PUBLICATION

2013 Amendments to United States and Japan Income Tax Treaty

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On January 24, 2013, the United States and Japan signed a proposed protocol to amend the existing tax treaty between the two countries, which was entered into in 2003. The amendments, which will take effect when ratified by the two countries, will apply generally on or after January 1 of the calendar year immediately after the ratification, except for interest and dividend withholding taxes, which will be effective on or after the first day of the third month following the ratification date.

Among other provisions, the proposed protocol covers the following principal matters:

1. Tax jurisdiction expanded for rules relating to dispositions of stock treated as real property interests. The U.S. and Japan each generally do not tax the capital gains on sales of stock of foreign persons not living in the respective taxing country. However, each country does tax the capital gains on direct and indirect sales of real estate transactions. Under the 2003 treaty, Japan taxes the capital gains of nonresident Americans from sales of shares in Japanese companies holding Japanese real estate. The proposed protocol imposes capital gains tax arising from the sale of shares in any corporation holding Japanese real estate, not just in Japanese companies. Under the 2003 treaty, the U.S. taxes capital gains of nonresident Japanese of stock in a domestic corporation that has U.S. real property interests when, at the time of the disposition, such U.S. real property interests comprise at least 50 percent of the corporation's value. Sales by Japanese shareholders owning five percent or less of the corporation's outstanding shares are exempt at the time of sale provided that the corporation's shares are publically traded. The proposed protocol amends the 2003 treaty by amending the definition of real property to mean "United States real property interest," which is not defined in the proposed protocol. Under U.S. domestic law, the definition restricts the publically traded exception to impose a five-year look back period for ownership (not just at time of sale) and requires that the shares must be "regularly traded."

2. Dividends and Interest. The U.S. generally imposes a 30 percent withholding tax on dividends paid to foreign persons. The 2003 treaty limits the ability of either country to impose withholding tax. Dividends can qualify for an exemption from withholding tax from the taxing country where paid and where the withholding tax would otherwise be paid if the recipient in the other country owns "more than 50 percent of the voting stock of the company paying the dividends for the period of twelve months ending on the date on which entitlement to the dividends is determined…" The proposed protocol reduces (i) the ownership requirement to "at least 50 percent ownership" and (ii) the holding requirement to six months, rather than 12 months. As to interest paid, the 2003 treaty limits the withholding tax to 10 percent. With certain exceptions, the proposed protocol exempts withholding by the source country.

3. Arbitration. The proposed protocol includes provisions for mandatory binding arbitration between the two countries. If the countries disagree over which country should collect the tax and don't resolve their differences within two years, the winning country in the arbitration collects the tax. The purpose is to avoid double taxation of the taxpayer. The provision also applies to pending cases at the time the protocol is ratified.

The protocol, once ratified, should be favorably received by taxpayers on both sides and should have a positive effect on investments made in each of the countries.

Download a Japanese translation of this Alert here.

Should you have questions regarding this proposed protocol or other aspects of the 2003 treaty, please contact any of the attorneys associated with the Firm's Tax Department.