US-Japan protocol exempts interest from source State taxation and reduces ownership for exemption from tax on certain dividends to 50%

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In brief

On January 24, 2013, the United States and Japan signed a new protocol and exchange of notes amending the existing 2003 income tax treaty, protocol and exchange of notes. The protocol is significant since it provides for exclusive residence State taxation of interest. In addition to other changes, the protocol expands the category of parent-subsidiary dividends exempt from source State taxation and allows the United States to fully apply the Foreign Investment in Real Property Tax Act (FIRPTA) rules with respect to capital gains. The protocol also establishes a mandatory arbitration procedure for the resolution of competent authority cases. Unlike the recent protocol with Spain, the protocol with Japan does not revise the limitation on benefits (LOB) article of the treaty.

In detail

Key provisions of the 2013 protocol and 2013 exchange of notes

Exclusive residence State taxation of interest

The protocol revises article 11 (interest) of the 2003 treaty generally to exempt all interest from source State taxation. Exceptions to the exemption apply with respect to (i) contingent interest (paralleling the comparable exception from the portfolio interest exemption under Section 871(h), which subjects such contingent interest to a ten percent maximum rate of tax, (ii) excess interest paid with respect to an ownership interest in an entity used to secure real estate (such as a REMIC), (iii) interest attributable to a permanent establishment in the other Contracting State, (iv) interest paid between related parties, to the extent the interest paid exceeds the amount that would be paid at arm's length (in such a case, tax may be imposed by the source State at a rate not to exceed five percent of the gross amount of the excess), and (v) interest paid pursuant to a back-to-back conduit arrangement.

Observation: The exemption from source State taxation is a significant favorable change from the 2003 treaty in that the taxation of interest under the protocol reflects a policy in US tax treaties that cedes interest taxation to the Residence State. The 2003 treaty contained a limited exemption from source State taxation in the case of interest beneficially owned by certain enumerated residents of the other Contracting State, including banks, investment banks, registered securities dealers and pension funds. In all other cases, interest beneficially owned by a resident of the other Contracting State is subject to a tax rate not to exceed ten percent.

The exclusion of interest paid pursuant to a back-to-back conduit arrangement from the benefits of article 11 is a provision that is not often seen in US tax treaties. The UK-US treaty, for example, contains a provision that the benefits of that treaty's interest article shall not apply with respect to interest paid pursuant to a 'conduit arrangement', although that treaty's language differs significantly from the protocol's language. In the case of the UK-US treaty, the corresponding Treasury Department Technical Explanation makes clear that the United States will interpret the rule of the treaty 'co-extensively and consistently with US domestic law', including the anti-conduit rules of Treasury Regulation sec. 1.881-3 and other regulations adopted under the authority of Section 7701(l). In this regard, it is unclear whether the language in the protocol imposes any interpretation or requirements in addition to the existing domestic anti-conduit rules.

Residence State taxation of parent-subsidiary dividends

Like a number of other recent US tax treaties and protocols, the 2003 treaty exempts certain parent-subsidiary dividends from source State taxation. For this provision to apply, the beneficial owner of the dividends must be a company that is a resident of the other Contracting State and that has owned, directly or indirectly through one or more residents of either Contracting State, shares representing more than 50% of the voting stock of the company paying the dividends. This ownership requirement must have been satisfied for the 12-month period ending on the date on which entitlement to the dividend is determined, and additionally, the beneficial owner of the dividends must satisfy additional criteria aimed at policing treaty shopping for the exemption from tax for dividends. The protocol is significant in that it further reduces the ownership percentage that must be satisfied from more than 50% of the voting stock standard in the 2003 treaty to at least 50% and also reduces the holding period from 12 months to six months. If the above criteria are not satisfied, source State taxation of dividends may be reduced to 5% of the gross amount of the dividends if the beneficial owner is a company that owns at least 10% of the voting stock of the company paying the dividends, and is reduced to 15% in most other cases (with special rules for RICs and REITs).

Observation: Every other US income tax treaty that eliminates source State taxation of parent-subsidiary dividends, including treaties negotiated or signed subsequent to the 2003 treaty, has an 80% ownership requirement. This change in the protocol that apparently decreases the ownership requirement to at least 50% was made in order for the 2003 treaty provision on taxation of parent-subsidiary dividends to be consistent with other recent amendments to bilateral treaties executed by Japan (e.g., the Japan-Switzerland treaty and the Japan-Netherlands treaty).

Residence: Dual-resident corporations no longer entitled to treaty benefits

The protocol amends the Residence article of the 2003 treaty by providing that in cases where a person, other than an individual, is a resident of both Contracting States, such a person is not considered a resident of either Contracting State for purposes of claiming benefits of the treaty.

Observation: The protocol is the only recently negotiated US tax treaty update that in effect precludes dual-resident corporations from obtaining treaty benefits.

Capital gains: full application of the FIRPTA rules

The 2003 treaty generally preserves the right of the source State to tax gains from the sale of a US real property interest (USRPI), which includes FIRPTA/US real property holding companies (USRPHCs). In this regard, the 2003 treaty specifically provides that gains derived by a resident of a Contracting State from the sale of a company's shares that is a resident of the other Contracting State (i.e., the source State) may be taxed in the source State provided the company whose shares were sold derives at least 50% of its value directly or indirectly from real property situated in the source State. An exception exists to source State taxation in cases where the relevant class of shares is traded on a recognized stock exchange (as defined in the 2003 treaty) and the resident or related persons own in the aggregate five percent or less of that class of shares. This 2003 treaty provision was intended to result in treatment comparable to Section 897(c), as confirmed by the Treasury Department's Technical Explanation of the 2003 treaty which cites to Section 897(c) and states, 'This paragraph thus permits the United States to tax US real property holding companies under its domestic law.' However, the language in the 2003 treaty was not entirely consistent with the requirements for shares in a US corporation to be treated as a US real property interest (USRPI) (e.g., status of a US corporation as a USRPHC at any time during a five-year testing period, and therefore a USRPI, is determined by reference to fair market value of its USRPIs). By defining the term 'real property situated in the other Contracting State' to include a USRPI in the case of the United States, the protocol removes any doubt about the application of the capital gains article in the case of gain from the sale of a USRPI.

LOB article: no changes indicating a more restrictive policy

Unlike the recent protocol signed between the United States and Spain (see the January 24, 2013 *US Tax Treaty Newsalert, "New protocol to US-Spain Treaty signals possible changes in US policy on limitation on benefits*"), the protocol with Japan does not significantly revise the LOB article.

Other revisions in the protocol

In addition to the points noted above, the protocol includes a mandatory arbitration procedure for certain potential double taxation cases that the competent authorities have not been able to resolve. (See the January 30, 2013 *PKN Alert, "New U.S.-Japan tax treaty protocol to introduce mandatory arbitration"*) The protocol also includes provisions relating to assistance in tax collection and increased information exchange. In addition to these changes in the exchange of taxpayer information, the US Treasury is currently negotiating with the Japanese tax authorities with respect to arrangements for the effective implementation of the Foreign Account Tax Compliance Act (FATCA).

Effective date

The protocol will enter into force on the date that the United States and Japan exchange the instruments of ratification. The protocol will be effective with respect to the withholding provisions on the first day of the third month following its entry into force. With respect to other taxes, it will be effective for taxable years beginning on or after January 1 following the date the protocol enters into force. Other provisions relating to the exchange of information, assistance in the collection of taxes and mutual agreement procedure have varying dates of effect.

Presently, the protocol has not been sent to the US Senate Foreign Relations Committee to begin the ratification process. Typically, the committee holds one hearing a year on tax agreements and does not schedule hearings until there is a critical mass of pending tax and trade agreements. Three bilateral tax agreements (a new income tax treaty with Hungary and protocols to the income tax treaties with Switzerland and Luxembourg) were reported out by the committee to the full Senate in 2011 with the recommendation that they should be approved. Ordinarily, the full Senate follows the recommendations of the committee, and generally will approve the proposed agreements by unanimous consent. However, these three pacts were not approved by the full Senate due to objections placed by Senator Rand Paul (R-Kentucky) under the normal unanimous consent procedures for treaty ratification, and no tax treaties have advanced through the Senate ratification process since that time. These procedural hurdles continue to leave the tax treaty ratification process in a state of flux for the time being.

The takeaway

Certain provisions of the Japan protocol (such as exemptions from source State tax on interest and certain dividends) reflect a modernization of the 2003 treaty consistent with US tax treaty policy. Unlike the recently signed United States-Spain protocol, the protocol does not reflect a fundamental shift in US tax treaty policy with regard to LOB provisions of the treaty.

Let's talk

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