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United States - Senate Consents to Ratify Protocol Amending Treaty with Japan

On July 17, 2019, the U.S. Senate voted in favor of ratifying the Protocol between the United States and Japan that was signed by both countries on January 24, 2013.[1] The Protocol, which was approved by the United States Senate Foreign Relations Committee on June 25, 2019, contains amendments to the existing income tax treaty between the United States and Japan that bring the existing treaty into closer conformity with current U.S. and Japanese tax treaty policy. (For prior coverage, see GMS *Flash Alert* 2019-107 (June 26, 2019).)

WHY THIS MATTERS

The Protocol makes several modifications to the existing U.S.-Japan treaty that may affect international assignees and their employers. For example, the Protocol replaces the Interest article in the existing U.S.-Japan treaty with an article that generally grants a taxpayer's country of residence the exclusive right to tax interest income, with certain exceptions.

In addition, the Protocol deletes the article contained in the original treaty that exempts teacher compensation from host country taxation, and modifies the resourcing provision under the Relief from Double Taxation article, which reduces the potential of double taxation for Japanese residents.

Lastly, the Protocol replaces the Exchange of Information article in the existing treaty with a new article that follows the approach of the U.S. Model Income Tax Treaty and the Organization for Economic Cooperation and Development (OECD) Model Tax Convention on Income and Capital.

Entry into Force

The provisions in the Protocol will enter into force upon the exchange of instruments of ratification by the respective countries; however, the date on which the Protocol enters into force is not necessarily the date on which its provisions take effect. For example, the Protocol will have effect with respect to taxes withheld at source for amounts paid or credited on or after the first day of the third month following the date on which the Protocol enters into force. Thus, the exemption from source-country taxation for interest payments will only apply to interest that is paid or credited on or after the first day of the third month following the date on which the Protocol enters into force. All other provisions of the Protocol will go into effect on January 1 of the year following the year in which the Protocol enters into force. Thus, assuming the ratification process is completed by the end of 2019, the Protocol will be in effect for the 2020 U.S. tax year.

Taxation of Investment Income

The Protocol deletes the Interest article contained in the existing treaty (Article 11) and replaces it with language that largely conforms to the U.S. Model. Following this amendment, interest arising in one treaty jurisdiction and paid to a beneficial owner who is a resident of the other treaty jurisdiction is generally subject to tax only in the owner's country of residence. This is a departure from the rules contained in the previous Interest article, which allowed the source-country to impose up to a 10-percent tax on interest payments when the beneficial owner of the interest was a resident of the other treaty jurisdiction. However, the Protocol does include anti-abuse provisions that allow for source-country taxation in regards to contingent interest payments and certain payments from U.S. real estate mortgage investment conduits.

The Protocol also amends the provisions of the existing treaty that govern the taxation of gains from the disposition of real property located in a Contacting State by a resident of the other Contracting State by defining what constitutes "real property situated in the other Contracting State" for purposes of Paragraph 1 of Article 13 of the existing treaty. The technical explanation of the Protocol provides that "real property situated in the other Contracting State" consists of:

1) Interest in the real property itself.

2) When "the other Contracting State" is Japan, the term includes shares or interests in a company, partnership or trust deriving the value of its property directly or indirectly principally from real property in Article 6 and situated in Japan.

3) When "the other Contracting State" is the United States, the term includes a "United States real property interest." Under section 897(c) of the U.S. Internal Revenue Code, the term "United States real property interest" includes shares in a U.S. corporation that owns sufficient U.S. real property interests to satisfy an "asset-ratio" test on certain testing dates. The term also includes certain foreign corporations that have elected to be treated as U.S. corporations for this purpose.

As a result of the modification, not only are gains attributable to the sale of real property allowed to be taxed by the country in which the property is located, but gains from the disposition of one's interest in entities that derive their value from real property located in a Contracting State are also subject to source-country taxation.

Compensation for Teachers and Researchers

Article 20 of the original treaty provided that teachers and researchers who were temporarily present in a Contracting State in order to teach or conduct research at an educational institution located in that state were exempt from taxation in that state on the compensation they received for performing such services. This exemption was only valid for up to two years from the date the individual first visited the host country, and the individual was required to be a resident of the other Contracting State during the period of temporary presence in the host country in order to qualify for the benefits conferred under this article.

Article VII of the Protocol deletes Article 20 of the original treaty in its entirety, thus repealing the benefits granted under the original article. However, individuals entitled to the benefits of Article 20 of the original treaty at the time the new Protocol enters into force shall continue to be entitled to these benefits until such time as they would have expired under the terms of the original treaty.

Directors' Fees

Article VI of the new Protocol restates Article 15 of the existing treaty in order to correct an error that was present in the Japanese-language text of the existing treaty. While the correction aligns the Japanese text with the English text, the function of Article 15 does not change, as directors' fees and other similar payments derived by residents of a Contracting State for services performed in their capacity as members of the board of directors of a company which is a resident of the other Contracting State are still subject to tax in that other Contracting State. Additionally, the Technical Explanation of Article VI of the new Protocol mirrors the language provided in the Technical Explanation of Article 15 of the existing treaty by stating that Article 15 only applies to individuals who, regardless of title or position, are members of the board of directors of a company, and that the remuneration referenced in Article 15 must be attributable to services performed as a member of the board of directors and no other function.[2]

Other Provisions

Article IX of the new Protocol modifies the rules in relation to relief from double taxation under Article 23 of the existing treaty. This provision includes a re-sourcing rule whereby, if the treaty allows the United States to tax an item of income owned by a resident of Japan, that income will be deemed to be U.S.-source income for Japanese foreign tax credit purposes. This provision is intended to ensure that a Japanese resident can obtain a Japanese foreign tax credit for U.S. taxes in situations where the treaty grants primary taxing rights over an item of income to the United States.

Lastly, the Protocol replaces the Exchange of Information article in the original treaty with one that aligns with current U.S. transparency standards, and amends the mutual agreement procedure by implementing a mandatory and binding arbitration provision in cases where the competent authorities are unable to reach a settlement.

FOOTNOTES:

1 For the text of the Protocol, see https://www.treasury.gov/resource-center/tax-policy/treaties/Documents/Treaty-Protocol-Japan-1-24-2013.pdf . For the vote on this and other Protocols, see the U.S. Senate web page "Roll Call Votes 116th Congress - 1st Session (2019)" at: https://www.senate.gov/legislative/LIS/roll_call_lists/vote_menu_116_1.htm .

2 For the Treasury Technical Explanation of the Protocol Signed at Washington on January 14, 2013, see: https://www.treasury.gov/resource-center/tax-policy/treaties/Documents/2013-Technical-Explanation-Between-US-Japan.pdf .

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