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Practical Issues Regarding the Application of the New Japan-U.S. Tax Treaty

The “Convention Between the Government of Japan and the Government of the United States of America for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income” which was executed in November 2003 (hereinafter referred to as the “New Treaty”) came into practical effect on July 1, 2004. The Treaty reduces the withholding tax rate to a significant extent, providing a reduced tax liability as compared to other tax treaties. On the other hand, the Treaty contains new rules and measures, which do not exist in other tax treaties.

Among these new rules and measures, the one which will have the greatest effect in practical terms is the “Limitation of Benefit Treaty (LOB Treaty)”. This clause is to ensure that only “eligible” entities may receive New Treaty tax benefits and to avoid treaty shopping by entities who are not eligible for tax benefits under the New Treaty, but who contemplate receiving these benefits through satisfying certain conditions (Article 22). As a result, on submitting the Application form for income tax convention to the tax authorities, it is now necessary for applicants to identify that such “eligibility” under the New Treaty.

It has been almost half a year since the application of the New Treaty was commenced, and certain practical issues have been raised, regarding the confirming of “eligibility”. This article presents these issues and explains the procedure for the application of the new Treaty.

I. Application form to apply for reduced tax rate

In order to apply for the reduced tax rate provided under the US and Japan tax treaty on dividends, interest and royalties payable by Japanese entities, an “Application form for income tax convention” must be submitted to the Tax Office by a recipient of income (a US resident) through a withholding agent (a Japanese entity). This enables the withholding agent to withhold the tax by applying a reduced tax rate under the New Treaty. The Application form for income tax convention should be submitted to the District Director of the Tax Office by the withholding agent (a payer) by a date prior to that of the first payment.

It should be noted that in order to apply for the reduced tax rate under the New Treaty, an “Application form for LOB Treaty” must be submitted. The submission of the “Application form for

income tax convention” alone is not sufficient. The question may then arise of what the “Application form for LOB Treaty” is and what difference there is between the normal “Application form for income tax convention” and the “Application form for LOB Treaty”. In practice, the “Application form for LOB Treaty” comprises of the “Application form for income tax convention” and an “Appendix with regard to the special clause (Form 17)”. This means that by attaching Form 17 to the “Application form for income tax convention”, it is considered that the “Application form for LOB Treaty” has been submitted to the Tax Office.

II. Attached documents to the “Application form for income tax convention”

1. In case of dividends and interest

If dividends or interest are to be tax exempted, it is necessary to attach to a document certifying that the payee is a resident of a country where tax exemption is eligible (this should be issued by US government) to the application form. Such a document must certify that the resident is eligible for tax exemption, not an ordinary certificate of residence. If such a certificate is not available, then an alternative document may be acceptable, provided that it states that the payee is a person eligible for tax exemption (this should be translated into Japanese). Currently, the US government states that it will not issue such certificates, so alternative documents should be obtained. Although clear instructions have not been given, it is considered that a document prepared by an accounting firm would suffice.

2. In the case of royalties

In the case of royalties, a document describing the contents of the royalty agreement and a certificate of residence must be attached to the application form. Under the New Tax Treaty, royalties are tax exempted without any specific requirement, so it is not necessary to prove that a payee is eligible for tax exemption under US tax law. The document describing the contents of the royalty agreement should identify the contents of the rights of the royalty, the agreement terms and agreement sum, so only a copy of the agreement describing clauses identifying such items would be sufficient.

3. Necessary document for special clause

The document identifying that the payee is an “eligible person” for the special clause of Article 22 of the New Tax Treaty should be attached to the Appendix with regard to the special clause (Form 17). Specifically, Form 17 should be filled in and documents clarifying the filled items should also be attached to confirm the description. Such a document would be sufficient as long as it shows that the payee is the listed company. A copy of a newspaper article or a copy of a

shareholder description of an annual report (in case of a subsidiary of the listed company) is acceptable. It is not necessary to request the securities exchange market to issue an official certificate that the payee is a listed company therein. In the case of the submission of Form 17, a certificate of residence must be also attached, even if tax exemption of above 1 and 2 is being sought. In conclusion, the submission of the certificate of residence is required in all cases for an application for New Tax Treaty.

III. Submission due

The “Application form for LOB Treaty” should be submitted at each payment by the withholding obligator to the District Director of the Tax Office. However, if the generation of income is the same at source and reason, its submission is not necessary, provided that the “Application form for LOB Treaty” was submitted within three (3) years prior to the date of the payment. This means that if the income source is the same (royalty, for example, under the same agreement), the Application may be submitted once every three (3) years.

IV. US certificate of residence

In order to obtain a US certificate of residence (Form 6166), it is necessary to file Form 8802 with the IRS. This would require more than one (1) month to obtain the certificate. Questions may arise as to how to cope in the case where Form 6166 is not available at the time of the dividend payment and as to whether a reduced tax rate may apply in such a case.

Basically, the withholding agent may not apply for the New Tax Treaty unless the complete set of documents have been received. If any document is missing, it would be necessary that the withholding agent withhold the tax at the tax rate prescribed under Japanese Income Tax law, not that under the tax treaty. In practice however, the withholding obligator may contact the Japanese tax authorities to give advance notice that the Form 6166 may be submitted later on, provided that the payee is a US resident and that the Form 6166 can be obtained with certainty.

Furthermore, Form 6166 should be submitted to each payer (the withholding agent). If a US company receives royalties from more than one Japanese company, Form 6166 should be submitted to each Japanese paying company. There is the issue of whether a copy is permitted, or if an original form should be attached, since issuing multiple original Form 6166 is difficult in practice. So far, Japanese tax authorities have suggested that the original should be attached. However, we assume that the Japanese tax authorities will become more flexible, taking into

account that it is impractical to demand the original form for all documents, that copied forms would be no less valid and that the benefits under the tax treaty are permitted without any such restriction under domestic laws.

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