

Japan: Inbound Tax Alert

Impact of OECD Multilateral Instrument on Japan's tax treaties

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In Brief

On 7 June 2017 representatives from 68 jurisdictions, including Japan, gathered together as signatories to the OECD's Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting (hereinafter the "Multilateral Instrument" or "MLI" for short). As signatory and party to the MLI, Japan has declared its position with regards to items included in the instrument and this will have impacts on the interpretation and application of a number of Japan's major bilateral tax treaties going forward. This newsletter briefly describes how the MLI modifies a treaty and how specifically the MLI will impact some of Japan's key existing treaties.

Applying the MLI

The MLI itself is a collection of proposed modifications to existing tax treaties based on the results of the OECD BEPS project, including modified treaty wording related to permanent establishments (PEs), anti-avoidance provisions, dispute resolution, and others. With respect to certain provisions, the MLI allows jurisdictions some flexibility to opt-in, choose alternatives, and/or reserve against. Collectively, these choices will form a jurisdiction's MLI position.

Under the MLI, an existing tax treaty that is in force between two jurisdictions and for which both jurisdictions declared that they wish to modify the treaty under the MLI is referred to as a Covered Tax Agreement ("CTA"). Generally, the MLI provisions will modify a CTA automatically (other than provisions requiring an affirmative opt-in), however, where one or both jurisdictions to a CTA choose to reserve the right for a specific provision to not apply, or where jurisdictions have differing MLI positions for a specific provision, such MLI provision would generally not modify the CTA.

After the MLI is in effect, to analyze the treaty impact on a particular transaction, companies will need to:

1. Understand whether the treaty in question is a CTA;
2. If yes, review the MLI to determine if there are provisions that could apply to the transaction;
3. If yes, review the MLI positions of each jurisdiction to the CTA to confirm whether the relevant MLI provision is applicable to such CTA. .
4. Analyze the treaty as modified by the MLI

Effective date

For the first five jurisdictions to ratify the MLI, it will enter into force on the first day of the month that follows a three month period beginning after the latest ratification. For each subsequent jurisdiction that ratifies the MLI, the MLI will enter into force on the first day of the month that follows a three month period from the date of such ratification. Further, with respect to a specific CTA, the MLI will enter into effect as follows:

1. with respect to withholding taxes, on the first day of the calendar year following the entry into force for both jurisdictions;
2. with respect to all other taxes, for taxable periods beginning on or after a six month period from the entry into force for both jurisdictions.

Impact on Japan's tax treaties

The chart and comments highlight the impact the MLI will likely have on some of Japan's major bilateral tax treaties with respect to certain MLI provisions. For details on the specific MLI provisions identified, please refer to the [MLI](#).

Category	Item (MLI provision)	US ¹	UK	HK	Singapore	Ireland	Germany	China
PE	Commissionaire/ Principal Role (Art. 12) ^{3,4}	N/A	N/A	N/A	N/A	N/A	N/A	N/A
	Prep/Aux (Art. 13(1)-(3)) ^{3,5}	N/A	N/A	N/A	N/A	N/A	Option A (Art. 13(2)) applies	N/A
	Anti-Fragment (Art. 13 (4)) ³	N/A	Art. 13(4) applies	N/A	N/A	Art. 13(4) applies	N/A	N/A
	Contract splitting (Art. 14)	N/A	N/A	N/A	N/A	N/A	N/A	N/A
Anti-Avoidance	Principal Purpose Test (Art. 7)	N/A	Art. 7(1) applies	Art. 7(1) applies	Art. 7(1) applies	Art. 7(1) applies	N/A ²	Art. 7(1) applies
Other	Capital gains (Art. 9)	N/A	N/A	N/A	N/A	Art. 9(4) applies	Art. 9(4) applies	N/A
	Third country PE (Art. 10)	N/A	N/A	N/A	N/A	N/A	Art. 10(1) – (3) applies	N/A

1. The US is not a signatory to the MLI, thus the US/Japan treaty is not a CTA, and none of the MLI provisions are applicable
2. The recently signed Japan-Germany treaty already includes a principal purpose test in-line with the MLI language.
3. Japan did not reserve the right for these provision to not apply.
4. Expands the definition of agency PE to include agents who play a principal role in concluding contracts (includes commissionaires).
5. Art. 13(2) requires all activities that otherwise would qualify as an exception to creating a PE to be preparatory or auxiliary in nature.

Note: For jurisdictions other than the US noted above where "N/A" is listed, this generally means that one or both parties to the CTA have reserved the right for that particular MLI provision to not apply or the parties have differing MLI positions.

Comments:

For the above mentioned CTAs, many of the MLI provisions related to PE will not apply despite Japan not reserving (i.e. the other jurisdiction opted out). Notwithstanding that, it should be noted that there is at least one example where the courts in Japan have interpreted an existing treaty in way that is broadly in line with the expanded PE definition under MLI provision Art. 13(2).

The inclusion of the principal purpose test (PPT) should have a significant impact on Japan's treaties, especially for those treaties that do not currently include comprehensive anti-tax avoidance provisions.

For certain CTAs, a one-year lookback period to determine whether a company is real estate rich, such that gains on the disposal of its shares, etc. would be taxable, will be added meaning that companies must examine whether the company was a real estate rich at any time during the 365 day period prior to disposal.

Deloitte's View

The overall impact of the MLI on Japan's tax treaties may be limited by the specific reservations (opt-outs) made by either party. However, as there will be some significant modifications (in particular with respect to the application of anti-avoidance measures), it will be important for taxpayers to understand whether the treaty provisions they have relied on in the past will still be available after the MLI comes into effect.

When analyzing the treaty impact of a transaction for a particular CTA, taxpayers will need to allocate additional time given that multiple documents (e.g. the MLI, each jurisdiction's MLI positions) will need to be reviewed. Further time may also be necessary to analyze the principal purpose test.

As a Japan court has previously interpreted a tax treaty in a way that is broadly in line with Art. 13(2) of the MLI, taxpayers that rely on the preparatory or auxiliary exception to having a PE in Japan may want to review their previous analysis (regardless of whether MLI Art. 13(2) will apply to the relevant treaty going forward).

As it is expected that the first modifications to a CTA will become effective in 2018, it is recommended to begin reviewing any current treaty positions and contemplated transactions involving a CTA as soon as possible.

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