



# Financial Services Tax News

Financial Services Tax Group

August 2006

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## New Japan-United Kingdom Tax Treaty

The Convention between Japan and the United Kingdom of Great Britain and Northern Ireland for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income and on Capital Gains (the "New Treaty") was signed on February 2, 2006. Upon completion of ratification by the two countries, the New Treaty will replace the current Japan-United Kingdom treaty, which was concluded in 1970.

This Newsletter focuses on amendments to the articles regarding dividends, interest, royalties, gains on share transfers, and *tokumei kumiai* profit distributions in the New Treaty. These amendments can be summarized as follows.

	<b>Current Treaty</b>		<b>New Treaty</b>	
<b>Dividends</b>	A company holding at least 25% of the voting power of the company paying the dividend for the 12 month period prior to the end of the accounting period	10%	A company holding, directly or indirectly, at least 50% of the voting power of the company paying the dividend for the 6 month period prior to the date on which entitlement to the dividends is determined	0%
			Pension funds or pension schemes	
			A company holding, directly or indirectly, at least 10% of the voting power of the company paying the dividend for the 6 month period prior to the date on which entitlement to the dividends is determined	5%
	Other than above	15%	Other than above	10%
<b>Interest</b>	Any beneficial owner	10%	Interest income received by the following beneficial owners: (a) Government, local authorities, debts claims guaranteed by Government certain bodies, (b) Banks, (c) Insurance companies, (d) Securities dealers, (e) Other non-financial institutions satisfying specified asset/liability tests (f) Pension funds or pension schemes	0%
			Other than above	
<b>Royalties</b>	Any beneficial owner	10%	Any beneficial owner	0%
<b>Gains on share transfer</b>	A share transfer deemed as a quasi-business transfer	Taxation in the source country	A share transfer deemed as a quasi-business transfer	Taxation in the source country
			Real estate holding company's share transfer	
<b>Tokumei-Kumiai (TK)</b>	Exemption from taxation in the source country	0%	No exemption from taxation in the source country	20%

## 1. Withholding tax on dividends, interests and royalties

### (1) Dividends

Under the New Treaty, dividends can be exempted from withholding tax when paid to a beneficiary who satisfies certain requirements. These requirements are satisfied when (1) dividends are paid to a corporation that owns 50% or more of the voting rights, directly or indirectly, in the corporation paying the dividend for the six month period prior to the date on which entitlement to the dividends is determined; or (2) when the dividends are paid to a pension fund or a pension scheme. A withholding tax rate of 5% is imposed on dividends paid to a corporation that owns 10% or more of the voting rights, directly or indirectly, for the six month period prior to the date on which entitlement to the dividends is determined. A withholding tax rate of 10% will apply in all other circumstances.

However, dividends paid by a *tokutei mokuteki kaisha* (a special purpose company often used in real estate investments in Japan) or a J-REIT (Japan Real Estate Investment Trust), which, subject to certain conditions, can deduct dividends paid from their income, are not entitled to either the 5% reduced rate or the full exemption. Dividends from these entities will instead be subject to a 10% withholding tax rate. Notwithstanding the above, dividends paid to a pension fund or pension scheme may still enjoy full exemption from withholding tax under the New Treaty.

With respect to dividends paid by a company in the United Kingdom, withholding tax is exempted under UK domestic tax law regardless of the application of any reduction or exemption permitted under the New Treaty.

### (2) Interest

Interest income received by certain entities (such as governmental entities, the central bank, pension funds and certain financial institutions) is exempt from withholding tax in the source country. For other circumstances, a 10% withholding tax will be imposed.

### (3) Royalties

Royalties are now exempted from withholding tax in the source country on income beneficially owned by a resident of the other contracting state.

## 2. Capital gains from sale of shares

### (1) Capital gains arising in the other Contracting State from the disposal of real estate holding company

Capital gains realized by a resident of a Contracting State from disposal of shares in a company situated in the other Contracting State, whose share value is derived at least 50%, directly or indirectly, from real estate situated in the other Contracting State may be taxed in the other Contracting State. There is a safe-harbor clause, under which minority shareholders are excluded from this rule if the relevant class of shares sold is traded on a recognized stock exchange and the resident and related persons hold in the aggregate 5% or less of that class of shares. In such case, the capital gains are not taxable in the source country.

### (2) Capital gains arising in the other Contracting States from the transfer of shares

With regard to profit realized by a resident of one Contracting State for the transfer of shares of a corporation incorporated in the other Contracting State, the source country, being the country where the corporation resides, will have the right to impose tax on the profit when the following requirements

are met:

- (a) If the shares held by the seller and other related persons amount to at least 25% of the total issued shares of such company at any time during the taxable year of the sale; and
- (b) If the total shares sold or transferred by the seller and related persons during the taxable year of sale amount to at least 5% of the total shares issued in the company.

This rule applies only when the capital gain is not taxed in one Contracting State.

### **3. Tokumei Kumiai (“TK”) profit distributions**

Under the current treaty, common market practice has been to consider TK profit distributions to a United Kingdom TK investor under a Japanese TK arrangement as exempt from the 20% withholding tax rate under Japanese domestic law. However, the New Treaty clarifies that TK profit distributions are subject to Japan’s 20% domestic withholding tax rate to non-resident investors.

### **4. Limitation on benefits**

Under The New Treaty, a comprehensive limitation of benefits provision is included in order to limit treaty benefits to qualifying residents of Japan and the United Kingdom. The limitation of benefit test applies to investment income that may be fully exempted under the New Treaty, including certain dividends, interest, royalties and capital gains.

The benefit in the New Treaty is available only to qualified persons, which definition includes individuals, qualified governmental entities, pension funds or pension plans, or the following:

- (a) A company if the principal class of its shares is listed, registered or admitted to dealings on a recognized stock exchange and is regularly traded on one or more recognized stock exchanges;
- (b) A company (such as a subsidiary of a listed company) 50% or more of whose shares or other beneficial interests are held by a qualified person;
- (c) Certain unit trusts and other trusts; and
- (d) A company - (i) in which 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) other specified conditions of receipt of benefits under the relevant articles are satisfied.

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

The New Treaty also contains anti-conduit rules and main purpose tests that are designed to limit treaty benefits together with general transfer pricing restrictions and in certain specified articles.

### **5. Effective dates**

The New Treaty will become effective on the 30th day after the date of exchange of diplomatic notes indicating approval by the Diet in Japan and Parliament in United Kingdom. If the New Treaty is implemented on or before December 31, 2006, it shall be applicable in the following manner:

(1) In Japan:

- (a) With regard to withholding taxes, it will be applicable to amounts taxable on or after January 1, 2007, or to receivables on or after January 1, 2007.
- (b) With regard to other taxes, the New Treaty is applicable to any taxable year commencing on or after January 1, 2007.

(2) In the United Kingdom:

- (a) With regard to withholding taxes, the New Treaty will be applicable to taxable amounts on or after January 1, 2007
- (b) With regard to income tax and capital gains tax, for any year of assessment beginning on or after April 6, 2007.
- (c) With regard to corporation tax, for any financial year beginning on or after April 1, 2007.

Qualifying conditions under the New Treaty are significantly more detailed than under the existing treaty and this extends to treaty application forms for Japanese tax remission. The above is a general summary only and investors are advised to seek detailed advice when applying or interpreting the provisions of the New Treaty to their particular circumstances.

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