Protocol to US-Japan Tax Treaty Enters Into Force: Overview and Impact of Changes

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In brief

On August 30, 2019, the governments of Japan and the United States of America exchanged instruments of ratification for a new protocol to the US-Japan Tax Treaty, clearing the way for long awaited changes set out under the protocol to take effect. This News Alert discusses the changes, and the potential impact of such changes to companies doing business between the US and Japan.

In detail

1. Background – the long road to ratification

A protocol (the “Protocol”) to the US-Japan Tax Treaty (the “Treaty”), which implements various long-awaited changes, entered into force on August 30, 2019 upon the exchange of instruments of ratification between the Government of Japan and the Government of the United States of America. The Protocol was originally signed by the US and Japan on January 24, 2013.

While Japan ratified the Protocol in the Diet on June 17, 2013, ratification on the US-side had been held up in the Senate, which finally ratified the document on July 17, 2019.

2. Key changes to Treaty to be implemented under Protocol

- **Article 10（Dividend）and Article 11 (Interest)**

The Protocol provides for exclusive residence-country taxation of interest and of an expanded category of nontaxable dividends, as below.

	Existing Treaty	Protocol
Dividend	Requirement for exemption: (1) Holding more than 50% (2) Holding period of 12 months or more	Requirements for exemption: (1) Holding at least 50% (2) Holding period of 6 months or more
Interest	In principle: 10% Bank, etc.: Exempt	In principle: Exempt (Note 1)

(Note 1)
- ✓ Interest in excess of the arm’s length rate may be taxed at source at the rate not exceeding 5%.
- ✓ Treaty benefit may not be provided for interest related to a back-to-back loan arrangement.
- ✓ Interest that is determined by reference to the cashflow of the debtor, any change in the value of any property of the debtor or dividend, etc. may be taxed at source at the rate not exceeding 10%.
- ✓ Interest paid with respect to the ownership interests in an entity used for the securitization of real estate mortgages or other assets may be taxed at source to the extent that the amount of interest paid exceeds the return of comparable debt instruments as specified by the law of the contracting state.

- **Article 13 (Capital gains)**

Real property situated in the other contracting state shall include:
(a) real property referred to in Article 6;
(b) in case of Japan, shares or interests in a company, partnership or trust (Note 2) deriving the value of its property directly or indirectly principally from real property referred to in Article 6 and situated in Japan; and
(c) in case of the US, a US real property interest (Note 3).

(Note 2) Under the existing Treaty, it is applicable only to a Japanese resident company, etc., while under the Protocol, it could apply to any company including a foreign company.
(Note 3) IRC 897(c), including a US real property and shares in a company where more than 50% of its business assets consists of real property.

- **Article 15 (Director's remuneration)**

The diplomatic note adds an explanation that if a resident of a contracting state does not serve as a member of a board of directors of a company, this article does not apply to his remuneration regardless of his title or position. Also, where a member of the board of directors of a company also has other functions (for example, as ordinary employee, advisory or consultant) with the company, this article does not apply to remuneration paid to such a person on account of such other functions (Section 3 of the Japanese Note).

- **Article 23 (Avoidance of double taxation)**

This article is to be revised in accordance with the introduction of foreign dividend exemption rules. The shareholding requirement of 10% of voting stock of a company shall be changed to 10% of the total shares issued by the company.

- **Article 25 (Mutual agreement procedure)**

The Protocol provides for resolution through mandatory binding arbitration of certain cases that the revenue authorities of the United States and Japan have been unable to resolve after a reasonable period of time (i.e., 2 years).

3. Effective date

In principle, the Protocol shall have effect:
(a) in respect of taxes withheld at source, for amounts paid or credited on or after November 1, 2019;
(b) in respect of other taxes, for taxable years beginning on or after January 1, 2020.

4. Takeaways

- Repatriation of profits from joint ventures

The change of the threshold under the Protocol for exemption from dividend withholding tax to 50% or more places 50%/50% joint ventures in the same position as other majority-owned subsidiaries. This change should be welcome news to existing US/Japanese joint ventures, who have until now been outside the scope of the dividend withholding tax exemption under the Treaty. Likewise, the Protocol's new six month holding period aligns the Treaty with other Japanese tax treaties, and may work to facilitate additional cross border investment and trade.

- Cross border financing

Support for the establishment and development of business between the US and Japan using intercompany loans has historically been disadvantaged by 10% withholding tax on interest payments under the existing Treaty, in comparison to business operations between Japan and other key OECD jurisdictions, such as the UK, and (more recently) Germany. The elimination of this withholding tax should provide more flexibility in relation to treasury operations for multinational groups headquartered in the US or Japan and entitled to benefits under the Treaty, subject to any other restrictions on interest deductibility under either US or Japanese domestic law (e.g., BEAT in the former and earnings stripping in the latter).

- **Treaty not subject to OECD's multilateral instrument, but binding arbitration option will be available to taxpayers**

The US is one of a few OECD member states that did not ratify the OECD's Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting ("MLI"). Thus, certain measures that will apply under other Japanese tax treaties as a result of the MLI; including, for example, the new Principal Purpose Test ("PPT")[1], will not apply to the Treaty.

The Protocol will, however, make another provision from the MLI, mandatory binding arbitration, available to taxpayers where the competent authorities of the US and Japan fail to otherwise resolve any question of double taxation. The Protocol will thus make it possible for taxpayers to benefit from arbitration under the Treaty, without the necessity of satisfying certain standards required under the MLI.

- **Ability to request information regarding persons not resident in either state**

Consistent with global trends of greater transparency and sharing of information, and particularly with a US focus on reporting requirements under the Foreign Account Tax Compliance Act ("FATCA"), the Protocol will allow the competent authorities of Japan or the US to request information regarding persons not resident in either State, but who may have a permanent establishment, or hold a bank account, in either Japan or the US. For example, the competent authority of the US could request information from the competent authority of Japan regarding a third country national with an account in Japan, if the US believes that the funds in the account held by that national should have, but were not, reported in the US under FATCA.

This increased ability of the respective competent authorities to obtain information puts additional emphasis on the importance of compliance by taxpayers with each country's financial reporting and declaration standards.

[1] The PPT is an anti-abuse measure introduced under the MLI, which gives tax authorities the right to disallow treaty benefits for an item of income or capital "if it is reasonable to conclude […] that obtaining that benefit was one of the principal purposes of any arrangement or transaction that resulted directly or indirectly in that benefit […]".

Let's talk

For a deeper discussion of how this issue might affect your business, please contact:

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