KPMG Japan Tax Newsletter

18 October 2017

New Japan-Denmark Tax Treaty

On 11 October 2017, the Government of Japan and the Government of the Kingdom of Denmark signed the 'Convention between Japan and the Kingdom of Denmark for the Elimination of Double Taxation with respect to Taxes on Income and the Prevention of Tax Evasion and Avoidance' (New Tax Treaty). The New Tax Treaty wholly amends the current tax treaty that entered into force in 1968 (Current Tax Treaty) and is broadly in line with the OECD Model Tax Convention (*1) and the Multilateral Instrument (MLI) (*2).

(*1) The draft of the 2017 update for the OECD Model Tax Convention that reflects recommendations presented in the final reports of the Base Erosion and Profit Shifting (BEPS) project was released on 11 July 2017 for public comments.

(*2) The MLI (the formal title: 'Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting') was prepared based on the recommendation of Action 15 of the BEPS project and was signed by 67 signatories on 7 June 2017. The MLI is a mechanism to reflect recommendations under the BEPS project in existing tax treaties in an efficient manner. Although Japan and Denmark signed the MLI, as both countries did not choose the Current Tax Treaty as a Covered Tax Agreement of the MLI, the MLI will not apply to either the Current Tax Treaty or the New Tax Treaty.

We have set out in this newsletter the main points of the New Tax Treaty.

1. Permanent Establishment (Article 5)

Article 5 of the New Tax Treaty (expect for paragraph 4 providing for the treatment of drilling rigs, etc. for the exploration of natural resources) is in line with Article 5 of the draft of the 2017 update for the OECD Model Tax Convention.

- The clause with respect to the scope of agents to be treated as permanent establishments will be amended in order to prevent artificial avoidance of permanent establishment status through commissionaire arrangements and similar strategies.
- The clause to exclude specific activities from permanent establishment status will be replaced with a clause similar to the alternative clause proposed in the commentary to Article 5 of the draft of the 2017 update for the OECD Model Tax Convention, under which some specific activities do not create a permanent establishment regardless of whether or not they have a preparatory or auxiliary character. The anti-fragmentation rule will also be introduced.

2. Business Profits (Article 7)

Article 7 of the New Tax Treaty introduces provisions concerning taxation of business profits attributable to a permanent establishment of a foreign enterprise, under which business profits are calculated by recognizing internal dealings between a head office and its branches and by applying the arm's length principle. This is the same as Article 7 of the OECD Model Tax Convention, which adopted the Authorised OECD Approach as an approach to calculate income attributable to a permanent establishment.

3. Dividends (Article 10)

The reduced tax rates on dividends will be amended as follows:

<table>
<tr><th colspan="2">Current Tax Treaty</th><th colspan="2">New Tax Treaty</th></tr>
<tr><th>Beneficial owners</th><th>Reduced tax rates</th><th>Beneficial owners</th><th>Reduced tax rates</th></tr>
<tr><td rowspan="2">A company which owns at least 25% of the voting shares of the dividend paying company during the period of 12 months immediately before the end of the accounting period for which the distribution of profits takes place</td><td rowspan="2">10%</td><td>A company which has owned directly at least 10% of the voting power of the dividend paying company (in the case where the dividend paying company is a resident of Denmark, the capital of that company) for the period of 6 months ending on the date on which entitlement to the dividends is determined</td><td>0%</td></tr>
<tr><td>A pension fund</td><td>0%</td></tr>
<tr><td>Other than the above</td><td>15%</td><td>Other than the above</td><td>15%</td></tr>
</table>

4. Interest (Article 11)

The reduced tax rates on interest will be amended as follows:

Current Tax Treaty	New Tax Treaty
10%	0%

《Notes for the New Tax Treaty》

A reduced tax rate of 10 percent will be applied to contingent interest payments (payments of interest determined by reference to receipts, sales, income, profits or other cash flow of the debtor or a related person, to any change in the value of any property of the debtor or a related person or to any dividend, partnership distribution or similar payment made by the debtor or a related person, or any other interest similar to such interest).

5. Royalties (Article 12)

Royalties will be tax exempt in the source country under the New Tax Treaty.

Current Tax Treaty	New Tax Treaty
10%	0%

《Notes for the New Tax Treaty》

Under the New Tax Treaty, 'consideration for the use of, or the right of use, industrial, commercial or scientific equipment', 'receipts from a bare boat charter of ships or aircraft' and 'proceeds arising from the alienation of any copyright, etc.' will be excluded from the scope of royalties.

6. Capital Gains (Article 13)

The provision for capital gains will be amended as follows:

Capital gains derived by a resident of a Contracting State from the alienation of:	Taxing rights of the other Contracting State	
	Current Tax Treaty	New Tax Treaty
Immovable property situated in the other Contracting State	Yes	Yes
Property forming part of the business property of a permanent establishment in the other Contracting State	Yes	Yes
Property pertaining to a fixed base in the other Contracting State for the purpose of performing professional services	Yes	
Shares of a company being a resident of the other Contracting State (only where the 25%/5% test is met)(*1)	Yes	
Shares in a company or comparable interests, where at any time during the 365 days preceding the alienation, these shares or comparable interests derived at least 50% of their value directly or indirectly from immovable property situated in the other Contracting State(*2)		Yes
Ships or aircraft operated in international traffic	No	No
Any property other than the above	No	No

(*1) Where shares held or owned by the alienator amount to at least 25 percent of the entire share capital of such company at any time during the taxable period and the total of shares alienated by the alienator during that taxable year amounts to at least 5 percent of the entire share capital of such company, the 25 percent/5 percent test is met.

(*2) Where such shares or comparable interests are traded on a recognized stock exchange and the resident and persons related to that resident own in the aggregate 5 percent or less of the class of such shares or comparable interests, the taxing right on the capital gains will not be granted to the other Contracting State.

7. Entitlement to Benefits (Article 21)

Article 21 (Entitlement to Benefits) will be added to the New Tax Treaty in line with Article 29 (Entitlement to Benefits) of the OECD Model Tax Convention, which is proposed to be introduced under the draft of the 2017 update for the OECD Model Tax Convention. This provision includes the following clauses:

- Limitation on Benefits (LOB) clauses — a person will have to satisfy certain conditions such as a qualified person test in order to get tax exemption for dividends, interest and royalties in a source country.
- Principal Purpose Test (PPT) clause — in principle, a benefit under the New Tax Treaty will not be granted if it is reasonable to conclude that obtaining such benefits was one of the principal purposes of any transactions, etc.

8. Mutual Agreement Procedure/MAP (Article 24)

Although a taxpayer is allowed to raise a MAP request only to the competent authority of a Contracting State in which they are resident under the Current Tax Treaty, a taxpayer will be able to raise a MAP request to the competent authority of either Contracting State under the New Tax Treaty. In addition, clauses for arbitration proceedings will be newly introduced in Article 24 of the New Tax Treaty.

9. Other Notable Points

The New Tax Treaty includes the following new clauses/provisions:

- Persons Covered (Article 1) — a clause with respect to the tax treatment of hybrid entities
- Associated Enterprises (Article 9) — a clause for corresponding adjustments
- Assistance in the Collection of Taxes (Article 26)

The following provisions will be amended in lieu with the OECD Model Tax Convention:

- Resident (Article 4) — the tie-breaker rule for determining the treaty residence of dual-resident persons other than individuals (The draft of the 2017 update for the OECD Model Tax Convention)
- Exchange of Information (Article 25)

10. Entry into Force (Article 30)

After the approval in accordance with the domestic procedures of the two countries (approval by the national Diet for Japan), the New Tax Treaty will enter into force on the 30th day after the date of exchange of diplomatic notes indicating such approval.

The timing of application of the New Tax Treaty is as follows, in principle:

Taxes levied on the basis of a taxable year	Taxes for any taxable years beginning on or after 1 January in the calendar year next following that in which the New Tax Treaty enters into force
Taxes levied not on the basis of a taxable year	Taxes levied on or after 1 January in the calendar year next following that in which the New Tax Treaty enters into force

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