January 31, 2013

Protocol to Japan-U.S. Tax Treaty

Japan and the United States Sign a Protocol Amending the Existing Japan-U.S. Income Tax Treaty

SUMMARY

On January 24, 2013, Japan and the United States signed a protocol, together with an exchange of notes related thereto, (the "Protocol"), amending the income tax treaty signed by the two countries in 2003 (as modified by a protocol and exchange of notes signed at the same time, the "Existing Treaty").

The Protocol makes a number of significant changes to the Existing Treaty, including the following:

- ***Interest***. Eliminates withholding tax on interest, subject to certain limitations;
- ***Dividends***. Expands the category of dividends eligible for zero rate of withholding tax;
- ***Capital Gains***. Amends the provisions of the Existing Treaty governing the taxation of capital gains in a manner that permits the U.S. to fully apply the Foreign Investment in Real Property Tax Act ("FIRPTA");
- ***Arbitration***. Provides for resolution through mandatory binding arbitration of certain cases that the competent authorities have been unable to resolve after a reasonable period of time, consistent with a number of recent U.S. tax treaties; and
- ***Exchange of Information and Mutual Assistance***. Provides for mutual assistance in the collection of taxes and also provides for the full exchange of taxpayer information between the tax authorities of each country.

These changes will bring the Existing Treaty into closer conformity with the current tax treaty policies of both the U.S. and Japan.

The Protocol will enter into force upon ratification by both countries and apply (i) in respect of withholding taxes, to payments made on or after the first day of the third month next following the date on which the Protocol enters into force, and (ii) in respect of other taxes, for taxable periods beginning on or after the January 1 following the date on which the Protocol enters into force. The mandatory arbitration provision

will apply to cases that are under consideration by the competent authorities as of the date on which the Protocol enters into force or that come under consideration after such date. The exchange of information and mutual assistance provisions will have effect from the date of entry into force of the Protocol.

DISCUSSION

Dividends

The Protocol relaxes the requirements to exempt intercompany dividends from withholding tax by eliminating the source-country withholding tax on dividends paid by a company (resident in one country) where the beneficial owner of the dividends is a company (resident of the other country) that has owned *at least 50 percent* (instead of "more than 50 percent" under the Existing Treaty) of the voting power of the company paying the dividend for a period of *six months* (instead of "twelve months" under the Existing Treaty) ending on the date on which entitlement to the dividends is determined. As with the Existing Treaty, specified limitation-on-benefits provisions must be satisfied by the recipient company.

Accordingly, a company that owns 50 percent of the voting stock in a 50/50 joint venture company could qualify for the zero rate for dividends.

Interest

The Protocol generally eliminates source-country withholding tax on interest. This is a significant enhancement of the Existing Treaty that eliminates the withholding tax completely only for limited cases.

Consistent with other U.S. treaties, this exemption from source-country withholding tax on interest will not apply to so-called "contingent interest." Specifically, interest that is determined by reference to receipts, sales, income, profits or other cash flow of the debtor or a related person, to any change in the value of any property of the debtor or a related person or to any dividend, partnership distribution or similar payment made by the debtor or a related person, or any other interest similar to such interest, may also be taxed in the state in which it arises and according to the laws of that state; however, consistent with the Existing Treaty, if the beneficial owner of the interest is a resident of the other state, the tax will not exceed 10 percent.[1]

The Protocol retains the special rules in respect of interest that is borne by a permanent establishment of the payor. Under these rules, if the permanent establishment is situated in Japan or the U.S., the interest

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[1] The Protocol retains the anti-abuse exception on excess inclusions from entities used to securitize real estate mortgages or other assets to the extent that the amount of interest paid exceeds the return on comparable debt instruments as specified by the law of that state.

shall be deemed to arise in such country; if the permanent establishment is situated in a country other than the U.S. or Japan, the interest shall not be deemed to arise in either the U.S. or Japan.[2]

The Protocol also retains the so-called "anti-conduit" rules in respect of certain "back-to-back" loan arrangements (in addition to the general limitation-on-benefits provision). In particular, a resident of Japan or the U.S. will not be considered the beneficial owner of interest in respect of a debt-claim if such debt-claim would not have been established unless a person that is not entitled to the same or more favorable treaty benefits and that is not a resident of either Japan or the U.S., held an equivalent debt-claim against such Japanese or U.S. resident. The exemption from source-country withholding tax under the Protocol will therefore not be available in respect of such arrangements.

Capital Gains

The Protocol amends the provisions of the Existing Treaty in a manner that permits the U.S. to fully apply FIRPTA. Under the Existing Treaty, the source-country generally has a right to tax gains from the sale of shares in a company that derives at least 50 percent of its value directly or indirectly from real property situated in that state, and from the sale of an interest in a partnership, trust or estate to the extent that its assets consist of real property situated in that state. While the Existing Treaty thus largely preserves U.S. taxing jurisdiction over the gain derived by a resident of Japan from the sale of direct or indirect interests in U.S. real property, it waives some U.S. taxing jurisdiction with respect to these gains by relaxing certain definitional requirements. For instance, under the Existing Treaty, the testing of whether a domestic company is a U.S. real property holding corporation ("USRPHC") is performed on the date of disposition and not throughout the five-year testing period provided under FIRPTA.[3] In addition, while both the Existing Treaty and FIRPTA provide an exclusion for dispositions of small share interests in USRPHCs traded on an established securities market, FIRPTA requires that such shares be "regularly" traded and provides a five-year testing period for the five-percent interest. The Protocol references the definition of "U.S. real property interest" under FIRPTA (in respect of real property situated in the U.S.) and thus incorporates FIRPTA into the treaty.[4]

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[2] While interest borne by a permanent establishment that is situated in a country other than the U.S. or Japan will not be eligible for benefits of the treaty, it may be eligible for benefits of the tax treaty, if any, between the country in which the permanent establishment is situated and the country of which the beneficial owner of the interest is a resident.

[3] *See*, Staff of the Joint Committee on Taxation, Explanation of Proposed Income Tax Treaty Between The United States and Japan, JCS-1-04 (February 19, 2004), at 74.

[4] The term "U.S. real property interest" also includes certain foreign corporations that have elected to be treated as U.S. corporations for this purpose. Section 897(i) of the U.S. Internal Revenue Code. The Existing Treaty also preserves the non-exclusive right of the state of source to tax gains from the sale of an interest in a partnership, trust or estate to the extent that its assets consist of real property situated in that state. This provision is consistent with Section 897(g) of the U.S. Internal Revenue Code that is incorporated under the Protocol by referencing the definition under FIRPTA. The provision of the Existing Treaty permitting distributions by a REIT, to the extent attributable to gains

(*footnote continued*)

Similarly, the Protocol expands Japan's taxation rights in respect of real property situated in Japan. Under the Protocol, Japan is permitted to tax U.S. residents on capital gains arising from the sale of shares of a company holding real property situated in Japan. Under the Existing Treaty, Japan is only permitted to tax such U.S. residents on the sale of shares of a Japanese company.

Arbitration

The Protocol introduces a mandatory arbitration provision (similar to those in a number of recent U.S. treaties and protocols).[5] Under this provision, where the competent authorities are unable to reach agreement using the mutual agreement procedures of the Existing Treaty after a reasonable period of time, the case shall be resolved through arbitration.

This mandatory arbitration procedure will not be applicable if the competent authorities agree that (i) a decision has been rendered by a Japanese or U.S. court or administrative tribunal; (ii) the case is not "suitable for resolution through arbitration"; or (iii) the case arises only through the consultation between the two competent authorities under the mutual agreement provisions dealing with double taxation not otherwise addressed in the treaty.

If a concerned person does not accept the determination of the arbitration panel, the determination will not be binding; otherwise, the determination shall constitute a resolution by mutual agreement under the treaty and shall be binding on both Japan and the U.S.

The Protocol provides several procedural rules, and the competent authorities may agree on other procedures as necessary for the effective and timely implementation of the mandatory arbitration provision.

A senior official of the U.S. Department of the Treasury has recently commented that mandatory arbitration would likely be a feature in an expected update to the U.S. Model Income Tax Convention.

Exchange of Information

The Protocol updates the rules for the exchange of taxpayer information between the tax authorities of the U.S. and Japan. The Protocol clarifies that such rules shall not be construed so as to impose on Japan or the U.S. the obligation to obtain or provide information that would reveal confidential

(*footnote continued*)

from the sale by the REIT of real property situated in the U.S., to be taxable by the U.S. under the capital gain provision of the treaty, is no longer required in light of the reference to "U.S. real property interest" and of Section 897(h) of the U.S. Internal Revenue Code, which provides that distributions from a REIT are treated as the sale of a U.S. real property interest, rather than a dividend, to the extent attributable to gain realized by the REIT on the sale of U.S. real property interests.

5 Other treaties that have a mandatory arbitration mechanism include Canada, Belgium, Germany and France. In addition, a protocol signed by Spain and the U.S. on January 14, 2013 includes a similar mandatory binding arbitration provision.

communications between a client and an attorney, solicitor or other admitted legal representative where such communications are produced for the purposes of seeking or providing legal advice or for the purposes of use in existing or contemplated legal proceedings.

The Protocol also states that Japan or the U.S. may not decline to provide information, because such information is held by financial institutions, nominees or persons acting in an agency or fiduciary capacity. This provision would effectively prevent Japan or the U.S. from arguing that its domestic bank secrecy laws (or similar legislation relating to disclosure of financial information by financial institutions or intermediaries) override its obligation to provide information. The Protocol also requires the disclosure of information regarding the beneficial owner of an interest in a person, such as the identity of a beneficial owner of bearer shares. These provisions are consistent with other recent U.S. tax treaties.[6]

In addition, the Protocol clarifies that a state is obligated to obtain the requested information even if that state has no direct tax interest in the case to which the request relates.

Mutual Assistance

The Protocol adds rules that would enable the tax authorities to assist each other in the collection of taxes in much broader cases than the Existing Treaty. Under the Existing Treaty, such assistance is limited to the extent necessary to ensure that treaty benefits are enjoyed only by persons entitled to those benefits. Under the Protocol, the tax authorities will also lend assistance in the collection of certain taxes (including costs of collection and other expenses) in respect of residents of Japan and the U.S. in specified circumstances. With respect to taxpayers that are companies, assistance is required where a resolution has been achieved under the mutual agreement procedure, the taxpayer company has terminated such procedure, or the tax claim was not eligible for such procedure. With respect to individuals, assistance is required generally in cases of fraud or willful evasion.

The Protocol makes clear that the tax authorities will lend assistance to each other, only insofar as the taxation is not contrary to the treaty, to any other agreement to which Japan or the U.S. are parties, and only to the extent allowable under the laws of Japan and the U.S. In addition, the mutual assistance provision will not obligate Japan or the U.S. to carry out administrative measures at variance with the laws or the administrative practices of either Japan or the U.S., or measures which would be contrary to public policy.

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6 We note in this regard that on June 21, 2012, the U.S. Department of the Treasury jointly issued a statement with Japan expressing mutual intent to pursue a framework for intergovernmental cooperation to facilitate the implementation of the Foreign Account Tax Compliance Act (“FATCA”) and improve international tax compliance based on the Existing Treaty.

Other Changes

- The Existing Treaty provides that the competent authorities will seek to determine a single state of residence of dual resident entities for treaty purposes. Under the Protocol, such dual residents will not be considered residents of either the U.S. or Japan.
- The Protocol eliminates the exemption available under the Existing Treaty for visiting teachers and researchers in respect of any remuneration for teaching or research. However, teachers and researchers entitled to such benefits at the time of entry into force of the Protocol will generally continue to be entitled to such benefits.
- The Protocol amends the rules that allow Japanese residents, subject to Japanese law, a credit against Japanese tax for tax payable in the U.S. in accordance with the treaty and the rules that allow the exclusion of certain intercompany dividends paid by a U.S. company to a Japanese company from Japanese taxable income.
- The Protocol includes a number of other relatively minor changes and clarifications to the Existing Treaty.

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