

Japan Tax Update

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PwC Japan Tax Newsletter

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The New Convention between Japan and France for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion and Fiscal Fraud with respect to Taxes on Income

A Protocol to amend the Convention between Japan and France for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion and Fiscal Fraud with respect to Taxes on Income became effective on December 1, 2007. The new rules on the withholding tax are effective for payments made from January 1, 2008. The Protocol reduces the tax burden in the source country on interest, dividends and royalties significantly in order to enhance investments between Japan and France. In addition, the Protocol introduces new anti-avoidance provisions including a limitation on benefits provision. The range of amendments of the Protocol is so extensive than in effect the Old Treaty was totally renewed.

This Newsletter provides an update to our earlier newsletter in February 2007 released by the Financial Service Tax Group immediately after the amendment protocol was signed and outlines further details of the important changes. In this newsletter, the above convention will be referred to as "the Old Treaty" and "the New Treaty" before and after the amendments, respectively.

Zeirishi-Hojin PricewaterhouseCoopers
Kasumigaseki Bldg., 15F
2-5 Kasumigaseki 3-chome
Chiyoda-ku, Tokyo 100-6015
Telephone: 81-3-5251-2400
<http://www.pwc.com/jp/tax>

*connectedthinking

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Significant Amendments Provision by Provision

1) Dividends (Article 10)

The following reduced withholding tax rates will apply for payments from a source country:

	Old Treaty		New Treaty	
Dividends between affiliated companies	A qualified resident holding directly at least 15% of the voting rights of the company paying the dividend*	0%	A resident company in France holding directly at least 15%, or directly or indirectly at least 25% of the voting rights of the Japanese resident company paying the dividend*	0%
	A company holding directly at least 15% of the voting rights of the company paying the dividend*	15%	A resident company in France holding directly or indirectly at least 10% of the voting rights of a company resident in France paying the dividend	5%
Other than above	15%		10%	

* Please note that different criterion apply to a Japanese resident company receiving the dividend.

Under the Old Treaty, withholding tax rates of 5% for certain privileged affiliated companies (0%, if a qualified resident company who met certain conditions was the beneficiary of dividends) and 15% for other than certain privileged affiliated companies applied.

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 a) dividends are paid from a *French* resident company to a Japanese resident company that owns 15% or more of the outstanding shares, directly or indirectly, in the company paying the dividend for the six month period prior to the date on which entitlement to the dividends is determined; or b) dividends are paid from a *Japanese* resident company to a French resident company that owns 15% or more of the voting rights directly, or 25% or more of the voting rights directly or indirectly, in the company paying the dividend for the six month period prior to the date on which entitlement to the dividends is determined.

A withholding tax rate of 5% is imposed on dividends paid to a company 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.

2) Interest (Article 11)

The class of the beneficiaries in the other Contracting State who enjoy the exemption from the withholding tax on interest in the source country is broadened.

Old Treaty	New Treaty
<p style="text-align: center;">10%</p> <p>(interest income received by certain entities such as governmental entities, the central bank is tax exempt)</p>	<p style="text-align: center;">10%</p> <p>(interest income received by certain financial institutions beside the previous beneficiaries is tax exempt)</p>

Under the Old Treaty, a withholding tax of 10% was imposed on interest. However, a complete exemption applied if the interest was beneficially owned by the Contracting State, a local authority of the Contracting State, the central bank of the Contracting State or certain other institutions.

Under the New Treaty the withholding tax rate on interest of 10% is unchanged and the circle of the beneficiaries to whom the withholding tax exemption applies was broadened. The withholding tax exemption applies if:

- the interest is beneficially owned by the Contracting State, a local authority of the Contracting State, the central bank of the Contracting State or any institution wholly owned by the Contracting State;
- the interest is beneficially owned by a resident of the Contracting State with respect to debt-claims guaranteed, insured or indirectly financed by the Government of the Contracting State;
- the interest is beneficially owned by either a bank, an insurance company, a registered securities dealer or any other enterprises, which fulfills certain criterion*; or
- the interest is paid with respect to indebtedness arising as a part of the sale on credit by a resident of the Contracting State of equipment or merchandise**.

* "Enterprise, which fulfills certain criterion", is defined as follows: provided that in the three taxable years preceding the taxable year in which the interest is paid, the enterprise derives more than 50% of its liabilities from the issuance of bonds in the financial markets or from taking deposit at interest, and more than 50% of the assets of the enterprise consists of debt-claims against persons other than related parties.

** Please note that the seller of equipment or merchandise must not be identical with the beneficiary receiving interests but must be a resident of the same Contracting State as the beneficiary. The credit must be granted as a part of the sale of equipment or merchandise. Therefore, if the buyer of equipment or merchandise takes a credit in order to pay the price not as a part of the sale separately, the interest income is not exempt from the withholding tax.

3) Royalties (Article 12)

Under the Old Treaty a withholding tax of 10% was imposed on royalties. Under the New Treaty the withholding tax rate is reduced to 0%.

Old Treaty	New Treaty
10%	0%

4) Capital gains (Article 13)

The taxation of the capital gains from sale has not changed substantially.

Real estate holding company

Under the Old Treaty capital gains realized by a resident of a Contracting State from disposal of shares in a company, whose main assets consists of, directly or indirectly, real estate situated in the other Contracting State might be taxed in the other Contracting State. Under the New Treaty capital gains realized by a resident of a Contracting State from disposal of shares in a company, 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. Under the New Treaty the real estate holding company is clearly defined.

Under the Old Treaty the gains derived from the sale of shares in a real estate holding company with real estate situated in the other Contracting State was not taxed in the other Contracting State, if the shares were traded on the recognized stock exchange. This exception is abolished under the New Treaty.

5) Social security contribution (Article 18)

If a resident individual of a Contracting State renders services in that Contracting State, social security payments made in the other Contracting State according to the agreement between Japan and France on Social Security* are deductible from the taxable income in that Contracting State where the individual is resident. This provision applies starting with resident income tax for the 2008 tax year.

*"The Agreement between Japan and France on Social Security" eliminates the double coverage by both the Japanese and French Social Security systems and makes it easier to qualify for benefits by allowing Social Security credits for amounts paid to either country. Prior to the agreement, if work was covered by both the French and Japanese Social Security systems, expatriates in a subsidiary or a representative office and their employer normally were required to pay Social Security taxes to both countries for the same work. The agreement between Japan and France allows people who work to pay the contributions to one single Social Security system. They are covered principally only by the Social Security system of the state in which they work. However people who work temporarily for less than 5 years in the other state can continue to be covered only by the Social Security system of the state of origin.

6) Tokumei Kumiai (Article 20 A)

The New Treaty provides new rules under which gains or profit distributions arising from a TK contract or similar contract in the source country may be taxed under the domestic law of the source country. The New Treaty clarifies that TK profit distributions paid by a Japanese TK operator to a French TK investor are subject to Japan's 20% domestic withholding tax rate.

Limitation of benefits (Article 22A)

The benefits in the Old Treaty were available principally to residents in the other Contracting State who fulfilled the conditions provided in the particular provision providing such benefits. Under the New Treaty, exemptions from withholding tax on investment income applies more broadly. However, anti-avoidance provisions combating the use by residents of third states of legal entities established in a Contracting State with a principal purpose to obtain the benefit of the New Treaty have been tightened. Therefore a comprehensive limitation of benefits provision is included in order to limit treaty benefits to qualifying residents of Japan and France. The limitation of benefit test applies to the following income (in the following as "the tested income"):

- business income (Article 7)
- dividends that may be fully exempted (Article 10 Paragraph 3)
- interests that may be fully exempted (Article 11 Paragraph 3)
- royalties (Article 12)
- capital gains (Article 13)
- other incomes (Article 22)

There is no limitation of benefit on income other than tested income such as dividends that may be taxed with a reduced withholding tax rate of 5/10%. Principles of the limitation of benefits are as follows:

- a) Requirements of a qualified person
The benefit in the New Treaty is available only to qualified persons, which by definition includes individuals, qualified governmental entities, publicly traded companies or subsidiaries of qualified persons.
- b) Requirements of a sub qualified person
A company in which shares representing at least 75% of the outstanding shares or voting rights of the company are owned, either directly or indirectly, by 7 or fewer persons who are equivalent beneficiaries is also entitled to the benefits. "Equivalent beneficiaries" are qualified persons and residents of third states who satisfy the following requirements:
 - The Contracting State at source has a convention with the third state in which the effective information exchange is provided;
 - The resident is a qualified person according to the limitation of benefits provision of the double tax treaty between the Contracting State and the third state, or in the absence of the limitation of benefits provision in that double tax treaty, the resident would be a qualified person, if the New Treaty would apply to; and
 - The resident would be entitled to a lower tax rate with respect to the tested income according to that double tax treaty between the Contracting State and the third state and the requirements thereof would not be more restrictive.
- c) Active business test
An active business test is provided under which a person not entitled to benefits as a qualified person may nonetheless be granted benefits with regard to the tested income. Active income is defined as income which is derived in connection with, or incidental to a business, if the resident of a Contracting State is engaged in that Contracting State in the active conduct of the business. If the resident of a Contracting State derives tested income from a business activity in the other Contracting State, the conditions set out above shall be considered to be satisfied only if the business activity carried on by the resident in that Contracting State is substantial in relation to the business activity carried on by the resident in the other Contracting State.
- d) Authorization of the competent authority
The competent authority of a Contracting State at source is authorized to determine that it is appropriate to grant benefits even in situations where none of the other tests of a) to c) is met in a case in which the tax payer did not use legal entities with a principal purpose to obtain the benefit of a tax treaty.

Specific Rules for the Treatment of Income Derived through Fiscally Transparent Entities (Article 4 Paragraph 6)

There are cases where an entity of a Contracting State deriving income from the other Contracting State, in which the entity is subject to tax, is not treated as resident of that Contracting State because the income is taxed at the beneficiary, member or participant level. In these cases the entity is subject to tax in the other Contracting State but would not be entitled to benefits in the Contracting State provided by the convention as the entity would not be a resident in the Contracting State.

Under the New Treaty an item of income which is derived through an entity which is treated differently in Japan and France for taxation purposes shall be eligible for the benefits of the New Treaty in the source country under certain conditions if such entity is a resident of that other Contracting State and satisfies any other conditions for the benefits specified in the New Treaty depending on the taxation rules in the Contracting State in which the entity is organized.

Cases	Benefits
An item of income is derived from a Contracting State (source country) through an entity organized in the other Contracting State (residence country), the income of which is taxed at the beneficiary, member or participant level	An item of income with regard to the part received by the beneficiary, member or participant who is a resident of the other Contracting State is eligible for benefits
An item of income is derived from a Contracting State (source country) through an entity organized in the other Contracting State (residence country), the income of which is taxed at the entity level	Eligible for benefits
An item of income is derived from a Contracting State (source country) through an entity organized in the Contracting State, the income of which is taxed at the beneficiary, member or participant level in the Contracting State but at the entity level in the other Contracting State	Not eligible for benefits

Effective Dates

The new treaty is applicable in the following manner:

	France	Japan
Withholding taxes	Applicable to taxable amounts on or after January 1, 2008	Applicable to amounts taxable on or after January 1, 2008
Other taxes on income	Applicable to income in any calendar year or taxable year commencing on or after January 1, 2008	Applicable to any taxable year commencing on or after January 1, 2008
Other taxes	Applicable to any taxable events on or after January 1, 2008	Applicable to any taxable year commencing on or after January 1, 2008

For more information, please consult your international tax representative or contact any of the following members listed below:

Zeirishi-Hojin PricewaterhouseCoopers
Kasumigaseki Bldg. 15F
2-5 Kasumigaseki 3-chome
Chiyoda-ku, Tokyo 100-6015
Telephone: 81-3-5251-2400
<http://www.pwc.com/jp/tax>

Jack Bird	813-5251-2577	jack.bird@jp.pwc.com
Masanori Kato	813-5251-2536	masanori.kato@jp.pwc.com
Yumiko Arai	813-5251-2475	yumiko.arai@jp.pwc.com
Nobuko Yamashita	813-5251-2763	nobuko.yamashita@jp.pwc.com
Fumiko Amano	813-5251-2693	fumiko.f.amano@jp.pwc.com