

Japan Tax Update

Monthly tax update

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New Japan-United Kingdom Tax Treaty

On 2 February 2006, Japan and the United Kingdom 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 (as amended by a protocol signed in 1980). The New Treaty is accompanied by a Protocol and an Exchange of Notes which provide further explanation of certain articles, and will become effective after each country has completed its respective constitutional procedures for ratification (in Japan, approval by the Diet).

Since the execution of the Old Treaty, there have been significant changes to the nature of the economic relationship and 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. Significantly, the New Treaty provides for substantial reductions in withholding taxes imposed on cross-border dividends, interest, and royalties, including the complete elimination of source-country withholding taxes on royalties and certain interest and intercompany dividend payments and exemptions for pension funds on certain income. The New Treaty also incorporates modern rules to ensure that 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 incorporated in the new Japan-US income tax treaty.

This Newsletter focuses on the key features of the New Treaty:

1. **Withholding tax rates on dividends, interest and royalties**
2. **Procedures for applying reduced tax rates**
3. **Capital gains arising from sale of shares**
4. **Income from Tokumei Kumiai arrangements**
5. **Anti-conduit provisions / main purpose tests**
6. **Transfer pricing**
7. **Limitation on benefits**
8. **Treatment of hybrid entities**
9. **Effective dates**
10. **Final comments**

1. Withholding tax rates on dividends, interest and royalties

A summary of the primary changes to withholding taxes follows:

Dividends (Article 10)

Beneficial owner	Old Treaty	New Treaty
Beneficial owner is a resident of UK - A company holding at least 25% of voting power in company paying dividends for 12 months	10%	
Beneficial owner is a resident of Japan - A company holding at least 10% of voting power in company paying dividends	10%	
A company holding, directly or indirectly, at least 50% of voting power in company paying dividends for 6 months		0%
Pension funds or pension schemes, provided that such dividends are not derived from the carrying on of a business by the such pension fund or pension scheme		0%
A company holding, directly or indirectly, at least 10% of voting power in company paying dividends for 6 months		5%
Other than above	15%	10%

- The six month holding period is determined from the date on which entitlement to the dividends is determined. Paragraph 2 of the Exchange of Notes states that in the case of Japan, the date on which entitlement to dividends is determined is the end of the accounting period for which the distribution of profits takes place.
- Dividends paid by a company which can claim a deduction for dividends paid to its beneficiaries in computing its taxable income in Japan are not entitled to the reduced rate of 5% or exemption. This provision will be applicable to a Tokutei Mokuteki Kaisha (special purpose company), a J-REIT (Japan Real Estate Investment Trust) and an investment corporation established under the Law Concerning Investment Trusts and Investment Corporations.

Interest (Article 11)

Beneficial owner	Old Treaty	New Treaty
All beneficial owners	10%	
<ul style="list-style-type: none"> • Government, local authority, central bank or institution wholly owned by 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 specified asset/liability test 		0%

<ul style="list-style-type: none"> • Pension fund or pension scheme, provided that such interest is not derived from the carrying on of a business by the such pension fund or pension scheme • A resident whose debt claim arises as part of the sale on credit of equipment or merchandise 		
Other than above		10%

- In the case of a special relationship between the payer and beneficial owner or between both of them and another person, if the amount of interest exceeds an arms length rate, the provisions under Article 11 will only apply to the arms length portion of the interest amount.

Royalties (Article 12)

Under the Old Treaty, royalties can be taxed in the country of source; however, the tax imposed is limited to a maximum of 10% of the gross amount of the royalties.

Under the New Treaty, royalties may only be taxed in the country in which the beneficial owner is resident.

In the case of a special relationship between the payer and beneficial owner or between both of them and another person, if the amount of the royalty exceeds an arms length rate, the provisions under Article 12 will only apply to the arms length portion of the royalty amount.

2. Procedures 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 must file the relevant "Application Form for Income Tax Convention" with the tax office (through the payer of such income).

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

- Attachment Form For Limitation On Benefits Article (Form 17)*;
- Certificate of United Kingdom residency; and
- If applicable, List of Members of Foreign Company or List of Partners of the Entity (Form 16)*.

* 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.

The above forms are also necessary to claim treaty benefits in respect of other income and capital gains.

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

Capital gains derived by a resident of a Contracting State from alienation of:	Taxing rights allocated to source Contracting State	Taxing rights allocated to source Contracting State
	Old Treaty	New Treaty
Immoveable property situated in other Contracting State	Yes	Yes
Shares in a company or interest in partnership or trust where such shares/interest derive at least 50% of their value (directly or indirectly) from immoveable property located in other Contracting State ¹		Yes
Shares in a company resident in other Contracting State ² (other than above)	Yes	Yes
Moveable property forming part of the business property of a permanent establishment in other Contracting State	Yes	Yes
Other than the above	No	No

4. Income, profits and gains from Tokumei Kumiai (TK) arrangements (Article 20)

Under the Old Treaty, profit distributions made to a United Kingdom resident TK investor are exempt from Japanese tax pursuant to the other income article (Article 23).

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%.

1 An exemption is provided for shares or interests that are traded on a recognised stock exchange [defined in Article 22(7)(c)] where the alienator, and persons related or connected thereto, own in the aggregate 5% or less of that class of shares or interest.

2 Under the Old Treaty, gains may be taxed if:

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

Under the New Treaty, the above requirements are retained with some minor modifications (e.g. the 25%/5% "entire share capital" tests were changed to 25%/5% "total issued shares" tests). However, a significant change is that only gains which are not subject to tax in the Contracting State in which the alienator is resident may be taxed in the other Contracting State if 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 is subject to a statutory exemption.

5. Anti-conduit provisions / main purpose tests

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 specify that a resident of a Contracting State will not be considered the beneficial owner of the relevant item of income if the income would not have been paid to the resident unless the resident pays income in respect of the same property (preferred stock, debt-claims or licenced 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.

In addition, Articles 10, 11, 12 and 21 include a main purpose test. This test provides that if the main purpose, or one of the main purposes, of the creation or assignment of shares, debt claim, licenced property or other property in respect of which income is paid (as the case may be), is to take advantage of the benefits available under the relevant article, no relief shall be available.

6. Transfer pricing (Article 9)

Both the Old Treaty and the New Treaty allow the profits of an enterprise of a Contracting State to be adjusted and taxed accordingly where its transactions with an enterprise of the other Contracting State with which it is related differ from those which would be made 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 an adjustment to the profits of an enterprise cannot be made unless an enquiry into the profits of the enterprise is initiated within 7 years from the end of the taxable year or chargeable period in which the profits should have accrued, unless there has been 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 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.

7. Limitation on benefits (Article 22)

The New Treaty includes a LOB test to ensure that benefits under the New Treaty are available only to a "qualified person". The LOB test applies to the following benefits available under the New Treaty:

- Article 7 (business profits)
- Article 10, paragraph 3 (dividend withholding tax exemption)
- Article 11, paragraph 3 (interest withholding tax exemption)
- Article 12 (royalties)
- Article 13 (capital gains)
- Article 21 (other income)

Qualified person test

A resident of a Contracting State is a “qualified person” if the person is:

- (a) an individual;
- (b) a qualified governmental entity (defined as the Government of a Contracting State, any political subdivision or local authority thereof, the Bank of Japan, the Bank of England or a person that is wholly owned, directly or indirectly, by the Government of a Contracting State or a political subdivision or local authority thereof);
- (c) a company if the principal class of its shares is listed, registered or admitted to dealings on a recognised stock exchange³ and is regularly traded on one or more of an extended list of recognised stock exchanges⁴;
- (d) a person other than an individual or a company if the principal class of units in that person is listed, registered or admitted to dealings on a recognised stock exchange³ and is regularly traded on one or more of the extended list of recognised stock exchanges⁴;
- (e) a pension fund or pension scheme (provided that as of the end of the prior taxable year or chargeable period more than 50% of the beneficiaries, members or participants are individuals who are residents of either Contracting State) or an organisation operated exclusively for a religious, charitable, educational, scientific, artistic, cultural or public purpose (or for more than one of these purposes), if all or part of its income or gains may be exempt from tax;
- (f) a person other than an individual if residents of either Contracting State that are qualified persons under (a), (b), (c), (d) or (e) above own, directly or indirectly, shares or other beneficial interests representing at least 50% of the voting power of the person; or
- (g) a trust or trustee of a trust in their capacity as such if at least 50% of the beneficial interests in the trust is held, directly or indirectly, by persons who are either:
 - (i) qualified persons under (a), (b), (c), (d) or (e) above; or
 - (ii) “equivalent beneficiaries”⁵.

3 Specified as (i) the London Stock Exchange and any other recognised investment exchange within the meaning of the Financial Services Act 1986 or, as the case may be, the Financial Services and Markets Act 2000; and (ii) any stock exchange established by a Stock Exchange or a securities dealers association under the terms of the Securities and Exchange Law (Law No.25 of 1948) of Japan.

4 In addition to the above, the Swiss Stock Exchange, the Irish Stock Exchange and the stock exchanges of Amsterdam, Brussels, Düsseldorf, Frankfurt, Hamburg, Johannesburg, Luxembourg, Madrid, Milan, New York, Paris, Singapore, Stockholm, Sydney, Toronto, Vienna, the NASDAQ System and any other stock exchange which the competent authorities agree to recognise.

5 An “equivalent beneficiary” is defined as 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 and:

- (i) that treaty contains provisions for effective exchange of information;
- (ii) the resident is a qualified person under LOB provisions in that treaty or, if the treaty does not contain LOB provisions, would be a qualified person when that treaty is read as including provisions corresponding to the definition of qualified person for the purposes of the New Treaty [or for the purposes of (g) above, a provision corresponding to (i)]; and
- (iii) the resident would be entitled under that treaty to a rate of tax that is at least as low as the rate applicable under the New Treaty with respect to the relevant item of income subject to the LOB test under conditions in that treaty which are no less restrictive than those under the New Treaty.

Where a resident of a Contracting State is a qualified person under (f) or (g) above, minimum periods of time over which it must have satisfied the relevant conditions are specified:

- in the case of withholding taxes, during the 12 month period preceding the date of payment of an item of income, profit or gain or, in the case of dividends, the date on which entitlement to the dividends is determined; and
- for all other cases, for at least half the days of the taxable year or chargeable period in which the relevant payment is made.

If a resident of a Contracting State does not meet the qualified person test, there are three further tests.

7 or fewer equivalent beneficiaries test

A company that is not a qualified person will still be eligible for benefits under the New Treaty if: (i) shares representing at least 75% of the voting power of the company are owned, directly or indirectly, by 7 or fewer persons who are equivalent beneficiaries; and (ii) the company satisfies other specified conditions for obtaining of benefits under the relevant article. In addition, the minimum time conditions discussed above are applicable.

Active business test

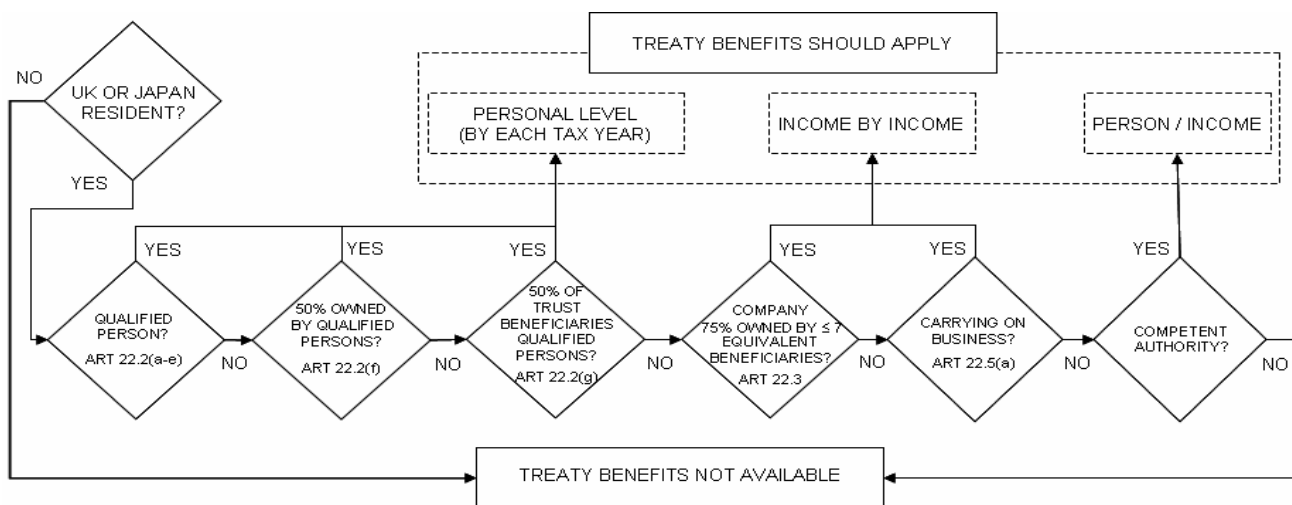
The active business test will be satisfied if the following conditions are met:

- (i) the resident is carrying on business in the country which it is resident (other than the business of making or managing investments for the resident's own account, unless the business is banking, insurance or securities business carried on by a bank, insurance company or securities dealer);
- (ii) the income, profits or gains derived from the other Contracting State is derived in connection with, or is incidental to, that business; and
 - [Regarding (ii) above, where the resident derives an item of income, profit or gain from a business carried on in the other Contracting State or derives an item of income, profit or gain arising in the other Contracting State from specified related parties, the business carried on in the country in which it is resident is substantial in relation to the business carried on in the other Contracting State (determined on the basis of all facts and circumstances)].
- (iii) the resident satisfies any other specified conditions in the relevant articles for the obtaining of benefits.

Competent Authority test

If a resident of a Contracting State does not satisfy the qualified person test, the 7 or fewer beneficiaries test or the active business test, the resident will be eligible for benefits under the New Treaty if the Competent Authority of the other Contracting State determines, in accordance with its domestic law or administrative practice, that the establishment, acquisition or maintenance of the resident and the conduct of its operations did not have as one of the principal purposes the obtaining of benefits under the New Treaty.

The application of the above LOB tests is summarised in the following diagram:



8. Treatment of hybrid entities (Article 4, paragraph 5)

The New Treaty provides specific rules 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.

Income, profit or gain derived from	Through entity organised in	Treatment of entity for tax purposes by Contracting State B	Availability of benefits
Contracting State A	Contracting State B	Pass-through	Treaty benefits available if beneficiary, member, or participant is resident of B and satisfies other conditions for eligibility under the treaty
Contracting State A	Contracting State B	Not pass-through	Treaty benefits available if entity is resident of B and satisfies other conditions for eligibility under the treaty
Contracting State A	Contracting State A	Not pass-through	Benefits not available

9. Effective dates (Article 28)

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 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, to amounts taxable* on or after 1 January 2007 (1 January in the calendar year next following that in which the New Treaty enters into force); and
- (ii) with respect to other taxes, 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 next following that in which the New Treaty enters into force).

In the United Kingdom

- (i) with respect to withholding taxes, to amounts taxable* on or after 1 January 2007 (1 January in the calendar year next following that in which the New Treaty enters into force);
- (ii) with respect to income tax and capital gains tax, for any year of assessment beginning on or after 6 April 2007 (6 April in the calendar year next following that in which the New Treaty enters into force); and
- (iii) with respect to corporation tax, for any financial year beginning on or after 1 April 2007 (1 April in the calendar year next 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, payment due dated falling on or after 1 January 2007.

10. Final comments

The New Treaty has also introduced subtle changes to the detailed articles, together with additional complexity accompanying the LOB tests and anti-conduit rules. Professional advice is strongly recommended when seeking to analyse entitlement to benefits under the New Treaty.

You have a vision. PricewaterhouseCoopers helps bring that vision to reality. We hope you enjoy the current issue of Japan Tax Update and appreciate your comments or ideas for what you'd like to see covered in future issues.

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