

New Japan-United Kingdom Tax Treaty

Japan and the United Kingdom have signed an income tax treaty (the “New Treaty”) that, if ratified by each country, will replace the current treaty (“Old Treaty”) that has been in force since 1970 (it was amended by a protocol signed in 1980). Since the implementation of the Old Treaty, there have been significant changes to the nature of the economic relationship and the investment activities between Japan and the United Kingdom, in addition to changes in the domestic tax regimes of both countries. Accordingly, the New Treaty represents a complete modernisation of the Old Treaty and is intended to stimulate investment between the two countries.

1. Withholding tax rates on dividends, interest and royalties

(1) Dividends

The New Treaty provides a reduced withholding tax rate on Dividends of 10%. In addition, 5% or 0% rates are provided for specific dividends that involve certain capital relationships.

* 5%: Dividends paid to a company holding, either directly or indirectly, at least 10% of the voting power in a company paying dividends for 6 months

* 0%: Dividends paid to a company holding, either directly or indirectly, at least 50% of the voting power in a company paying dividends for 6 months

Dividends paid by a company which can claim a deduction for dividends paid to its beneficiaries when computing its taxable income in Japan are not entitled to the reduced rate of 5% or exemption. This provision would be applicable to a Tokutei Mokuteki Kaisha (special purpose company), a J-REIT (Japan Real Estate Investment Trust) or an investment corporation established under the Law Concerning Investment Trusts and Investment Corporations.

* The six month holding period is determined from the date on which entitlement to the dividends is determined.

(2) Interest

The New Treaty provides reduced withholding rates of 10% on interest. This reduced rate is the same as that of the Old Treaty and is also incorporated in the new Japan-US income tax treaty. This reduced rate is applied not only to interest on Treasury Bonds or general bank deposits but also to interest on loans. Accordingly the withholding tax rate on interest on loans

is 10%, and this is paid by a Japanese subsidiary to a parent company based in the UK.

The following interests may only be taxed in the country in which the beneficial owner is a resident:

- * Government, a local authority, a central bank, or any institution wholly owned by the government;
- * A resident of a Contracting State whose debt claim is guaranteed, insured or indirectly financed by one of the above of the other Contracting State;
- * A bank, insurance company, securities dealer or other non-financial institution satisfying the specified asset/liability test;
- * A pension fund or pension scheme, provided that such interest is not derived from any business conducted by such pension fund or pension scheme; and
- * A resident whose debt claim arises as part of the sale on credit of equipment or merchandise.

(3) Royalties

Under the New Treaty, royalties may only be taxed in the country in which the beneficial owner is a resident. Accordingly no tax will be withheld on royalty paid to a company based in the UK. Also, a Japanese company will be able to receive a royalty payment from the UK without it being subject to tax, even though the UK domestic law stipulates a tax rate of 22%.

(4) Procedure for applying reduced withholding tax rates

Under the Old Treaty, in order for a resident of the United Kingdom to apply the reduced rates of tax in respect of dividends, interest or royalties in Japan, it was required to file the relevant "Application Form for Income Tax Convention" with the tax office (through the payer of the income).

Under the New Treaty, as a limitation of benefits ("LOB") article is included (please refer to 7. below), the following additional documents will be required (for payments from Japan to the United Kingdom):

- (i) Attachment Form For Limitation On Benefits Article (Form 17)*; and
- (ii) Certificate of United Kingdom residency.

* These forms were originally prepared for the purposes of the income tax treaty between Japan and the United States and will be amended for general use.

However, for the New Treaty to be applied in the UK, i.e., for Japanese companies to be able to claim treaty benefits such as tax exemption on interest or royalty, the approval of the UK Inland Revenue is required. However, since in the UK no tax is withheld on dividends domestically, it

is not necessary to carry out any specific procedure.

2. Capital gains arising from the sale of shares (Article 13)

Under the New Treaty the taxing rights are allocated to the source country upon capital gains being derived from the alienation of shares as stated below. Other gains may be exempt in the source country.

* Shares in a company or interest in a partnership or trust where such shares/interest derive at least 50% of their value (directly or indirectly) from immovable property located in another (or “the other”) Contracting State

* Shares in a company are deemed to be based in another (or “the other”) Contracting State in the following situations,

(i) Shares held or owned by the alienator (together with such shares held or owned by any other related persons as may be aggregated therewith) amount to at least 25% of the entire share capital of the company at any time during the taxable year or the year of assessment; and

(ii) The total number of shares alienated by the alienator and any related persons during that taxable year or the year of assessment amount to at least 5% of the entire share capital of the company.

However, only gains which are not subject to taxation in the Contracting State in which the alienator is resident may be taxed in the other Contracting State if the conditions of the 25%/5% “total issued shares” tests are met. In this regard, paragraph 5 of the Exchange of Notes provides that gains are to be regarded as subject to tax if:

(i) they are subject to tax in the same way as other gains derived from the disposal of shares; or

(ii) in the case of a corporate reorganisation, the laws of a Contracting State allow for the taxation of gains arising from the disposal of shares to be deferred, unless any gains from a subsequent disposal or reorganisation are subject to a statutory exemption.

* Moveable property that forms part of the business property of a permanent establishment in another (or “the other”) Contracting State

3. Transfer pricing

Both the Old Treaty and the New Treaty allow the profits of an enterprise of a Contracting State to be adjusted and taxed accordingly in the event that its transactions with an enterprise of another (or “the other”) Contracting State, to which it is related, differ from those that would be conducted between independent enterprises because of conditions made or imposed between

the two enterprises. However, the New Treaty provides that where profits are adjusted and taxed in a Contracting State, a corresponding adjustment shall be made in the other Contracting State if the same profits have been taxed in the other Contracting State and the Competent Authority of that other Contracting State agrees that the profits have been adjusted properly. The New Treaty also provides that the profits of an enterprise cannot be adjusted unless an enquiry into the profits of the enterprise is initiated within 7 years from the end of the taxable year or the chargeable period in which the profits should have accrued, unless there has been an incident of fraud or evasion. Under the domestic tax law of both Japan and the United Kingdom, the statute of limitations is 6 years, although in cases of fraud or evasion, the statute of limitations is extended to 7 years and 21 years respectively.

Article 25 of the New Treaty provides that where a resident of a Contracting State considers that the actions of one or both Contracting States results in taxation that is not in accordance with the treaty, it must present its case to the Competent Authority of the Contracting State in which it is resident within 3 years from the first notification of the action resulting in taxation that is perceived as being not in accordance with the treaty or, if later, within 6 years from the end of the taxable year or chargeable period in respect of which that taxation is imposed or proposed.

4. Limitation of benefits (LOB)

The New Treaty incorporates modern rules to ensure that the benefits of the treaty are enjoyed as intended by the businesses and residents of the two countries and to prevent improper exploitation of the treaty. Similar provisions were included in the new Japan-US income tax treaty.

Under the LOB test of the New Treaty, the following can be classified as a “qualified person”;

- * A company if the principal class of its shares is listed, registered or admitted to dealings on a recognised stock exchange and is regularly traded on one or more of an extended list of recognised stock exchanges;
- * A company (such as a subsidiary of a listed company or an owner company) whose 50% or more shares or other beneficial interests are held by other qualified person; and
- * A company: (i) whose shares representing at least 75% of the voting power of the company are owned, either directly or indirectly, by 7 or fewer persons who are equivalent beneficiaries; and (ii) satisfying other specified conditions of receipt of benefits under the relevant article.
- * An “equivalent beneficiary” is defined as a resident of a state that has concluded a tax treaty with the Contracting State (i.e. Japan or the United Kingdom) from which the benefits under the New Treaty are claimed.

In addition, an active business test and a competent authority test are provided in the New Treaty.

5. Other key points

(1) Tokumei kumiai arrangement (TK)

The New Treaty provides that TK distributions paid to a United Kingdom resident may be taxed in Japan pursuant to Article 20, thereby specifically excluding TK distributions from the other income article. Under the Japanese Income Tax Law, TK distributions are subject to withholding tax at the rate of 20%.

(2) Treatment of hybrid entities

The New Treaty provides specific rules for when dealing with income, derived from a Contracting State through an entity organised in the other Contracting State, which is treated differently in each Contracting State for tax purposes.

(3) Anti-conduit provisions

Articles 10 (dividends), 11 (interest), 12 (royalties) and 21 (other income) include anti-conduit provisions to prevent back-to-back arrangements that seek to take advantage of benefits available under the New Treaty. More specifically, these provisions stipulate that a resident of a Contracting State will not be considered to be the beneficial owner of the relevant item of income if the income would not have been paid to the resident had the resident not paid income in respect of the same property (preferred stock, debt-claims or licensed property) to a person who is: (i) neither a resident of Japan or the United Kingdom; and (ii) not entitled to benefits that are at least equivalent to those under the New Treaty.

6. Effective dates

The New Treaty will become effective on the thirtieth day after the date of exchange of diplomatic notes indicating approval by the Diet in Japan and Parliament in the United Kingdom.

Assuming that this will occur during the latter part of 2006, the New Treaty will be applicable as follows:

In Japan:

- (i) with respect to withholding taxes, it will be applicable to amounts taxable* on or after 1 January 2007 (1 January in the calendar year following that in which the New Treaty enters into force); and

(ii) with respect to other taxes, it will be applicable to income for fiscal years commencing on or after 1 January 2007 (income for any taxable year beginning on or after 1 January in the calendar year following that in which the New Treaty enters into force).

In the United Kingdom:

(i) with respect to withholding taxes, it will be applicable to amounts taxable* on or after 1 January 2007 (1 January in the calendar year following that in which the New Treaty enters into force);

(ii) with respect to income tax and capital gains tax, it will be applicable for any year of assessment beginning on or after 6 April 2007 (6 April in the calendar year following that in which the New Treaty enters into force); and

(iii) with respect to corporation tax, it will be applicable for any financial year beginning on or after 1 April 2007 (1 April in the calendar year following that in which the New Treaty enters into force).

* For dividends, payment liabilities determined on or after 1 January 2007. For interest and royalties, payments with due dates that fall on or after 1 January 2007.

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