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New United States – Japan Income Tax Treaty Signed

United States-Japan Income Tax Treaty (November 6, 2003)

Overview

On November 6, 2003, the new U.S.-Japan income tax treaty (the "Treaty") was signed. U.S. Senate and Japanese Diet approval is expected, and it is likely that the Treaty will become effective beginning in 2005 (but the reduced withholding rates could start in mid-2004). The Treaty eliminates the withholding tax on royalties, certain dividends and interest and generally updates the current U.S.-Japan income tax treaty, which went into effect on July 9, 1972.

Withholding Tax on Dividends and Branch Profits Tax

In a major change from prior practice, and going even farther than the recently activated U.S.-U.K. treaty, the Treaty provides a full withholding tax exemption for dividends paid by U.S. and Japanese corporations to corporate shareholders that own more than five percent of the dividend paying corporation's voting stock, and satisfy certain limitation on benefits provisions and have satisfied these conditions for at least 12 months. The Treaty reduces the current treaty's 10 percent withholding tax rate on dividends paid to 10 percent or more shareholders to five percent. The withholding tax rate is 10 percent for dividends paid to all other shareholders.

Japanese corporations with a U.S. permanent establishment (not including those that would be eligible to receive tax free dividends from a controlled subsidiary) will now be subject to the U.S. branch profits tax at a rate of five percent (reduced from the statutory rate of 30 percent). Under the current treaty, Japanese corporations are exempt from the branch profits tax.

Royalties and Interest

The Treaty eliminates withholding tax on royalties and that will be of major help to U.S. multinationals with foreign tax credit limitation problems.

Although the Treaty generally retains the 10 percent withholding tax on interest under the current treaty, the categories of interest that are exempt from withholding tax are expanded to include interest paid on debt held by financial institutions, including banks, insurance companies and pension funds, and on debt incurred to finance the purchase of equipment or merchandise.

Fiscally Transparent Entities and Limitation on Benefits

The Treaty modifies the rules on income derived by fiscally transparent and hybrid entities (including limited liability companies). The Treaty generally applies a two-step test to determine if such income is eligible for Treaty benefits. The first step looks to the internal law of the Treaty partner in which the payee of the income is resident to determine whether the entity or its members has earned or is the "owner" of the item of income. The next step is to determine whether the "owner" of the item of income qualifies for Treaty benefits.

The Treaty contains a fairly standard modern limitation on benefits provision, but, as in the new U.K. treaty, the provision is bolstered by special anti-conduit rules. Although the Internal Revenue Code contains an anti-conduit regime, it is a new concept for such rules to be specifically included in the body of a treaty.

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The limitation on benefits rule provides that a U.S. or Japanese resident is eligible for Treaty benefits if it is an individual, a governmental entity, a company or a subsidiary thereof whose stock is regularly traded on a "recognized stock exchange" (defined as any stock exchange established under the Securities and Exchange Law of Japan, the NASDAQ system, any exchange registered with the SEC as a national exchange under the Securities Exchange Act of 1934 and any other exchange agreed upon by the U.S. and Japanese competent authorities) or an entity that is owned or controlled by individuals or entities that are entitled to Treaty benefits. Certain entities (other than publicly traded companies) must also satisfy a "base erosion" test. Additionally, a resident of one country is eligible for Treaty benefits if it is engaged in a trade or business in the other country and the income at issue arises in connection with that trade or business. A U.S. or Japanese resident must generally satisfy the applicable limitation on benefits provision at least for the one-year period ending on the payment date of the relevant item (or the dividend declaration for dividends).

The anti-conduit provision supports the limitation on benefits provision. It denies Treaty benefits to items of income paid in a transaction or series of transactions in which the income recipient eligible for Treaty benefits is obligated to pay all or a substantial portion of the income item to a person not eligible for Treaty benefits and a "main purpose" of the transaction is to obtain Treaty benefits.

Transfer Pricing

The exchange of diplomatic notes accompanying the Treaty states that the parties will adhere to OECD transfer pricing guidelines in transfer pricing examinations and in competent authority proceedings. Although the exact intent of this provision is not clear, it seems to limit the ability of each taxing authority to assert a position that is inconsistent with OECD guidelines. For example, since OECD guidelines discourage the use of "secret comparables," a U.S. taxpayer could invoke this provision if the Japanese National Tax Administration made a transfer pricing adjustment based on secret comparables.

The body of the Treaty also includes transfer pricing provisions, including one that holds that a taxing authority must begin a transfer pricing examination within the seven-year period beginning on the end of the taxable year subject to examination and another limiting the attribution of profits to a permanent establishment.

Effective Date

The Treaty will generally go into effect on January 1 of the year following the year in which the parties exchange instruments of ratification. Under a special rule, the withholding tax provisions are effective on July 1 of a year if the instruments of ratification are exchanged prior to April 1 of that year. A taxpayer may elect treatment under the current U.S.-Japan treaty for an interim period if the current treaty provides greater relief.

Planning Considerations

The Treaty reflects changes in U.S. treaty policy first enacted in the new U.K. treaty. Since the Treaty is expected to go into effect in due course, all U.S. taxpayers with Japanese operations or Japanese source income and all Japanese taxpayers with U.S. operations or U.S. source income should review their tax planning in light of the Treaty. In particular, taxpayers may consider deferring payments that would be subject to withholding tax under current rules but not under the Treaty until the Treaty goes into effect.

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