KPMG Japan Tax Newsletter

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AMENDED JAPAN-US TAX TREATY

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The instruments of ratification for the protocol to amend the existing Japan-US tax treaty (Protocol) were exchanged between the two governments and entered into force on 30 August 2019. Although the Protocol was signed on 25 January 2013 (Japan time) and approved by the Japanese Diet on 17 June 2013, it took 6 years and 7 months from the signature to the enactment due to additional time necessary for US ratification procedures.

We have set out in this newsletter the timing of application of the Protocol and the main points of the amendments to the Japan-US tax treaty.

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I. Timing of Application

The Protocol will be applied as follows:

Taxes withheld at source	Amounts paid or credited on or after 1 November 2019
Other taxes	Taxable years beginning on or after 1 January 2020

Notwithstanding the above, the provisions of Article 25, 26 and 27 that were amended under the Protocol will be applied as follows:

Addition of paragraphs 5 through 7 (mandatory binding arbitration clauses) to Article 25 (Mutual Agreement Procedure)	This will be applied to the following cases: • Cases that are under consideration by the competent authorities as of 30 August 2019 (For such cases, the commencement date shall be 30 August 2019.) • Cases that come under consideration after 30 August 2019
Amendments to Article 26 (Exchange of Information) and Article 27 (Assistance in the Collection of Taxes)	These will be applied from 30 August 2019.

Please note that the 'grandfather' clause of Article 20 (Professors) that was abolished under the Protocol will be discussed in '5. Professors (Article 20)' below.

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II. Main Points of Amendments

We have set out in this section an outline of the main points of the amendments. Note that the details of each article and treaty shopping provision(s) such as the Limitation on Benefits (LOB) provision should be examined and relevant requirements met in order to obtain treaty benefits.

1. Dividends (Article 10)

Requirements to obtain exemption from withholding tax on dividends from subsidiaries will be relaxed as follows:

Reduced tax rates	Beneficial owner	
	Before amendment	After amendment
Exemption	A company holding directly or indirectly more than 50% of the voting stock of the dividend paying company for 12 months (Only when certain conditions of the LOB provision are met.)	A company holding directly or indirectly at least 50% of the voting stock of the dividend paying company for 6 months (Only when certain conditions of the LOB provision are met.)
5%	A company holding directly or indirectly at least 10% of the voting stock of the dividend paying company	No amendment
10%	Other than the above	No amendment

The reduced tax rates applicable to dividends received by pension funds, dividends paid by US Regulated Investment Companies (RICs) or US Real Estate Investment Trusts (US-REITs) and dividends paid by Japanese Tokutei Mokuteki Kaisha (TMKs) or Toshi Houjin (J-REITs), etc. are different from those indicated in the above table and were not amended.

2. Interest (Article 11)

Although interest received by financial institutions, etc. is exempt from tax at source under the pre-amended tax treaty, all interest will be exempt under the amended tax treaty in principle.

Reduced tax rates	Beneficial owner	
	Before amendment	After amendment
Exemption	• Contracting states, political subdivisions or local authorities thereof • Central banks • Banks • Insurance companies • Securities dealers • Pension funds, etc.	All
10%	Other than the above	

However, 'contingent interest' ((a) or (b) indicated below) will be subject to tax at a rate not exceeding 10 percent in the source country under the amended tax treaty.

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(a) interest determined by reference to the following:

- receipts, sales, income, profits or other cash flow of the debtor or a related person
- any change in the value of any property of the debtor or a related person
- any dividend, partnership distribution or similar payment made by the debtor or a related person

(b) any other interest similar to (a)

Note that certain interest paid with respect to the ownership interests in an entity used for the securitization of real estate mortgages or other assets (excess interest with respect to a residual interest of a real estate mortgage investment conduit (REMIC) in the US) are taxed in accordance with the domestic tax law of the source country, which will remain unchanged under the amended tax treaty.

3. Capital Gains (Article 13)

Under the Japan-US tax treaty, if a resident of a Contracting State transfers any of the following assets, the taxing rights on capital gains from such transfers are granted to the other Contracting State:

- Real property situated in the other Contracting State
- Shares in a company holding real property situated in the other Contracting State
- Shares in failed financial institutions of the other Contracting State
- Property forming part of the business property of a permanent establishment located in the other Contracting State

The second item in the above was amended as follows:

Before amendment	After amendment
Shares in a company that is a resident of the other Contracting State and that derives at least 50% of its value directly or indirectly from real property situated in the other Contracting State	(a) Where the other Contracting State is Japan Shares in a company deriving the value of its property principally, directly or indirectly, from real property situated in Japan (b) Where the other Contracting State is the US US real property interest

It is understood that the above amendments should have the following impacts:

(a) Where the other Contracting State is Japan

Japan had taxing rights over capital gains on transfers of shares in a Japanese company that derives at least 50 percent of its value directly or indirectly from real property situated in Japan under the pre-amended tax treaty. Under the amended tax treaty Japan has the right to tax capital gains on transfers of shares in a company (even if the company is not a resident of Japan) that

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derives the value of its property directly or indirectly principally from real property situated in Japan.

(b) Where the other Contracting State is the US

Under the amended tax treaty, the US has the right to tax capital gains on a transfer of a 'US real property interest' as defined under US domestic tax law. The term 'US real property interest' broadly means an interest in real property located in the US and any interest in a US corporation that constitutes a US real property holding corporation (i.e. a US corporation that derives at least 50 percent of its value from US real property interests) at any time during the 5-year period ending on the date of the disposal of the interest.

4. Directors' fees (Article 15)

Only the Japanese text of Article 15 was amended. The Japanese government has explained that the purpose of the amendment is to make the scope of persons covered by Article 15 for each country more consistent since there are differences in such scopes due to discrepancies between the domestic tax laws and corporate laws of the two countries.

Although directors (torishimariyaku), executive officers (shikkouyaku) and company auditors (kansayaku) are included in the definition of 'director' under Japanese domestic law and therefore are considered persons to be covered by Article 15 in Japan under the pre-amended tax treaty, the Japanese text of Article 15 has been amended so that only members of the board of directors (torishimariyaku-kai-no-kouseiin) will be covered by Article 15 under the amended tax treaty.

The Exchange of Notes related to the Protocol contains the following understanding between the two governments:

- It is understood that if a resident of a Contracting State does not serve as a member of a board of directors of a company, Article 15 does not apply to the person's remuneration regardless of the title or position of the person.
- It is understood that where a member of the board of directors of a company also has other functions (for example, as an ordinary employee, advisor, or consultant) with the company, Article 15 does not apply to remuneration paid to such a person on account of such other functions.

5. Professors (Article 20)

The Protocol deletes Article 20, which granted residents of one Contracting State who are temporarily present in the other Contracting State for the purpose of teaching or conducting research tax exemption in the other Contracting State under certain conditions.

The Protocol provides a 'grandfather' clause under which individuals receiving benefits under Article 20 as of 30 August 2019 will continue to be entitled to such benefits until such time as they would have ceased to be entitled to the benefits if the Protocol had not entered into force.

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6. Elimination of Double Taxation (Article 23)

Paragraph 1 of Article 23 providing for how to eliminate double taxation in Japan was amended under the Protocol.

Paragraph 1 of Article 23 of the pre-amended tax treaty includes a provision to relax the definition of eligible US subsidiaries for the purposes of the indirect foreign tax credit system. As the indirect foreign tax credit system was abolished and the Foreign Dividends Exclusion System (FDE)[*] was introduced under the 2009 tax reform, such paragraph has worked as a provision to relax the definition of eligible US subsidiaries for the purposes of the FDE system based on a provision in the domestic tax law.

[*] Under the FDE system, when a Japanese company receives dividends from its foreign subsidiary, the Japanese company is allowed to recognize only 5 percent of the dividends as taxable income. If a Japanese company owns at least 25 percent of the total shares or voting shares in a foreign company for 6 months or more, such foreign company is treated as an eligible foreign subsidiary for the purposes of the FDE.

Under the Protocol, the following amendments were made with respect to Paragraph 1 of Article 23:

- The provision to relax the definition of eligible US subsidiaries for the purposes of the indirect foreign tax credit system was amended to a provision to relax the definition of eligible US subsidiaries for the purposes of the FDE system. (As this change has already been achieved by the provision in domestic tax law, as discussed above, this amendment will not have any practical effects.)
- The relaxed definition of an eligible US subsidiary for a Japanese company was amended from 'a US company in which a Japanese company holds at least 10 percent of the voting shares for 6 months or more' to 'a US company in which the Japanese company holds at least 10 percent of the total shares for 6 months or more.'

7. Others

■ Mutual Agreement Procedure (Article 25)

The Protocol added new paragraphs 5 through 7 to Article 25 in order to provide for mandatory binding arbitration rules.

Under the newly introduced provisions, where a person has presented a case to the competent authority on the basis that the actions of one or both of the Contracting States of which the person is a resident have resulted for that person in taxation not in accordance with the provisions of this Convention, and the competent authorities of the Contracting States are unable to reach an agreement to resolve that case within 2 years, the case shall be resolved through arbitration conducted based on the request of the presenter.

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Exchange of Information (Article 26)

Article 26 was fully amended in line with the amended Article 26 of the OECD Model Tax Convention 2010. The Japanese Ministry of Finance has explained that there are no changes in substance from the pre-amended tax treaty.

Assistance in the Collection of Taxes (Article 27)

Article 27 provides that the Contracting States should lend assistance to each other in the collection of taxes. Although this article was applied only to cases of abuse of the tax treaty under the pre-amended tax treaty, the scope covered by this article was expanded and this article will be applied broadly to delinquent revenue claims under the amended tax treaty.

The kinds of tax covered by Article 27 in the case of Japan are income tax, corporation tax, special reconstruction income tax, special reconstruction corporation tax, consumption tax (excluding consumption tax imposed by a local authority), inheritance tax and gift tax.

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