside the foreign country, the contract is split into separate phases, or activities are carried out by an entity which is resident in a country subject to more advantageous Treaty provisions. Even so, it appears that an entity escaping the application of the supervisory activities provision could still fall foul of one of the other provisions of the permanent establishment Article and be treated as having a permanent establishment in any case.

Given the difficulties for a tax planner faced with the issue of supervisory activities and permanent establishments, it is hoped that the precedent set down in *Thiel's case*³⁶ will continue to be followed and that the Treaties will be applied in a manner in keeping with the aims of the OECD Model Convention: to avoid double taxation and to limit unwarranted interference in commercial affairs. Meantime, given the large number of unsolved issues, some of which have been raised in this paper, a tax planner would be wise to go carefully.

36 Above n 13.