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International Tax

United States Tax Alert

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Protocol signed to amend existing income tax treaty with Japan

On January 24, 2013, the United States and Japan signed a protocol ("proposed protocol") that would amend the existing income tax treaty and protocol ("2003 treaty" and "2003 protocol") to conform more closely to current tax treaty policies of the United States and Japan.

This alert outlines some of the key features of the proposed protocol as we understand them at this initial public stage in the process of moving the protocol toward entry into force. To the extent that provisions of the proposed protocol raise questions, developments between now and ratification may well answer them. For example, the U.S. Treasury Department most likely will issue a Technical Explanation (TE) at the time of the Senate Foreign Relations Committee hearing that will be held before the proposed protocol is ratified by the United States. The upcoming TE may provide significant additional guidance on some of the provisions of the proposed protocol.

Effective date provisions

The proposed protocol will take effect only if it is ratified by both contracting states. It will enter into force on the date of the exchange of the instruments of ratification. For withholding taxes, the 2013 protocol will apply to dividends and interest paid or credited on or after the first day of the third month following the date the protocol enters into force. For other taxes it will take effect for taxable years beginning on or after January 1 of the calendar year immediately following entry into force.

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Dividends and Interest

Dividends –Under the 2003 treaty, dividends paid by one resident of a contracting state to a resident of the other contracting state can qualify for an exemption from withholding tax if the resident of the first contracting state directly or indirectly owns "more than 50 percent of the voting stock of the company paying the dividends for the period of twelve months ending on the date on which entitlement to the dividends is determined…."[1] The proposed protocol generally would relax these requirements by dropping the ownership requirement from "more than 50 percent" to "at least 50 percent" and reducing the holding period requirement from twelve months to six months.

Interest – Interest, currently subject to a withholding tax of up to 10 percent[2] under the 2003 treaty, generally would be exempt from source country taxation under the proposed protocol, subject to standard exceptions (e.g. contingent interest and non-arm's length interest). These changes would make the 2003 treaty more consistent with the U.S. model treaty. The 2003 treaty, as amended by the protocol after it enters into force, would be Japan's first tax treaty to have such a provision on interest.

Interests in Real Property

The 2003 treaty limits the ability of the United States to tax dispositions of U.S. real property interests ("USRPIs") under FIRPTA. Under the 2003 treaty, the sale of shares in a domestic corporation is taxable if, at the time of the disposition, interests in U.S. real property comprise at least 50% of its value. In the case of shares in a publicly traded corporation, the 2003 treaty exempts from tax any shareholder who, together with related parties, has an ownership interest of 5% or less of the publicly traded shares at the time of the sale. In contrast, U.S. domestic law tests for U.S. real property holding company status, and greater-than-5% ownership, over a five-year look-back period (not just on the date of disposition).

In both of these respects, the proposed protocol would increase U.S. taxing jurisdiction over USRPIs to the full extent permitted by FIRPTA by amending the definition of real property in Article 13 to

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[1] See U.S.-Japan income tax treaty, Article 10.3(a).

[2] See generally U.S.-Japan income tax treaty, Article 11.2. However, there are certain exemptions in the U.S.-Japan income tax treaty from interest withholding for certain entities including banks, insurance companies, registered securities dealers, pension funds, and certain governmental entities, provided the associated requirements are met. See U.S.-Japan income tax treaty, Article 11.3(a)-(e).

include a “United States real property interest.” This change is consistent with the U.S. model treaty. As the term “United States real property interest” is not defined in the proposed protocol, the U.S. law definition of the term would presumably govern. Thus, in determining whether shares of a domestic corporation are real property, the disposition of which would be taxable under the proposed protocol, the statutory five-year look-back period would apply. Similarly, by adopting the definition of a U.S. real property interest from domestic U.S. law, the publicly traded exception is tightened: the shares must be “regularly traded,” and the exception is not available if the taxpayer’s ownership level exceeded 5% at any time during the five-year look-back period.

Other provisions

The proposed protocol would add a binding mandatory arbitration provision (binding on both competent authorities but not on the taxpayer) for mutual agreement procedure cases that the competent authorities are unable to resolve within a period generally of two years. Currently, there are four U.S. tax treaties in force (with Belgium, Germany, Canada, and France) that have such a provision; the pending protocols with Switzerland and Spain also include such a provision. The mandatory arbitration provision in the proposed protocol would apply to any dispute arising under the treaty, and would even apply to cases that the competent authorities are already considering when the protocol enters into force.

Additionally, the proposed protocol replaces Article 26 on the exchange of information and Article 27 on administrative assistance with broad provisions that are consistent with recent U.S. treaty policy and intergovernmental agreements under FATCA.

Conclusion

The proposed protocol should have a significant effect on cross-border investments between the United States and Japan. Many of the provisions, such as the complete exemption of interest income from withholding tax and mandatory binding arbitration, will be welcomed by investors and multinationals of both countries. Taxpayers potentially affected by these changes should watch for additional guidance that may emerge in the TE and other guidance.

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