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by Jason Connery, Douglas Poms, and Jennifer Blasdel

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SPECIAL REPORTS

Eligibility for Treaty Benefits Under the Japan-U.S. Income Tax Treaty

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To be entitled to benefits under income tax treaties, companies must satisfy eligibility requirements. This article includes flowcharts to help practitioners navigate the eligibility requirements of the Japan-U.S. income tax treaty[1] applicable to Japanese companies.

Income tax treaties may exempt business income from source country income taxes and eliminate or reduce domestic withholding taxes on payments between residents of countries that are parties to an income tax treaty. To be entitled to benefits under U.S. income tax treaties, a company must not only be a resident of the tax treaty partner's country, but generally must also satisfy at least one of the tests in the treaty's limitation on benefits provision, if applicable.

The flowcharts in this article focus on the eligibility of Japanese companies claiming benefits on income that would otherwise be subject to U.S. taxation. This article does not address the eligibility for treaty benefits of entities that are partnerships or are otherwise transparent for U.S. or Japanese tax purposes. This article is based on the treaty, the protocol to the treaty, and the U.S. Treasury technical explanation to the treaty.

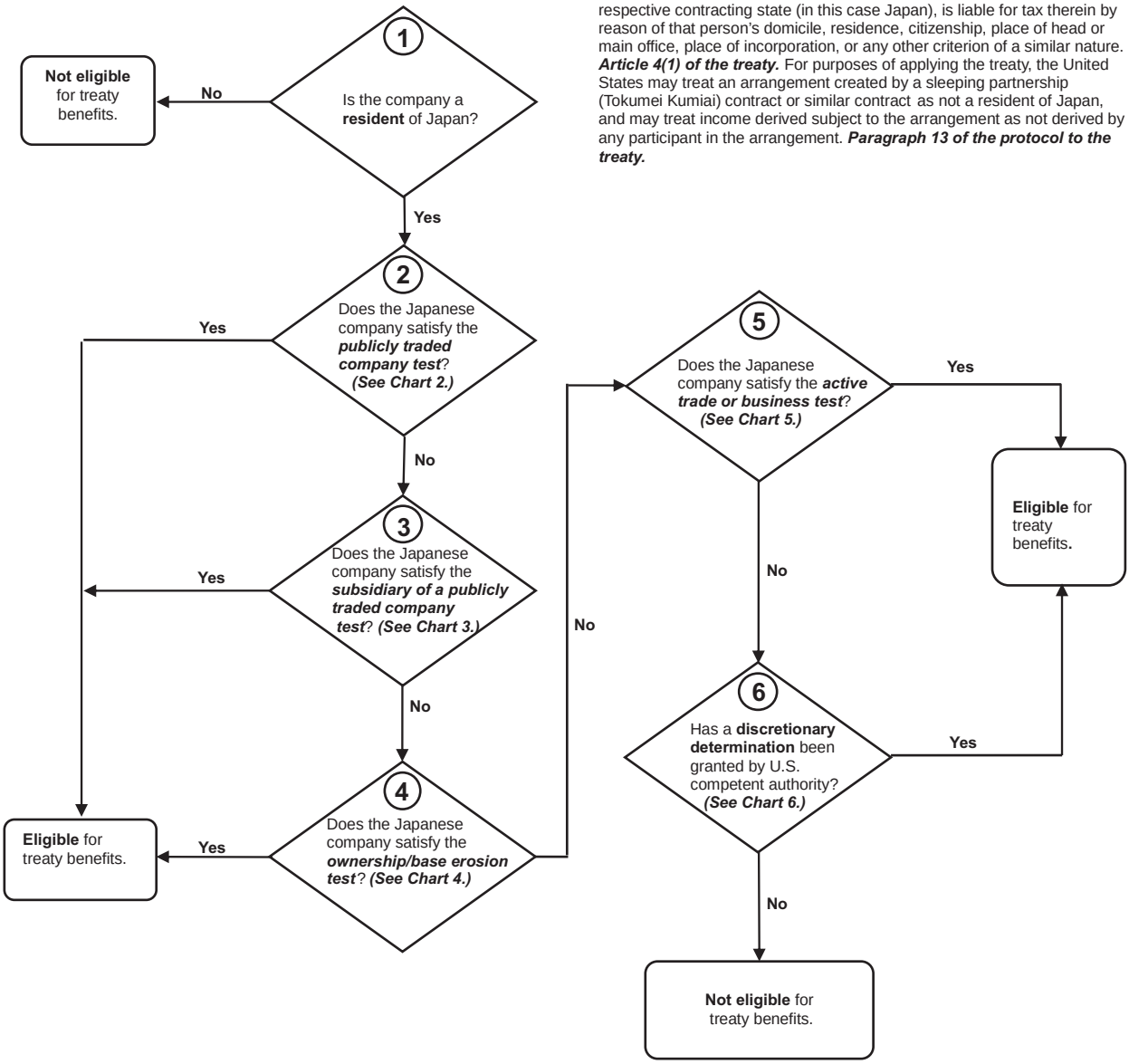
This article is the eighth in a series[2] that provides flowcharts to assist practitioners in determining a company's eligibility for tax treaty benefits under the LOB provisions of specific U.S. income tax treaties, and when applicable, in determining eligibility for a 0 percent withholding tax rate on cross-border intercompany dividend payments to the company.

[1]Convention Between the Government of the United States of America and the Government of Japan for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion With Respect to Taxes on Income and Capital, Nov. 6, 2003.

[2]*See* Jason Connery, Douglas Poms, and Jennifer Blasdel, ''Eligibility for Treaty Benefits Under the 2009 Protocol to the France-U.S. Income Tax Treaty,'' *Tax Notes Int'l*, Apr. 12, 2010, p. 149, *Doc 2010-5809*, or *2010 WTD 69-14*; John Venuti, Connery, Poms, and Blasdel, ''Eligibility for Treaty Benefits Under the Netherlands-U.S. Income Tax Treaty,'' *Tax Notes Int'l,* Nov. 23, 2009, p. 601, *Doc 2009-24084*, or *2009 WTD 223-11*; Venuti, Connery, Poms, and Alexey Manasuev, ''Eligibility for Treaty Benefits Under the Canada-U.S. Income Tax Treaty,'' *Tax Notes Int'l*, June 15, 2009, p. 967, *Doc 2009-11815*, or *2009 WTD 113-15*; Venuti, Ron Dabrowski, Poms, and Manasuev, ''Eligibility for Treaty Benefits Under U.K.-U.S. Income Tax Treaty,'' *Tax Notes Int'l*, Mar. 23, 2009, p. 1095, *Doc 2009-4590*, or *2009 WTD 56-9*; Venuti, Connery, Poms, and Manasuev, ''Eligibility for Treaty Benefits Under the Luxembourg-U.S. Income Tax Treaty,'' *Tax Notes Int'l*, July 21, 2008, p. 285, *Doc 2008-14359*, or *2008 WTD 142-8*; Venuti, Dabrowski, Poms, and Manasuev, ''Eligibility for Treaty Benefits Under the France-U.S. Income Tax Treaty,'' *Tax Notes Int'l*, Feb. 11, 2008, p. 523, *Doc 2008-773*, or *2008 WTD 33-10*; and Venuti and Manasuev, ''Eligibility for Zero Withholding on Dividends in the New Germany-U.S. Protocol,'' *Tax Notes Int'l*, Jan. 14, 2008, p. 181, *Doc 2007-27516*, or *2008 WTD 12-10*.

This article contains seven flowcharts. The first six flowcharts analyze the LOB provision of the treaty as applied to Japanese companies. The seventh flowchart analyzes the requirements a Japanese company must satisfy to qualify for a 0 percent withholding tax rate on cross-border intercompany dividend payments to the company under article 10(3) of the treaty. Although the flowcharts provide a comprehensive review of applicable provisions under the treaty, taxpayers and their tax advisers should carefully evaluate each case and determine whether the requirements of the treaty are met based on all facts and circumstances. ◆

Chart 1. Eligibility for Treaty Benefits Under Article 22 (LOB) of the Japan-U.S. Tax Treaty



"Resident" generally means any person who, under the laws of the respective contracting state (in this case Japan), is liable for tax therein by reason of that person's domicile, residence, citizenship, place of head or main office, place of incorporation, or any other criterion of a similar nature. ***Article 4(1) of the treaty.*** For purposes of applying the treaty, the United States may treat an arrangement created by a sleeping partnership (Tokumei Kumiai) contract or similar contract as not a resident of Japan, and may treat income derived subject to the arrangement as not derived by any participant in the arrangement. ***Paragraph 13 of the protocol to the treaty.***

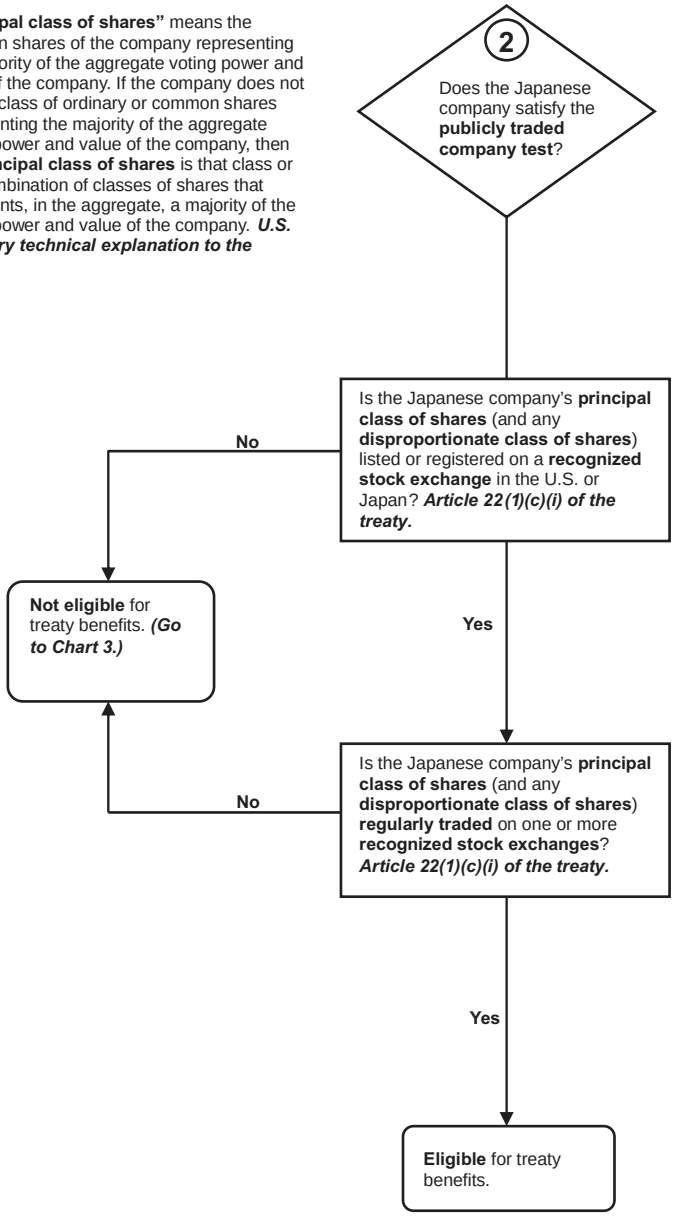
Pension Funds and Tax-Exempt Organizations

1) A Japanese resident pension fund is eligible for all treaty benefits, provided that as of the end of the prior tax year more than 50 percent of its beneficiaries, members, or participants are individuals who are residents of either the U.S. or Japan. ***Article 22(1)(e) of the treaty.***

2) A person organized under the laws of Japan is eligible for all treaty benefits (even if it is exempt from tax in Japan), provided that it was established and maintained in Japan exclusively for a religious, charitable, educational, scientific, artistic, cultural, or public purpose. ***Article 22(1)(d) of the treaty.*** Such a person is entitled to all benefits of the treaty without regard to the residence of its beneficiaries or members. ***U.S. Treasury technical explanation to the treaty.***

Chart 2. Publicly Traded Company Test Under Article 22(1)(c)(I) (LOB) of the Japan-U.S. Tax Treaty

"Principal class of shares" means the common shares of the company representing the majority of the aggregate voting power and value of the company. If the company does not have a class of ordinary or common shares representing the majority of the aggregate voting power and value of the company, then the **principal class of shares** is that class or any combination of classes of shares that represents, in the aggregate, a majority of the voting power and value of the company. ***U.S. Treasury technical explanation to the treaty.***



"Disproportionate class of shares" means any class of shares of a company that is a resident of a contracting state (in this case, Japan) that is subject to terms or other arrangements that entitle the holders of that class of shares to a portion of the income of the company derived from the other contracting state (in this case, the U.S.) that is larger than the portion those holders would receive absent such terms or arrangements. ***Article 22(5)(a) of the treaty.***

"Recognized stock exchange" means:

- **(i)** any stock exchange established under the terms of the Securities and Exchange Law (Law No. 25 of 1948) of Japan, including the Tokyo Stock Exchange;
- **(ii)** the NASDAQ system and any stock exchange registered with the U.S. Securities and Exchange Commission as a national securities exchange under the U.S. Securities Exchange Act of 1934; and
- **(iii)** any other stock exchange agreed upon by the competent authorities. ***Article 22(5)(b) of the treaty; U.S. Treasury technical explanation to the treaty.***

A class of shares is considered to be **regularly traded** in a tax year if the aggregate number of shares of that class traded on one or more recognized exchanges in the prior tax year is at least 6 percent of the average number of shares outstanding in that class during that prior tax year. ***Paragraph 11 of the protocol to the treaty.*** Trading on one or more **recognized stock exchanges** may be aggregated for purposes of meeting the **regularly traded** standard of the **publicly traded company test**. Authorized but unissued shares are not considered for purposes of the **publicly traded company test.** ***U.S. Treasury technical explanation to the treaty.***

Chart 3. Subsidiary of a Publicly Traded Company Test Under Article 22(1)(c)(ii) (LOB) of the Japan-U.S. Tax Treaty

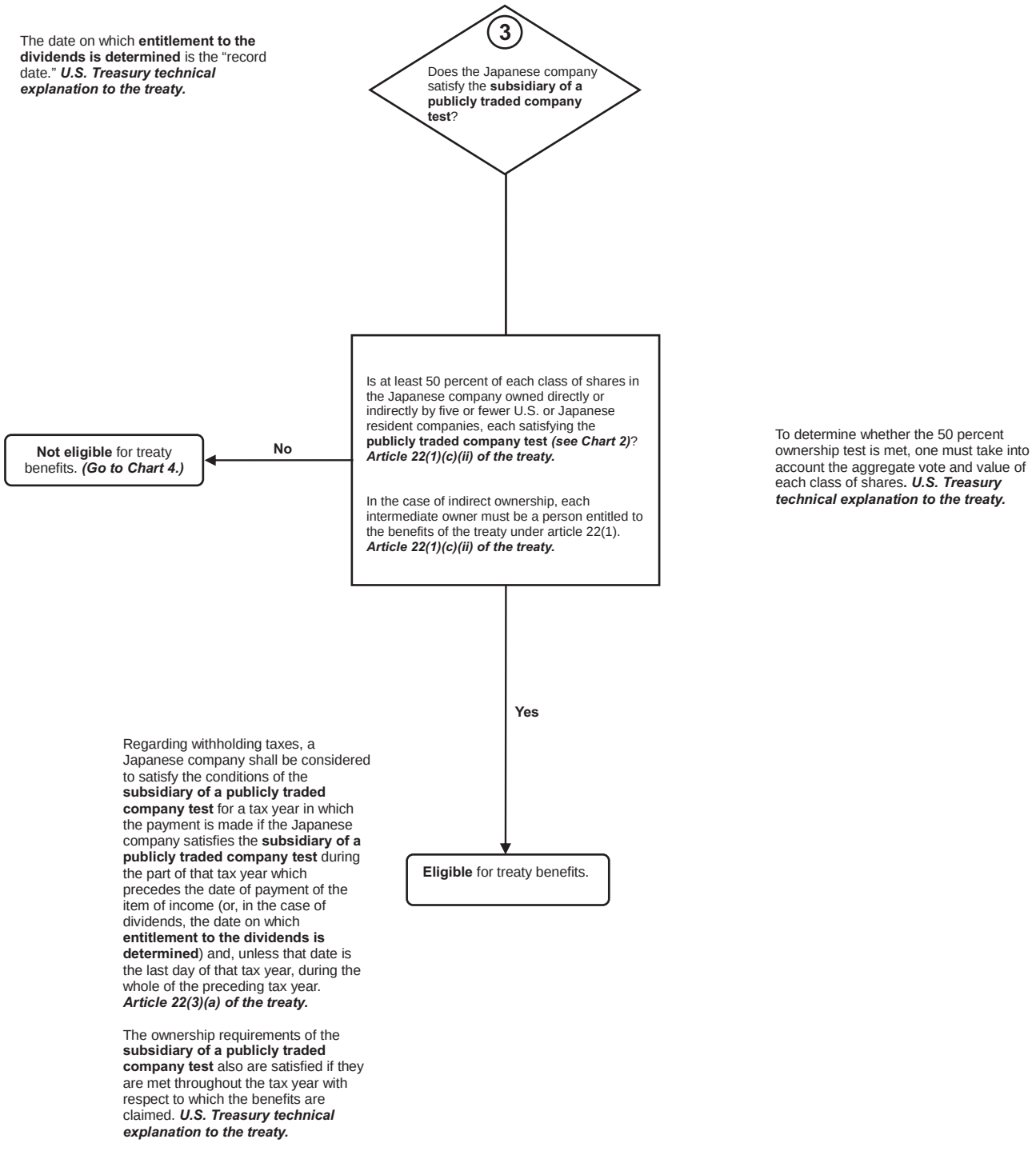
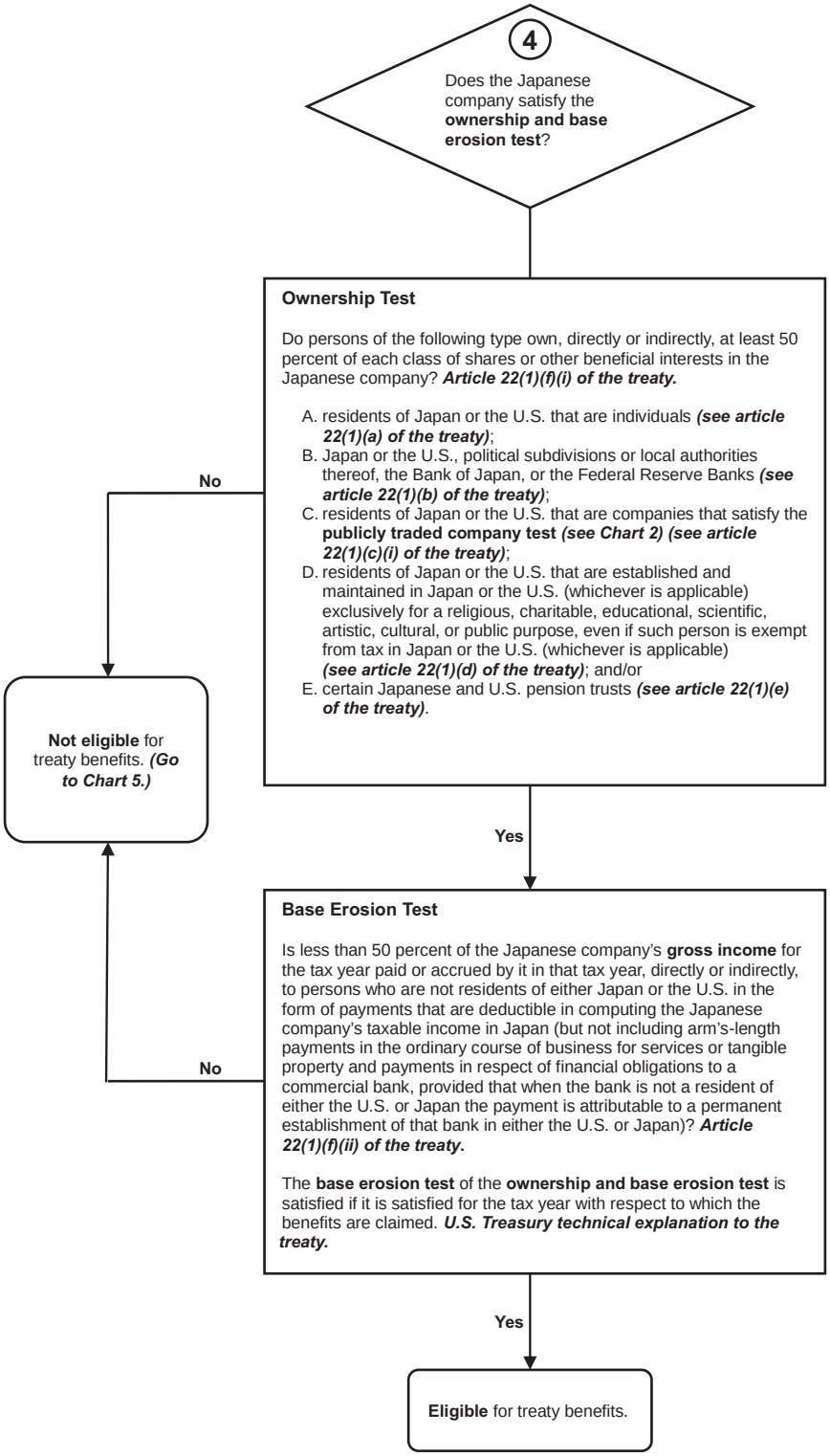


Chart 4. Ownership and Base Erosion Test Under Article 22(1)(f) (LOB) of the Japan-U.S. Tax Treaty



Regarding withholding taxes, a Japanese company is considered to satisfy the **ownership test** of the **ownership and base erosion test** for a tax year in which the payment is made if such Japanese company satisfies the conditions described in the **ownership test** of the **ownership and base erosion test** during the part of that tax year which precedes the date of payment of the item of income (or, in the case of dividends, the date on which **entitlement to the dividends is determined** ***(see Chart 3 for the definition)*** and, unless that date is the last day of that tax year, during the whole of the preceding tax year. ***Article 22(3)(b)(i).***

The ownership requirements of the **ownership test** of the **ownership and base erosion test** also are satisfied if they are met throughout the tax year with respect to which the benefits are claimed. ***U.S. Treasury technical explanation to the treaty.***

In all other cases, a Japanese company shall be considered to satisfy the conditions of the **ownership test** of the **ownership and base erosion test** for a tax year in which the payment is made if such Japanese company satisfies the conditions of the **ownership test** on at least half the days of the tax year. ***Article 22(3)(b)(ii) of the treaty.***

"Gross income" means the total revenues derived by a resident of a contracting state (in this case, Japan) from its business, less the direct costs of obtaining such revenues. ***Article 22(5)(c) of the treaty.***

In the case of the U.S., this definition corresponds to the definition of the term "gross income" in section 61 of the Internal Revenue Code and the regulations thereunder. Depreciation and amortization deductions, which do not represent payments or accruals to other persons, are disregarded for the purpose of determining gross income. ***U.S. Treasury technical explanation to the treaty.***

Chart 5. Active Trade or Business Test Under Article 22(2) (LOB) of the Japan-U.S. Tax Treaty

(Only applies if an item of income is derived in connection with or incidental to an active trade or business in Japan)

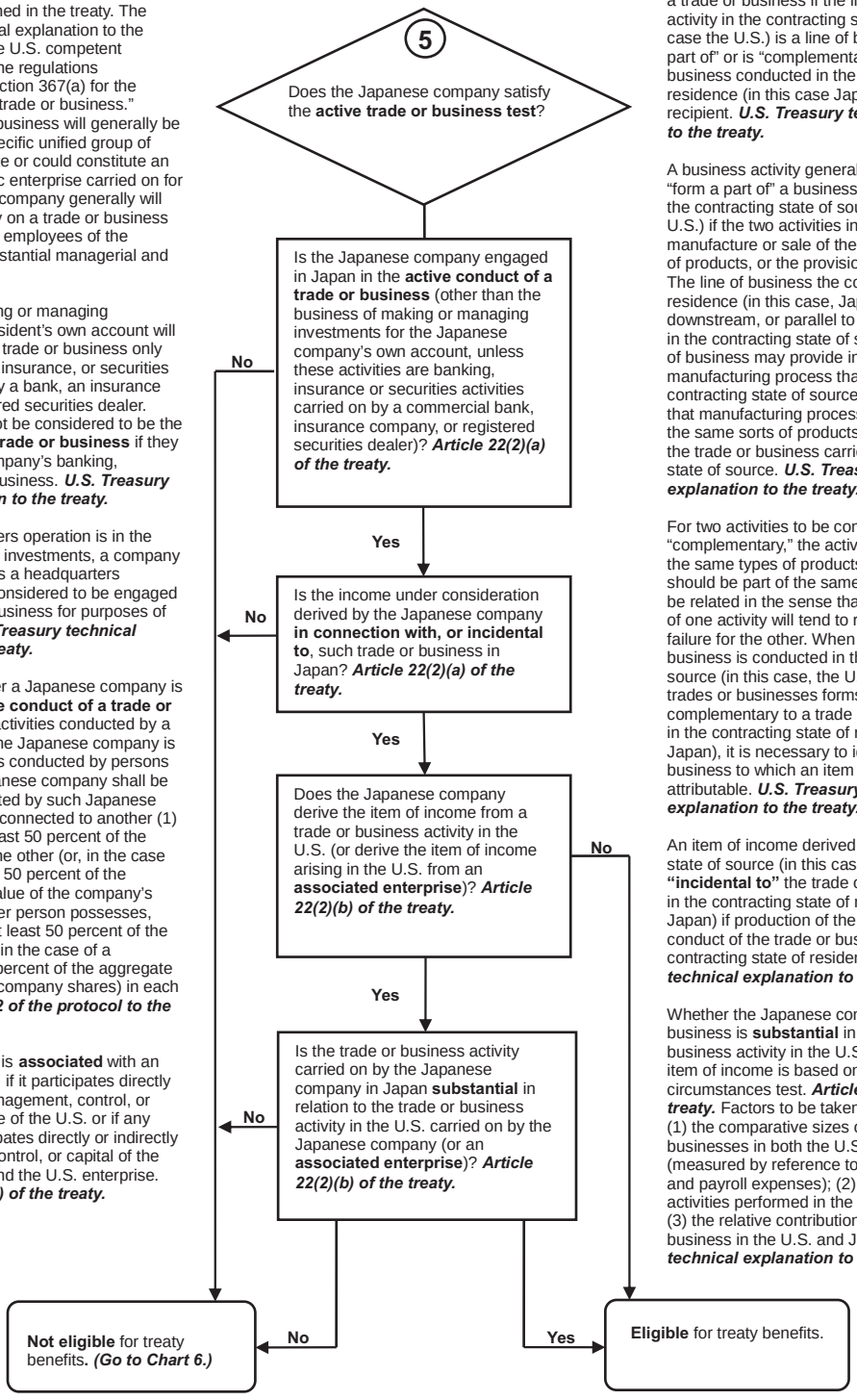
The phrase **"active conduct of a trade or business"** is not defined in the treaty. The U.S. Treasury technical explanation to the treaty explains that the U.S. competent authority will refer to the regulations promulgated under section 367(a) for the definition of the term "trade or business." Therefore, a trade or business will generally be considered to be a specific unified group of activities that constitute or could constitute an independent economic enterprise carried on for profit. Furthermore, a company generally will be considered to carry on a trade or business only if the officers and employees of the company conduct substantial managerial and operational activities.

The business of making or managing investments for the resident's own account will be considered to be a trade or business only when part of banking, insurance, or securities activities conducted by a bank, an insurance company, or a registered securities dealer. These activities will not be considered to be the conduct of an **active trade or business** if they are not part of the company's banking, insurance, or dealer business. ***U.S. Treasury technical explanation to the treaty.***

Because a headquarters operation is in the business of managing investments, a company that functions solely as a headquarters company will not be considered to be engaged in an active trade or business for purposes of article 22(2)(a). ***U.S. Treasury technical explanation to the treaty.***

In determining whether a Japanese company is "engaged in the **active conduct of a trade or business**" in Japan, activities conducted by a partnership in which the Japanese company is a partner and activities conducted by persons connected to the Japanese company shall be deemed to be conducted by such Japanese company. A person is connected to another (1) if one possesses at least 50 percent of the beneficial interest in the other (or, in the case of a company, at least 50 percent of the aggregate vote and value of the company's shares) or (2) if another person possesses, directly or indirectly, at least 50 percent of the beneficial interest (or, in the case of a company, at least 50 percent of the aggregate vote and value of the company shares) in each person. ***Paragraph 12 of the protocol to the treaty.***

A Japanese company is **associated** with an **enterprise** of the U.S. if it participates directly or indirectly in the management, control, or capital of an enterprise of the U.S. or if any third person(s) participates directly or indirectly in the management, control, or capital of the Japanese company and the U.S. enterprise. ***Article 9(1)(a) and (b) of the treaty.***



Income is considered derived **in connection with** a trade or business if the income-producing activity in the contracting state of source (in this case the U.S.) is a line of business that "forms a part of" or is "complementary" to the trade or business conducted in the contracting state of residence (in this case Japan) by the income recipient. ***U.S. Treasury technical explanation to the treaty.***

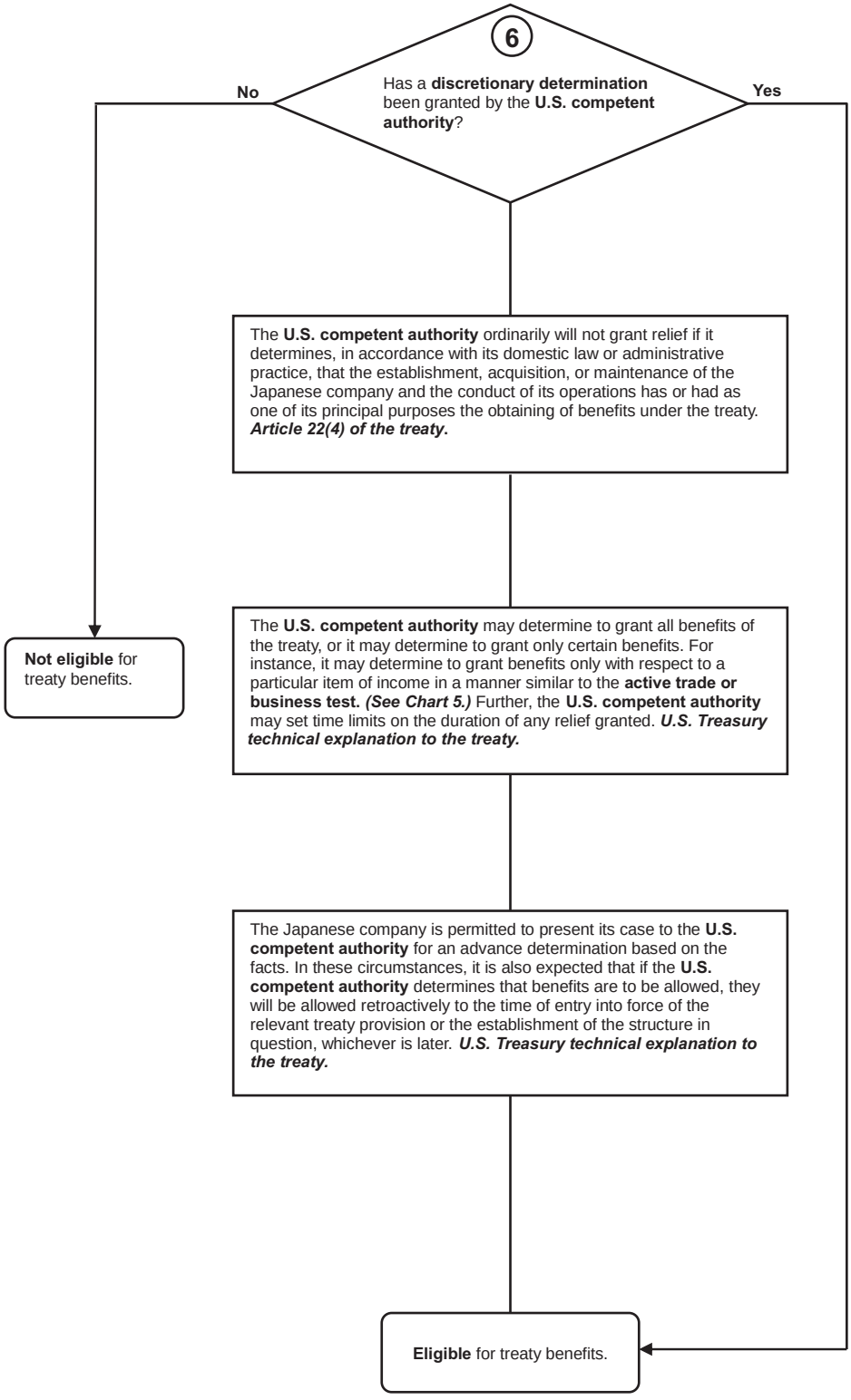
A business activity generally will be considered to "form a part of" a business activity conducted in the contracting state of source (in this case, the U.S.) if the two activities involve the design, manufacture or sale of the same products or type of products, or the provision of similar services. The line of business the contracting state of residence (in this case, Japan) may be upstream, downstream, or parallel to the activity conducted in the contracting state of source. Thus, the line of business may provide inputs for a manufacturing process that occurs in the contracting state of source, may sell the output of that manufacturing process, or simply may sell the same sorts of products that are being sold by the trade or business carried on in the contracting state of source. ***U.S. Treasury technical explanation to the treaty.***

For two activities to be considered to be "complementary," the activities need not relate to the same types of products or services, but they should be part of the same overall industry and be related in the sense that the success or failure of one activity will tend to result in success or failure for the other. When more than one trade or business is conducted in the contracting state of source (in this case, the U.S.) and only one of the trades or businesses forms a part of or is complementary to a trade or business conducted in the contracting state of residence (in this case Japan), it is necessary to identify the trade or business to which an item of income is attributable. ***U.S. Treasury technical explanation to the treaty.***

An item of income derived from the contracting state of source (in this case, the U.S.) is **"incidental to"** the trade or business carried on in the contracting state of residence (in this case Japan) if production of the item facilitates the conduct of the trade or business in the contracting state of residence. ***U.S. Treasury technical explanation to the treaty.***

Whether the Japanese company's trade or business is **substantial** in relation to the trade or business activity in the U.S. that generated the item of income is based on a facts and circumstances test. ***Article 22(2)(b) of the treaty.*** Factors to be taken into account include: (1) the comparative sizes of the trades or businesses in both the U.S. and Japan (measured by reference to asset values, income, and payroll expenses); (2) the nature of the activities performed in the U.S. and Japan; and (3) the relative contributions made to that trade or business in the U.S. and Japan. ***U.S. Treasury technical explanation to the treaty.***

Chart 6. Discretionary Determination by U.S. Competent Authority Under Article 22(4) (LOB) of the Japan-U.S. Tax Treaty



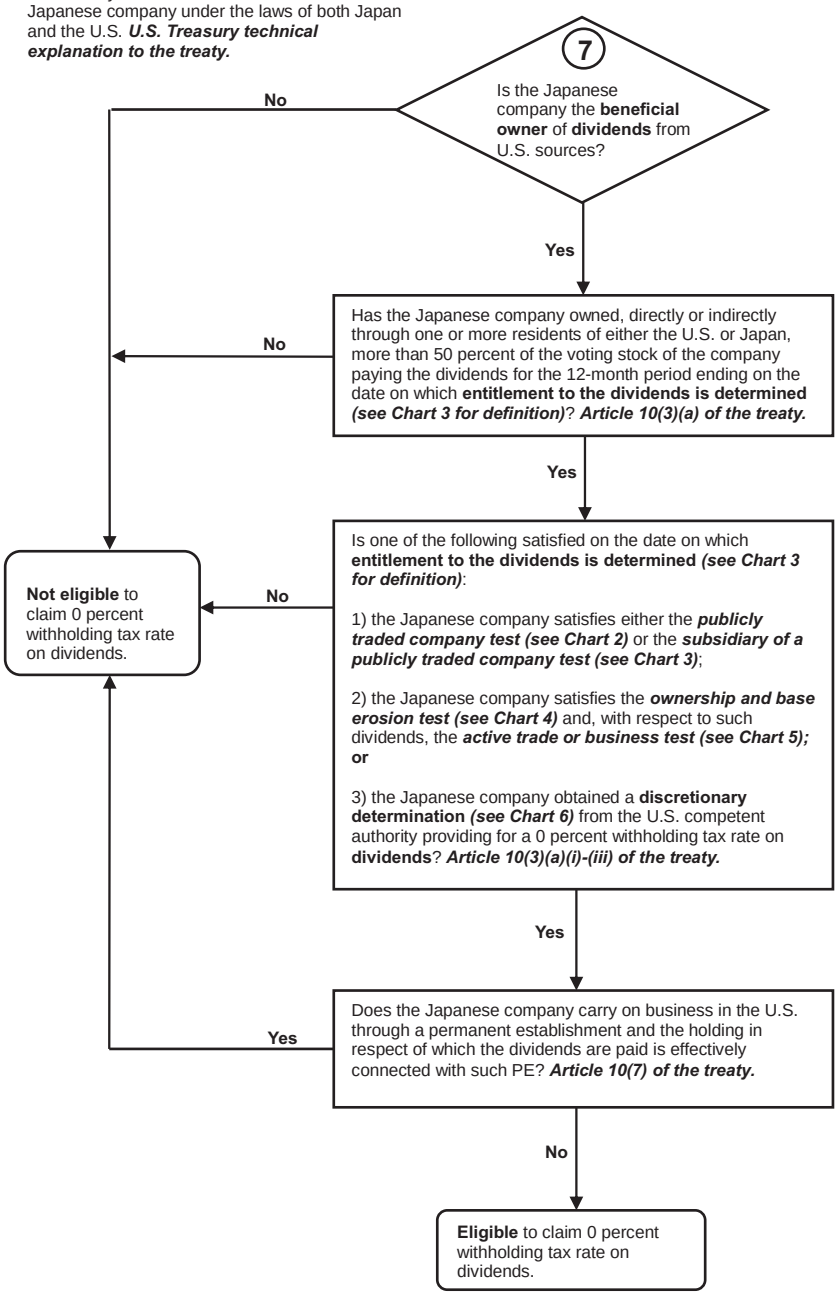
The **"U.S. competent authority"** is the Secretary of the Treasury or his delegate. ***Article 3(k)(ii) of the treaty.***

Requesting competent authority assistance — A taxpayer may request the assistance of the U.S. competent authority under Rev. Proc. 2006-54. The U.S. competent authority may determine in its own discretion that the taxpayer qualifies for certain benefits under the LOB article of the treaty.

There is a US $15,000 user fee for requesting a **discretionary determination** under the LOB provision. If a request is submitted for more than one entity, a separate user fee is charged for each entity. ***Rev. Proc. 2006-54, section 14.02.***

Chart 7. Eligibility for 0 Percent Withholding Tax Rate on Dividend Under Article 10(3) of the Japan-U.S. Tax Treaty

Stock owned by the Japanese company through an entity will be treated as owned directly by the Japanese company to the extent that the income of the entity is treated as the income of the Japanese company under the laws of both Japan and the U.S. ***U.S. Treasury technical explanation to the treaty.***



Dividends paid by U.S. regulated investment companies and U.S. real estate investment trusts do not qualify for a 0 percent U.S. withholding tax rate. ***Article 10(4) of the treaty.***

"Beneficial owner" is not defined in the treaty and, thus, is defined under the internal law of the country imposing the tax (here, the U.S.). ***Article 3(2) of the treaty.***

The **beneficial owner** of a dividend is the person to which the dividend income is attributable for tax purposes under the laws of the source state (in this case, the U.S.). Thus, if the Japanese company receives dividends as a nominee or agent on behalf of another person that is not a resident of Japan, the dividend is not entitled to the benefits of article 10 of the treaty. However, a dividend received by a nominee on behalf of a resident of Japan would be entitled to benefits. ***U.S. Treasury technical explanation to the treaty.***

"Dividends" means income from shares or other rights, not being debt-claims, participating in profits, as well as income that is subjected to the same taxation treatment as income from shares by the tax laws of the contracting state of which the payer is a resident. ***Article 10(6) of the treaty.***

The term **"dividends"** is defined broadly and is intended to cover all arrangements that yield a return on an equity investment in a corporation as determined in accordance with paragraph 2 of article 3 (general definitions) of the treaty under the tax laws of the contracting state of source (in this case, the U.S.), as well as arrangements that might be developed in the future. Under the laws of the U.S., a constructive dividend that results from a non-arm's-length transaction between a corporation and a related party is a dividend. A payment denominated as interest that is made by a thinly capitalized corporation may be treated as a dividend to the extent that the debt is recharacterized as equity. ***U.S. treasury technical explanation to the treaty.***

In the case of the U.S., the term **"dividend"** includes amounts treated as a dividend under U.S. law upon the sale or redemption of shares or upon a transfer of shares in a reorganization. *See, e.g.,* Rev. Rul. 92-85, 1992-2 C.B. 69 (sale of foreign subsidiary's stock to U.S. sister company is a deemed dividend to extent of subsidiary's and sister's earnings and profits). Further, a distribution from a U.S. publicly traded limited partnership, which is taxed as a corporation under U.S. law, is a dividend for purposes of article 10. However, a distribution by a limited liability company is not characterized by the U.S. as a dividend and, therefore, is not a dividend for purposes of article 10, provided the LLC is not characterized as an association taxable as a corporation under U.S. law***. U.S. Treasury technical explanation to the treaty.***

Pension Funds

Dividends paid by a U.S. company to a Japanese pension fund that is the beneficial owner of the dividends are not subject to U.S. withholding tax, provided that the dividends are not derived from the carrying on of a business, directly or indirectly, by the pension fund. ***Article 10(3)(b) of the treaty.***