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EXPLANATION OF PROPOSED INCOME TAX TREATY BETWEEN THE UNITED STATES AND JAPAN

SCHEDULED FOR A HEARING

BEFORE THE

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CONTENTS

	Page
INTRODUCTION	1
I. SUMMARY	2
II. OVERVIEW OF U.S. TAXATION OF INTERNATIONAL TRADE AND INVESTMENT AND U.S. TAX TREATIES	4
A. U.S. Tax Rules	4
B. U.S. Tax Treaties	7
III. OVERVIEW OF JAPANESE TAX LAW	9
A. National Income Taxes	9
B. International Aspects of Domestic Japanese Law	11
C. Other Taxes	13
IV. THE UNITED STATES AND JAPAN: CROSS BORDER INVESTMENT AND TRADE	14
V. EXPLANATION OF PROPOSED TREATY	38
Article 1. General Scope	38
Article 2. Taxes Covered	41
Article 3. General Definitions	42
Article 4. Residence	44
Article 5. Permanent Establishment	48
Article 6. Income from Real Property	50
Article 7. Business Profits	51
Article 8. Shipping and Air Transport	56
Article 9. Associated Enterprises	58
Article 10. Dividends	60
Article 11. Interest	66
Article 12. Royalties	70
Article 13. Gains	72
Article 14. Income from Employment	76
Article 15. Directors' Fees	77
Article 16. Artistes and Sportsmen	77
Article 17. Pensions, Social Security, Annuities, and Child Support Payments	79

			Page
Article	18.	Government Service	80
Article	19.	Payments to Students and Business Apprentices	81
Article	20.	Income from Teaching or Research	82
Article	21.	Other Income	82
Article	22.	Limitation on Benefits	83
Article	23.	Relief From Double Taxation	89
Article	24.	Non-Discrimination	92
Article	25.	Mutual Agreement Procedure	94
Article	26.	Exchange of Information	95
Article	27.	Administrative Assistance	96
Article	28.	Members of Diplomatic Missions and Consular Posts	96
Article	29.	Consultation	97
Article	30.	Entry into Force	97
Article	31.	Termination	98

VI. ISSUES ... 99

A. Zero Rate of Withholding Tax on Direct Dividends ... 99

B. Anti-Conduit Rules ... 103

C. Insurance Excise Tax ... 105

D. Taxation of Gains on Shares in Restructured Financial Institutions ... 106

E. Income from the Rental of Ships and Aircraft ... 108

F. Non-Arm's Length Interest and Royalty Payments and Contingent Interest Payments ... 109

G. Sale of U.S. Real Property Holding Corporations ... 112

H. Teachers, Students, and Trainees ... 114

I. U.S. Model Tax Treaty Divergence ... 119

INTRODUCTION

This pamphlet,[1] prepared by the staff of the Joint Committee on Taxation, describes the proposed income tax treaty between the United States and Japan, as supplemented by a protocol (the "proposed protocol") and an exchange of diplomatic notes (the "notes"). The proposed treaty, proposed protocol, and notes were signed on November 6, 2003. Unless otherwise specified, the proposed treaty, the proposed protocol, and the notes are hereinafter referred to collectively as the "proposed treaty." The Senate Committee on Foreign Relations has scheduled a public hearing on the proposed treaty for February 25, 2004.[2]

Part I of the pamphlet provides a summary of the proposed treaty. Part II provides a brief overview of U.S. tax laws relating to international trade and investment and of U.S. income tax treaties in general. Part III contains a brief overview of Japanese tax laws. Part IV provides a discussion of investment and trade flows between the United States and Japan. Part V contains an article-by-article explanation of the proposed treaty. Part VI contains a discussion of issues raised by the proposed treaty.

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[1] This pamphlet may be cited as follows: Joint Committee on Taxation, *Explanation of Proposed Income Tax Treaty Between the United States and Japan* (JCS–1–04), February 19, 2004.

[2] For the text of the proposed treaty, *see* Senate Treaty Doc. 108–14.

I. SUMMARY

The principal purposes of the proposed treaty are to reduce or eliminate double taxation of income earned by residents of either country from sources within the other country and to prevent avoidance or evasion of the taxes of the two countries. The proposed treaty also is intended to promote close economic cooperation between the two countries and to eliminate possible barriers to trade and investment caused by overlapping taxing jurisdictions of the two countries.

As in other U.S. tax treaties, these objectives principally are achieved through each country's agreement to limit, in certain specified situations, its right to tax income derived from its territory by residents of the other country. For example, the proposed treaty contains provisions under which each country generally agrees not to tax business income derived from sources within that country by residents of the other country unless the business activities in the taxing country are substantial enough to constitute a permanent establishment (Article 7). Similarly, the proposed treaty contains "commercial visitor" exemptions under which residents of one country performing personal services in the other country will not be required to pay tax in the other country unless their contact with the other country exceeds specified minimums (Articles 14 and 16). The proposed treaty provides that dividends, interest, royalties, and certain capital gains derived by a resident of either country from sources within the other country generally may be taxed by both countries (Articles 10, 11, 12, and 13); however, the rate of tax that the source country may impose on a resident of the other country on dividends, interest, and royalties may be limited or eliminated by the proposed treaty (Articles 10, 11, and 12). In the case of dividends, the proposed treaty contains provisions that would eliminate source-country tax on certain dividends in which certain ownership thresholds and other requirements are satisfied.

In situations in which the country of source retains the right under the proposed treaty to tax income derived by residents of the other country, the proposed treaty generally provides for relief from potential double taxation through the allowance by the country of residence of a tax credit for certain foreign taxes paid to the other country (Article 23).

The proposed treaty contains the standard provision (the "saving clause") included in U.S. tax treaties pursuant to which each country retains the right to tax its residents and citizens as if the treaty had not come into effect (Article 1). In addition, the proposed treaty contains the standard provision providing that the treaty may not be applied to deny any taxpayer any benefits the taxpayer would be entitled under the domestic law of a country or under any other agreement between the two countries (Article 1).

The proposed treaty contains provisions which can operate to deny the benefits of the dividends article (Article 10), the interest article (Article 11), the royalties article (Article 12), the other income article (Article 21), and the insurance excise tax provision (Article 1(a) of the proposed protocol) with respect to amounts paid in connection with certain conduit arrangements. The proposed treaty also contains a detailed limitation-on-benefits provision to prevent the inappropriate use of the treaty by third-country residents (Article 22).

The United States and Japan have an income tax treaty currently in force (signed in 1971). The proposed treaty would replace this treaty. The proposed treaty is similar to other recent U.S. income tax treaties, the 1996 U.S. model income tax treaty ("U.S. model"), and the 1992 model income tax treaty of the Organization for Economic Cooperation and Development, as updated ("OECD model"). However, the proposed treaty contains certain substantive deviations from these treaties and models. These deviations are noted throughout the explanation of the proposed treaty in Part V of this pamphlet.

II. OVERVIEW OF U.S. TAXATION OF INTERNATIONAL TRADE AND INVESTMENT AND U.S. TAX TREATIES

This overview briefly describes certain U.S. tax rules relating to foreign income and foreign persons that apply in the absence of a U.S. tax treaty. This overview also discusses the general objectives of U.S. tax treaties and describes some of the modifications to U.S. tax rules made by treaties.

A. U.S. Tax Rules

The United States taxes U.S. citizens, residents, and corporations on their worldwide income, whether derived in the United States or abroad. The United States generally taxes nonresident alien individuals and foreign corporations on all their income that is effectively connected with the conduct of a trade or business in the United States (sometimes referred to as "effectively connected income"). The United States also taxes nonresident alien individuals and foreign corporations on certain U.S.-source income that is not effectively connected with a U.S. trade or business.

Income of a nonresident alien individual or foreign corporation that is effectively connected with the conduct of a trade or business in the United States generally is subject to U.S. tax in the same manner and at the same rates as income of a U.S. person. Deductions are allowed to the extent that they are related to effectively connected income. A foreign corporation also is subject to a flat 30-percent branch profits tax on its "dividend equivalent amount," which is a measure of the effectively connected earnings and profits of the corporation that are removed in any year from the conduct of its U.S. trade or business. In addition, a foreign corporation is subject to a flat 30-percent branch-level excess interest tax on the excess of the amount of interest that is deducted by the foreign corporation in computing its effectively connected income over the amount of interest that is paid by its U.S. trade or business.

U.S.-source fixed or determinable annual or periodical income of a nonresident alien individual or foreign corporation (including, for example, interest, dividends, rents, royalties, salaries, and annuities) that is not effectively connected with the conduct of a U.S. trade or business is subject to U.S. tax at a rate of 30 percent of the gross amount paid. Certain insurance premiums earned by a nonresident alien individual or foreign corporation are subject to U.S. tax at a rate of one or four percent of the premiums. These taxes generally are collected by means of withholding.

Specific statutory exemptions from the 30-percent withholding tax are provided. For example, certain original issue discount and certain interest on deposits with banks or savings institutions are exempt from the 30-percent withholding tax. An exemption also is provided for certain interest paid on portfolio debt obligations. In

addition, income of a foreign government or international organization from investments in U.S. securities is exempt from U.S. tax.

U.S.-source capital gains of a nonresident alien individual or a foreign corporation that are not effectively connected with a U.S. trade or business generally are exempt from U.S. tax, with two exceptions: (1) gains realized by a nonresident alien individual who is present in the United States for at least 183 days during the taxable year; and (2) certain gains from the disposition of interests in U.S. real property.

Rules are provided for the determination of the source of income. For example, interest and dividends paid by a U.S. citizen or resident or by a U.S. corporation generally are considered U.S.-source income. Conversely, dividends and interest paid by a foreign corporation generally are treated as foreign-source income. Special rules apply to treat as foreign-source income (in whole or in part) interest paid by certain U.S. corporations with foreign businesses and to treat as U.S.-source income (in whole or in part) dividends paid by certain foreign corporations with U.S. businesses. Rents and royalties paid for the use of property in the United States are considered U.S.-source income.

Because the United States taxes U.S. citizens, residents, and corporations on their worldwide income, double taxation of income can arise when income earned abroad by a U.S. person is taxed by the country in which the income is earned and also by the United States. The United States seeks to mitigate this double taxation generally by allowing U.S. persons to credit foreign income taxes paid against the U.S. tax imposed on their foreign-source income. A fundamental premise of the foreign tax credit is that it may not offset the U.S. tax liability on U.S.-source income. Therefore, the foreign tax credit provisions contain a limitation that ensures that the foreign tax credit offsets only the U.S. tax on foreign-source income. The foreign tax credit limitation generally is computed on a worldwide basis (as opposed to a "per-country" basis). The limitation is applied separately for certain classifications of income. In addition, a special limitation applies to the credit for foreign taxes imposed on foreign oil and gas extraction income.

For foreign tax credit purposes, a U.S. corporation that owns 10 percent or more of the voting stock of a foreign corporation and receives a dividend from the foreign corporation (or is otherwise required to include in its income earnings of the foreign corporation) is deemed to have paid a portion of the foreign income taxes paid by the foreign corporation on its accumulated earnings. The taxes deemed paid by the U.S. corporation are included in its total foreign taxes paid and its foreign tax credit limitation calculations for the year in which the dividend is received.

An excise tax is imposed on insurance premiums paid to a foreign insurer or reinsurer with respect to U.S. risks. The rate of tax is either four percent or one percent. The rate of the excise tax is four percent of the premium on a policy of casualty insurance or indemnity bond that is (1) paid by a U.S. person on risks wholly or partly within the United States, or (2) paid by a foreign person on risks wholly within the United States. The rate of the excise tax is one percent of the premium paid on a policy of life, sickness or accident insurance, or an annuity contract. The rate of the excise

tax is also one percent of any premium for reinsurance of any of the foregoing types of contracts.

Two exceptions to the application of the insurance excise tax are provided. One exception is for amounts that are effectively connected with the conduct of a U.S. trade or business (provided no treaty provision exempts the amounts from U.S. taxation). Thus, under this exception, the insurance excise tax does not apply to amounts that are subject to U.S. income tax in the hands of a foreign insurer or reinsurer pursuant to its election to be taxed as a domestic corporation under Code section 953(d), or pursuant to its election under Code section 953(c) to treat related person insurance income as effectively connected to the conduct of a U.S. trade or business. The other exception applies to premiums on an indemnity bond to secure certain pension and other payments by the United States government.

B. U.S. Tax Treaties

The traditional objectives of U.S. tax treaties have been the avoidance of international double taxation and the prevention of tax avoidance and evasion. Another related objective of U.S. tax treaties is the removal of the barriers to trade, capital flows, and commercial travel that may be caused by overlapping tax jurisdictions and by the burdens of complying with the tax laws of a jurisdiction when a person's contacts with, and income derived from, that jurisdiction are minimal. To a large extent, the treaty provisions designed to carry out these objectives supplement U.S. tax law provisions having the same objectives; treaty provisions modify the generally applicable statutory rules with provisions that take into account the particular tax system of the treaty partner.

The objective of limiting double taxation generally is accomplished in treaties through the agreement of each country to limit, in specified situations, its right to tax income earned from its territory by residents of the other country. For the most part, the various rate reductions and exemptions agreed to by the source country in treaties are premised on the assumption that the country of residence will tax the income at levels comparable to those imposed by the source country on its residents. Treaties also provide for the elimination of double taxation by requiring the residence country to allow a credit for taxes that the source country retains the right to impose under the treaty. In addition, in the case of certain types of income, treaties may provide for exemption by the residence country of income taxed by the source country.

Treaties define the term "resident" so that an individual or corporation generally will not be subject to tax as a resident by both the countries. Treaties generally provide that neither country will tax business income derived by residents of the other country unless the business activities in the taxing jurisdiction are substantial enough to constitute a permanent establishment or fixed base in that jurisdiction. Treaties also contain commercial visitation exemptions under which individual residents of one country performing personal services in the other will not be required to pay tax in that other country unless their contacts exceed certain specified minimums (e.g., presence for a set number of days or earnings in excess of a specified amount). Treaties address passive income such as dividends, interest, and royalties from sources within one country derived by residents of the other country either by providing that such income is taxed only in the recipient's country of residence or by reducing the rate of the source country's withholding tax imposed on such income. In this regard, the United States agrees in its tax treaties to reduce its 30-percent withholding tax (or, in the case of some income, to eliminate it entirely) in return for reciprocal treatment by its treaty partner.

In its treaties, the United States, as a matter of policy, generally retains the right to tax its citizens and residents on their worldwide income as if the treaty had not come into effect. The United States also provides in its treaties that it will allow a credit against U.S. tax for income taxes paid to the treaty partners, subject to the various limitations of U.S. law.

The objective of preventing tax avoidance and evasion generally is accomplished in treaties by the agreement of each country to exchange tax-related information. Treaties generally provide for the exchange of information between the tax authorities of the two countries when such information is necessary for carrying out provisions of the treaty or of their domestic tax laws. The obligation to exchange information under the treaties typically does not require either country to carry out measures contrary to its laws or administrative practices or to supply information that is not obtainable under its laws or in the normal course of its administration or that would reveal trade secrets or other information the disclosure of which would be contrary to public policy. The Internal Revenue Service (the "IRS"), and the treaty partner's tax authorities, also can request specific tax information from a treaty partner. This can include information to be used in a criminal investigation or prosecution.

Administrative cooperation between countries is enhanced further under treaties by the inclusion of a "competent authority" mechanism to resolve double taxation problems arising in individual cases and, more generally, to facilitate consultation between tax officials of the two governments.

Treaties generally provide that neither country may subject nationals of the other country (or permanent establishments of enterprises of the other country) to taxation more burdensome than that it imposes on its own nationals (or on its own enterprises). Similarly, in general, neither treaty country may discriminate against enterprises owned by residents of the other country.

At times, residents of countries that do not have income tax treaties with the United States attempt to use a treaty between the United States and another country to avoid U.S. tax. To prevent third-country residents from obtaining treaty benefits intended for treaty country residents only, treaties generally contain an "anti-treaty-shopping" provision that is designed to limit treaty benefits to bona fide residents of the two countries.

III. OVERVIEW OF JAPANESE TAX LAW [3]

A. National Income Taxes

Overview

Japanese law treats individual income taxes and corporation income taxes separately, under the Income Tax Law and the Corporation Tax Law, respectively. The general principles of tax law reflected in these basic laws may be modified or supplemented by the Special Tax Measures Law. The Japanese income tax system and general rules are broadly similar to the U.S. income tax system and general rules and reflect many of the same complexities, including detailed rules for defining the tax base, deductions, depreciation, credits, and timing. Many types of income, including interest, dividends and employment income (for individuals), are subject to withholding at the source.

Individuals

For individuals resident in Japan, income tax is assessed primarily on the basis of an individual's aggregate income, except that retirement income, timber income, interest income, and certain dividends and capital gains are subject to special rules and may be separately taxed in some cases. The rate structure is progressive and extends from 10 percent for taxable income under 3.3 million yen (approximately $31,000 [4]) to 37 percent for marginal taxable income over 18 million yen (approximately $168,224). Certain interest, including from bank deposits, is taxed at 15 percent. Individuals may elect to have dividends from listed companies taxed at 15 percent (seven percent between April 2003 and March 2008) and excluded from aggregate income. Capital gains from sales of securities are taxed at 20 percent (seven percent for listed stocks from 2003 to 2007). Capital gains from the sale of land and buildings are taxed at various rates and are subject to various deduction amounts, depending on the use of the property and whether the holding period qualifies as long-term (five years or more). Only 50 percent of long-term capital gains, other than with respect to sales of land, buildings and securities, are subject to tax.

Corporations

Domestic Japanese corporations are taxed on their net taxable income. The general corporate tax rate is 30 percent, except that corporations with capital of no more than 100 million yen (approxi-

[3] The information in this section relates to Japanese law and is based on the Joint Committee staff's review of publicly available secondary sources, including in large part a publication of the Japanese Government. *See* Tax Bureau, Japanese Ministry of Finance, *An Outline of Japanese Taxes* (2003 ed.). The description is intended to serve as a general overview; it may not be fully accurate in all respects, as many details have been omitted and simplifying generalizations made for ease of exposition.

[4] U.S. dollar equivalents were calculated using an exchange rate of 107 yen to one dollar.

mately $935,000) are taxed at 22 percent on their annual net taxable income up to eight million yen (approximately $75,000). However, a special surplus tax, which was suspended through December 31, 2003, is imposed on corporate capital gains from the sale of land located in Japan.

Dividends (less interest on acquisition debt) received from another domestic corporation are excluded from the corporate income tax base (the exclusion is limited to 50 percent if the recipient corporation owns 25 percent or less of the shares of the distributor). Japan introduced corporate consolidation for 100 percent-owned domestic corporate groups for taxable years ending on or after March 31, 2003. The national rate for such consolidated groups is two percent higher than the regular corporate rate; the additional two percent is scheduled to sunset after March 31, 2004.

B. International Aspects of Domestic Japanese Tax Law

Residency

Under Japanese tax law, resident individuals are subject to tax on their worldwide income, while nonresident individuals generally are subject to tax only on income from sources within Japan. A nonresident individual is one who is not domiciled in Japan and has had his residence in Japan for less than one year. However, a resident who has no intention of residing in Japan permanently and has had a residence or domicile in Japan for no more than five years is subject to tax only on the total income derived from sources within Japan and on the income from other sources paid in Japan or remitted to Japan from abroad.

Japanese domestic corporations are subject to tax on their worldwide income. A domestic corporation is one that is incorporated or has its head office in Japan. Foreign (non-domestic) corporations are subject to tax only upon their income from sources in Japan.

Controlled foreign corporation rules

Japanese tax law provides a set of rules pertaining to controlled foreign corporations ("CFC"), foreign corporations owned over 50 percent, directly or indirectly, by domestic corporations and residents. Under those rules, all of the undistributed income of a CFC is attributed to any domestic corporation owning directly or indirectly five percent or more of the stock of a CFC if the tax burden of the foreign subsidiary is 25 percent or less. In general, the attribution does not occur in a tax year in which the CFC is actively conducting its main business in the country in which its head or main office is located.

Business income

Foreign corporations and nonresident individuals generally are subject to tax in Japan only on income from sources within Japan. Business income derived in Japan by a foreign corporation or nonresident individual is generally taxed in the same manner as the income of a domestic corporation or resident individual if the foreign corporation or nonresident individual maintains a permanent establishment [5] in Japan. Under domestic Japanese tax law there are several categories of permanent establishment. Depending upon the type of permanent establishment maintained and the type of income earned, non-business income may be attributed to the permanent establishment and taxed as aggregate income, or such income may be taxed separately at a flat withholding rate of 20 percent (15 percent for certain interest income) of gross revenue.

[5] The Japanese tax statutes do not use the term "permanent establishment," although such term is used by most secondary authorities, including the Ministry of Finance, to describe the domestic tax law. The statutes refer to the concept of a place of business in Japan, which is similar to the concept of a permanent establishment. Under the statutes, a foreign corporation or individual with a fixed place in Japan in which all or part of its business is transacted is deemed to have a place of business in Japan. The statutes also provide certain exemptions from this definition that more closely match up the concept of place of business with that of permanent establishment.

Other income

In the absence of a permanent establishment, Japan imposes a withholding tax of 20 percent on Japan-source gross dividend payments to nonresident individuals and foreign corporations. Japan does not impose a branch profits tax.

Japan-source interest payments to nonresident individuals and foreign corporations without a permanent establishment are generally subject to withholding tax on the gross interest payments at a rate of 20 percent. However, a withholding rate of 15 percent is generally imposed on interest payments on Japanese government bonds, domestic corporation debentures and domestic bank deposits.

Japan-source royalties paid to nonresident individuals and foreign corporations without a permanent establishment are generally subject to a 20 percent withholding tax on the gross payments. Royalty income under Japanese tax law includes payments for sales of technology.

Nonresident individuals and foreign corporations carrying on a business in Japan through a permanent establishment in Japan are taxed on gains with respect to the disposition of assets giving rise to Japan source income. Other nonresident individuals and foreign corporations are generally not taxed on gains from the disposal of Japanese assets, except for the sale or disposal of real property situated in Japan, the disposal or cutting of timber standing in Japan, and the sale of a substantial interest in a domestic corporation. The sale of five percent or more of the issued shares of a domestic corporation, made by a nonresident or foreign corporation (and certain related parties), is deemed to be a sale of a substantial interest if the nonresident or foreign corporation (and related parties) owned 25 percent or more of such issued shares during the year of sale or during the preceding two years.

Japanese double tax relief is provided to domestic corporations and resident individuals through a foreign tax credit. Japanese foreign tax credits are subject to an overall limitation generally equal to the product of Japanese income tax multiplied by the ratio of foreign source income to taxable income. Surplus foreign taxes may be carried forward for three years. Surplus foreign tax credit limitation may also be carried forward for three years. A taxpayer may elect to deduct all foreign taxes for a taxable year in lieu of the foreign tax credit. A domestic corporation is also generally allowed indirect foreign tax credits with respect to foreign taxes attributable to dividends from foreign subsidiaries owned 25 percent or more by the domestic corporate taxpayer for at least six months.

C. Other Taxes

In addition to the national income taxes described above, other taxes are levied at the national or local levels. Additional national taxes include a broad based (VAT-type) five-percent consumption tax (which includes a one-percent local consumption tax collected at the national level), excise taxes on gasoline, other fuels, liquor, tobacco and certain other items, inheritance and gift taxes, land value tax, registration and license taxes, and stamp tax. Japan also provides a social security system funded by taxes on employers and employees (through payroll withholding) to provide employee health, pension, workers' accident compensation, and unemployment benefits.

Prefectural inhabitants tax, municipal inhabitants tax and enterprise tax are taxes on income collected at the local level, but subject to the general rules and rate limits prescribed by the Local Tax Law (enacted by the national government).[6] The bases for the individual and corporate inhabitants taxes are almost the same as those of the corresponding national income taxes. The aggregate rates for the inhabitants taxes are progressive and vary from approximately five to 13 percent for individuals and 17 to 21 percent for corporations. The inhabitants taxes include a per capita tax on individuals and corporations.

The local enterprise tax is levied on corporations engaging in business and individuals engaging in certain types of businesses. The tax base for the enterprise tax is generally similar to that applied to business income by the national income tax, but items may be more or less widely defined in an attempt to link the base to the benefits provided to business by local government. The enterprise tax rates vary from approximately three to five percent for individuals and five to 10 percent for corporations, plus an added value levy and capital levy for corporations.

In addition, various excise and property taxes are assessed at the local level.

[6] There are 47 prefectures in Japan, and approximately 6,500 cities, towns and villages.

IV. THE UNITED STATES AND JAPAN: CROSS-BORDER INVESTMENT AND TRADE

A. Introduction

A principal rationale for negotiating tax treaties is to improve the business climate for business persons in one country who might aspire to sell goods and services to customers in the other country and to improve the investment climate for investors in one country who might aspire to own assets in the other country. Clarifying the application of the two nations' income tax laws makes more certain the tax burden that will arise from different transactions, but may also increase or decrease that burden. Where there is, or where there is the potential to be, substantial cross-border trade or investment, changes in the tax structure applicable to the income from trade and investment has the potential to alter future flows of trade and investment. Therefore, in reviewing the proposed treaty it may be beneficial to examine the cross-border trade and investment between the United States and Japan.

When measuring by trade in goods or services or when measuring by direct and non-direct cross-border investment, the United States and Japan are important components of each country's current and financial accounts. In 2002, aggregate cross-border investment between the United States and Japan totaled $110.0 billion. Substantial cross-border investment by persons in both countries over the years has resulted in cross-border income flows in excess of $40 billion (real 2002 dollars) annually since 1995. The income from cross-border trade and investment generally is subject to income tax in either the United States or Japan and in many cases the income is subject to withholding taxes.

B. Overview of International Transactions Between the United States and Japan

The value of trade between the United States and Japan is large. In 2002, the United States exported $80.1 billion of goods and services to Japan and imported $140.4 billion in goods and services from Japan.[7] These figures represent 8.2 percent of all exports from the United States and 10.1 percent of all imports into the United States. Similarly, the value of cross-border investment, U.S. investments in Japan and Japanese investments in the United States is large. In 2002, U.S. investments in Japan increased by $25.9 billion and Japanese investments in the United States increased by $84.1 billion.[8] The increase in U.S. investments in Japan represents 14.5 percent of the increase in all U.S. assets abroad in 2002. The increase in Japanese-owned U.S. assets represents 11.9 percent of the increase in all foreign-owned assets in the United States in 2002. Table 1, below, summarizes the international transactions between the United States and Japan in 2002.

Table 1 presents the balance of payments accounts between the United States and Japan. Two primary components comprise the balance of payments account: the current account and the financial account.[9] The current account measures flows of receipts from the current trade in goods and services between the United States and Japan and the flow of income receipts from investments by U.S. persons in Japan and by Japanese persons in the United States. The financial account measures U.S. investment in Japan and Japanese investment in the United States.

[7] Patricia E. Abaroa and Renee M. Sauers, "U.S. International Transactions, Second Quarter 2003," *Survey of Current Business*, vol. 83, October 2003, pp. 28–57.

[8] *Ibid.*

[9] Prior to 1999, the U.S. Department of Commerce, Bureau of Economic Analysis reported and described international transactions by reference to the "current account" and the "capital account." Beginning in June 1999 the Bureau of Economic Analysis adopted a three-group classification to make U.S. data reporting more closely aligned with international guidelines. The three groups are labeled, as in Table 1: current account; capital account; and financial account. Under this regrouping, the "financial account" encompasses all transactions that used to fall into the old "capital account," that is the financial account measures U.S. investment abroad and foreign investment in the United States. The new (post-1999) system redefines the "current account" by removing a small part of the old measure of unilateral transfers and including it in the newly defined "capital account." The newly defined capital account consists of capital transfers and the acquisition and disposal of non-produced, non-financial assets. For example, the newly defined capital account includes such transactions as forgiveness of foreign debt, migrants' transfers of goods and financial assets when entering or leaving the country, transfers to title to fixed assets, and the acquisition and disposal of non-produced assets such as natural resource rights, patents, copyrights, and leases. In practice, the Bureau of Economic Analysis believes the newly defined "capital account" transactions will be small in comparison to the current account and financial account.

Table 1.—International Transactions Between the United States and Japan, 2002

[Dollars is in billions, nominal]

Current Account Balance	**−80.1**
Exports of Goods and Services from the United States and Income Receipts from Japan	92.7
Merchandise	49.7
Services	30.4
Income receipts from U.S.-owned assets in Japan	12.6
Imports of goods and services from Japan and income payments to Japan	173.2
Merchandise	121.4
Services	18.9
Payments on Japanese-owned U.S. assets	32.8
Unilateral Transfers	0.5
Financial Account Balance	**−58.2**
Japanese Investment in the United States	84.1
Direct Investment	5.0
Private non-direct investment	[1] 79.1
Official	[1] n.a.
U.S. Investment in Japan	25.9
Direct Investment	4.5
Private non-direct investment	21.4
Increase in government assets	0.0
Capital Account Transactions, net	**0.0**
Statistical Discrepancy	**21.8**

Notes:

[1] Foreign private holding and foreign official holdings of assets are combined in the data to avoid disclosure of holdings by foreign official agencies. The Bureau of Economic Analysis combines official asset holdings with other non-direct investment.

Source: Patricia E. Abaroa and Renee M. Sauers, “U.S. International Transactions, Second Quarter 2003,” *Survey of Current Business*, vol. 83, October 2003, pp. 28–57.

C. Trends in Current Account Income Flows Between the United States and Japan

Payments of royalties

As Table 1 displays, the current account consists of three primary components: trade in goods; trade in services; and payment of income on assets invested abroad. Numerous disparate activities comprise trade in services. Among the sources of receipts from exported services are payments for transportation of goods, travel by persons and passenger fares, payments for professional services such as management consulting, architecture, engineering, and legal services, financial services, insurance services, computer and information services, and film and television tape rentals. Also included in receipts for services are the returns from investments in intangible assets in the form of royalties and license fees. In 2002, U.S. persons received approximately $6.4 billion in royalty and license fees from Japan, making Japan the largest payor of royalties and license fees among all U.S. trading partners. The $6.4 billion paid by Japanese persons accounted for 14 percent of all royalties and license fees paid to the United States in 2002.[10] In 2002, Japanese persons received $5.0 billion in royalties and license fees from the United States. The $5.0 billion paid to Japanese persons made Japan the largest recipient of royalties and license fees paid by the United States and constituted 26 percent of all royalties and license fees paid abroad by the United States.[11] Figure 1 documents the cross-border payments of royalties and license fees between the United States and Japan.[12] Even with virtually no growth in such receipts to the United States over the past decade (coinciding with Japan's prolonged economic slump), the aggregate amount of such cross-border flows has grown from less than $2.0 billion in 1982[13] (measured in real 2002 dollars) to more than $11.0 billion in 2002.

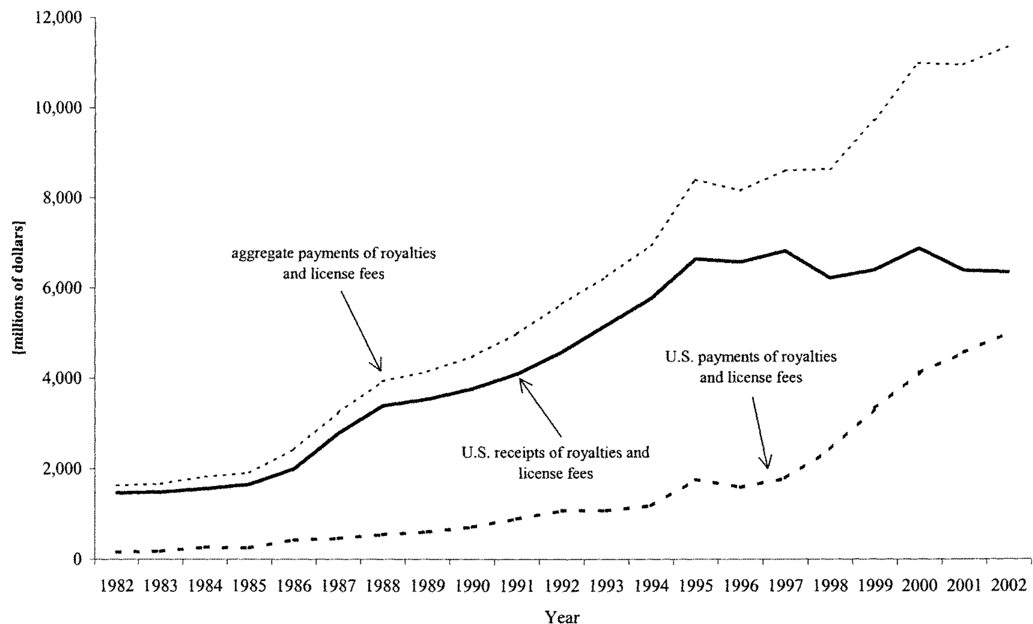
[10] Maria Borga and Michael Mann, "U.S. International Services: Cross-Border Trade in 2002 and Sales Through Affiliates in 2001," *Survey of Current Business,* vol. 83, October 2003, pp. 58-118. The second, third, and fourth largest payors of royalties and license fees to the United States in 2002 were the United Kingdom, $4.5 billion, Canada, $3.1 billion, and Germany, $3.1 billion.

[11] *Ibid.* The second, third, and fourth largest recipients of royalties and license fees paid by the United States in 2002 were Germany, $2.1 billion, Switzerland, $1.9 billion, and the Netherlands, $1.5 billion.

[12] In Figure 1 through Figure 4 a solid line represents payments to the United States from Japan and a heavy broken line represents payments from the United States to Japan. Figure 1 and Figure 2 also have a lighter broken line representing the sum of payments from Japan and from the United States.

[13] A change in the measurement of data used to compile the series "royalties and license fees" does not permit consistent reporting of these data over a longer period.

Figure 1.--U.S. and Japan Payments of Royalties and License Fees, 1982-2002
[Millions of Real 2002 Dollars]



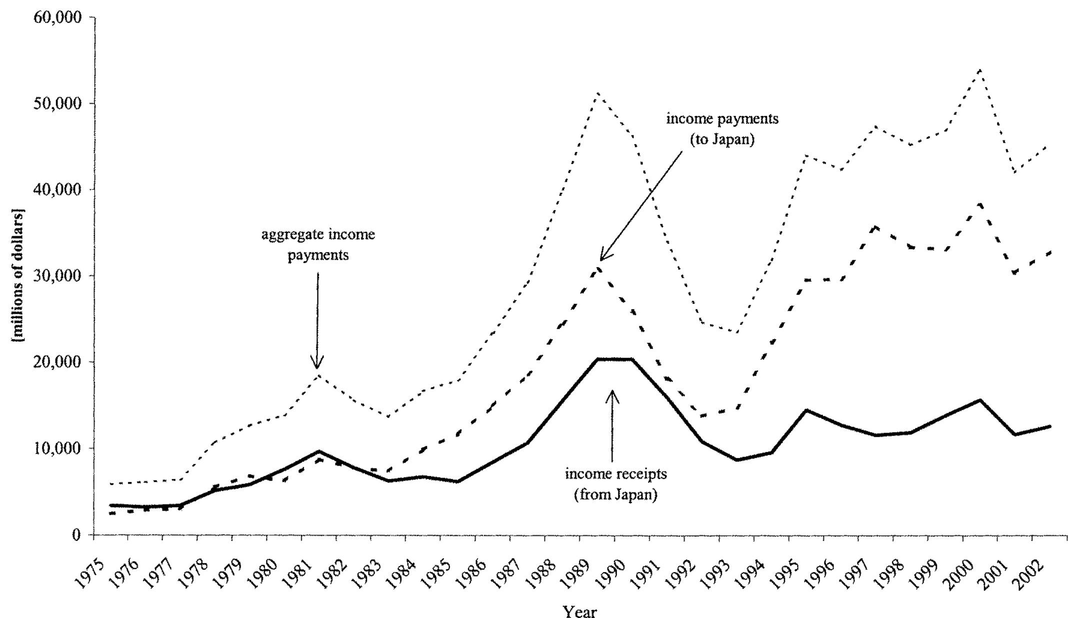
Source: JCT tabulations of data from Bureau of Economic Analysis.

Income receipts from investments

Overview

Figure 2 shows the growth in cross-border receipts between the United States and Japan that has occurred in cross-border payments of income from Japanese assets owned by U.S. persons and from U.S. assets owned by Japanese persons. Measured in real dollars, income received by U.S. persons from the ownership of assets in Japan has grown approximately three and one half times since 1975. Over the same period, income received by Japanese persons from the ownership of assets in United States has grown more than twelve fold.

Figure 2.--U.S. and Japan Receipts of Income from Investments, 1975-2002
[Millions of Real 2002 Dollars]



Source: JCT tabulations of data from Bureau of Economic Analysis.

Income from direct investment and income from non-direct investment

Income from foreign assets is categorized as income from "direct investments" and income from "non-direct investments." Direct investment constitutes assets over which the owner has direct control. The Department of Commerce defines an investment as direct when a single person owns or controls, directly or indirectly, at least 10 percent of the voting securities of a corporate enterprise or the equivalent interest in an unincorporated business. Often the income that crosses borders from direct investments is in the form of dividends from a subsidiary to a parent corporation, although interest on loans between such related corporations is another source of income from a direct investment. In non-direct investments the investor generally does not have control over the assets that underlie the financial claims. Non-direct investments consist mostly of holdings of corporate equities and corporate and government bonds, generally referred to as "portfolio investments," and bank deposits and loans. Hence, the income from non-direct investments generally is interest or dividends. Japanese persons have substantial holdings of U.S. government bonds. Figure 3 shows the payments by the U.S. government to Japanese persons, largely interest on Japanese holdings of U.S. government bonds. The income paid by the U.S. government to Japanese persons was roughly ten times larger in 2002 than in 1975 (measured in real 2002 dollars). Such payments totaled over $18 billion in 2002.[14]

[14] Comparable data are not available for holdings of Japanese government bonds by U.S. persons. The interest from U.S. holdings of Japanese government bonds is included in portfolio income in Figure 4 below.

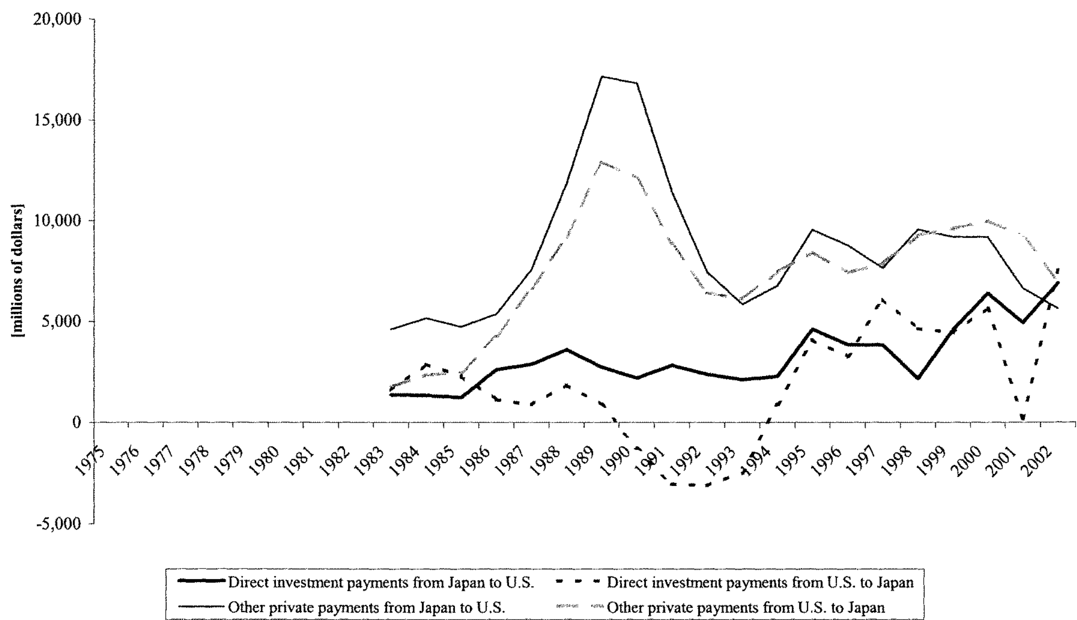
Figure 3.--Real U.S. Government Payments to Japanese Persons, 1975-2002
[Millions of Real 2002 Dollars]

Source: JCT tabulations of data from Bureau of Economic Analysis.

Income paid by the U.S. government to Japanese persons was larger than the sum of the income received by Japanese persons from their direct and portfolio (non-governmental) and other non-direct investments in the United States. This has been the case in every year since 1986. In 2002, the income received by Japanese persons from direct investments in the United States totaled $7.5 billion and the income received by Japanese persons from portfolio (non-governmental) and other non-direct investments in the United States totaled $7.0 billion. These totals exceeded the income received by U.S. persons on their direct investments in Japan, $6.9 billion in 2002, and the income received by U.S. persons on their portfolio and other non-direct investments in Japan, $5.6 billion in 2002. Figure 4 records the cross-border income flows from direct and portfolio and other non-direct investments between the United States and Japan. The income received in the United States (the solid lines in Figure 4) from such investments generally exceeded that received in Japan (the broken lines in Figure 4) from 1986 to 1993.[15] Over the past decade these income flows have been of comparable magnitude.

[15] The Bureau of Economic Analysis estimates a negative income flow across borders attributable to foreign direct investment when losses in foreign affiliates' operations result in the parent company providing funds to cover the loss and pay factors of production.

Figure 4.--U.S. and Japan Income from Direct and Non-Direct Investments, 1982-2002
[Millions of Real 2002 Dollars]



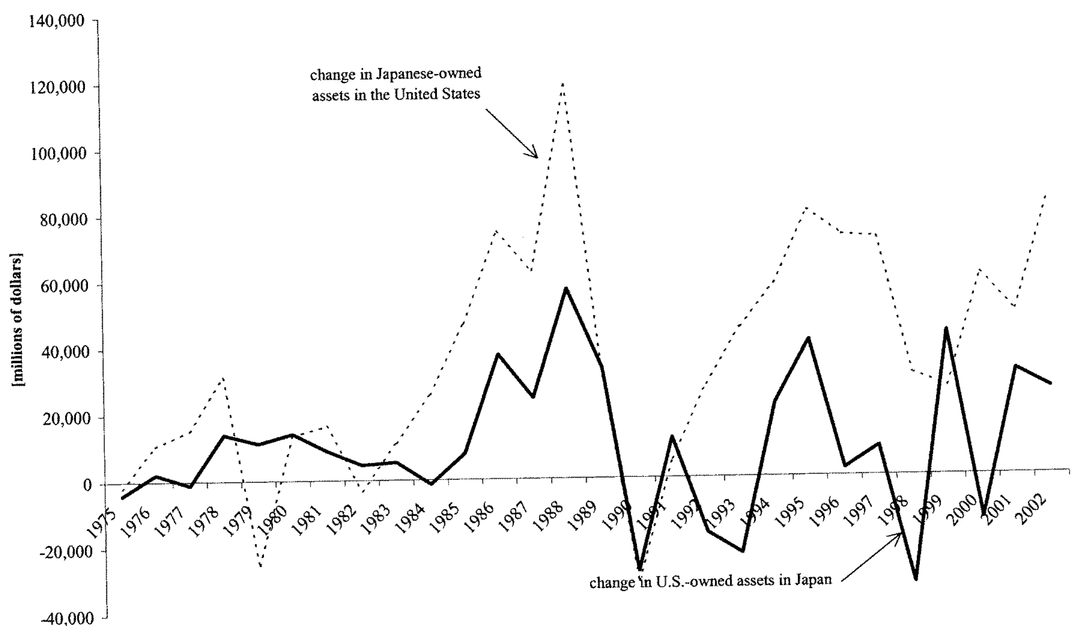
Source: JCT tabulations of data from Bureau of Economic Analysis.

D. Trends in the Financial Account Between the United States and Japan

As discussed above, the current account of international transactions between the United States and Japan records the current-year flow of receipts from current export of goods and services and the income flows arising from past investments. The financial account of international transactions between the United States and Japan (the bottom portion of Table 1) measures the change in U.S ownership of Japanese assets and the change in Japanese ownership of U.S. assets. The importance of the financial account, as documented in preceding discussion, is that ownership of assets abroad generates future receipts of income. In 2002, aggregate cross-border investment between the United States and Japan totaled $110.0 billion. As Table 1 documented, in 2002 the United States' financial account balance with Japan was a −$58.2 billion, i.e., in 2002, Japanese persons accumulated $58.2 billion more in additional assets in the United States than U.S. persons accumulated in additional assets in Japan. For most of the past two decades, Japanese persons have accumulated U.S. assets at a greater rate than U.S. persons have accumulated Japanese assets. Figure 5, below, shows the annual change in U.S.-owned Japanese assets and the annual change in Japanese-owned U.S. assets.[16]

[16] In Figure 5 through Figure 9 a solid line indicates the net acquisition (purchase of assets, purchase of securities, bank deposit, or extension of credit) by U.S. persons of Japanese assets. If the solid line reports a negative number, there was a net disposition of such assets. In Figure 5 through Figure 9 a broken line indicates the net acquisition by Japanese persons of U.S. assets. If the broken line reports a negative number, there was a net disposition of such assets.

Figure 5.--U.S. and Japan Financial Account Annual Change in Assets Owned, 1975-2002
[Millions of Real 2002 Dollars]

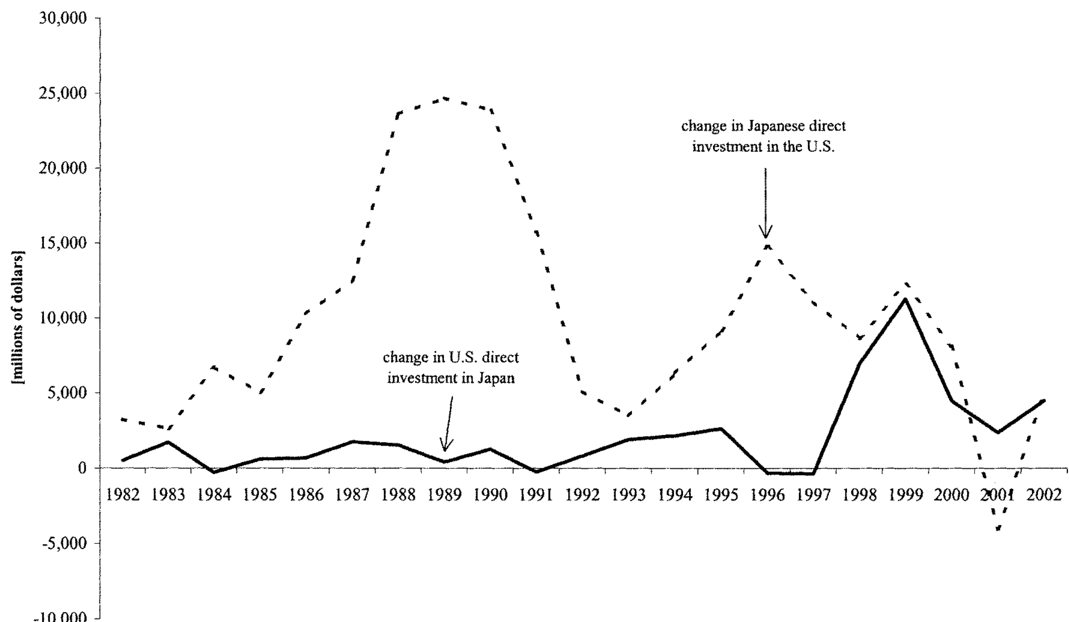


Source: JCT tabulations of data from Bureau of Economic Analysis.

Figure 6, Figure 7, Figure 8, and Figure 9 decompose these annual changes in asset ownership into direct investment and components of non-direct investment. Figure 6 reports the annual change in U.S. direct investment in Japan and the annual change in Japanese direct investment in the United States since 1982.[17] Almost all years over the past two decades have showed an increase in the amount of direct investment in assets of the one country by investors in the other country. The changes measured in direct investment occur because of increases or decreases in equity investment, changes in intra-company debt, the reinvestment of earnings, and currency valuation adjustments.

[17] A change in the measurement of data used to compile the series "direct investments" does not permit consistent reporting of these data over a longer period.

Figure 6.--Change in U.S. and Japan Direct Investment, 1982-2002
[Millions of Real 2002 Dollars]



Source: JCT tabulations of data from Bureau of Economic Analysis.

Total direct investment by U.S. persons in Japan is large. Measured on an historical cost basis,[18] the value of U.S. direct investment in Japan as of the end of 2002 was $65.7 billion. This represented the sixth largest U.S. direct investment position abroad in 2002 after the United Kingdom ($255.4 billion), Canada ($152.5 billion), the Netherlands ($145.5 billion), Switzerland ($70.1 billion) and Bermuda ($68.9 billion).[19] The value of Japanese direct investment in the United States is $152.0 billion. This the fourth largest foreign direct investment position in the United States after the United Kingdom ($283.3 billion), France ($170.6 billion), and the Netherlands ($154.8 billion).[20]

Non-direct investment generally may be thought of as consisting of two components, portfolio investment, that is, the purchase of securities, and lending activities. Figure 7 reports the annual change in the holdings of Japanese securities (stocks and bonds) by U.S. persons and the annual change in the holdings of U.S. securities (other than Treasury securities) by Japanese persons. In 2002, U.S. holdings of Japanese stocks and bonds increased by $9.0 billion to a year-end estimated value of $175.0 billion. Of this total, Japanese stocks account for $140.5 billion and Japanese bonds account for $34.5 billion. Among U.S. holdings of foreign stocks, the value of Japanese stock held is second only to holdings of U.K. equities by U.S. persons. Among holdings of foreign bonds, U.S. holdings of Japanese bonds is the third greatest of any country, after holdings of U.K. and German bonds.[21] Japanese holdings of U.S. securities (other than Treasury securities) increased by $49.2 billion in 2002, so that at the end of 2002, Japanese persons held $106.2 billion of U.S. corporate stocks and $163.4 billion of U.S. corporate bonds and the bonds of certain Federal agencies (other than general obligation Treasury bonds). These holdings represented the third largest holdings of stocks, after the United Kingdom and Canada, and the second largest holdings of corporate and agency bonds, after the United Kingdom.[22]

[18] The Bureau of Economic Analysis prepares detailed estimates of direct investment by country and industry on an historical cost basis only. Thus, the estimates reported reflect price levels of earlier periods. For estimates of aggregate direct investment the Bureau of Economic Analysis also produces current-cost and market value estimates.

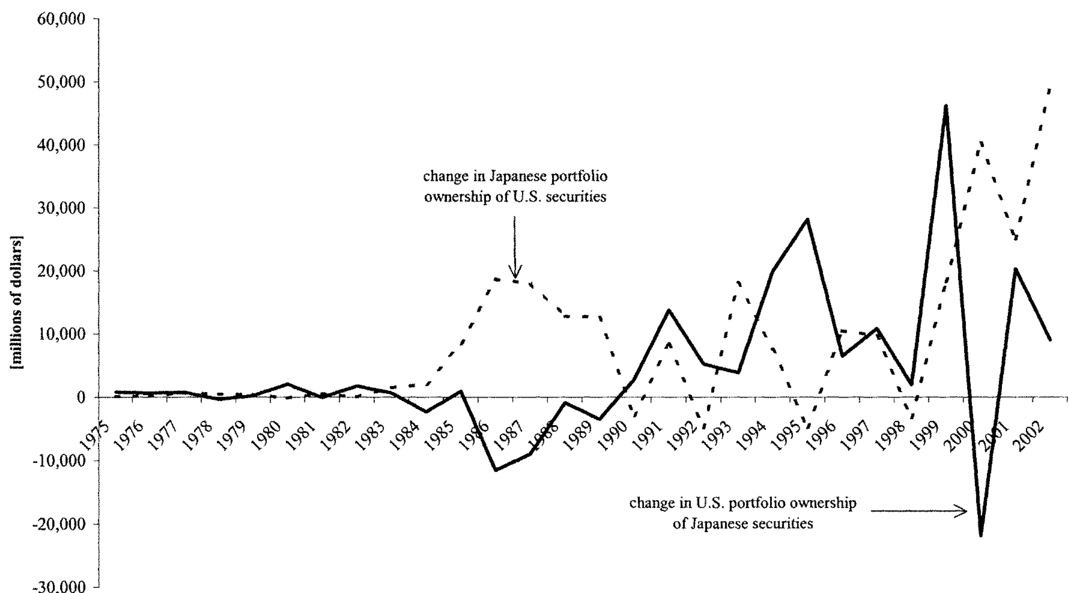
[19] Maria Borga, "Direct Investment Positions for 2002: Country and Industry Detail," *Survey of Current Business,* vol. 83, July 2003, pp. 22–31.

[20] *Ibid.*

[21] Elena L. Nguyen, "The International Investment Position of the United States at Yearend 2002," *Survey of Current Business,* vol. 83, July 2003, pp. 12–21.

[22] *Ibid.*

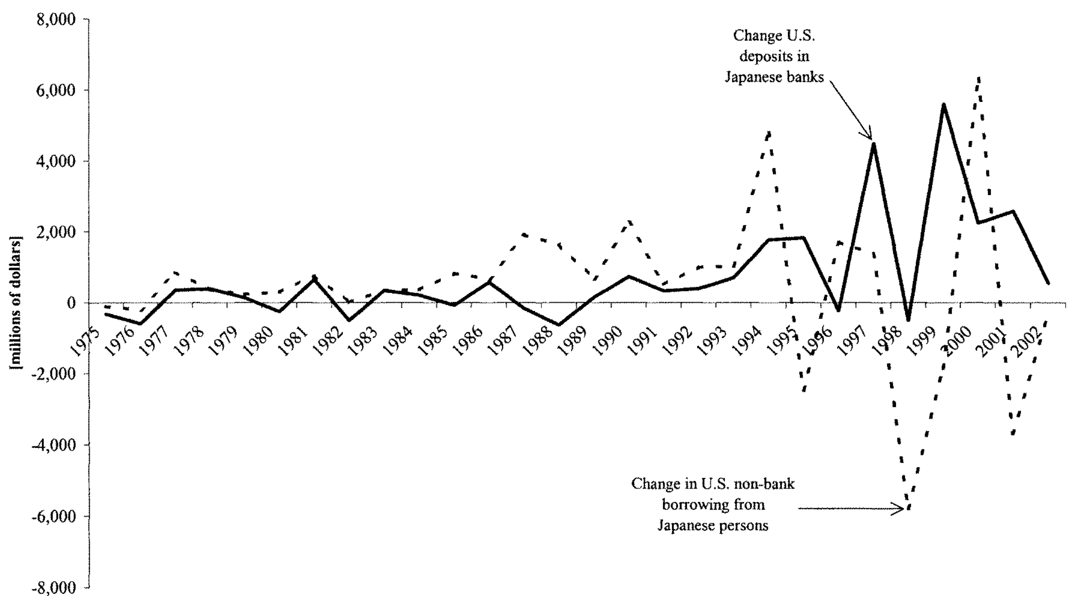
Figure 7.--Change in U.S. and Japan Ownership of Portfolio Securities, 1975-2002
[Millions of Real 2002 Dollars]



Source: JCt tabulations of data from Bureau of Economic Analysis.

Lending activities, aside from the sale of debt securities, constitute the remaining source of non-direct cross-border investment. When a U.S. bank makes a loan to a foreign person abroad (including a foreign subsidiary), the U.S. bank is making a foreign investment. When a non-bank U.S. person makes a deposit in a foreign bank, the non-bank U.S. person is making a foreign investment. Likewise if a U.S. business draws on a line of credit from a Japanese bank, the Japanese bank is making an investment in the United States. Such deposit and borrowing activity can be quite variable and changes in exchange rates and business activity abroad may lead to substantial variability in the annual level of such activity. Figure 8 indicates that deposits by non-banking U.S. persons in Japanese banks generally have been increasing over the past decade as almost every year has shown an increase. On the other hand, borrowing by non-banking U.S. persons from Japanese persons has been substantially more variable, making it difficult to estimate whether the aggregate amount of such debt owed by non-banking U.S. persons to Japanese banks has increased or decreased when measured in real dollars.

Figure 8.--Change in U.S. and Japan Non-Direct Investment by Persons Other Than Banks, 1975-2002
[Millions of Real 2002 Dollars]

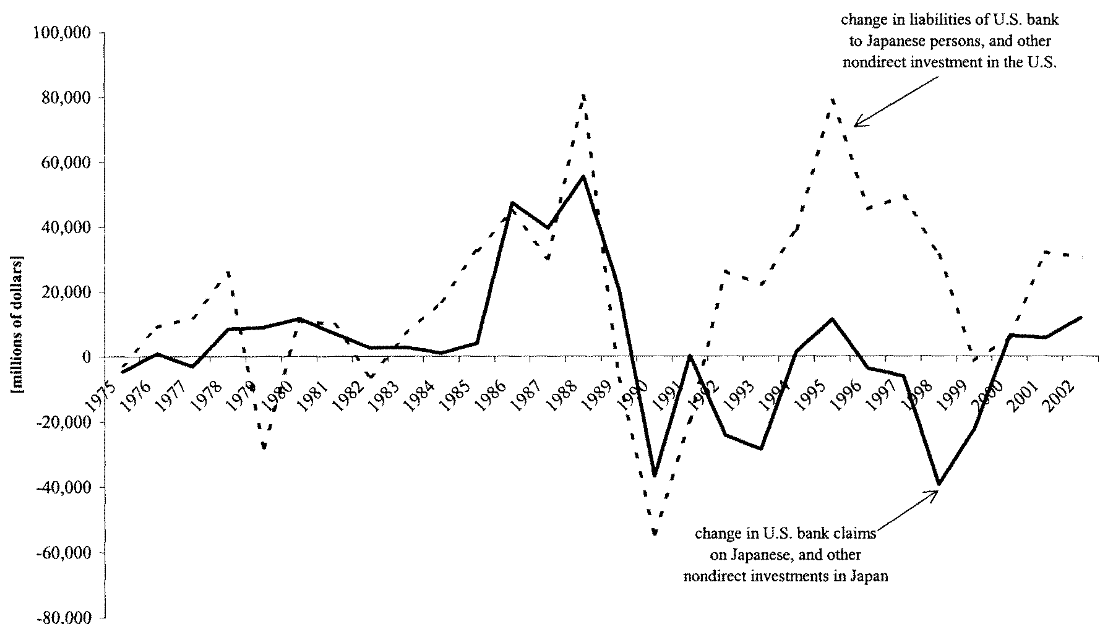


Source: JCT tabulations of data from Bureau of Economic Analysis.

Figure 9 reports cross-border investment activity between the United States and Japan by U.S. banks, including intra-affiliate loans. The solid line in Figure 9 indicates that for most of the past decade lending by U.S. banks to Japan has declined and outstanding loans have been repaid. The broken line in Figure 9 includes data on U.S. bank borrowing from Japanese affiliates and deposits accepted from Japanese persons. However, in Figure 9, the broken line also includes annual changes in Japanese holdings of U.S. Treasury securities and changes in the holding of Treasury securities dominate the banking data in most years. Japanese persons are the largest non-U.S. holders of U.S. Treasury securities. As of December 2002, Japan held $386.7 billion in U.S. Treasury securities adding private and official holdings.[23] This represented almost one third of Treasury securities held outside the United States.

[23] *Ibid.* Foreign private holding and foreign official holdings of Treasury securities are combined in the data to avoid disclosure of holdings by foreign official agencies.

Figure 9.--Change in U.S. and Japan Non-Direct Investment by U.S. Banks, 1975-2002
[Millions of Real 2002 Dollars]



Source: JCT tabulations of data from Bureau of Economic Analysis.

E. Income Taxes and Withholding Taxes on Cross-Border Income Flows

The data presented above shows that U.S. persons own a substantial amount of direct investment in Japan and Japanese persons own a substantial amount of direct investment in the United States. Similarly, the data reveal substantial portfolio investments by persons of each country in the securities of the other country. In addition to portfolio holdings of private securities, Japanese persons hold substantial amounts of U.S. Treasury securities. Lastly, cross-border bank lending also has been large in magnitude and variable, year to year. Returns on such investments are paid to their owners via dividends, interest, and royalties. Under the present treaty, payments of dividends, certain interest, and royalties are subject to withholding taxes in both the United States and Japan. In addition, U.S. affiliates located in Japan pay income taxes to Japan and U.S. affiliates of Japanese companies pay income taxes in the United States.

Data from tax returns reflect the substantial magnitudes of cross-border investment and trade and income flows reported above. In 2000, U.S. corporations with Japanese parent companies had $19 billion of income subject to tax and paid $6 billion in U.S. Federal income taxes. U.S. corporations, including U.S. parent companies of Japanese controlled foreign corporations, received $6 billion of dividends from Japanese corporations in 1999. Of the reported $6 billion in dividends on returns, approximately $3 billion reflected the grossed up value of net dividends to account for deemed taxes paid to Japan. U.S. corporations recognized a total of about $12 billion in taxable income originating in Japan, including the dividend amounts just cited. This income was subjected to an average Japanese tax rate of approximately 38 percent.

Data for withholding taxes from the late 1990s show that Japan and the United States collected roughly the same amounts of receipts, between $500 million and $1 billion annually, by withholding tax on respective payments to each other.[24] The data suggest that controlled foreign corporations from each nation repatriated about the same amount, 50 percent, of current corporate earnings and profits. However, data from withholding taxes may be a misleading indicator of cross-border investment and income flows. With respect to dividend income from direct investments, a taxpayer can control the amount and timing of tax paid, because a taxpayer only pays withholding tax when dividends are repatriated to the home country. In addition, a significant amount of Japanese portfolio investment in the United States (e.g., holdings of Treasury securities) generates flows of income that are exempt from withholding tax.

[24] For example, data for 1999 show that the United States collected $857 million from withholding tax on all U.S. payments to Japan. Statistics of Income Division, Internal Revenue Service, "Foreign Recipients of U.S. Income, 1998 and 1999," *SOI Bulletin,* vol. 22, Summer 2002, p. 213. Data for 1999 also show that Japan collected $815 million from Japanese payments to U.S. corporations filling Form 1118. This latter figure understates total Japanese collections because it only relates to payment to certain U.S. corporations and not all payments, but this difference is not substantial. Brian Raub, "Corporate Foreign Tax Credit, 1999," *SOI Bulletin,* vol. 23, Fall 2003, pp. 270–73.

F. Analyzing the Economic Effects of Income Tax Treaties

Among other things, tax treaties often change both the amount and timing of income taxes and the country (source or residence) that has priority to impose such taxes. If the tax treaty changes increase the after-tax return to cross-border trade and investment, or to particular forms of trade or investment, in the long run there could be significant tax effects as, for example, the amount of income from Japanese investment subject to domestic U.S. income tax or withholding taxes changes. Generally, to the extent a treaty reduces barriers to capital and labor mobility, more efficient use of resources will result and economic growth in both countries will be enhanced, although there may be negative transitional effects occurring in specific industries or geographic regions. On the other hand, tax treaties may also lead to tax base erosion if they create new opportunities for tax arbitrage. Tax treaties also often increase and improve information sharing between tax authorities. Improvements in information sharing should reduce the potential for outright evasion of U.S. and Japanese income tax liabilities.

Generally, a treaty-based reduction in withholding rates will reduce directly U.S. tax collections in the near term on payments from the United States to Japan, but will increase U.S. tax collections on payments from Japan to the United States because of the reduction in foreign taxes that are potentially creditable against the U.S. income tax. To the extent that the withholding rate reduction encourages more income flows between the treaty parties, this initial dampening of collections on payments to Japan and related decrease in foreign tax credits will begin to reverse. The proposed treaty is likely to have complex effects on U.S. tax receipts. Recent withholding tax data suggest that the treaty's reductions in dividend and royalty withholding rates will reduce U.S. withholding tax collections on dividend and royalty payments from the United States to Japan by roughly $200 million per year in the near term, assuming no change in the amount of such payments. At the same time, the reduction in Japanese withholding taxes will create a roughly equivalent reduction occurring in Japanese taxes available for crediting against U.S. tax, again assuming no change in the amount of such payments.

However, this simple analysis is incomplete. A complete analysis of a withholding change, or any other change in a treaty, would also account for non-tax related factors, such as portfolio capital needs in the affected countries, and the corresponding relation between current and financial accounts. Both the United States and Japan forecast budget deficits that are large and must be financed. Also, as noted above, growth in Japan has been slow for the past decade and continues to be slow in comparison to that of the United States, even accounting for the recent recession in the United States. The potential for future growth in each country is an important determinant of cross-border investment decisions. More recently the dollar has depreciated relative to the yen. The dollar depreciation makes more attractive exporting goods from the United States to Japan in the short run and may make less attractive investment in Japan by U.S. persons. In sum, even in the short run, the larger macroeconomic outlook is likely to be a more

important determinant of future cross-border income and investment flows and the related tax collections.

V. EXPLANATION OF PROPOSED TREATY

Article 1. General Scope[25]

Overview

The general scope article describes the persons who may claim the benefits of the proposed treaty. It also includes a "saving clause" provision similar to provisions found in most U.S. income tax treaties.

The proposed treaty generally applies to residents of the United States and to residents of Japan, with specific modifications to such scope provided in other articles (e.g., Article 18 (Government Service), Article 24 (Non-Discrimination), and Article 25 (Mutual Agreement Procedure)). This scope is consistent with the scope of other U.S. income tax treaties, the U.S. model, and the OECD model. For purposes of the proposed treaty, residence is determined under Article 4 (Residence).

The proposed treaty provides that it does not restrict in any manner any exclusion, exemption, deduction, credit, or other allowance accorded by internal law, by any other agreement between the United States and Japan, or by any multilateral agreement to which the United States and Japan are parties. Thus, the proposed treaty will not apply to increase the tax burden of a resident of either the United States or Japan. According to the Treasury Department's Technical Explanation (hereinafter referred to as the "Technical Explanation"), the fact that the proposed treaty only applies to a taxpayer's benefit does not mean that a taxpayer may select inconsistently among treaty and internal law provisions in order to minimize its overall tax burden. In this regard, the Technical Explanation sets forth the following example. Assume a resident of Japan has three separate businesses in the United States. One business is profitable and constitutes a U.S. permanent establishment. The other two businesses generate effectively connected income as determined under the Internal Revenue Code (the "Code"), but do not constitute permanent establishments as determined under the proposed treaty; one business is profitable and the other business generates a net loss. Under the Code, all three businesses would be subject to U.S. income tax, in which case the losses from the unprofitable business could offset the taxable income from the other businesses. On the other hand, only the income of the business which gives rise to a permanent establishment is taxable by the United States under the proposed treaty. The Technical Explanation makes clear that the taxpayer may not invoke the proposed treaty to exclude the profits of the profitable business that does not constitute a permanent establishment and invoke U.S. internal law

[25] The text of the proposed treaty does not include subject headings or titles for the articles. This pamphlet includes standard subject headings for ease of use.

to claim the loss of the unprofitable business that does not constitute a permanent establishment to offset the taxable income of the permanent establishment.[26]

The proposed treaty provides that the dispute resolution procedures under its mutual agreement article (Article 25) take precedence over the corresponding provisions of any other agreement to which the United States and Japan are parties in determining whether a taxation measure is within the scope of the proposed treaty. The proposed treaty also provides that the dispute resolution procedures set forth in Article XVII of the General Agreement on Trade in Services ("GATS") shall not apply to any taxation measure unless the competent authorities agree that the measure is not within the scope of the non-discrimination provisions of Article 24 (Non-Discrimination) of the proposed treaty. The Technical Explanation clarifies that no national treatment obligation undertaken by the United States and Japan pursuant to GATS will apply to a taxation measure, unless the competent authorities otherwise agree. For purposes of this provision, the term "measure" means a law, regulation, rule, procedure, decision, administrative action, or any similar provision or action, as related to taxes of every kind and description imposed by a treaty country. The proposed treaty does not provide any limitation on the application of the most favored nation obligation ("MFN") of Article II of GATS. Given there is no MFN obligation in the proposed treaty, there should be no conflict between the proposed treaty and the MFN obligation of GATS.

The Technical Explanation points out that, unlike the U.S. model, the proposed treaty does not include an additional limitation on the application of the national treatment and MFN obligations of other agreements. Except as discussed above with respect to GATS, subparagraph 2(b) of the proposed treaty provides that if there were overlap between Article 24 and the national treatment or MFN obligations of another agreement, benefits would be available under both the proposed treaty and that agreement. The Treasury Explanation clarifies that if benefits are available under that agreement that are not available under Article 24, a resident of the United States or Japan is entitled to the benefits provided under the overlapping agreement. Thus, if an existing agreement overlaps with Article 24 of the proposed treaty, remedies would be available under both agreements; if benefits are available under the existing agreement but not under Article 24, a resident is entitled to the benefits under the applicable agreement; and if benefits are available under Article 24 but not under the existing agreement, a resident is entitled to the benefits under Article 24. These rules may be more burdensome to apply than would be the case if the U.S. model rule had been incorporated. Furthermore, if an overlap does exist the consequences may be more severe in the case applying these rules to multilateral agreements versus bilateral agreements.

[26] See Rev. Rul. 84–17, 1984–1 C.B. 308.

Saving clause

Like all U.S. income tax treaties and the U.S. model, the proposed treaty includes a "saving clause." Under this clause, with specific exceptions described below, the proposed treaty does not affect the taxation by either treaty country of its residents or its citizens. By reason of this saving clause, unless otherwise specifically provided in the proposed treaty, the United States may continue to tax its citizens who are residents of Japan as if the treaty were not in force. For purposes of the proposed treaty (and, thus, for purposes of the saving clause), the term "residents," which is defined in Article 4 (Residence), includes corporations and other entities as well as individuals.

The proposed treaty contains a provision under which the saving clause (and therefore the U.S. jurisdiction to tax) applies to a former U.S. citizen or long-term resident (whether or not treated as such under Article 4 (Resident)), whose loss of citizenship or resident status, respectively, had as one of its principal purposes the avoidance of tax; such application is limited to the ten-year period following the loss of citizenship or resident status. Section 877 of the Code provides special rules for the imposition of U.S. income tax on former U.S. citizens and long-term residents for a period of 10 years following the loss of citizenship or resident status; these special tax rules apply to a former citizen or long-term resident only if his or her loss of U.S. citizenship or resident status had as one of its principal purposes the avoidance of U.S. income, estate or gift taxes. For purposes of applying the special tax rules to former citizens and long-term residents, individuals who meet a specified income tax liability threshold or a specified net worth threshold generally are considered to have lost citizenship or resident status for a principal purpose of U.S. tax avoidance.

Under U.S. domestic law, an individual is considered a "long-term resident" of the United States if the individual (other than a citizen of the United States) was a lawful permanent resident of the United States in at least eight of the 15 taxable years ending with the taxable year in which the individual ceased to be a long-term resident. However, an individual is not treated as a lawful permanent resident for any taxable year if such individual is treated as a resident of a foreign country for such year under the provisions of a tax treaty between the United States and the foreign country and the individual does not waive the benefits of such treaty applicable to residents of the foreign country.

Exceptions to the saving clause are provided for the following benefits conferred by a treaty country: the allowance of correlative adjustments when the profits of an associated enterprise are adjusted by the other country (Article 9, paragraph 2); protection from profit adjustments by the other country when an examination is not initiated within seven years of the taxable year for which the change to profits would take place (Article 9, paragraph 3); the exemption from source- and residence-country tax for certain pension, social security, alimony, and child support payments (Article 17, paragraph 3); relief from double taxation through the provision of a foreign tax credit (Article 23); protection from discriminatory tax treatment with respect to transactions with residents of the other country (Article 24); benefits under the mutual agreement proce-

dures (Article 25); and benefits to diplomatic and consular officers of one country who may be residents of the other country (Article 28). These exceptions to the saving clause permit residents or citizens of the United States or Japan to obtain such benefits of the proposed treaty with respect to their country of residence or citizenship.

In addition, the saving clause does not apply to certain benefits conferred by one of the countries upon individuals who neither are citizens of that country nor have been admitted for permanent residence in that country. Under this set of exceptions to the saving clause, the specified treaty benefits are available to, for example, a citizen of Japan who spends enough time in the United States to be taxed as a U.S. resident but who has not acquired U.S. permanent residence status (i.e., does not hold a "green card"). The benefits that are covered under this set of exceptions are the exemptions from host country tax for certain compensation from government service (Article 18), certain income received by visiting students and trainees (Article 19), and certain income received by visiting teachers (Article 20).

Article 2. Taxes Covered

The proposed treaty generally applies to the taxes of the United States and Japan that are covered in this Article. However, Article 24 (Non-Discrimination) of the proposed treaty is applicable to all taxes imposed at all levels of government, including State and local taxes. In addition, paragraph 3 of Article 8 (Shipping and Air Transport) provides that if a political subdivision or local authority of the United States seeks to impose tax on the profits of any enterprise of Japan from the operation of ships or aircraft in international traffic, in circumstances where the proposed treaty would preclude the imposition of a Federal income tax on such profits, the United States Government will use its best endeavors to persuade the political subdivision or local authority to refrain from imposing tax to preserve the exemption from local inhabitant taxes and the enterprise tax in Japan in respect of the operation of ships or aircraft in international traffic by U.S. enterprises.

In the case of the United States, the proposed treaty applies to the Federal income taxes imposed by the Code, but excludes social security taxes. Like the U.S. model, the proposed treaty also applies to the accumulated earnings tax and the personal holding company tax.

The proposed treaty does not specify that U.S. insurance excise tax with respect to U.S. risks is included among covered taxes. The proposed protocol, however, provides a waiver of this U.S. excise tax, subject to an "anti-conduit" rule. Specifically, the protocol provides that the U.S. excise tax on insurance policies issued by foreign insurers generally is not imposed on policies, the premiums on which are receipts of an insurance business carried on by an enterprise of Japan. Under the anti-conduit rule, the waiver applies to the extent that the risks covered by such premiums are not reinsured with a person not entitled to the benefits of the proposed treaty or any other tax treaty entered into by the U.S. that provides exemption from the U.S. insurance excise tax. For example, under the protocol, if a U.S. insurer reinsures U.S. risks with a

Japanese insurer that does not in turn reinsure the risks, the U.S. insurance excise tax would not apply. If the Japanese insurer reinsures the U.S. risks with an Italian insurer that is covered by the U.S.-Italy treaty (which provides a waiver of the U.S. insurance excise tax with a comparable anti-conduit rule), the U.S. excise tax would not apply. The excise tax continues to apply, however, if the Japanese insurer reinsures the U.S. risks with a foreign insurer that is not entitled to the waiver under the proposed treaty or equivalent benefits under a different U.S. tax treaty.

The proposed treaty also does not specify that the U.S. excise tax with respect to private foundations is included as a covered tax, but the proposed protocol provides a rate reduction or waiver of the tax in certain circumstances. In the case of dividends and interest derived by private foundations organized in Japan, the private foundations excise tax is limited to the rates provided for in the dividends and interest articles of the proposed treaty, respectively. In the case of royalties and other income derived by such private foundations, the excise tax is waived.

In the case of Japan, the proposed treaty applies to the income tax and the corporation tax (hereafter referred to as "Japanese tax").

The proposed treaty also contains a rule generally found in U.S. income tax treaties (including the present treaty) that provides that the proposed treaty applies to any identical or substantially similar taxes that may be imposed subsequently in addition to or in place of the taxes covered. The proposed treaty obligates the competent authority of each country to notify the competent authority of the other country of any significant changes in its internal tax laws or of any significant official published materials concerning the application of the proposed treaty, including explanations, regulations, rulings, or judicial decisions. The Technical Explanation states that this requirement relates to changes that are significant to the operation of the proposed treaty.

Article 3. General Definitions

The proposed treaty provides definitions of a number of terms for purposes of the proposed treaty. Certain of the standard definitions found in most U.S. income tax treaties are included in the proposed treaty.

The term "Japan" means all the territory of Japan, including its territorial sea, in which the laws relating to Japanese tax are in force, and all the area beyond its territorial sea, including the seabed and subsoil thereof, over which Japan has jurisdiction in accordance with international law and the laws relating to Japanese tax are in force.

The term "United States" means the United States of America (including the States thereof and the District of Columbia), but does not include Puerto Rico, the Virgin Islands, Guam, or any other U.S. possession or territory. The term "United States" also includes the territorial sea of the United States and the seabed and subsoil of the submarine areas adjacent to that territorial sea, over which the United States exercises sovereign rights in accordance with international law.

The term "Contracting State" means the United States or Japan, as the context requires.

The term "tax" means Japanese tax or United States tax, as the context requires.

The term "person" includes an individual, a company and any other body of persons. The protocol to the proposed treaty provides that the term "any other body of persons" includes an estate, trust, and partnership.

A "company" under the proposed treaty is any body corporate or any entity that is treated as a body corporate for tax purposes.

The term "enterprise" applies to the carrying on of any business, while the term "business" includes the performance of professional services and other activities of an independent character. The definitions of "enterprise" and "business" in the proposed treaty are identical to the same definitions recently added to the OECD model in conjunction with the deletion of Article 14 (Independent Personal Services) from the OECD model. The Technical Explanation states that the inclusion of these definitions is intended to clarify that the performance of personal services or other activities of an independent character are considered to constitute an enterprise, covered by Article 7 (Business Profits) and not Article 21 (Other Income). By contrast, the U.S. model does not provide definitions of the terms "enterprise" and "business" because, unlike the proposed treaty and the OECD model, the U.S. model continues to include a separate article concerning the treatment of independent personal services.

The terms "enterprise of a Contracting State" and "enterprise of the other Contracting State" mean, respectively, an enterprise carried on by a resident of a treaty country and an enterprise carried on by a resident of the other treaty country.

The proposed treaty defines "international traffic" as any transport by a ship or aircraft, except when the transport is solely between places in the other treaty country. Accordingly, with respect to a Japanese enterprise, purely domestic transport within the United States does not constitute "international traffic."

The term "national" means, in relation to Japan: (i) any individual possessing the nationality of Japan and (ii) any juridical person or other organization deriving such status under Japanese law. In relation to the United States: (i) any individual possessing the citizenship of the United States and, (ii) any legal person, partnership, or association deriving their status as such under the laws of the United States.

The U.S. "competent authority" is the Secretary of the Treasury or his delegate. The U.S. competent authority function has been delegated to the Commissioner of Internal Revenue, who has redelegated the authority to the Director, International (LMSB). On interpretative issues, the latter acts with the concurrence of the Associate Chief Counsel (International) of the IRS. The Japanese "competent authority" is the Minister of Finance or his authorized representative.

The term "pension fund" means any person that: (i) is organized under the laws of the United States or Japan and, (ii) is established and maintained primarily to administer or provide pensions or other similar remuneration, including social security payments

and (iii) is exempt from tax with respect to the activities described in (ii). The Technical Explanation provides that a Japanese investment fund is exempt from tax with respect to activities described in (ii) even though it is subject to certain non-income taxes specifically applicable to pension funds.

The proposed treaty also contains the standard provision that, unless the context otherwise requires or the competent authorities agree upon a common meaning pursuant to Article 26 (Mutual Agreement Procedure), all terms not defined in the proposed treaty have the meaning pursuant to the respective tax laws of the country that is applying the treaty.

Article 4. Residence

The assignment of a country of residence is important because the benefits of the proposed treaty generally are available only to a resident of one of the treaty countries as that term is defined in the proposed treaty. Furthermore, issues arising because of dual residency, including situations of double taxation, may be avoided by the assignment of one treaty country as the country of residence when under the internal laws of the treaty countries a person is a resident of both countries.

Internal taxation rules

United States

Under U.S. law, the residence of an individual is important because a resident alien, like a U.S. citizen, is taxed on his or her worldwide income, while a nonresident alien is taxed only on certain U.S.-source income and on income that is effectively connected with a U.S. trade or business. An individual who spends sufficient time in the United States in any year or over a three-year period generally is treated as a U.S. resident. A permanent resident for immigration purposes (i.e., a "green card" holder) also is treated as a U.S. resident.

Under U.S. law, a company is taxed on its worldwide income if it is a "domestic corporation." A domestic corporation is one that is created or organized in the United States or under the laws of the United States, a State, or the District of Columbia.

Japan

Under Japanese law, resident individuals are subject to tax on their worldwide income, while nonresident individuals generally are subject to tax only on income arising in Japan. A person who has resided continuously in Japan for one year or more is considered to be a resident. A nonresident individual is an individual who has not resided continuously in Japan for a year or more and does not have a Japanese domicile. Domicile is considered to be the place where a person has the base or center for his life.

Companies that are resident in Japan are subject to tax on their worldwide income. A company is resident in Japan if it is incorporated or has its head office in Japan. Japan does not use the "managed and controlled" test for determining the residence of a company. Companies that are not resident in Japan only pay tax on Japanese-source income.

Proposed treaty rules

The proposed treaty specifies rules to determine whether a person is a resident of the United States or Japan for purposes of the proposed treaty. The rules generally are consistent with the rules of the U.S. model.

The proposed treaty generally defines "resident of a Contracting State" to mean any person who, under the laws of that country, is liable to tax in that country by reason of the person's domicile, residence, citizenship, place of head or main office, place of incorporation, or any other criterion of a similar nature. The Technical Explanation notes that "place of management" is not included because neither U.S. law nor Japanese law looks to place of management as a relevant criterion in determining residence.

The Technical Explanation also states that the term "resident of a Contracting State" includes that Contracting State and any political subdivision or local authority thereof. The proposed treaty also provides special rules to treat as residents of a treaty country certain organizations that generally are exempt from tax in that country. Under these rules, a resident includes a legal person that is organized under the laws of a treaty country and is generally exempt from tax in the treaty country because it is established and maintained: (1) to provide pensions or other similar benefits to employees pursuant to a tax-exempt scheme or plan; or (2) exclusively for a religious, charitable, scientific, artistic, cultural, or educational purposes.

The term "resident of a Contracting State" does not include any person that is liable to tax in that country only on income from sources in that country or on profits attributable to a permanent establishment in that country. The proposed treaty provides that Japan will treat an individual who is a U.S. citizen or lawful permanent resident of the United States (i.e., a "green card" holder) as a resident of the United States only if he or she has a substantial presence, permanent home, or habitual abode in the United States and is not a resident of a third country for purposes of a tax treaty between such country and Japan. The determination of whether a citizen or national is considered a resident of the United States or Japan is made based on the principles of the treaty tie-breaker rules described below.

The proposed treaty provides a set of "tie-breaker" rules to determine residence in the case of an individual who, under the basic residence definition, would be considered to be a resident of both countries. Under these rules, an individual is deemed to be a resident of the country in which he or she has a permanent home available. If the individual has a permanent home in both countries, the individual's residence is deemed to be the country with which his or her personal and economic relations are closer (i.e., his or her "center of vital interests"). If the country in which the individual has his or her center of vital interests cannot be determined, or if he or she does not have a permanent home available in either country, he or she is deemed to be a resident of the country in which he or she has an habitual abode. If the individual has a habitual abode in both countries or in neither country, he or she is deemed to be a resident of the country of which he or she is a national. If the individual is a national of both countries or neither

country, the competent authorities of the countries will settle the question of residence by mutual agreement.

In the case of any person other than an individual that would be a resident of both countries, the proposed treaty requires the competent authorities to endeavor to settle the issue of residence by mutual agreement and to determine the mode of application of the proposed treaty to such person.

The Technical Explanation states that paragraph 5 of Article 4 is included in the proposed treaty because Japan continues to maintain a remittance system of taxation for individuals who are residents but not domiciled in Japan. Such persons are subject to tax in Japan on non-Japanese source income only to the extent the income or gains are remitted to Japan. Thus the proposed treaty allows such persons to qualify for benefits in order to reduce or eliminate tax to the extent the relevant income is remitted to or received in Japan. The Technical Explanation provides the example of a Japanese resident who is not domiciled in Japan, but maintains a brokerage account in Singapore into which is paid $100 in U.S. source portfolio dividend income. Under this example, the United States may impose withholding tax at the statutory rate of 30 percent because the dividend income will not be taxed in Japan as it has not been remitted to Japan. If, however, the dividend income is instead paid into a brokerage account in Tokyo, the Japanese resident will be subject to tax in Japan, and, under the proposed treaty, the United States generally will reduce the rate of withholding tax to 10 percent.

Fiscally transparent entities

The proposed treaty contains specific rules for fiscally transparent entities. The Technical Explanation generally defines fiscally transparent entities as entities in which income derived by such entities is taxed at the beneficiary, member, or participant level. Entities are not considered fiscally transparent if the entity tax may be relieved under an integrated system.

Under the proposed treaty, the rules for fiscally transparent entities are conveyed under five different fact patterns. The results under these five cases are consistent with rules for fiscally transparent entities found in recent U.S. income tax treaties and with U.S. domestic law. The proposed treaty contains more specific rules than what is generally found in U.S. income tax treaties because under Japanese domestic law an item of income is generally not "deemed" to belong to another taxpayer and thus Japanese domestic law lacks the concept found under U.S. domestic law that allows an item of income to flow from a partnership or other fiscally transparent entity up to its beneficiaries, members, or participants.

Under the first and third of the five cases, an item of income derived from the United States or Japan through an entity that is organized in the other country or a third state and treated as a fiscally transparent entity under the laws of the other country generally will be eligible for the benefits of the proposed treaty to the extent such benefits would be granted if the income were directly derived by the beneficiaries, members, or participants. Under the second, fourth, and fifth cases, an item of income derived from the United States or Japan through an entity organized in the other

country or a third state and that is not treated as a fiscally transparent entity under the tax laws of the other country generally will be eligible for the benefits of the proposed treaty only if the entity is a resident of that other country. The Technical Explanation provides detailed examples under each of the five cases for obtaining a result consistent with the rules of the proposed treaty.

However, the proposed treaty does not address the "sixth" fact pattern that arises with respect to fiscally transparent entities. This "sixth" case involves an item of income that is derived from the United States or Japan through an entity organized in that country and treated as an item of income of the beneficiaries, members or participants of that entity under the tax laws of the other country. The Technical Explanation states that the result in this case depends on whether the entity is liable to tax in the country in which it is organized.

Pursuant to the Technical Explanation, if an item of income is derived from the United State or Japan through an entity organized in that country and that is treated as the item of income of the entity under the laws of that country, then such country is not prevented from taxing the entity in accordance with its domestic law pursuant to the saving clause of this Article. The Technical Explanation states that the rules for fiscally transparent entities are not an exception to the saving clause. For example, if a U.S. limited liability company ("LLC") with Japanese members elects to be taxed as a corporation for U.S. tax purposes, the United States will tax that LLC on its worldwide income on a net basis, without regard to whether Japan views the LLC as fiscally transparent. Thus, if a U.S. company pays interest to a U.S. LLC that elects to be treated as a corporation for U.S. tax purposes, the interest income will not be eligible for benefits under the proposed treaty. The Technical Explanation notes that in the case of income derived in the United States, this result is consistent with U.S. domestic law.[27] The result in Treas. Reg. sec. 1.894–1(d)(2)(ii) (providing rules for the eligibility of treaty benefits of items of income paid by U.S. entities that are not fiscally transparent under U.S. law but are fiscally transparent under the laws of the jurisdiction of the person claiming the treaty benefits.)

However, if the entity is not liable to tax under the laws of the country where it is organized, then income derived through the entity is treated as an item of income of the beneficiaries, members or participants of that entity under the tax laws of both the United States and Japan. Under the general principles of the proposed treaty, as well as the principles underlying the first and third cases, such income will be eligible for the benefits of the proposed treaty to the extent that the beneficiaries, members or participants are residents of the other country and satisfy any other conditions specified in the proposed treaty. For example, if a U.S. corporation pays interest income to a U.S. partnership that is not liable to tax as an entity under the tax laws of either the United States or Japan and the income is treated as the income of the partners of

[27] The same result would obtain from Treas. Reg. sec. 1.894–1(d)(2)(ii) (providing rules for the eligibility of treaty benefits of items of income paid by U.S. entities that are not fiscally transparent under U.S. law but are fiscally transparent under the laws of the jurisdiction of the person claiming the treaty benefits).

the U.S. partnership under the tax laws of both the United States and Japan, then the income will be entitled to the benefits of the proposed treaty to the extent the partners of the U.S. partnership are Japanese residents that satisfy any other condition specified in the proposed treaty.

Paragraph 13 of the protocol provides specific rules regarding the application of the proposed treaty to an arrangement created by a "sleeping partnership" (Tokumei Kumiai) contract or similar contract. In general, these rules allow the United States and Japan to apply their respective domestic tax law to income derived subject to such an arrangement and to distributions made pursuant to the arrangement. The Technical Explanation states that Japanese tax law treats income derived subject to such an arrangement as the income of the active partner or operator. The operator then is entitled to a deduction for amounts paid to the sleeping partner or investor, who takes such amounts into income as a distribution from the arrangement.

Subparagraph 13(a) of the protocol provides that the United States may treat such an arrangement as not a resident of Japan, and may treat income derived subject to the arrangement as not derived by any participant in the arrangement. Thus, the United States will not grant the benefits of the proposed treaty to any income derived subject to the arrangement. For example, if a U.S. corporation pays interest income to an arrangement created by a sleeping partnership (Tokumei Kumiai) contract, then the United States will not grant the benefits of the proposed treaty to that interest income even if the operator and investor in the arrangement are Japanese residents.

Subparagraph 13(b) of the protocol provides that Japan may impose tax at source, in accordance with its domestic law, on distributions that a person makes pursuant to a sleeping partnership (Tokumei Kumiai) contract and that are deductible in computing the taxable income in Japan of that person. For example, if a Japanese person acting as the operator in the arrangement makes a distribution pursuant to the arrangement to another person that is deductible in computing the taxable income in Japan of the Japanese person, then Japan may impose tax at source on the distribution even if the investor is a U.S. resident.

Article 5. Permanent Establishment

The proposed treaty contains a definition of the term "permanent establishment" that generally follows the pattern of other recent U.S. income tax treaties, the U.S. model, and the OECD model.

The permanent establishment concept is one of the basic devices used in income tax treaties to limit the taxing jurisdiction of the host country and thus to mitigate double taxation. Generally, an enterprise that is a resident of one country is not taxable by the other country on its business profits unless those profits are attributable to a permanent establishment of the resident in the other country. In addition, the permanent establishment concept is used to determine whether the reduced rates of, or exemptions from, tax provided for dividends, interest, and royalties apply, or whether those items of income will be taxed as business profits.

In general, under the proposed treaty, a permanent establishment is a fixed place of business in which the business of an enterprise is wholly or partly carried on. A permanent establishment includes a place of management, a branch, an office, a factory, a workshop, a mine, an oil or gas well, a quarry, or other place of extraction of natural resources. It also includes a building site, a construction or assembly project, or an installation or drilling rig or ship used for the exploration of natural resources, if such project, or activity relating to such installation, rig, or ship, as the case may be, continues for more than 12 months. The Technical Explanation states that the 12-month test applies separately to each individual site or project, with a series of contracts or projects that are interdependent both commercially and geographically treated as a single project. The Technical Explanation further states that if the 12-month threshold is exceeded, the site or project constitutes a permanent establishment as of the first day that work in the country began.

Under the proposed treaty, the following activities are deemed not to constitute a permanent establishment: (1) the use of facilities solely for storing, displaying, or delivering goods or merchandise belonging to the enterprise; (2) the maintenance of a stock of goods or merchandise belonging to the enterprise solely for storage, display, or delivery or solely for processing by another enterprise; and (3) the maintenance of a fixed place of business solely for the purchase of goods or merchandise or for the collection of information for the enterprise. The proposed treaty also provides that the maintenance of a fixed place of business solely for the purpose of carrying on, for the enterprise, any other activity of a preparatory or auxiliary character does not constitute a permanent establishment. The proposed treaty provides that a combination of these activities will not give rise to a permanent establishment, if the combination results in an overall activity that is of a preparatory or auxiliary character. This rule is derived from the OECD model but differs from the U.S. model, which provides that any combination of otherwise excepted activities is deemed not to give rise to a permanent establishment, without the additional requirement that the combination, as distinct from each individual activity, be preparatory or auxiliary. The Technical Explanation states that it is assumed that if preparatory or auxiliary activities are combined, the combination generally will also be of a preparatory or auxiliary character, but that a permanent establishment may result from a combination of such activities if this is not the case.

Under the proposed treaty, if a person, other than an independent agent, is acting in a treaty country on behalf of an enterprise of the other country and has, and habitually exercises in such first country, the authority to conclude contracts in the name of such enterprise, the enterprise is deemed to have a permanent establishment in the first country in respect of any activities undertaken for that enterprise. This rule does not apply where the activities are limited to the preparatory and auxiliary activities described in the preceding paragraph.

Under the proposed treaty, no permanent establishment is deemed to arise if the agent is a broker, general commission agent, or any other agent of independent status, provided that the agent

is acting in the ordinary course of its business. The Technical Explanation states that whether an enterprise and an agent are independent is a factual determination, and that the relevant factors in making this determination include: (1) the extent to which the agent operates on the basis of instructions from the principal; (2) the extent to which the agent bears business risk; and (3) whether the agent has an exclusive or nearly exclusive relationship with the principal.

The proposed treaty provides that the fact that a company that is a resident of one country controls or is controlled by a company that is a resident of the other country or that carries on business in the other country does not in and of itself cause either company to be a permanent establishment of the other.

Article 6. Income from Real Property

This article covers income from real property. The rules covering gains from the sale of real property are included in Article 13 (Gains).

Under the proposed treaty, income derived by a resident of one country from real property situated in the other country may be taxed in the country where the property is situated. This rule is consistent with the rules in the U.S. and OECD models. The term "real property" generally has the meaning that it has under the law of the country in which the property in question is situated.[28]

The proposed treaty provides that income from real property includes income from property accessory to real property, livestock and equipment used in agriculture and forestry, rights to which the provisions of general law respecting real property apply, usufruct of real property, and rights to variable or fixed payments as consideration for the working of, or the right to work, mineral deposits and other natural resources. Ships and aircraft are not regarded as real property.

The proposed treaty specifies that the country in which the property is situated also may tax income derived from the direct use, letting, or use in any other form of real property. The rules of this article, permitting source-country taxation, also apply to the income from real property of an enterprise.

The proposed treaty does not grant an exclusive taxing right to the country where the property is situated; such country is merely given the primary right to tax. The proposed treaty also does not impose any limitation in terms of the rate or form of tax such country may impose. Thus, the proposed treaty does not include paragraph 5 of Article 6 of the U.S. model, regarding the allowance of an election to be taxed on a net basis on income from real property. Net basis taxation, however, is available under the tax laws of both the United States and Japan. Thus, taxpayers generally should be able to obtain the same tax treatment in the country where the real property is situated regardless of whether the income is treated as business profits attributable to a permanent establishment or income from real property.

[28] In the case of the United States, the term "real property" is defined in Treas. Reg. sec. 1.897–1(b).

Article 7. Business Profits

Internal taxation rules

United States

U.S. law distinguishes between the U.S. business income and the other U.S. income of a nonresident alien or foreign corporation. A nonresident alien or foreign corporation is subject to a flat 30–percent rate (or lower treaty rate) of tax on certain U.S.-source income if that income is not effectively connected with the conduct of a trade or business within the United States. The regular individual or corporate rates apply to income (from any source) that is effectively connected with the conduct of a trade or business within the United States. The performance of personal services within the United States may constitute a trade or business within the United States.

The treatment of income as effectively connected with a U.S. trade or business depends upon whether the source of the income is U.S. or foreign. In general, U.S.-source periodic income (such as interest, dividends, rents, and wages) and U.S.-source capital gains are effectively connected with the conduct of a trade or business within the United States if the asset generating the income is used in (or held for use in) the conduct of the trade or business or if the activities of the trade or business were a material factor in the realization of the income. All other U.S.-source income of a person engaged in a trade or business in the United States is treated as effectively connected with the conduct of a trade or business in the United States (under what is referred to as a "force of attraction" rule).

The income of a nonresident alien individual from the performance of personal services within the United States is excluded from U.S.-source income, and therefore is not taxed by the United States in the absence of a U.S. trade or business, if the following criteria are met: (1) the individual is not in the United States for over 90 days during the taxable year; (2) the compensation does not exceed $3,000; and (3) the services are performed as an employee of, or under a contract with, a foreign person not engaged in a trade or business in the United States, or are performed for a foreign office or place of business of a U.S. person.

Foreign-source income generally is effectively connected income only if the foreign person has an office or other fixed place of business in the United States and the income is attributable to that place of business. Only three types of foreign-source income are considered to be effectively connected income: rents and royalties for the use of certain intangible property derived from the active conduct of a U.S. business; certain dividends and interest either derived in the active conduct of a banking, financing or similar business in the United States or received by a corporation the principal business of which is trading in stocks or securities for its own account; and certain sales income attributable to a U.S. sales office. Special rules apply for purposes of determining the foreign-source income that is effectively connected with a U.S. business of an insurance company.

Any income or gain of a foreign person for any taxable year that is attributable to a transaction in another year is treated as effectively connected with the conduct of a U.S. trade or business if it would have been so treated had it been taken into account in that other year (Code sec. 864(c)(6)). In addition, if any property ceases to be used or held for use in connection with the conduct of a trade or business within the United States, the determination of whether any income or gain attributable to a sale or exchange of that property occurring within 10 years after the cessation of business is effectively connected with the conduct of a trade or business within the United States is made as if the sale or exchange occurred immediately before the cessation of business (Code sec. 864(c)(7)).

Japan

Foreign corporations and nonresident individuals generally are subject to tax in Japan only on income arising in Japan. Business income derived in the Japan by a foreign corporation or nonresident individual generally is taxed in the same manner as the income of a resident corporation or individual.

Proposed treaty limitations on internal law

Under the proposed treaty, business profits of an enterprise of one of the countries are taxable in the other country only to the extent that they are attributable to a permanent establishment in the other country through which the enterprise carries on business. This is one of the basic limitations on a country's right to tax income of a resident of the other country. The rule is similar to those contained in the U.S. and OECD models.

Although the proposed treaty does not provide a definition of the term "business profits," the Technical Explanation states that the term generally means income derived from any trade or business. This definition includes income from independent personal services, which, unlike the U.S. model but like the OECD model and some recent U.S. tax treaties, is not addressed in a separate article. Although the proposed treaty does not include a separate article for independent personal services, this article limits the right of a treaty country to tax income from the performance of personal services by a resident of the other treaty country in a manner similar to the limitations provided in the separate article applicable to independent personal services that is included in the U.S. model and other U.S. treaties.

Because the definition of "business profits" includes independent personal services under the proposed treaty, the Technical Explanation states that the term includes income attributable to notional principal contracts and other financial instruments to the extent that the income is attributable to a trade or business of dealing in such instruments or otherwise is related to a trade or business (e.g., notional principal contracts entered into for the purpose of hedging currency risk arising from an active trade or business). Any other income derived from financial instruments is addressed in Article 21 (Other Income), unless specifically governed by another article.

The Technical Explanation states that business profits also include income earned by an enterprise from the furnishing of per-

sonal services. For example, a U.S. consulting firm whose employees or partners perform services in Japan through a permanent establishment may be taxed in Japan on a net basis under this article, rather than Article 14 (Income from Employment), consistent with the OECD model. However, salaries of employees of the consulting firm would remain subject to Article 14 (Income from Employment). In addition, the Technical Explanation states that business profits include income derived by a partner resident in one treaty country that is attributable to personal services performed in the other treaty country through a partnership with a permanent establishment in that other country. Thus, income that may be taxed as business profits includes all income that is attributable to the permanent establishment with respect to the performance of personal services carried on by the partnership (whether by the partner herself, other partners in the partnership, or employees assisting the partners), as well as any income from activities that are ancillary to the performance of the services (e.g., charges for facsimile services). For example, if a Japanese partnership has four partners who are resident and perform personal services only in the Japanese office and one partner who performs personal services in a U.S. office that is a permanent establishment in the United States (and the five partners agree to equally split profits), the four Japanese resident partners may be taxed in the United States with respect to their shares of the income that is attributable to the U.S. office. The services that generate the income attributable to the U.S. office would include the services performed by the partners in the U.S. office, as well as any income with respect to services performed on behalf of the Japanese office by a Japanese partner who travels to the United States and performs such services in the United States, regardless of whether the Japanese partner actually visited or used the U.S. office while performing the services in the United States.

The proposed treaty provides that there will be attributed to a permanent establishment the business profits which it might be expected to make if it were a distinct and separate enterprise engaged in the same or similar activities under the same or similar conditions and dealing wholly independently with the enterprise of which it is a permanent establishment and other associated enterprises. The Technical Explanation states that this rule permits the use of methods other than separate accounting to determine the arm's-length profits of a permanent establishment where it is necessary to do so for practical reasons, such as when the affairs of the permanent establishment are so closely bound up with those of the head office that it would be impossible to disentangle them on any strict basis of accounts.

Unlike the U.S. model, the proposed treaty does not provide explicitly that the profits attributed to a permanent establishment include only those profits derived from the permanent establishment's assets or activities. However, the Technical Explanation states that this rule nevertheless is understood to apply to the proposed treaty because it is implicit in this article and is consistent with the application of the arm's-length standard for purposes of determining the profits attributable to a permanent establishment.

Thus, the "force of attraction" rule of U.S. internal law does not apply for such purposes.

The notes permit the treaty countries to determine the taxable business profits of a permanent establishment by treating the permanent establishment as having the same amount of capital that it would require to support its activities if it were a distinct and separate enterprise engaged in the same or similar activities. This means, for example, that a permanent establishment cannot be funded entirely with debt. To the extent that a permanent establishment does not have sufficient capital to carry on its activities as if it were a distinct and separate enterprise, a treaty country may attribute such capital to the permanent establishment and deny an interest deduction to the extent necessary to reflect that capital attribution. With regard to financial institutions other than insurance companies, the notes permit the treaty countries to determine the amount of capital to be attributed to a permanent establishment by allocating the institution's total equity between or among its various offices on the basis of the proportion of the financial institution's risk-weighted assets attributable to each of them.

In the case of a permanent establishment to which a treaty country attributes additional capital because the permanent establishment is undercapitalized, the Technical Explanation states that U.S. internal law prescribes the method for making such an attribution of additional capital.[29] However, the Technical Explanation notes that U.S. internal law does not take into account the fact that some assets are more risky than other assets, and that an independent enterprise would require less capital to support a perfectly hedged U.S. Treasury security than it would to support an equity security or other asset with significant market and/or credit risk. Thus, U.S. internal law requires taxpayers in some cases to allocate more capital to the United States (and, thus, reduces the taxpayer's interest deduction) than is appropriate. To address these cases, the Technical Explanation states that the proposed treaty permits taxpayers to apply a more flexible approach that takes into account the relative risk of its assets in the various jurisdictions in which it conducts business. However, the Technical Explanation also states that taxpayers are permitted to apply U.S. internal law, rather than risk-weighted attribution, if U.S. internal law results in less U.S. taxable income in the taxpayer's particular circumstances.

In applying the arm's-length standard to determine the taxable business profits of a permanent establishment, the Technical Explanation observes that it is necessary to draw an economic (as well as legal) distinction between operating through a single legal entity rather than through separate legal entities. For example, an entity that operates through branches rather than separate subsidiaries will have lower capital requirements because all of the assets of the entity are available to support all of the entity's liabilities (with some exceptions attributable to local regulatory restrictions). Thus, most commercial banks and some insurance companies operate through branches rather than subsidiaries. While the benefit that comes from such lower capital costs must be allocated

[29] *See* Treas. reg. sec. 1.882–5.

among the branches in an appropriate manner, this issue does not arise in the case of an enterprise that operates through separate entities because each entity must either be capitalized separately or compensate another entity for providing capital (e.g., through a guarantee).

The Technical Explanation states that, whereas U.S. internal law does not recognize inter-branch transactions because they do not have legal significance, the notes provide that such internal dealings may be used to allocate income in cases where the dealings accurately reflect the allocation of risk within the enterprise. For example, in the case of global dealing in securities, many banks use internal swap transactions to transfer risk from one branch to a central location (e.g., a hedge center) where traders have the expertise to manage that particular type of risk. Under the proposed treaty, such banks also are permitted to use such swap transactions as a means of allocating income between or among the branches, provided the allocation method used by the bank complies with the transfer pricing rules of U.S. internal law. However, the books of a branch will not be respected if the results are inconsistent with a functional analysis. For example, income from a transaction that is booked in a particular branch (or home office) would not be allocated to that location if the sales and risk management functions that generate such income are performed in another location.

In computing taxable business profits of a permanent establishment, the proposed treaty provides that deductions are allowed for expenses, wherever incurred, which are attributable to the activities of the permanent establishment. These deductions include executive and general administrative expenses, research and development expenses, interest, and other expenses incurred, regardless of which accounting unit of the enterprise books the expenses, provided they are incurred for the purposes of the permanent establishment. The Technical Explanation states that a permanent establishment may deduct payments made to its head office or another branch in compensation for services performed for the benefit of the branch, provided the deduction comports to the arm's-length standard. The method for computing the amount of such a deduction would depend upon the terms of the arrangements between the branches and head office.

The proposed treaty provides that this article does not affect the application of any law of a treaty country relating to the determination of the tax liability of a person in cases where the information available to the competent authority of the treaty country is inadequate to determine the profits to be attributed to a permanent establishment. The Technical Explanation states that, although the IRS has the authority to apply this rule even in the absence of this provision, the determination of taxable business profits of a permanent establishment under this rule must be consistent with the arm's-length standard.

Like the U.S. model and the OECD model, the proposed treaty provides that business profits are not attributed to a permanent establishment merely by reason of the purchase of goods or merchandise by the permanent establishment for the enterprise. This rule is only relevant to an office that performs functions in addition to

purchasing because such activity does not, by itself, give rise to a permanent establishment under Article 5 (Permanent Establishment) to which income can be attributed. When it applies, the rule provides that business profits may be attributable to a permanent establishment with respect to its non-purchasing activities (e.g., sales activities), but not with respect to its purchasing activities. Other recent U.S. tax treaties have not included this rule on the grounds that it is inconsistent with the arm's-length principle, which would view a separate and distinct enterprise as receiving some compensation to perform purchasing services.[30]

The proposed treaty requires the determination of business profits of a permanent establishment to be made in accordance with the same method year by year unless a good and sufficient reason to the contrary exists.

Where business profits include items of income that are dealt with separately in other articles of the proposed treaty, those other articles, and not the business profits article, govern the treatment of those items of income. Thus, for example, dividends are taxed under the provisions of Article 10 (Dividends), and not as business profits, except as specifically provided in Article 10. Similarly, income derived from shipping and air transport activities in international traffic is taxable only in the country of residence of the enterprise, regardless of whether it is attributable to a permanent establishment situated in the source country, as provided by Article 8 (Shipping and Air Transport).

The proposed treaty provides that, for purposes of the taxation of business profits, income may be attributable to a permanent establishment (and therefore may be taxable in the source country) even if the payment of such income is deferred until after the permanent establishment or fixed base has ceased to exist. This rule incorporates into the proposed treaty the rule of Code section 864(c)(6) described above. This rule applies with respect to business profits (Article 7), dividends (Article 10, paragraph 7), interest (Article 11, paragraph 6), royalties (Article 12, paragraph 3), and other income (Article 21, paragraph 2). A similar rule is included in paragraph 4 of Article 13 (Gains).

The Technical Explanation notes that this article is subject to the saving clause of paragraph 4 of Article 1 (General Scope). Thus, in the case of the saving clause, if a U.S. citizen who is a resident of Japan derives business profits from the United States that are not attributable to a permanent establishment in the United States, the United States may tax those profits, notwithstanding that paragraph 1 of this article would exempt the income from U.S. Tax.

Article 8. Shipping and Air Transport

Article 8 of the proposed treaty covers income from the operation of ships and aircraft in international traffic. The rules governing income from the disposition of ships, aircraft, and containers are in Article 13 (Capital Gains).

[30] *See, e.g.*, Convention Between the Government of the United States of America and the Government of the United Kingdom of Great Britain and Northern Ireland for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and on Capital Gains, Treaty Doc. 107–19.

The United States generally taxes the U.S.-source income of a foreign person from the operation of ships or aircraft to or from the United States. An exemption from U.S. tax is provided if the income is earned by a corporation that is organized in, or an alien individual who is resident in, a foreign country that grants an equivalent exemption to U.S. corporations and residents. The United States has entered into agreements with a number of countries providing such reciprocal exemptions.

The proposed treaty provides that profits that are derived by an enterprise of one country from the operation in international traffic of ships or aircraft are taxable only in that country, regardless of the existence of a permanent establishment in the other country. "International traffic" is defined in Article 3(1)(i) (General Definitions) as any transport by a ship or aircraft, except when the transport is solely between places in the other treaty country.

The proposed treaty provides that profits from the operation of ships or aircraft in international traffic include profits derived from the rental of ships or aircraft on a full basis (i.e., with crew). The proposed treaty also includes profits from the rental of ships or aircraft on a bareboat basis (i.e., without crew) if such rental activities are incidental to the activities from the operation of ships or aircraft in international traffic. The Technical Explanation notes that this provision is generally consistent with the OECD model but narrower than the U.S. model, which also covers rentals from bareboat leasing that are not incidental to the operation of ships and aircraft in international traffic by the lessee. Under the proposed treaty, income from such rentals is covered by Article 7 (Business Profits).

The proposed treaty provides that profits derived by an enterprise from the inland transport of property or passengers within either treaty country are treated as profits from the operation of ships or aircraft in international traffic (and, thus, governed by this article) if such transport is undertaken as part of international traffic by the enterprise. For example, if a Japanese enterprise contracts to carry property from the United States to Japan and, as part of the contract, it transports (or contracts to transport) the property by truck from its point of origin to an airport in the United States, the income earned by the Japanese enterprise from the overland leg of the journey would be taxable only in Japan. Similarly, the Technical Explanation states that this article would also apply to income from lighterage undertaken as part of the international transport of goods.

The proposed treaty provides for an exemption from certain local taxes in Japan in respect of the operation of ships or aircraft in international traffic by U.S. enterprises, provided that no state or local government in the United States imposes a similar tax in respect of such operations by Japanese enterprises. The proposed treaty specifically provides that a U.S. enterprise will be exempt from the local inhabitant taxes and the enterprise tax in Japan in respect of the operation of ships or aircraft in international traffic provided that no state or local government in the United States imposes a similar tax on or in respect of such operations by Japanese enterprises. Absent this provision, Japan could apply these taxes to

U.S. shipping and aircraft enterprises because the local inhabitant tax and the enterprise tax are not covered taxes under Article 2.

The notes to the proposed treaty further provide that if a state or local authority of the United States seeks to levy a tax similar to these taxes on the profits of any Japanese enterprise from the operation of ships or aircraft in international taxes in circumstances where the proposed treaty would preclude the imposition of Federal income tax on those profits, the Government of the United States will use its best endeavors to persuade that political subdivision or local authority to refrain from imposing such tax. The Technical Explanation states that it is the understanding of the Treasury Department that no such state or local tax is imposed on Japanese airlines and shipping companies in the United States.

The proposed treaty provides that profits of an enterprise of a country from the use, maintenance, or rental of containers (including trailers, barges, and related equipment for the transport of containers) used for the transport of goods or merchandise in international traffic is taxable only in that country. The Technical Explanation states that, unlike the OECD model, this rule applies without regard to whether the recipient of the income is engaged in the operation of ships or aircraft in international traffic or whether the enterprise has a permanent establishment in the other country.

Under the proposed treaty, as under the U.S. model, the shipping and air transport provisions apply to profits derived from participation in a pool, joint business, or international operating agency. This refers to various arrangements for international cooperation by carriers in shipping and air transport.

The Technical Explanation notes that this article is subject to the saving clause of paragraph 4 of Article 1 (General Scope), as well as Article 22 (Limitation on Benefits).

Article 9. Associated Enterprises

The proposed treaty, like most other U.S. tax treaties, contains an arm's-length pricing provision. The proposed treaty recognizes the right of each country to make an allocation of profits to an enterprise of that country in the case of transactions between related enterprises, if conditions are made or imposed between the two enterprises in their commercial or financial relations that differ from those that would be made between independent enterprises. In such a case, a country may allocate to such an enterprise the profits that it would have accrued but for the conditions so imposed and tax the enterprise accordingly. This treatment is consistent with the U.S. model.

The proposed treaty specifies that the analysis for determining the profits of an enterprise is generally based on a comparison of the conditions in the transactions made between associated enterprises and those made between independent enterprises. The Technical Explanation states that the qualifier "generally" is used to describe the arm's-length analysis because in some cases an analysis based on transactions between independent enterprises is not possible, either because comparable transactions have not taken place or because data regarding such transactions is not available to the associated enterprise. Factors affecting the comparability of trans-

actions include: (1) the characteristics of the property or services transferred; (2) the functions of the enterprise and the enterprise associated with it, taking into account the assets used and risks assumed by the enterprise and the enterprise associated with it; (3) the contractual terms between the enterprise and the enterprise associated with it; (4) the economic circumstances of the enterprise and the enterprise associated with it; and (5) the business strategies pursued by the enterprise and the enterprise associated with it. The Technical Explanation states these comparability factors correspond to those set out in the OECD Transfer Pricing Guidelines and are consistent with the U.S. domestic transfer-pricing provisions.

However, the proposed treaty provides that a country may not allocate profits to an enterprise under the article if an examination of the enterprise is not "initiated" within seven years from the end of the taxable year in which such profits would have accrued to that enterprise, absent an allocation under the article. This limitation does not apply in the case of fraud, willful default or the inability to initiate an examination within the prescribed period due to the actions or inaction of the enterprise. Neither the U.S. model nor the OECD model contains a comparable limitation on a country's ability to allocate profits to an enterprise. The Technical Explanation states this limitation is unlikely to apply in the case of the United States and Japan given the generally applicable three- and six-year statute of limitations, respectively, as well as, in the case of the United States, the policy of the IRS to initiate and close examinations on as current a basis as possible. The proposed treaty's saving clause retaining full taxing jurisdiction in the country of residence or citizenship does not apply in the case of the limitation. Thus, the limitation may apply to a potential adjustment by a country to the profits of an enterprise of that country that is also a resident of that country. The proposed treaty does not define when an examination of an enterprise is "initiated" for purposes of the article, and in accord with Article 3 (General Definitions), the term will be defined under the domestic laws of the two countries. The Technical Explanation does not provide any guidance regarding when an examination is considered initiated for U.S. purposes.

For purposes of the proposed treaty, an enterprise of one country is related to an enterprise of the other country if one of the enterprises participates directly or indirectly in the management, control, or capital of the other enterprise. Enterprises also are related if the same persons participate directly or indirectly in the enterprises' management, control, or capital.

When a redetermination of a tax liability has been made by one country under the provisions of the article, the other country will make an appropriate adjustment to the amount of tax paid in that country on the redetermined income. In making such adjustment, due regard is to be given to other provisions of the proposed treaty. The proposed treaty's saving clause retaining full taxing jurisdiction in the country of residence or citizenship does not apply in the case of such adjustments. Accordingly, internal statute of limitations provisions do not prevent the allowance of appropriate correlative adjustments. However, the Technical Explanation states that statutory or procedural limitations cannot be overridden to impose

additional tax because paragraph 2 of Article 1 (General Scope) provides that the proposed treaty cannot restrict any statutory benefit.

The proposed treaty also provides that the countries will conduct transfer pricing examinations and evaluate advanced pricing arrangement applications in accordance with the OECD Transfer Pricing Guidelines. Therefore, a country's domestic transfer pricing guidelines may be applied only to the extent they are consistent with the OECD Transfer Pricing Guidelines. The Technical Explanation states that the reference in the proposed treaty to the OECD Transfer Pricing Guidelines is a reference to the document as amended from time to time. Therefore, as the OECD Transfer Pricing Guidelines change, there may be corresponding changes in the obligations of the two countries under the proposed treaty. However, the Technical Explanation also states that because the OECD is a consensus-based organization, the OECD Transfer Pricing Guidelines cannot be updated without the acquiescence of all of its member states, including the United States and Japan.

Article 10. Dividends

Internal taxation rules

United States

The United States generally imposes a 30-percent tax on the gross amount of U.S.-source dividends paid to nonresident alien individuals and foreign corporations. The 30-percent tax does not apply if the foreign recipient is engaged in a trade or business in the United States and the dividends are effectively connected with that trade or business. In such a case, the foreign recipient is subject to U.S. tax on such dividends on a net basis at graduated rates in the same manner that a U.S. person would be taxed.

Under U.S. law, the term dividend generally means any distribution of property made by a corporation to its shareholders, either from accumulated earnings and profits or current earnings and profits. However, liquidating distributions generally are treated as payments in exchange for stock and, thus, are not subject to the 30-percent withholding tax described above (see discussion of capital gains in connection with Article 13 below).

Dividends paid by a U.S. corporation generally are U.S.-source income. Also treated as U.S.-source dividends for this purpose are portions of certain dividends paid by a foreign corporation that conducts a U.S. trade or business. The U.S. 30-percent withholding tax imposed on the U.S.-source portion of the dividends paid by a foreign corporation is referred to as the "second-level" withholding tax. This second-level withholding tax is imposed only if a treaty prevents application of the statutory branch profits tax.

In general, corporations are not entitled under U.S. law to a deduction for dividends paid. Thus, the withholding tax on dividends theoretically represents imposition of a second level of tax on corporate taxable income. Treaty reductions of this tax reflect the view that where the United States already imposes corporate-level tax on the earnings of a U.S. corporation, a 30-percent withholding rate may represent an excessive level of source-country taxation. Moreover, the reduced rate of tax often applied by treaty to dividends

paid to direct investors reflects the view that the source-country tax on payments of profits to a substantial foreign corporate shareholder may properly be reduced further to avoid double corporate-level taxation and to facilitate international investment.

A real estate investment trust ("REIT") is a corporation, trust, or association that is subject to the regular corporate income tax, but that receives a deduction for dividends paid to its shareholders if certain conditions are met. In order to qualify for the deduction for dividends paid, a REIT must distribute most of its income. Thus, a REIT is treated, in essence, as a conduit for Federal income tax purposes. Because a REIT is taxable as a U.S. corporation, a distribution of its earnings is treated as a dividend rather than income of the same type as the underlying earnings. Such distributions are subject to the U.S. 30-percent withholding tax when paid to foreign owners.

A REIT is organized to allow persons to diversify ownership in primarily passive real estate investments. As such, the principal income of a REIT often is rentals from real estate holdings. Like dividends, U.S.-source rental income of foreign persons generally is subject to the 30-percent withholding tax (unless the recipient makes an election to have such rental income taxed in the United States on a net basis at the regular graduated rates). Unlike the withholding tax on dividends, however, the withholding tax on rental income generally is not reduced in U.S. income tax treaties.

U.S. internal law also generally treats a regulated investment company ("RIC") as both a corporation and a conduit for income tax purposes. The purpose of a RIC is to allow investors to hold a diversified portfolio of securities. Thus, the holder of stock in a RIC may be characterized as a portfolio investor in the stock held by the RIC, regardless of the proportion of the RIC's stock owned by the dividend recipient.

A foreign corporation engaged directly in the conduct of a trade or business in the United States is subject to a flat 30-percent branch profits tax on its "dividend equivalent amount." The dividend equivalent amount is the corporation's earnings and profits which are attributable to its income that is effectively connected with its U.S. trade or business, decreased by the amount of such earnings that are reinvested in business assets located in the United States (or used to reduce liabilities of the U.S. business), and increased by any such previously reinvested earnings that are withdrawn from investment in the U.S. business.

If a U.S. branch of a foreign corporation has allocated to it an interest deduction in excess of the interest actually paid by the branch, such excess interest is treated as if it were paid on a notional loan to a U.S. subsidiary from its foreign corporate parent. This excess interest is subject to 30-percent withholding tax absent a specific statutory exemption.

Japan

In the absence of a permanent establishment, Japan imposes a withholding tax of 20 percent on Japanese-source gross dividend payments to nonresident individuals and foreign corporations. Japan does not impose a branch profits tax.

Japanese tax law also provides for special investment vehicles comparable to U.S. REITs and RICs. Income earned through these entities is generally subject only to a single level of tax, as the entity is allowed a deduction for amounts distributed to its shareholders.

Proposed treaty limitations on internal law

In general

Under the proposed treaty, dividends paid by a company that is a resident of a treaty country to a resident of the other country may be taxed in such other country. Such dividends also may be taxed by the country in which the payor company is resident (the "source country"), but the rate of such tax is limited. Under the proposed treaty, source-country taxation of dividends generally is limited to 10 percent of the gross amount of the dividends paid to residents of the other treaty country. A lower rate of five percent applies if the beneficial owner of the dividend is a company that owns at least 10 percent of the voting stock of the dividend-paying company. Both of these rates represent reductions from the rates applicable in the present treaty, which provides a general dividend rate of 15 percent and a reduced intercompany rate of 10 percent (on more restrictive terms than those of the proposed treaty).

The term "beneficial owner" is not defined in the present treaty or the proposed treaty, and thus is defined under the internal law of the source country. The Technical Explanation states that the beneficial owner of a dividend for purposes of this article is the person to which the dividend income is attributable for tax purposes under the laws of the source country. Further, companies holding shares through fiscally transparent entities such as partnerships are considered to hold their proportionate interest in the shares.

In addition, the proposed treaty provides a zero rate of withholding tax with respect to certain intercompany dividends in cases in which there is a sufficiently high (greater than 50-percent) level of ownership (often referred to as "direct dividends"). A zero rate also would apply with respect to dividends received by a tax-exempt pension fund, provided that such dividends are not derived from the carrying on of a business, directly or indirectly, by such fund.

Zero rate for direct dividends

Under the proposed treaty, the withholding tax rate is reduced to zero on dividends beneficially owned by a company that has owned greater than 50 percent of the voting power of the company paying the dividend for the 12-month period ending on the date on which entitlement to the dividend is determined, provided that the company receiving the dividend either: (1) qualifies for treaty benefits under the "publicly traded" test of the anti-treaty-shopping provision (subparagraph 1(c) of Article 22 (Limitation on Benefits)); (2) satisfies both the "ownership/base-erosion" and the "active trade or business" tests described in subparagraph 1(f) and paragraph 2 of Article 22 (Limitation on Benefits); or (3) is granted eligibility for the zero rate by the competent authorities pursuant to paragraph

4 or Article 22 (Limitation on Benefits) (subparagraph 3(a) of Article 10 (Dividends)).[31]

Under the current U.S.-Japan treaty, these dividends may be taxed at a 10-percent rate. The proposed treaty would be the fourth U.S. income tax treaty to provide a zero rate for certain intercompany dividends (after the U.S. treaties with the United Kingdom, Australia, and Mexico).

Dividends paid by U.S. RICs and REITs and similar Japanese entities

The proposed treaty generally denies the five-percent and zero rates of withholding tax to dividends paid by "pooled investment vehicles" (e.g., RICs and REITs).

The 10-percent rate of withholding tax generally is allowed for dividends paid by a RIC. In the case of dividends paid by a REIT, the 10-percent rate is allowed only if one of three additional conditions is met: (1) the person beneficially entitled to the dividend is an individual or a pension fund, and such person holds an interest of not more than 10 percent in the REIT; (2) the dividend is paid with respect to a class of stock that is publicly traded, and the person beneficially entitled to the dividend is a person holding an interest of not more than five percent of any class of the REIT's stock; or (3) the person beneficially entitled to the dividend holds an interest in the REIT of not more than 10 percent, and the REIT is "diversified" (i.e., the gross value of no single interest in real property held by the REIT exceeds 10 percent of the gross value of the REIT's total interest in real property).[32]

Dividends received by tax-exempt pension funds from RICs generally are eligible for the zero rate.

The Technical Explanation indicates that the restrictions on availability of the lower rates are intended to prevent the use of RICs and REITs to gain unjustifiable source-country benefits for certain shareholders resident in Japan. For example, a company resident in Japan could directly own a diversified portfolio of U.S. corporate shares and pay a U.S. withholding tax of 10 percent on dividends on those shares. There is a concern that such a company instead might purchase 10 percent or more of the interests in a RIC, which could even be established as a mere conduit, and thereby obtain a lower withholding rate by holding a similar portfolio through the RIC (transforming portfolio dividends generally taxable at 10 percent into non-portfolio dividends taxable under the treaty at a rate of zero or five percent).

Similarly, the Technical Explanation gives an example of a resident of Japan directly holding real property and required to pay U.S. tax either at a 30-percent rate on gross income or at graduated rates on the net income. By placing the property in a REIT, the investor could transform real estate income into dividend income, taxable at the lower rates provided in the proposed treaty.

[31] Both direct ownership and indirect ownership through entities resident in either contracting state will count for this purpose.

[32] Under the proposed protocol, for purposes of the diversification test, foreclosure property is not considered an interest in real property, and a REIT holding a partnership interest is treated as owning its proportionate share of any interest in real property held by the partnership (paragraph 6 of the proposed protocol).

The limitations on REIT dividend benefits are intended to protect against this result.

Rules similar to the special rules for dividends paid by U.S. RICs and REITs apply in the case of dividends paid by analogous Japanese entities, for similar reasons (paragraph 5 of Article 10 (Dividends)). Thus, dividends paid by a company that is entitled to a deduction for dividends paid in computing its taxable income in Japan generally are not eligible for the five-percent or zero rates of withholding tax. The 10-percent rate does apply to dividends paid by such a company, provided that not more than 50 percent of the assets of the company consist, directly or indirectly, of real property situated in Japan (in other words, the company is analogous to a U.S. RIC, not a REIT). The zero rate applies to dividends paid by such a company and beneficially owned by a pension fund, again provided that not more than 50 percent of the assets of the company consist, directly or indirectly, of real property situated in Japan. With respect to dividends not eligible for the 10-percent rate by reason of the preceding provisions (i.e., companies analogous to U.S. REITs), the 10-percent rate applies if one of three conditions is met. First, the dividend may qualify for the 10-percent rate if the beneficial owner of the dividend is an individual or a pension fund holding an interest of not more than 10 percent in the company. Second, the dividend may qualify for the 10-percent rate if it is paid with respect to a class of interest in the company that is publicly traded, and the beneficial owner of the dividend is a person holding an interest of not more than five percent of any class of interest in the company. Third, the dividend may qualify for the 10-percent rate if the beneficial owner of the dividend holds an interest in the company of 10 percent or less and a company is "diversified" (as defined above).

Special rules and limitations

The proposed treaty's reduced rates of tax on dividends do not apply if the dividend recipient carries on business through a permanent establishment in the source country, and the holding in respect of which the dividends are paid is effectively connected with such permanent establishment. In such cases, the dividends effectively connected to the permanent establishment are taxed as business profits (Article 7).

The proposed treaty prevents the United States from imposing a tax on dividends paid by a Japanese company unless such dividends are paid to a resident of the United States or are attributable to a permanent establishment in the United States. Thus, this provision generally overrides the ability of the United States to impose a "secondary" withholding tax on the U.S.-source portion of dividends paid by a Japanese company. The proposed treaty also restricts the right of the United States to impose corporate-level taxes on the undistributed profits of Japanese companies (e.g., the accumulated earnings tax, the personal holding company tax), other than a branch profits tax.

The United States is allowed under the proposed treaty to impose the branch profits tax (at a rate of five percent) on a Japanese corporation that has a permanent establishment in the United States or is subject to tax on a net basis in the United States on

income from real property or gains from the disposition of interests in real property. The tax is imposed on the dividend-equivalent amount, as defined in the Code (generally, the dividend amount a U.S. branch office would have paid up to its parent for the year if it had been operated as a separate U.S. subsidiary). In cases in which a Japanese corporation conducts a trade or business in the United States but not through a permanent establishment, the proposed treaty completely eliminates the branch profits tax that the Code would otherwise impose on such corporation (unless the corporation earned income from real property as described above). Japan currently does not impose a branch profits tax. If Japan were to impose such tax, the base of such a tax would be limited to an amount analogous to the U.S. "dividend equivalent amount."

The branch profits tax will not be imposed by the United States in cases in which a zero-rate would apply if the U.S. branch business had been conducted by the Japanese company through a separate U.S. subsidiary. Thus, subparagraphs 9(a), (b), and (c) of Article 10 (Dividends) apply in the branch profits context requirements parallel to the general zero-rate eligibility conditions set forth in subparagraph 3(a)(i), (ii), and (iii) of Article 10 (Dividends).

The proposed treaty provides an anti-conduit provision under which the provisions with respect to dividends will not apply to dividends paid pursuant to certain back-to-back preferred stock arrangements. This provision is similar to anti-conduit rules dealing with interest, royalties, and other income in the proposed treaty. In this context, a resident of a contracting state will not be considered the beneficial owner of dividends in respect of preferred stock or other similar interest if such preferred stock or other interest would not have been established or acquired unless a person that is not entitled to the same or more favorable treaty benefits and that is not a resident of either contracting state held equivalent preferred stock or other interest in the resident. The Technical Explanation states that this provision was included in the proposed treaty at the request of Japan, which does not have anti-conduit rules under its internal law as the United States does. The Technical Explanation explains that the anti-conduit rule in the proposed treaty does not limit the ability of the United States to enforce existing anti-avoidance provisions under U.S. domestic law, including in particular the rules of Treas. Reg. sec. 1.881–3, regulations adopted under the authority of section 7701(l) of the Code, and any other anti-avoidance provision of broad application.

The proposed treaty generally defines "dividends" as income from shares (or other corporate participation rights that are not treated as debt under the law of the source country), as well as other amounts that are subjected to the same tax treatment as income from shares by the source country (e.g., constructive dividends).

Relation to other articles

The Technical Explanation notes that the saving clause of subparagraph 4(a) of Article 1 (General Scope) permits the United States to tax dividends received by its residents and citizens, subject to the special foreign tax credit rules of paragraph 3 of Article 23 (Relief from Double Taxation), as if the proposed treaty had not come into effect.

The benefits of the dividends article are also subject to the provisions of Article 22 (Limitation on Benefits). Thus, if a resident of Japan is the beneficial owner of dividends paid by a U.S. company, the shareholder must qualify for treaty benefits under at least one of the tests of Article 22 in order to receive the benefits of the dividends article.

Article 11. Interest

Internal taxation rules

United States

Subject to several exceptions (such as those for portfolio interest, bank deposit interest, and short-term original issue discount), the United States imposes a 30-percent withholding tax on U.S.-source interest paid to foreign persons under the same rules that apply to dividends. U.S.-source interest, for purposes of the 30-percent tax, generally is interest on the debt obligations of a U.S. person, other than a U.S. person that meets specified foreign business requirements. Interest paid by the U.S. trade or business of a foreign corporation also is subject to the 30-percent tax. A foreign corporation is subject to a branch-level excess interest tax with respect to certain "excess interest" of a U.S. trade or business of such corporation. Under this rule, an amount equal to the excess of the interest deduction allowed with respect to the U.S. business over the interest paid by such business is treated as if paid by a U.S. corporation to a foreign parent and, therefore, is subject to the 30-percent withholding tax.

Portfolio interest generally is defined as any U.S.-source interest that is not effectively connected with the conduct of a trade or business if such interest (1) is paid on an obligation that satisfies certain registration requirements or specified exceptions thereto, and (2) is not received by a 10-percent owner of the issuer of the obligation, taking into account shares owned by attribution. However, the portfolio interest exemption does not apply to certain contingent interest income.

If an investor holds an interest in a fixed pool of real estate mortgages that is a real estate mortgage interest conduit ("REMIC"), the REMIC generally is treated for U.S. tax purposes as a pass-through entity and the investor is subject to U.S. tax on a portion of the REMIC's income (generally, interest income). If the investor holds a so-called "residual interest" in the REMIC, the Code provides that a portion of the net income of the REMIC that is taxed in the hands of the investor—referred to as the investor's "excess inclusion"—may not be offset by any net operating losses of the investor, must be treated as unrelated business income if the investor is an organization subject to the unrelated business income tax, and is not eligible for any reduction in the 30-percent rate of withholding tax (by treaty or otherwise) that would apply if the investor were otherwise eligible for such a rate reduction.

Japan

Japan-source interest payments to residents and nonresidents generally are subject to withholding tax at a rate of 20 percent at the time of payment of the interest. However, a rate of 15 percent

generally is imposed on interest payments to nonresidents with respect to bonds, debentures and bank deposits.

Proposed treaty limitations on internal law

The proposed treaty generally provides that interest arising in one of the treaty countries (the source country) and paid to a resident of the other treaty country generally may be taxed by both countries. This provision is similar to paragraph (1) of Article 13 of the present treaty, but is contrary to the position of the U.S. model, which provides an exemption from source country tax for interest earned by a resident of the other country.

Like the present treaty, the proposed treaty limits the rate of source country tax that may be imposed on interest income. Under the proposed treaty, if the beneficial owner of interest is a resident of the other treaty country, the source country tax on such interest generally may not exceed 10 percent of the gross amount of such interest. This rate is the same as the present treaty rate, but is higher than the U.S. model rate, which is zero.

The proposed treaty provides a complete exemption from source country tax in the case of interest arising in a treaty country and beneficially owned by: (1) the Government of the other treaty country (including political subdivisions and local authorities thereof), the central bank of the other treaty country, or any institution wholly owned by the Government of the other treaty country; (2) a resident of the other treaty country with respect to indebtedness that is guaranteed, insured or indirectly financed by the Government of the other treaty country (including political subdivisions and local authorities thereof), the central bank of the other treaty country, or any institution wholly owned by the Government of the other treaty country; (3) a resident of the other treaty country that is a bank (including an investment bank), insurance company, registered securities dealer, or any other institution if, in the three taxable years preceding the taxable year in which the interest is paid, more than 50 percent of the liabilities of such institution is derived from the issuance of bonds in the financial markets or from taking interest-bearing deposits and more than 50 percent of the assets of such institution consists of indebtedness issued by unrelated persons;[33] (4) a resident of the other treaty country that is

[33] The Technical Explanation states that the exemption for other institutions that satisfy the 50-percent asset and liability tests contemplates non-bank financial institutions such as commercial finance companies or consumer credit companies that obtain more than half of their borrowed funds by borrowing from the public. The Technical Explanation also clarifies that the 50-percent tests can be applied over the three-year testing period on the basis of the average percentage of qualifying liabilities and assets of the institution at the end of the three years preceding the taxpayer year in which the interest is paid. Although the Technical Explanation indicates that such average percentage is determined by averaging the percentage of qualifying assets and liabilities for each year during the testing period, the Technical Explanation does not clarify how to determine the percentage of qualifying assets and liabilities for each year. In addition, the Technical Explanation does not clarify how to apply the 50-percent tests to institutions that have not been in existence for three years. For purposes of the 50-percent liability test, the notes provide that the term "bonds" includes bonds, commercial paper and medium-term notes, whether or not collateralized. The notes also provide that bonds generally shall not be treated as having been issued in the financial markets if they are subject to transfer restrictions that generally are applicable to private placements. However, the notes state that offerings qualifying for exemption from securities registration requirements pursuant to Rule 144A promulgated under the Securities Act of 1933 (or similar provisions under the domestic law of Japan) shall not be treated as subject to private placement transfer restrictions and, thus, shall be treated as having been issued in the financial markets.

a pension fund to the extent that the interest is derived from passive investments; and (5) a resident of the other treaty country with respect to indebtedness arising as part of the sale of equipment or merchandise on credit by a resident of the same treaty country.

The proposed treaty defines the term "interest" as interest from government securities, bonds, debentures, and any other form of indebtedness, whether or not secured by mortgage and whether or not carrying a right to participate in the debtor's profits. The term includes premiums attaching to such securities, bonds, or debentures. The term also includes all other income that is treated as interest under the internal law of the country in which the income arises. Interest does not include income covered in Article 10 (Dividends). Unlike the U.S. model, the proposed treaty does not exclude from the definition of interest penalty charges for late payment.

The reductions in source country tax on interest under the proposed treaty do not apply if the beneficial owner of the interest carries on business through a permanent establishment in the source country and the interest paid is attributable to the permanent establishment. In such an event, the interest is taxed under Article 7 (Business Profits). This rule includes beneficial owners that perform independent personal services through a permanent establishment because, unlike the U.S. model but like the OECD model, independent personal services are not addressed in a separate article.

The proposed treaty provides that interest is treated as arising in a treaty country if the payer is a resident of that country.[34] However, if the interest expense is borne by a permanent establishment, the interest will have as its source the country in which the permanent establishment is located, regardless of the residence of the payer. Thus, for example, if a French resident has a permanent establishment in Japan and that French resident incurs indebtedness to a U.S. person, the interest on which is borne by the Japanese permanent establishment, the interest would be treated as having its source in Japan. In the case of interest that is incurred by a U.S. branch of a Japanese resident company, the Technical Explanation indicates that the interest expense allocation rules under U.S. law determine the amount of interest expense that is treated as having been borne by the U.S. branch for purposes of this article.

The proposed treaty addresses the issue of non-arm's length interest charges between related parties (or parties having an otherwise special relationship) by stating that this article applies only to the amount of arm's-length interest. Any amount of interest paid in excess of the arm's-length interest is taxable in the treaty country of source at a rate not to exceed five percent of the gross amount of the excess. The treatment of excess interest under the proposed treaty differs from the U.S. model, which provides that any amount of interest paid in excess of the arm's-length interest is taxable according to the laws of each country, taking into account the other provisions of the treaty. For example, the U.S.

[34] This is consistent with the source rules of U.S. law, which provide as a general rule that interest income has as its source the country in which the payer is resident.

model provides that excess interest paid to a parent corporation may be treated as a dividend under local law and, thus, entitled to the benefits of treaty provisions relating to dividends.[35] With respect to interest paid in an amount that is less than the amount that would have been paid in the absence of the special relationship, the Technical Explanation provides that a treaty country may characterize a transaction to reflect its substance and impute interest under the authority of Article 9 (Associated Enterprises).

The proposed treaty provides an anti-abuse exception to the general source-country reductions in tax for interest paid with respect to ownership interests in a vehicle used for the securitization of real estate mortgages or other assets, to the extent that the amount of interest paid exceeds the rate of return on comparable debt instruments as specified by the domestic law of the source country. The Technical Explanation states that this provision ensures that the source country reductions in tax do not apply to excess income inclusions with respect to residual interests in a real estate mortgage investment conduit ("REMIC"). This provision is analogous to the U.S. model, but is drafted reciprocally, presumably to apply to similar Japanese securitization vehicles.

Unlike the U.S. model, the proposed treaty does not provide an anti-abuse exception for certain "contingent interest" payments. Under the U.S. model, if interest is paid by a source country resident and is determined with reference to the 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, then such interest generally may be taxed in the source country in accordance with its internal laws. However, if the beneficial owner is a resident of the other treaty country, the U.S. model provides that such interest may not be taxed at a rate exceeding the maximum rate prescribed in the treaty for dividends. The Technical Explanation of the proposed treaty states that this anti-abuse exception was not included in the proposed treaty because the maximum rate for dividends under the proposed treaty (i.e., 10 percent) is the same as the general rate applicable to interest. However, the absence of this anti-abuse exception in the proposed treaty could permit financial institutions that are eligible for complete exemption from source country tax on interest to circumvent even the reduced source country tax on dividends under the proposed treaty by structuring as contingent interest payments that are economically equivalent to dividends.

The proposed treaty provides that the reductions in source country tax apply to interest payments that are deemed to be received by a treaty country resident and allocated as interest expense for purposes of determining income that is attributable to a permanent establishment of such resident in the other treaty country or taxable on a net basis in the other treaty country as income from real property or gain on real property, to the extent such deemed interest payments exceed the actual interest paid by the permanent es-

[35] The Technical Explanation claims that the treatment of excess interest under the proposed treaty "is consistent in most circumstances with the results under the U.S. model and U.S. domestic law and practice."

tablishment in the other treaty country or paid with respect to debt secured by real property situated in the other treaty country. The Technical Explanation states that this provision extends the reduction in source country tax to include allocable excess interest that is determined under the branch-level interest tax provisions of U.S. internal law (Code sec. 884(f)).

The proposed treaty provides an anti-conduit provision under which the provisions with respect to interest will not apply to interest that is paid pursuant to certain back-to-back lending arrangements. This provision is similar to anti-conduit rules dealing with dividends, royalties, and other income in the proposed treaty. In this context, a resident of a contracting state will not be considered the beneficial owner of interest in respect of a debt-claim if such debt-claim would not have been established unless a person that is not entitled to the same or more favorable treaty benefits and that is not a resident of either contracting state held an equivalent debt-claim against the resident. Certain other aspects of this provision are discussed above in more detail with regard to a comparable anti-conduit provision in Article 10 (Dividends).

Article 12. Royalties

Internal taxation rules

United States

Under the same system that applies to dividends and interest, the United States imposes a 30-percent withholding tax on U.S.-source royalties paid to foreign persons. U.S.-source royalties include royalties for the use of or right to use intangible property in the United States.

Japan

Royalties paid to nonresidents are generally subject to a 20-percent withholding rate.

Proposed treaty limitations on internal law

The proposed treaty provides that royalties arising in a country (the source country) and beneficially owned by a resident of the other country are exempt from tax in the source country. This exemption from source country tax is similar to that provided in the U.S. model.

The term "royalties" means any consideration for the use of, or the right to use, any copyright of literary, artistic or scientific work (including cinematographic films and films or tapes for radio or television broadcasting). The term also includes consideration for the use of, or the right to use, any patent, trademark, design or model, plan, secret formula or process, or other like right or property, or for information concerning industrial, commercial, or scientific experience. Unlike the U.S. model, the term does not include gain from the alienation of any right or property described in the preceding two sentences, regardless of whether the amount of such gain is contingent on the productivity, use, or disposition of the right or property. Such gains are dealt with under Article 13 (Gains) and, as the Technical Explanation states, generally are subject to the same treatment under the proposed treaty as royal-

ties. The Technical Explanation also states that the term royalties does not include income from leasing personal property.

The exemption from source country tax does not apply if the beneficial owner of the royalties carries on a business through a permanent establishment in the source country, and the royalties are attributable to the permanent establishment. In that event, the royalties are taxed as business profits (Article 7). According to the Technical Explanation, royalties attributable to a permanent establishment but received after the permanent establishment is no longer in existence are taxable in the country where the permanent establishment existed.

The proposed treaty addresses the issue of non-arm's-length royalties between related parties (or parties otherwise having a special relationship) by providing that this article applies only to the amount of arm's-length royalties. Any amount of royalties paid in excess of the arm's-length interest is taxable in the country in which it arises at a rate not to exceed five percent. This provision is found in the U.S. model and other U.S. tax treaties, but the rule that limits the withholding rate to a specified percentage has not been included in the U.S. model or other U.S. tax treaties. The Technical Explanation states that the proposed treaty's treatment of such excess amounts is consistent in most circumstances with the results under the U.S. model and U.S. domestic law. Absent this rule, the United States would treat such excess amounts as a dividend or as a contribution to capital, depending on the relationship between the parties, and tax such amounts accordingly. Under the proposed treaty, a maximum five percent withholding tax rate generally applies to dividends where the beneficial owner is a company owning directly or indirectly at least 10 percent of the voting stock of the company paying the dividends. This rule is similar to rules provided in paragraph 8 of Article 11 (Interest) and paragraph 3 of Article 21 (Other Income.)

The proposed treaty also includes an anti-conduit rule that states that a resident of the United States or Japan shall not be considered the beneficial owner of royalties in certain "back-to-back" arrangements. This rule is similar to other anti-conduit rules included in the proposed treaty dealing with interest, dividends, and other income, which can be found in paragraph 11 of Article 10 (Dividends), paragraph 11 of Article 11 (Interest), and paragraph 4 of Article 21 (Other Income). These anti-conduit rules are significantly narrower than similar rules that are provided under U.S. domestic law. The Technical Explanation notes that the limited anti-conduit rules provided in the proposed treaty are not included in the U.S. model, but are included at the request of Japan in order to ensure that Japan can prevent residents of third countries from improperly obtaining the benefits of the proposed treaty in certain limited circumstances. The Technical Explanation also states the United States does not intend the inclusion of such anti-conduit rules in the proposed treaty to create a negative inference regarding the application of U.S. domestic anti-abuse rules, other articles of the proposed treaty, or other U.S. tax treaties.

The royalty rule specifically provides that a resident of the United States or Japan shall not be considered the beneficial owner of royalties in respect of intangible property if such royalties would

not have been paid unless the resident pays royalties in respect of the same intangible property to a person that is not entitled to the same or more favorable treaty benefits and that is not a resident of either the United States or Japan.

The Technical Explanation notes that this article is subject to the saving clause of paragraph 4 of Article 1 (General Scope), as well as Article 22 (Limitation on Benefits).

Article 13. Gains

Internal taxation rules

United States

Generally, gain realized by a nonresident alien or a foreign corporation from the sale of a capital asset is not subject to U.S. tax unless the gain is effectively connected with the conduct of a U.S. trade or business or, in the case of a nonresident alien, he or she is physically present in the United States for at least 183 days in the taxable year. However, the Foreign Investment in Real Property Tax Act ("FIRPTA"), effective June 19, 1980, extended the reach of U.S. taxation to dispositions of U.S. real property by foreign corporations and nonresident aliens regardless of their physical presence in the United States.

Under FIRPTA, the nonresident alien or foreign corporation is subject to U.S. tax on the gain from the sale of a "U.S. real property interest" as if the gain were effectively connected with a trade or business conducted in the United States. A "U.S. real property interest" generally includes an interest in a domestic corporation if at least 50 percent of the assets of the corporation consist of U.S. real property at any time during the five-year period ending on the date of disposition ("U.S. real property holding corporation"). FIRPTA contained a provision expressly overriding any tax treaty but generally delaying such override until after December 31, 1984.[36]

Japan

In general, capital gains of resident individuals (50 percent of long-term capital gains) are subject to tax at the regular individual tax rate under a special net capital gains calculation. Capital gains taxes of resident individuals are separately calculated for sales of land and buildings and sales of securities, and are subject to lower rates. Capital gains of domestic corporations are treated as ordinary income. However, a special surplus tax, which was suspended through December 31, 2003, is imposed on corporate capital gains from the sale of land located in Japan.

Nonresident individuals and foreign corporations carrying on a business in Japan through a permanent establishment in Japan are taxed on gains with respect to the disposition of assets giving rise to Japan source income. Other nonresident individuals and foreign corporations are generally not taxed on gains from the disposal of Japanese assets, except for the sale or disposal of real property situated in Japan, the disposal or cutting of timber standing in Japan, and the sale of a substantial interest in a domestic

[36] *See* Foreign Investment in Real Property Tax Act, Pub. L. No. 96–499, sec. 1125(c)(1) (1980).

corporation. The sale of five percent or more of the issued shares of a domestic corporation, made by a nonresident or foreign corporation (and certain related parties), is deemed to be a sale of a substantial interest if the nonresident or foreign corporation (and related parties) owned 25 percent or more of such issued shares during the year of sale or during the preceding two years.

Present treaty

The present treaty provides that the gain derived by a resident of one treaty country may not be taxed by the other treaty country unless the gain: (1) is derived from the sale, exchange or other disposition of real property situated in the other treaty country; (2) arises out of the sale, exchange or other disposition of certain intangible property deriving income from sources in the other treaty country and taxable under the royalty article; (3) is effectively connected with a permanent establishment in the other treaty country; or (4) is derived by an individual resident of the treaty country who is present in the other treaty country for 183 days during the taxable year or who maintains a fixed base in the other treaty country with which such property is effectively connected for such period. FIRPTA overrode the present treaty with respect to dispositions of U.S. real property holding corporations but was consistent with the treaty's exception for situs country taxation of gains from the disposition of real property.

Proposed treaty limitations on internal law

The proposed treaty specifies rules governing when a country may tax gains from the alienation of property by a resident of the other country. Generally, except as described below with respect to real property and certain other property, gains from disposition of any property are taxable only by the country in which the alienator is resident.

Under the proposed treaty, gains derived by a resident of one treaty country from the alienation of real property situated in the other country may be taxed in the country in which the property is situated. For the purposes of this article, real property is defined in Article 6 of the proposed treaty. That definition has the same meaning which it has under the laws of the country in which the property in question is situated, and specifically includes property accessory to real property, livestock and equipment used in agriculture and forestry, rights to which the provisions of general law respecting real property apply, usufruct of real property and rights to variable or fixed payments as consideration for the working of, or the right to work, mineral deposits and other natural resources.

The proposed treaty preserves the non-exclusive right of a treaty country to tax gains from the indirect alienation of real property situated in that treaty country by means of alienation of certain entities holding an interest in real property. Paragraph 2(a) of the proposed treaty provides that gains derived by a treaty country resident from the alienation of shares in a company that is a resident of the other treaty county and that currently derives at least 50 percent of its value directly or indirectly from real property situated in the other treaty country may be taxed by the other treaty country. Gains from the alienation of shares which are part of a

class of shares which are traded on a recognized stock exchange and of which the alienator (and persons related thereto) own in the aggregate five percent or less are not taxable by the other treaty country. Paragraph 2(b) permits the treaty country in which the real property is located to tax gains from the alienation of an interest in a partnership, trust or estate to the extent that its assets consist of real property located in that treaty country. This provision is similar to Code section 897(g).

These provisions have the effect of permitting the United States to tax U.S. real property holding corporations under U.S. domestic law in most instances. Under the proposed treaty, however, the testing of whether a domestic company is a U.S. real property holding corporation is performed on the date of disposition and not throughout the five-year testing period provided under FIRPTA. In addition, while both the proposed treaty and FIRPTA provide an exclusion for dispositions of small share interests in U.S. real property holding corporations traded on an established securities market, FIRPTA requires that such shares be "regularly" traded and provides a five-year testing period for the five percent interest. The treatment of U.S. real property holding corporations under the proposed treaty varies from the U.S. model treaty.

Paragraph 9 of the protocol provides that distributions made by a REIT are taxable under paragraph 1 of Article 13, to the extent such distributions are attributable to gains from the alienation by the REIT of real property situated in the United States. This rule is consistent with Code section 897(h)(1).

Paragraph 3 of Article 13 contains a unique exception to the general disposition rule that is not in the U.S. model, and is of special relevance to Japan. Where a treaty country provides substantial financial assistance to a financial institution resident in that country pursuant to a domestic law concerning the resolution of imminent insolvency of financial institutions in that country, and a resident of the other treaty country acquires shares in the financial institution from the first treaty country, the first treaty country may tax gains derived from the later disposition of such shares by such acquirer, provided that the disposition occurs within five years from the first date on which such financial assistance was provided. However, the exception does not apply if the resident of the other treaty country acquired any shares in the financial institution from the first treaty country before the treaty enters into force or pursuant to a binding contract entered into before the treaty enters into force. Thus, a person that acquired any shares before the treaty enters into force will not be subject to tax under this paragraph with respect to any shares acquired after the treaty enters into force. The effect of this paragraph is to shift a portion of such financial assistance to the U.S. fisc, to the extent that future U.S. investors may claim foreign tax credits for Japanese taxes allowed under this provision.

Paragraph 4 contains a provision that permits a country to tax gains from the alienation of property (other than real property and dispositions to which paragraph 3 applies) that forms a part of the business property of a permanent establishment located in that country. This rule also applies to gains from the alienation of such a permanent establishment (alone or with the enterprise as a

whole). A resident of Japan that is a partner in a partnership doing business in the United States generally will have a permanent establishment in the United States as a result of the activities of the partnership, assuming that the activities of the partnership rise to the level of a permanent establishment.[37] Under this provision, the United States generally may tax a partner's distributive share of income realized by a partnership on the disposition of personal (movable) property forming part of the business property of the partnership in the United States.

The proposed treaty provides that gains derived by a resident of one of the treaty countries from the alienation of ships or aircraft operated in international traffic by the resident, and any personal property pertaining to the operation of such ships or aircraft, are taxable only in such country. A similar rule also applies to gains derived from the sale of containers, including trailers, barges and related equipment, used in international traffic, except where such containers were used solely within the other treaty country. The Technical Explanation states that the rules of this paragraph apply notwithstanding paragraph 4, even if the income is attributable to a permanent establishment maintained by the enterprise in the other contracting state. The general treatment and exception noted above are consistent with the rules under Article 8 relating to profits from the operation of ships, aircraft and containers in international traffic.

Gains from the alienation of any property other than that discussed above, including intangible rights that would produce royalties, is taxable under the proposed treaty only in the country where the person alienating the property is resident. The treatment of gains from the alienation of intangible property is the same as under the U.S. model treaty. Under the present treaty, the gain on the disposition of such property is treated as a royalty (and is subject to withholding at a rate not exceeding 10 percent) to the extent that the consideration for such disposition is contingent on the productivity, use, or subsequent disposition of such property or rights.

Pursuant to paragraph 10 of the protocol, gains from the exercise of stock options are treated under as remuneration under Article 14 (Income from Employment) of the proposed treaty and not under Article 13.

Notwithstanding the foregoing limitations on taxation of certain gains, the saving clause of subparagraph 4(a) of Article 1 (General Scope) permits the United States to tax its citizens and residents as if the treaty had not come into effect. Thus, any limitation in this article on the right of the United States to tax gains does not apply to gains of a U.S. citizen or resident, including gains of certain former citizens and long-term residents of the United States, as provided under Paragraph 4(b) of Article 1 of the proposed treaty and section 877.

The benefits of this article are also subject to the provisions of Article 22 (Limitation on Benefits). Thus, only a resident of a treaty country that satisfies one of the conditions in Article 22 is entitled to the benefits of this article.

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[37] *See, e.g.,* Rev. Rul. 91–32, 1991–1 C.B. 107.

Article 14. Income from Employment

Under the proposed treaty, salaries, wages, and other similar remuneration derived from services performed as an employee in one treaty country (the source country) by a resident of the other treaty country are taxable only by the country of residence if three requirements are met: (1) the individual is present in the source country for not more than 183 days in any 12-month period commencing or ending in the taxable year or year of assessment concerned; (2) the individual is paid by, or on behalf of, an employer who is not a resident of the source country; and (3) the remuneration is not borne by a permanent establishment of the employer in the source country. These limitations on source country taxation are similar to the rules of the U.S. model and OECD model.

The proposed treaty contains a special rule that permits remuneration derived by a resident of one treaty country with respect to employment as a regular member of the crew of a ship or aircraft operated in international traffic by an enterprise of the other treaty country to be taxed in the treaty country of residence of the enterprise operating the ship or aircraft. The Technical Explanation states this taxing jurisdiction is not exclusive. This provision is similar to the OECD model but is contrary to the U.S. model, which provides that such remuneration may be taxed only in the treaty country of residence of the employee. The Technical Explanation states that the United States generally may not tax the salary of a Japanese resident who is employed by a U.S. carrier because U.S. internal law does not impose tax on such income of a person who is neither a citizen nor a resident of the United States, even if the person is employed by a U.S. entity. However, the Technical Explanation does not discuss whether Japanese internal law provides similar treatment of U.S. residents employed by Japanese carriers.

This article is subject to the provisions of the separate articles covering directors' fees (Article 15), pensions, social security, annuities, alimony, and child support payments (Article 17), and government service income (Article 19).

Employee share and stock option plans

Article 10 of the proposed protocol provides special rules concerning the treatment of employee stock option plans under this article. The proposed protocol states that any benefits enjoyed by employees under such plans relating to the period between grant and exercise of an option constitute "other similar remuneration" and are subject to the application of this article. The proposed protocol requires the allocation of taxing jurisdiction between the treaty countries over such plans if an employee: (1) has been granted a share or stock option in the course of employment in one of the treaty countries; (2) has exercised that employment in both treaty countries during the period between grant and exercise of the option; (3) remains in that employment on the date of the exercise; and (4) under the respective domestic laws of the treaty countries, would be taxable by both countries with respect to the gain on the option. Under this special allocation rule, each treaty country may tax, as the source country, only the portion of the gain on an option that relates to the period or periods between the grant and the ex-

ercise of the option during which the employee has exercised employment in that treaty country. The Technical Explanation states that the portion attributable to a treaty country under this rule will be determined by multiplying the gain by a fraction, the numerator of which is the number of days during which the employee exercised employment in that country and the denominator of which is the total number of days between the grant and the exercise of the option.

To prevent the special allocation rule from resulting in the double taxation of stock option plans, the proposed protocol states that the competent authorities of the treaty countries will endeavor to resolve by mutual agreement any difficulties or doubts arising from the interpretation or application of this article and Article 24 (Relief from Double Taxation) in relation to employee share or stock option plans. In a formal understanding between the United States and Japan, the treaty countries acknowledge that the special allocation rule provided in the proposed protocol may be insufficient to avoid double taxation in all cases due to the interaction between the internal laws of the United States and Japan concerning employee stock options. For example, double taxation may result because a stock option is treated in one treaty country as "qualified" (i.e., taxed on sale of the optioned stock rather than on grant or exercise of the stock option) but treated in the other treaty country as "nonqualified" (i.e., taxed on grant or exercise of the stock option and on sale of the optioned stock).

In cases in which double taxation would occur under the proposed protocol, the understanding states that the competent authorities of the United States and Japan will, through a mutual agreement procedure, provide measures for the elimination of double taxation at the time of sale of the optioned stock. Such measures could include the allowance of a foreign tax credit for source country taxes that are imposed at the time of exercise or sale in accordance with this article and the proposed protocol, notwithstanding any otherwise applicable limitations in the domestic law foreign tax credit provisions of the United States or Japan.

Article 15. Directors' Fees

Under the proposed treaty, director's fees and other similar payments derived by a resident of one country in his or her capacity as a member of the board of directors of a company that is a resident of that other country is taxable in that other country, regardless of where the services are performed. In this regard, the proposed treaty follows the OECD model. In contrast, under the U.S. model, the country of the company's residence may tax the remuneration of nonresident directors, but only with respect to remuneration for services performed in that country.

Article 16. Artistes and Sportsmen

Like the U.S. and OECD models, the proposed treaty contains a separate set of rules that apply to the taxation of income earned by entertainers (such as theater, motion picture, radio, or television artistes or musicians) and athletes. These rules apply notwithstanding the other provisions dealing with the taxation of income from personal services (Articles 7 and 14) and are intended, in

part, to prevent entertainers and athletes from using the treaty to avoid paying any tax on their income earned in one of the countries. In keeping with this purpose, if the performer would be exempt from host-country tax under Article 16, but would be taxable under either Article 7 or 14, tax may be imposed under either of those articles.

Paragraph 1 provides that income derived by an entertainer or athlete who is a resident of one country from his or her personal activities as such in the other country may be taxed in the other country if the amount of the gross receipts derived by him or her from such activities exceeds $10,000 or its equivalent in yen. The $10,000 threshold includes expenses that are reimbursed to the entertainer or athlete or borne on his or her behalf. Under this rule, if a Japanese entertainer or athlete maintains no permanent establishment in the United States and performs (as an independent contractor) in the United States for total compensation of $10,000 during a taxable year, the United States would not tax that income. If, however, that entertainer's or athlete's total compensation were $20,000, the full amount would be subject to U.S. tax. The proposed treaty's taxation threshold of $10,000 is lower than the $20,000 threshold of the U.S. model.

Paragraph 2 provides that where income in respect of activities performed in one treaty country by an entertainer or athlete in his or her capacity as such accrues not to the entertainer or athlete but to another person that is a resident of the other treaty country, that income is taxable by the country in which the activities are performed unless the contract pursuant to which the activities are performed allows that other person to designate the individual who is to perform the activities.[38] This provision prevents highly-paid entertainers and athletes from avoiding tax in the country in which they perform by, for example, routing the compensation for their services through a "star company" resident in the same treaty country in which the star is resident. For example, if a Japanese athlete is employed by a Japanese baseball team, and the team enters into a contract with a U.S. promoter to play in the United States, the United States may tax the income accruing to the team unless the contract allows the team (rather than the promoter) to designate the athlete.

Paragraph 2 differs from the analogous provision in the U.S. model, although each is directed at mitigating the circumvention of paragraph 1 through the formation of an entity. Paragraph 2 of Article 17 of the U.S. model looks to whether the performer participates in the profits of the company in any manner rather than whether the company has the ability to designate the individual to perform the services.

In cases where paragraph 2 is applicable, the income of the "employer" may be subject to tax in the host treaty country even if it has no permanent establishment in the host country. Taxation under paragraph 2 is on the person providing the services of the performer. This paragraph does not affect the rules of paragraph 1, which apply to the performer himself. The income taxable by vir-

[38] This rule is based on the U.S. domestic law provision characterizing income from certain personal service contracts as foreign personal holding company income in the context of the foreign personal holding company provisions. *See* Code sec. 553(a)(5).

tue of paragraph 2 is reduced to the extent of salary payments to the performer, which fall under paragraph 1.

This article applies only with respect to the income of entertainers and sportsmen. Others involved in a performance or athletic event, such as producers, directors, technicians, managers, coaches, etc., remain subject to the provisions of Articles 7 (Business Profits) and 14 (Income from Employment). In addition, except as provided in paragraph 2 of Article 16, income earned by persons that are not individuals is not covered by Article 16.

As explained in the Technical Explanation, Article 16 of the treaty applies to all income connected with a performance by the entertainer, such as appearance fees, award or prize money, and a share of the gate receipts. Income derived from a treaty country by a performer who is a resident of the other treaty country from other than actual performance, such as royalties from record sales and payments for product endorsements, is not covered by this article, but is covered by other articles of the treaty, such as Article 12 (Royalties) or Article 7 (Business Profits). As indicated the Technical Explanation, where an individual fulfills a dual role as performer and non-performer (such as a player-coach or an actor-director), but his role in one of the two capacities is negligible, the predominant character of the individual's activities should control the characterization of those activities. In other cases there should be an apportionment between the performance-related compensation and other compensation.

Consistent with Article 14 (Income from Employment), Article 16 also applies regardless of the timing of actual payment for services. Thus, a bonus paid to a resident of a treaty country with respect to a performance in the other treaty country during a particular taxable year would be subject to Article 16 for that year even if it was paid after the close of the year.

This article is subject to the provisions of the saving clause of subparagraph 4(a) of Article 1 (General Scope). Thus, if an entertainer or a sportsman who is a resident of Japan is a citizen of the United States, the United States may tax all of his income from performances in the United States without regard to the provisions of this article, subject, however, to the special foreign tax credit provisions of paragraph 3 of Article 23 (Relief from Double Taxation). In addition, the benefits of this article are subject to the provisions of Article 22 (Limitation on Benefits).

Article 17. Pensions, Social Security, Annuities, and Child Support Payments

The proposed treaty generally provides that private pensions and other similar remuneration, including social security payments, beneficially owned by a resident of one country may be taxed only in the recipient's country of residence. The Technical Explanation clarifies that pensions and other similar remuneration includes both periodic and lump-sum payments.

This provision of the proposed treaty does not apply to pensions in respect of government service (including payments under Code section 457, 401(a) and 403(b) plans established for government employees, as explained in the Technical Explanation). Rather, such payments generally are covered by Article 18, which provides

that pensions paid by a country (or political subdivision or local authority) for services rendered in the discharge of functions of a governmental nature may be taxed only in that country.

The residence-based rule of taxation under this article follows the U.S. model treaty with respect to pensions, but not with respect to social security benefits. In contrast, the U.S. model would provide that pensions paid out of funds created by a country are taxable only in that country. Under this article, as under the present treaty, however, social security benefits (including U.S. Tier 1 Railroad Retirement benefits, as clarified in the Technical Explanation) are taxable in the recipient's country of residence.

The proposed treaty provides that annuities derived and beneficially owned by a resident of one country may be taxed only in the recipient's country of residence. The term "annuities" means a stated sum paid periodically at stated times during an individual's life, or during a specified and ascertainable period of time, under an obligation to make the payments in return for adequate and full consideration (other than services rendered). The Technical Explanation clarifies that the term "annuities" does not include pensions or similar remuneration.

This article also addresses the treatment of periodic payments made pursuant to a written separation agreement or decree of divorce, separate maintenance, or compulsory support, as well as payments for the support of a child. Such payments generally are taxable only in the recipient's country of residence. However, such payments that are not deductible by the payor in his or her country of residence are not taxable to the recipient in either country. The saving clause of Article 1, paragraph 4, does not apply to such payments.

Article 18. Government Service

Under paragraph 1 of this article, remuneration, other than a pension, paid by a treaty country (or a political subdivision or local authority thereof) to an individual for services rendered to that country (or subdivision or authority) generally is taxable only by that country. However, such remuneration is taxable only by the other (host) country if the services are rendered in that other country by an individual who is a resident of that country and who: (1) is also a national of that country; or (2) did not become a resident of that country solely for the purpose of rendering the services. The rules of this paragraph, unlike the corresponding rules of the U.S. model, apply to remuneration paid only to government employees and not to independent contractors engaged by governments to perform services for them.

Paragraph 2 provides that any pension and similar remuneration paid by, or out of funds to which contributions are made by, a treaty country (or a political subdivision or local authority thereof) to an individual for services rendered to that country (or subdivision or authority) generally is taxable only by that country. However, such a pension is taxable only by the other country if the individual is a national and resident of that other country. In contrast to the U.S. model, the provision does not apply to pensions paid by such entities as government-owned corporations, unless the pension contributions were made by the government. Social security

benefits with respect to government service are subject to paragraph 1 of Article 17 (Pensions, Social Security, Annuities and Support Payments) and not this article.

The proposed treaty provides that if a treaty country (or a political subdivision or local authority thereof) is carrying on a business, the provisions of Articles 14 (Income from Employment), 15 (Directors' Fees), 16 (Artistes and Sportsmen), and 17 (Pensions, Social Security, Annuities and Support Payments) will apply to remuneration and pensions for services rendered in connection with that business.

This article is generally not subject to the saving clause of the proposed treaty, Article 1, paragraph 4(a) (applicable to treaty country residents and, in the case of the United States, its citizens). However, in the case of benefits conferred by the United States, the saving clause will apply to U.S. citizens and permanent residents. Thus, for example, a resident of Japan who, in the course of rendering services to the government of Japan, becomes a resident of the United States (but not a permanent resident) would be entitled to the exemption from taxation by the United States. In addition, an individual who receives a pension paid by the government of Japan in respect of services rendered to that government is taxable on that pension only in Japan unless the individual is a U.S. citizen or acquires a U.S. green card.

Article 19. Payments to Students and Business Apprentices

The treatment provided to students and business apprentices under the proposed treaty generally corresponds to the treatment provided under the present treaty, with certain modifications. The provision in the proposed treaty corresponds to the provision in the U.S. model and is similar to the provision of the OECD model.

Under the proposed treaty, a student or business apprentice who visits a country (the host country) for the primary purpose of his or her full-time education at a university, college, or other recognized educational institution of a similar nature, or for his or her full-time training, and who immediately before that visit is, or was a resident of the other treaty country, generally is exempt from host country tax on payments he or she receives for the purpose of such maintenance, education, or training; provided, however, that such payments arise outside the host country. The Technical Explanation states that for purposes of this article, the requirement that the individual's "primary purpose" is education or training is not satisfied if the visitor comes principally to work, but also is a part-time student.

Under the proposed treaty, the exemption from host country tax will apply to a business apprentice only for a period of not more than one year from the date he or she first arrives in the host country for the purpose of training. However, the Technical Explanation clarifies that if a business apprentice remains in the host country longer than one year, he or she does not retroactively lose the exemption applicable to the first 12 months of residence in the host country.

In the case of an individual who receives personal services income from a source outside the host country, the present treaty limits the amount of personal services income exempt to a qualified

student or business trainee to $5,000. The proposed treaty would eliminate this $5,000 exemption, and any such personal service income would be subject to host country income tax.[39]

This article of the proposed treaty is an exception from the saving clause in the case of persons who are neither citizens nor lawful permanent residents of the host country.

Article 20. Income from Teaching or Research

The treatment provided to professors and teachers under the proposed treaty generally corresponds to the treatment provided under the present treaty. Such a provision is not part of the U.S. model. Such a provision is not part of the OECD model.

Under the proposed treaty, a professor or teacher who visits a country (the host country) for the purpose of teaching or engaging in research at a university, college, or other recognized educational institution of a similar nature, and who immediately before that visit is, or was a resident of the other treaty country, generally is exempt from host country tax on any remuneration received for teaching or research. However, the treaty benefit only applies if the visiting professor or teacher, while resident in the host country, remains a resident, within the meaning of Article 4, of the other treaty country. This exemption applies for not more than the two-year period beginning on the date of the professor's or teacher's arrival in the host country. The Technical Explanation states that an individual must first re-establish domicile for a substantial period of time (normally at least one year) in his or her home country before again claiming benefits under this article for a new two-year period.

This article of the proposed treaty is an exception from the saving clause in the case of persons who are neither citizens nor lawful permanent residents of the host country.

Article 21. Other Income

This article is a catch-all provision intended to cover items of income not specifically covered in other articles, and to assign the right to tax income from third countries to either the United States or Japan. As a general rule, items of income not otherwise dealt with in the proposed treaty which are beneficially owned by residents of one of the countries are taxable only in the country of residence. This rule is similar to the rules in the U.S. and OECD models.

The Technical Explanation offers the following examples of "other income": gambling winnings, punitive damages, payments for a covenant not to compete, and income from certain financial instruments. The Technical Explanation also notes that the article applies to items of income that are not dealt with because of their source. For example, royalties derived by a resident of one treaty country from a third country are not taxable by the other treaty country under this article.

In addition, paragraph 8 of the proposed protocol provides that fees received in connection with a loan of securities, guarantee fees,

[39] The present treaty also provides a $10,000 exemption related to certain host country government programs of research, study, or training. The proposed treaty would not have special rules related to host country government programs.

and commitment fees paid by a resident of one contracting state and beneficially owned by a resident of the other contracting state are taxable only in the residence country of the beneficial owner, unless the fees are attributable to, or the right in respect of which such fees are paid is effectively connected with, a permanent establishment of the beneficial owner in the source country.

The Technical Explanation states that under U.S. tax law, partnership and trust income and distributions have the character of the associated distributable net income, and thus generally are covered under other articles of the proposed treaty.

The general rule providing for exclusive residence-country taxation does not apply to income (other than income from real property) if the beneficial owner of the income is a resident of one country and carries on business in the other country through a permanent establishment situated therein, and the income is attributable to such permanent establishment. In such a case, the provisions of Article 7 (Business Profits) apply.

The proposed treaty deals with non-arm's-length payments between related parties by providing that the amount of income for purposes of applying this article is the arm's-length amount that would have been agreed upon by the payor and the beneficial owner in the absence of the special relationship. Any amount paid in excess of such amount is taxable by the country of source at a maximum rate of five percent of the gross amount of the excess.

The proposed treaty provides an anti-conduit provision under which the provisions of this article will not apply to amounts paid pursuant to certain back-to-back arrangements. This provision is similar to anti-conduit rules dealing with dividends, interest, and royalties in the proposed treaty. In this context, a resident of a contracting state will not be considered the beneficial owner of other income in respect of a right or property if such other income would not have been paid to the resident unless the resident pays other income in respect of the same right or property to a person that is not entitled to the same or more favorable treaty benefits and that is not a resident of either contracting state.

This article is subject to the saving clause, so U.S. citizens who are residents of Japan will continue to be taxable by the United States on income that is not dealt with elsewhere in the proposed treaty. The benefits of this article are also subject to the provisions of Article 22 (Limitation on Benefits).

Article 22. Limitation on Benefits

In general

The proposed treaty contains a provision generally intended to limit the indirect use of the proposed treaty by persons who are not entitled to its benefits by reason of residence in the United States or Japan. The present treaty does not include such a provision.

The proposed treaty is intended to limit double taxation caused by the interaction of the tax systems of the United States and Japan as they apply to residents of the two countries. At times, however, residents of third countries attempt to use a treaty. This use is known as "treaty shopping," which refers to the situation where a person who is not a resident of either treaty country seeks

certain benefits under the income tax treaty between the two countries. Under certain circumstances, and without appropriate safeguards, the third-country resident may be able to secure these benefits indirectly by establishing a corporation or other entity in one of the treaty countries, which entity, as a resident of that country, is entitled to the benefits of the treaty. Additionally, it may be possible for the third-country resident to reduce the income base of the treaty country resident by having the latter pay out interest, royalties, or other amounts under favorable conditions either through relaxed tax provisions in the distributing country or by passing the funds through other treaty countries until the funds can be repatriated under favorable terms.

The proposed anti-treaty shopping article provides that a treaty country resident is entitled to all treaty benefits only if it is described in one of several specified categories. Generally, a resident of either country qualifies for the benefits accorded by the proposed treaty if such resident satisfies any other specified conditions for obtaining benefits and falls within one of the following categories of persons:

(1) An individual;
(2) Certain governmental entities;
(3) A company that satisfies a public company test and certain subsidiaries of such a company;
(4) An organization operated exclusively for religious, charitable, educational, scientific, artistic, cultural, or public purposes;
(5) A pension fund that meets an ownership test; and
(6) An entity that satisfies an ownership test and a base erosion test.

Alternatively, a resident that does not fit into any of the above categories may claim treaty benefits with respect to certain items of income under an active business test. In addition, a person that does not satisfy any of the above requirements, including the active business test, may be entitled to the benefits of the proposed treaty if the source country's competent authority so determines.

Individuals

Under the proposed treaty, individuals who are residents of one of the countries are entitled to treaty benefits.

Governmental entities

Under the proposed treaty, certain governmental entities are entitled to treaty benefits. These entities include the two countries, any political subdivisions or local authorities of the two countries, the Bank of Japan or the Federal Reserve Banks.

Public company tests

A company that is a resident of the United States or Japan is entitled to treaty benefits if the principal class of its shares and any disproportionate class of its shares is listed on a recognized U.S. or Japanese stock exchange and is regularly traded on one or more recognized stock exchanges. Thus, such a company is entitled to the benefits of the proposed treaty regardless of where its actual owners reside.

In addition, a company that is a resident of Japan or the United States is entitled to treaty benefits if at least 50 percent of each class of the company's shares is owned (directly or indirectly) by five or fewer companies that satisfy the test described in the paragraph above, provided that each intermediate owner used to satisfy the control requirement is entitled to treaty benefits under one of the six categories enumerated above (i.e., an individual; certain governmental entities; a company that satisfies a public company test and certain subsidiaries of such a company; an organization operated exclusively for religious, charitable, educational, scientific, artistic, cultural, or public purposes; a pension fund that meets an ownership test; or an entity that satisfies an ownership test and a base erosion test). For purposes of withholding taxes, a company is considered to satisfy this test for a taxable year in which a payment is made if it meets these requirements during the part of the taxable year that precedes the date of payment of the income (or the date on which entitlement to a dividend is determined in the case of dividends) and, unless such date is the last day of that taxable year, during the whole of the preceding taxable year. Although the proposed treaty is not clear on this point, the Technical Explanation states that a company may also meet this test if it satisfies the requirements throughout the taxable year in which treaty benefits are claimed.

The term "principal class of shares" is not defined in the proposed treaty and, in accord with Article 3 (General Definitions), the term will be defined under the domestic laws of the two countries. For purposes of the United States, the Technical Explanation states that this term 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, 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.

A "disproportionate class of shares" is described as any class of shares of a company that is a resident of one of the countries 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 country that is larger than the portion such holders would receive in the absence of such terms and arrangements.

The term "recognized stock exchange" means the NASDAQ; 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; any stock exchange established under the terms of the Securities and Exchange Law (Law No. 25 of 1948) of Japan; and any other stock exchange agreed upon by the competent authorities of the two countries.

A class of shares is considered to be "regularly traded" on one or more recognized stock exchanges in a taxable year if the aggregate number of shares of that class traded on one or more recognized exchanges in the prior taxable year is at least six percent of the average number of shares outstanding in that class during the

prior taxable year. The Technical Explanation states that this requirement can be met by aggregating trading on one or more recognized exchanges. The Technical Explanation also states authorized but unissued shares are not considered for purposes of this test.

Charitable organizations

Under the proposed treaty an entity is entitled to treaty benefits if it is an organization that is established exclusively for religious, charitable, educational, scientific, artistic, cultural, or public purposes (even if the entity is exempt from tax in the country of residence).

Pension funds

An entity is entitled to treaty benefits under the proposed treaty if it is a pension fund (as defined in Article 3 (General Definitions)), provided that as of the end of the prior taxable year more than 50 percent of the beneficiaries, members, or participants of the fund are individuals who are residents of one of the countries.

Ownership and base erosion tests

Under the proposed treaty, an entity that is a resident of one of the countries is entitled to treaty benefits if it satisfies an ownership test and a base erosion test. Under the ownership test, a person that falls within certain categories of persons enumerated above (i.e., individuals; certain governmental entities; companies that meet the public company test; an organization operated exclusively for religious, charitable, educational, scientific, artistic, cultural, or public purposes; or pension funds that meet the ownership test described above) must own (directly or indirectly) at least 50 percent of each class of shares or other beneficial interests in the entity. With respect to withholding taxes, a resident is considered to satisfy this test for a taxable year in which a payment is made if it meets the requirements during the part of the taxable year that precedes the date of payment of the income (or the date on which entitlement to a dividend is determined in the case of dividends) and, unless such date is the last day of that taxable year, during the whole of the preceding taxable year. Alternatively, the Technical Explanation states that with respect to withholding taxes this test may also be meet if the ownership threshold is satisfied throughout the taxable year in which treaty benefits are claimed; however, the language of the proposed treaty is not clear on this point. With respect to taxes other than withholding taxes, a resident is considered to satisfy this test only if the resident satisfies the test on at least half the days of the taxable year.

The base erosion test is satisfied if less than 50 percent of the entity's gross income for the taxable year in which treaty benefits are claimed is paid or accrued by the entity in that taxable year, directly or indirectly, in the form of deductible payments (in the entity's country of residence) to persons who are not residents of either treaty country. With respect to withholding at source in Japan, a resident of the United States will be considered to satisfy the base erosion test for a taxable year if the resident satisfies the test for the three taxable years preceding the taxable year in which a payment is made. The term "gross income" means the total reve-

nues derived by a resident of one of the countries from its business, less the direct costs of obtaining such revenues.

For purposes of the base erosion test, deductible payments do not include arm's-length payments in the ordinary course of business for services or tangible property and payments in respect of financial obligations to a commercial bank; provided that, if the bank is not a resident of one of the countries, such payment is attributable to a permanent establishment of that bank located in one of the countries. However, the Technical Explanation states that trust distributions are deductible payments to the extent they are deductible from the taxable base.

The Technical Explanation states that trusts may be entitled to the benefits of this article if they are treated as residents of one of the countries and they otherwise satisfy the requirements of the article.

Active business test

Under the active business test, a resident of one of the countries is entitled to treaty benefits with respect income derived from the other country if (1) the resident is engaged in the active conduct of a trade or business in its country of residence, and (2) the income is derived in connection with, or is incidental to, that trade or business. Furthermore, where the trade or business generating the income in question is carried on either by the person deriving the income or an associated enterprise, the trade or business carried on in the country of residence must be substantial in relation to the activity in the source country. The proposed treaty provides that the business of making or managing investments for the resident's own account does not constitute an active trade or business unless these activities are banking, insurance, or securities activities carried on by a bank, insurance company, or registered securities dealer.

The Technical Explanation states that income is considered to be derived "in connection" with an active trade or business if the activity generating the item of income in the other country is a line of business that forms a part of, or is complementary to, the trade or business. The Technical Explanation also states that a business activity generally is considered to form a part of a business activity conducted in the other country 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 in the country of residence may be, in relation to the activity in the country of source, upstream (e.g., providing inputs to a manufacturing process that occurs in the other country), downstream (e.g., selling the output of a manufacturer that is a resident of the other country), or parallel (e.g., selling in one country the same sorts of products that are being sold by the trade or business carried on in the other country). In order for two activities to be considered "complimentary," the Technical Explanation states that 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 of the other.

The Technical Explanation states that income is considered "incidental" to a trade or business if the production of such item facilitates the conduct of the trade or business in the other country. The Technical Explanation further states that an example of such "incidental" income is interest income earned from the short-term investment of working capital of a resident of a country in securities issued by persons in the other country.

The proposed treaty provides that whether a trade or business is substantial is determined on the basis of all the facts and circumstances. The Technical Explanation states that this takes into account the comparative sizes of the trades or businesses in each country (measured by reference to asset values, income and payroll expenses), the nature of the activities performed in each country, and the relative contributions made to that trade or business in each country.

The proposed treaty provides that in determining whether a person is engaged in the active conduct of a trade or business, activities conducted by a partnership in which that person is a partner and activities conducted by persons connected to such person will be deemed to be conducted by such person. For this purpose, a person is connected to another person if (1) one person owns at least 50 percent of the beneficial interest in the other person (or, in the case of a company, owns shares representing at least 50 percent of the aggregate voting power and value of the company or the beneficial interest in the company), or (2) another person owns, directly or indirectly, at least 50 percent of the beneficial interest in each person (or, in the case of a company, owns shares representing at least 50 percent of the aggregate voting power and value of the company or the beneficial interest in the company). The proposed treaty provides that, in any case, persons are considered to be connected if on the basis of all the facts and circumstances, one has control of the other or both are under the control of the same person or persons.

The term "trade or business" is not defined in the proposed treaty. However, as provided in Article 3 (General Definitions), undefined terms are to have the meaning which they have under the laws of the country applying the proposed treaty. In this regard, the Technical Explanation states that the U.S. competent authority will refer to the regulations issued under Code section 367(a) to define the term "trade or business."

Grant of treaty benefits by the competent authority

The proposed treaty provides a "safety valve" for a person that has not established that it meets one of the other more objective tests, but for which the allowance of treaty benefits would not give rise to abuse or otherwise be contrary to the purposes of the treaty. Under this provision, such a person may be granted treaty benefits if the competent authority of the source country determines that the establishment, acquisition, or maintenance of such resident and the conduct of its operations did not have as one of its principal purposes the obtaining of benefits under the proposed treaty.

Article 23. Relief From Double Taxation

Internal taxation rules

United States

The United States taxes the worldwide income of its citizens and residents. It attempts unilaterally to mitigate double taxation generally by allowing taxpayers to credit the foreign income taxes that they pay against U.S. tax imposed on their foreign-source income. An indirect or "deemed-paid" credit is also provided. Under this rule, a U.S. corporation that owns 10 percent or more of the voting stock of a foreign corporation and that receives a dividend from the foreign corporation (or an inclusion of the foreign corporation's income) is deemed to have paid a portion of the foreign income taxes paid (or deemed paid) by the foreign corporation on its earnings. The taxes deemed paid by the U.S. corporation are included in its total foreign taxes paid for the year the dividend is received.

A fundamental premise of the foreign tax credit is that it may not offset the U.S. tax on U.S.-source income. Therefore, the foreign tax credit provisions contain a limitation that ensures that the foreign tax credit only offsets U.S. tax on foreign-source income. The foreign tax credit limitation generally is computed on a worldwide consolidated basis. Hence, all income taxes paid to all foreign countries are combined to offset U.S. taxes on all foreign income. The limitation is computed separately for certain classifications of income (e.g., passive income and financial services income) in order to prevent the crediting of foreign taxes on certain high-taxed foreign-source income against the U.S. tax on certain types of traditionally low-taxed foreign-source income. Other limitations may apply in determining the amount of foreign taxes that may be credited against the U.S. tax liability of a U.S. taxpayer.

Japan

Japanese double tax relief is unilaterally provided to domestic corporations and resident individuals through a foreign tax credit. A domestic corporation is also generally allowed indirect foreign tax credits with respect to foreign taxes attributable to dividends from foreign subsidiaries owned 25 percent or more by the domestic corporate taxpayer for at least six months before the decision to distribute dividends is made. Japanese foreign tax credits are subject to an overall limitation equal to the product of Japanese income tax multiplied by the ratio of foreign source income to taxable income. Surplus foreign taxes may be carried forward for three years. Surplus foreign tax credit limitation may also be carried forward for three years. A taxpayer may elect to deduct all foreign taxes for a taxable year in lieu of the foreign tax credit.

Proposed treaty limitations on internal law

Overview and present treaty

One of the principal purposes for entering into an income tax treaty is to limit double taxation of income earned by a resident of one of the countries that may be taxed by the other country. Unilateral efforts to limit double taxation are imperfect. Because of differences in rules as to when a person may be taxed on business in-

come, a business may be taxed by two countries as if it were engaged in business in both countries. Also, a corporation or individual may be treated as a resident of more than one country and be taxed on a worldwide basis by both.

Part of the double tax problem is dealt with in other articles of the proposed treaty that limit the right of a source country to tax income. This article provides further relief where both Japan and the United States otherwise still tax the same item of income. This article is not subject to the saving clause, so that the country of citizenship or residence will waive its overriding taxing jurisdiction to the extent that this article applies.

The present treaty provides separate rules for relief from double taxation for the United States and Japan. The present treaty generally provides for relief from double taxation of U.S. residents and citizens by requiring the United States to allow a credit against its tax for taxes paid to Japan. The determination of this credit is made in accordance with U.S. law. In the case of Japan, the present treaty generally provides relief from double taxation by requiring Japan to permit a credit against its tax for taxes paid to the United States, subject to Japanese law provisions allowing a foreign tax credit. The present treaty provides that taxes on income and profits imposed by any political subdivision or any local authority of a treaty country shall be subject to credit by the other treaty country.

Treaty restrictions on U.S. internal law

The proposed treaty generally provides that Japan will allow its residents a credit against Japanese tax for U.S. Federal income tax. The amount of the credit, however, shall not exceed that part of the Japanese tax which is appropriate to that income. Japan is not required to allow a credit for taxes imposed by any political subdivision or local authority of the United States. The proposed treaty also requires Japan to allow a deemed-paid credit, with respect to Japanese taxes, to any Japanese company that receives dividends from a U.S. company if the Japanese company owns 10 percent or more of the voting stock of such U.S. company during the period of six months immediately before the day when the obligation to pay dividends is confirmed. The credits are subject to the provisions of Japanese law regarding the allowance of credits against Japanese tax for taxes payable in any country other than Japan.

The proposed treaty contains a re-sourcing rule for these purposes. Under the proposed treaty, income derived by a resident of Japan which may be taxed by the United States under the proposed treaty will be deemed to be U.S.-source income for Japanese foreign tax credit purposes.

The proposed treaty generally provides that the United States will allow a U.S. citizen or resident a foreign tax credit for the income taxes imposed by Japan. The proposed treaty also requires the United States to allow a deemed-paid credit, with respect to Japanese income tax, to any U.S. company that receives dividends from a Japanese company if the U.S. company owns 10 percent or more of the voting stock of such Japanese company. The credit generally is to be computed in accordance with the provisions and sub-

ject to the limitations of U.S. law (as such law may be amended from time to time without changing the general principles of the proposed treaty provisions). Thus, although the treaty requires that the United States allow a foreign tax credit, the U.S. statutory provisions in effect at the time a credit is given will determine the terms of the credit.[40] These provisions are similar to those found in the U.S. model and many U.S. treaties.

The proposed treaty provides that the taxes referred to in paragraphs 1(a) and 2 of Article 2 will be considered creditable income taxes for purposes of the proposed treaty. This includes the Japanese income tax and corporation tax. The proposed treaty does not require the United States to provide a foreign tax credit for taxes imposed by any political subdivision or local authority of Japan. However, such taxes may be creditable under U.S. internal law.

The proposed treaty contains a re-sourcing rule for these purposes. Under the proposed treaty, an item of gross income (as defined under U.S. law) that is derived by a U.S. resident and that may be taxed by Japan under the proposed treaty will be deemed to be Japan-source income for U.S. foreign tax credit purposes. The Technical Explanation states that this re-sourcing rule is intended to ensure that a U.S. resident can obtain a U.S. foreign tax credit for Japanese taxes paid when the proposed treaty assigns to Japan primary taxing jurisdiction over an item of gross income.[41] The Technical Explanation further states that in the case of a U.S.-owned foreign corporation, Code section 904(g)(10) may apply for purposes of determining the amount of the U.S. foreign tax credit with respect to income subject to the re-sourcing rule. Code section 904(g)(10) generally applies the foreign tax credit limitation separately to re-sourced income.

Paragraph 3 of the proposed treaty contains special rules designed to provide relief from double taxation for U.S. citizens, former U.S. citizens and former U.S. long-term residents who are Japanese residents under the proposed treaty. The Technical Explanation states that the rules of paragraph 3 apply only if the United States imposes tax on a U.S. citizen, former U.S. citizen or former U.S. long-term resident in accordance with the saving clause provisions of Article 1, paragraph 4, and do not apply to the extent that the United States imposes tax on such persons in a manner that is consistent with the provisions of the proposed treaty other than Article 1, paragraph 4.

Under subparagraph 3(a), consistent with the U.S. model, Japan will allow a foreign tax credit to a U.S. citizen, former U.S. citizen, or former U.S. long-term resident who is a Japanese resident by taking into account only the amount of U.S. taxes, if any, that may be imposed pursuant to the proposed treaty on a Japanese resident

[40] The U.S. credit under the proposed treaty is subject to the various limitations of U.S. law. *See* Code secs. 901–908. For example, the credit against U.S. tax generally is limited to the amount of U.S. tax due with respect to net foreign source income within the relevant foreign tax credit limitation category, and the dollar amount of the credit is determined in accordance with U.S. currency translation rules. *See, e.g.*, Code secs. 904(a) and (d) and 986. Similarly, U.S. law applies to determine carryover periods for excess credits and other inter-year adjustments. When the alternative minimum tax is due, the alternative minimum tax foreign tax credit generally is limited in accordance with U.S. law to 90 percent of alternative minimum tax liability. Code sec. 59(a)(2).

[41] Although the U.S. model does not contain a re-sourcing rule, the present treaty does contain a similar rule, as do some other U.S. tax treaties.

who is neither a U.S. citizen, nor a former U.S. citizen, nor a former U.S. long-term resident. For example, if a U.S. citizen resident in Japan receives U.S. source portfolio dividends, the foreign tax credit granted by Japan will be limited to 10 percent of the dividend—the amount of U.S. tax that may be imposed under subparagraph 2(b) of Article 10, even if the shareholder is subject to U.S. net income tax because of his U.S. citizenship.

Subparagraph 3(b) eliminates the potential for double taxation that can arise because subparagraph (a) provides that Japan need not provide full relief for the U.S. tax imposed on residents of Japan who are U.S. citizens, former U.S. citizens or former U.S. long-term residents. Under subparagraph 3(b), the United States will credit the applicable tax actually paid to Japan, determined after application of the rules of subparagraph 3(a). The credit allowed by the United States will not reduce the amount of U.S. tax that is creditable against the Japanese tax in accordance with subparagraph 3(a).

Subparagraph 3(c) provides that for purposes of the computation of the U.S. credit for tax paid to Japan under subparagraph 3(b), the income that is subject to Japanese taxation is re-sourced as Japan-source income, but only to the extent necessary to allow the United States to grant such credit.

The Technical Explanation provides detailed examples of the application of the rules of paragraph 3, consistent with the technical explanation of the U.S. model.

Article 24. Non-Discrimination

The proposed treaty contains a comprehensive non-discrimination article, applicable to taxes of every kind and description (not just income taxes), imposed at any level of government. It is similar to the non-discrimination article in the U.S. model and to provisions that have been included in other recent U.S. income tax treaties.

In general, under the proposed treaty, one country cannot discriminate by imposing more burdensome taxes on nationals of the other country than it would impose on its own comparably situated nationals in the same circumstances.[42] Not all instances of differential treatment are discriminatory. Differential treatment is permissible in some instances under this rule on the basis of tax-relevant differences (e.g., the fact that one person is subject to worldwide taxation in a treaty country and another person is not, or the fact that an item of income may be taxed at a later date in one person's hands but not in another person's hands).

Under the proposed treaty, neither country may tax a permanent establishment of an enterprise of the other country less favorably than it taxes its own enterprises carrying on the same activities. Similar to the U.S. and OECD models, however, a country is not obligated to grant residents of the other country any personal allowances, reliefs, or reductions for tax purposes that are granted to its own residents or nationals.

[42] A national of one treaty country may claim protection under this article even if the national is not a resident of either treaty country. For example, a U.S. citizen who is resident in a third country is entitled to the same treatment in Japan as a comparably situated Japanese national.

Subject to the anti-avoidance rules described in paragraph 1 of Article 9 (Associated Enterprises), paragraph 8 of Article 11 (Interest), paragraph 4 of Article 12 (Royalties), and paragraph 3 of Article 21 (Other Income), each treaty country is required to allow its residents to deduct interest, royalties, and other disbursements paid by them to residents of the other country under the same conditions that it allows deductions for such amounts paid to residents of the same country as the payor. The Technical Explanation states that the term “other disbursements” is understood to include a reasonable allocation of executive and general administrative expenses, research and development expenses, and other expenses incurred for the benefit of a group of related persons that includes the person incurring the expense. The Technical Explanation further states that the exception with respect to paragraph 8 of Article 11 (Interest) would include the denial or deferral of certain interest deductions under section 163(j) of the Code, thus preserving for the United States the ability to apply its earnings stripping rules.

In addition, any debts of a resident of one treaty country to a resident of the other treaty country shall, for purposes of determining the taxable capital of the obligor, be deductible under the same conditions as if they had been owed to a resident of the same treaty country.

The non-discrimination rules also apply to enterprises of one country that are owned in whole or in part by residents of the other country. Enterprises resident in one country, the capital of which is wholly or partly owned or controlled, directly or indirectly, by one or more residents of the other country, will not be subjected in the first country to any taxation (or any connected requirement) that is more burdensome than the taxation (or connected requirements) that the first country imposes or may impose on other similar enterprises. As noted above, some differences in treatment may be justified on the basis of tax-relevant differences in circumstances between two enterprises. In this regard, the Technical Explanation provides examples of Code provisions that are understood by the two countries not to violate the nondiscrimination provision of the proposed treaty, including the rules that tax U.S. corporations making certain distributions to foreign shareholders in what would otherwise be nonrecognition transactions, the rules that impose a withholding tax on non-U.S. partners of a partnership, and the rules that prevent foreign persons from owning stock in subchapter S corporations.

The proposed treaty provides that nothing in the non-discrimination article may be construed as preventing either of the countries from imposing a branch profits tax as described in paragraph 9 of Article 10 (Dividends).

In addition, notwithstanding the definition of taxes covered in Article 2 (Taxes Covered) and subparagraph (d) of paragraph 1 of Article 3 (General Definitions), this article applies to taxes of every kind and description imposed by either country, or any political subdivision or local authority thereof. The Technical Explanation states that customs duties are not regarded as taxes for this purpose.

The saving clause does not apply to the non-discrimination article. Thus, a U.S. citizen who is resident in Japan may claim benefits with respect to the United States under this article.

Article 25. Mutual Agreement Procedure

The proposed treaty contains the standard mutual agreement provision, with some variation, that authorizes the competent authorities of the two countries to consult together to attempt to alleviate cases of double taxation not in accordance with the proposed treaty.

Under this article, a person who considers that the actions of one or both of the countries cause him or her to be subject to tax which is not in accordance with the provisions of the proposed treaty may (irrespective of internal law remedies) present his or her case to the competent authority of the country in which he or she is a resident or, if the case arises under paragraph 1 of Article 24 (relating to non-discrimination), a national. Similar to the OECD model, but unlike the U.S. model, the proposed treaty provides that the case must be presented within three years from the first notification of the action resulting in taxation not in accordance with the provisions of the proposed treaty.

The proposed treaty provides that if the objection appears to be justified and that competent authority is not itself able to arrive at a satisfactory solution, that competent authority must endeavor to resolve the case by mutual agreement with the competent authority of the other country, with a view to the avoidance of taxation which is not in accordance with the proposed treaty. The proposed treaty provides that any agreement reached will be implemented notwithstanding any time limits or other procedural limitations under the domestic laws of either country (e.g., a country's applicable statute of limitations). The proposed treaty provides an exception from this rule for such limitations as apply for purposes of giving effect to such agreements (e.g., a domestic law requirement that the taxpayer file a return reflecting the agreement within a designated time period).

The competent authorities of the countries are to endeavor to resolve by mutual agreement any difficulties or doubts arising as to the interpretation or application of the proposed treaty. In particular, the competent authorities may agree to: (1) the same attribution of income, deductions, credits, or allowances of an enterprise of one treaty country to the enterprise's permanent establishment situated in the other country; (2) the same allocation of income, deductions, credits, or allowances between persons; (3) the settlement of conflicting applications of the proposed treaty, including conflicts regarding (i) the characterization of particular items of income, (ii) the characterization of persons, (iii) the application of source rules with respect to particular items of income, and (iv) the meaning of any term used in the proposed treaty; and (4) advance pricing arrangements. The Technical Explanation clarifies that this list is a non-exhaustive list of examples of the kinds of matters about which the competent authorities may reach agreement.

The proposed treaty provides that the competent authorities may consult together for the elimination of double taxation regarding cases not provided for in the proposed treaty.

The proposed treaty authorizes the competent authorities to communicate with each other directly for purposes of reaching an agreement in the sense of this mutual agreement article. The Technical Explanation states that this provision makes clear that it is not necessary to go through diplomatic channels in order to discuss problems arising in the application of the proposed treaty.

The Technical Explanation states that the provisions of Article 25 (Mutual Agreement Procedure) of the proposed treaty will have effect from the date of entry into force of the proposed treaty, without regard to the taxable or chargeable period to which the matter relates.

Article 26. Exchange of Information

The proposed treaty provides that the two competent authorities will exchange such information as is relevant to carry out the provisions of the proposed treaty or the domestic laws of the two countries concerning taxes of every kind and description imposed by either of the two countries (insofar as the taxation thereunder is not contrary to the proposed treaty). This provision is parallel to that in the U.S. model. This exchange of information is not restricted by Article 1 (General Scope). Therefore, for example, information with respect to third-country residents is covered by these procedures. The two competent authorities may exchange information on a routine basis, on request in relation to a specific case, or spontaneously. The Technical Explanation states that it is contemplated that all of these types of exchange will be utilized, as appropriate.

The proposed treaty provides that if specifically requested by the competent authority of a country, the competent authority of the other country must provide information under this article in the form of authenticated copies of original documents (including books, papers, statements, records, accounts, and writings).

Any information received under the proposed treaty is treated as secret in the same manner as information obtained under the domestic laws of the country receiving the information. The exchanged information may be disclosed only to persons or authorities (including courts and administrative bodies) involved in the assessment, collection, or administration of, the enforcement or prosecution in respect of, or the determination of appeals in relation to, taxes of every kind and description imposed by either of the two countries. Such information may also be disclosed to supervisory bodies of the above (e.g., the tax-writing committees of Congress and the General Accounting Office).[43] Disclosure is permitted only to the extent necessary for such persons, authorities, or bodies to perform their responsibilities. Exchanged information may be disclosed in public court proceedings or in judicial decisions.

As is true under the U.S. model and the OECD model, the proposed treaty provides that a country is not required to carry out administrative measures at variance with the laws and administrative practice of either country, to supply information that is not obtainable under the laws or in the normal course of the administration of either country, or to supply information that would disclose

[43] *See* paragraph 7 of the notes. The notes state that information received by these bodies must only be used in the performance of their role in discharging their responsibilities to oversee the administration of the tax laws.

any trade, business, industrial, commercial, or professional secret or trade process or information, the disclosure of which would be contrary to public policy.

The notes state that the powers of each country's competent authority to obtain information include the ability to obtain information held by financial institutions, nominees, or persons acting in an agency or fiduciary capacity. This does not include the ability to obtain information relating to communications between a client and its legal representative (acting as such) to the extent the communications are protected under domestic law. The Technical Explanation states that, in the case of the United States, the scope of the privilege for such confidential communications is coextensive with the attorney-client privilege under U.S. law. The notes also provide that the competent authorities may obtain information relating to the ownership of legal persons. The notes confirm that each country's competent authority is able to exchange such information in accordance with this article.

The proposed treaty states that both countries shall take necessary measures (including legislation, rule making, or administrative arrangement) to ensure that its competent authority has sufficient power to obtain information for purposes of exchange regardless of whether that country may need such information for purposes of its own taxes. The Technical Explanation states that the competent authority of the United States already has sufficient powers to comply with this provision and that Japan changed its laws in 2003 to provide its competent authority with sufficient powers to comply with this provision.

The Technical Explanation states that the exchange of information provisions of the proposed treaty will have effect from the date of entry into force of the proposed treaty, without regard to the taxable or chargeable period to which the matter relates.

Article 27. Administrative Assistance

Under the proposed treaty, a country may collect on behalf of the other country such amounts as may be necessary to ensure that relief granted under the treaty by the other country does not inure to the benefit of persons not entitled thereto. If a country collects such amounts, that country is responsible to the other country for the sums collected. However, neither country is obligated to carry out administrative measures that would be contrary to its laws and administrative practice or its public policy.

Article 28. Members of Diplomatic Missions and Consular Posts

The proposed treaty contains the rule found in the U.S. model, the present treaty, and other U.S. tax treaties that its provisions do not affect the fiscal privileges of members of diplomatic missions or consular posts under the general rules of international law or under the provisions of special agreements. Accordingly, the proposed treaty will not defeat the exemption from tax which a host country may grant to the salary of diplomatic officials of the other country. The saving clause does not apply in the application of this article. Although the non-application of the saving clause to this article of the proposed treaty is not limited to benefits conferred by

a country upon individuals who are neither citizens nor permanent residents of that country, as under the U.S. model, the Technical Explanation to the proposed treaty notes that the operation of this article should nevertheless be the same as the U.S. model as a practical matter. It is unlikely that members of diplomatic missions or consular posts of one country are citizens or persons admitted for permanent residence in the other country. Thus, for example, U.S. diplomats who are considered residents of Japan may be protected from Japanese tax.

Article 29. Consultation

The proposed treaty provides that, if a treaty country believes that a substantial change in the domestic laws relevant to the proposed treaty has been or will be made in the other treaty country, the treaty country may make a written request to the other treaty country through diplomatic channels for consultations with a view to determining the possible effect of such change on the balance of benefits provided by the proposed treaty and, if appropriate, to amending the provisions of the proposed treaty to arrive at an appropriate balance of benefits. The proposed treaty provides that the treaty country receiving such a request shall enter into consultations with the requesting treaty country within three months from the date on which the request is received. The Technical Explanation notes that any amendments to the proposed treaty resulting from such consultations would require a protocol or new treaty that would be subject to ratification by the Senate.

Article 30. Entry into Force

The proposed treaty provides that the treaty is subject to ratification in accordance with the applicable procedures of each country, and that instruments of ratification will be exchanged as soon as possible. The proposed treaty will enter into force upon the exchange of instruments of ratification.

With respect to the United States, the proposed treaty will be effective with respect to taxes withheld at source for amounts paid or credited on or after the first day of July of the calendar year in which the proposed treaty enters into force, provided the proposed treaty enters into force before the first day of April of the calendar year. If the proposed treaty enters into force after the 31st day of March of a calendar year, the proposed treaty will be effective with respect to taxes withheld at source for amounts paid or credited on or after the first day of January of the calendar year following the calendar year in which the proposed treaty enters into force. With respect to other taxes, the proposed treaty will be effective for taxable periods beginning on or after the first day of January next following the date on which the proposed treaty enters into force.

With respect to Japan, the proposed treaty will be effective with respect to taxes withheld at source for amounts taxable on or after the first day of July of the calendar year in which the proposed treaty enters into force, provided the proposed treaty enters into force before the first day of April of the calendar year. If the proposed treaty enters into force after the 31st day of March of a calendar year, the proposed treaty will be effective with respect to taxes withheld at source for amounts taxable on or after the first

day of January of the calendar year following the calendar year in which the proposed treaty enters into force. With respect to taxes on income that are not withheld at source and the enterprise tax, the proposed treaty will be effective with regard to income for taxable years beginning on or after the first day of January next following the date on which the proposed treaty enters into force.

The present treaty generally will cease to have effect in relation to any tax from the date on which the proposed treaty takes effect in relation to that tax. Taxpayers may elect temporarily to continue to claim benefits under the present treaty with respect to a period after the proposed treaty takes effect. For such a taxpayer, the present treaty would continue to have effect in its entirety for a 12-month period from the date on which the provisions of the proposed treaty would otherwise take effect. The present treaty will terminate on the last date on which it has effect in relation to any tax in accordance with the provisions of this article.

Notwithstanding the entry into force of the proposed treaty, an individual who is entitled to the benefits of Article 19 (Payments to Students and Business Apprentices) or Article 20 (Income from Teaching or Research) of the present treaty at the time the proposed treaty enters into force will continue to be entitled to such benefits as if the present treaty remained in force. The Technical Explanation states that the treatment of trainees under the present treaty may be more generous than under the proposed treaty. The Technical Explanation states that the special rule in the proposed treaty was included so that the rules do not change with respect to certain individuals who have based their decisions to come to a host country on the assumption that the benefits of the present treaty would apply to them.

Article 31. Termination

The proposed treaty will remain in force until terminated by either country. Either country may terminate the proposed treaty, after the expiration of a period of five years from the date of its entry into force, by giving six months prior written notice of termination to the other country through diplomatic channels. In such case, with respect to the United States, a termination is effective with respect to taxes withheld at source for amounts paid or credited on or after the first day of January of the calendar year next following the expiration of the six-month notice period. With respect to other taxes, a termination is effective for taxable periods beginning on or after the first day of January of the calendar year next following the expiration of the six-month notice period.

With respect to Japan, a termination is effective with respect to taxes withheld at source for amounts taxable on or after the first day of January of the calendar year next following the expiration of the six-month notice period. With respect to taxes on income that are not withhold and the enterprise tax, a termination is effective with regard to income for taxable years beginning on or after the first day of January of the calendar year next following the expiration of the six-month notice period.

VI. ISSUES

A. Zero Rate of Withholding Tax on Direct Dividends

In general

The proposed treaty would eliminate withholding tax on dividends paid by one corporation to another corporation that owns greater than 50 percent of the stock of the dividend-paying corporation (often referred to as "direct dividends"), provided that certain conditions are met (subparagraph 3(a) of Article 10 (Dividends)). The elimination of withholding tax under these circumstances is intended to reduce further the tax barriers to direct investment between the two countries.

Under the present treaty, these dividends are permitted to be taxed by the source country at a maximum rate of 10 percent, a tax that both Japan and the United States do impose as a matter of internal law. The principal immediate effects of the zero-rate provision on U.S. taxpayers and the U.S. fisc would be: (1) to relieve U.S. corporations of the burden of Japanese withholding taxes in connection with qualifying dividends received from Japanese subsidiaries; (2) to relieve the U.S. fisc of the requirement to allow foreign tax credits with respect to these dividends; and (3) to eliminate the withholding tax revenues currently collected by the U.S. fisc with respect to qualifying dividends received by Japanese corporations from U.S. subsidiaries.[44]

Until 2003, no U.S. treaty provided for a complete exemption from withholding tax under these circumstances, and the U.S. and OECD models currently do not provide for such an exemption. However, many bilateral tax treaties to which the United States is not a party eliminate withholding taxes under similar circumstances, and the same result has been achieved within the European Union under its "Parent-Subsidiary Directive." In addition, in 2003, the Senate approved adding zero-rate provisions to the U.S. treaties with the United Kingdom, Australia, and Mexico. These provisions are similar to the provision in the proposed treaty, although the proposed treaty allows a lower ownership threshold than the UK, Australia, and Mexico provisions (i.e., more than 50 percent, as opposed to at least 80 percent). Thus, the proposed treaty would be the fourth U.S. treaty to provide a complete exemption from withholding tax on direct dividends, and would define the category of exempt dividends somewhat more broadly than the previous three treaties.

[44] *See* Part IV of this pamphlet for an economic analysis of this provision and of the proposed treaty in general.

Description of provision

Under the proposed treaty (subparagraph 3(a) of Article 10 (Dividends)), the withholding tax rate is reduced to zero on dividends beneficially owned by a company that has owned greater than 50 percent of the voting power of the company paying the dividend for the 12–month period ending on the date on which entitlement to the dividend is determined, provided that the company receiving the dividend either: (1) qualifies for treaty benefits under the "publicly traded" test of the anti-treaty-shopping provision (subparagraph 1(c) of Article 22 (Limitation on Benefits)); (2) satisfies both the "ownership/base-erosion" and the "active trade or business" tests described in subparagraph 1(f) and paragraph 2 of Article 22 (Limitation on Benefits); or (3) is granted eligibility for the zero rate by the competent authorities pursuant to paragraph 4 or Article 22 (Limitation on Benefits).[45]

Issues

In general

In view of the relative novelty of zero-rate dividend provisions in the U.S. treaty network, the Committee may wish to devote particular attention to the benefits and costs of taking this step. The Committee also may want to determine whether the inclusion of the zero-rate provision in the proposed treaty (as well as in the U.K., Australia, and Mexico treaties) signals a general shift in U.S. treaty policy, and under what circumstances the United States may seek to include similar provisions in other treaties. The Committee posed these questions in its tax treaty reports in 2003, and it may wish to satisfy itself that these questions have been answered.[46]

Benefits and costs of adopting a zero rate with Japan

Tax treaties mitigate double taxation by resolving the potentially conflicting claims of a residence country and a source country to tax the same item of income. In the case of dividends, standard international practice is for the source country to yield mostly or entirely to the residence country. Thus, the residence country preserves its right to tax the dividend income of its residents, and the source country agrees either to limit its withholding tax to a relatively low rate (e.g., five percent) or to forgo it entirely.

Treaties that permit a positive rate of dividend withholding tax allow some degree of double taxation to persist. To the extent that the residence country allows a foreign tax credit for the withholding tax, this remaining double taxation may be mitigated or eliminated, but then the priority of the residence country's claim to tax the dividend income of its residents is not fully respected. Moreover, if a residence country imposes limitations on its foreign tax credit,[47] withholding taxes may not be fully creditable as a

[45] Both direct ownership and indirect ownership through entities resident in either contracting state will count for this purpose.

[46] *See* Senate Committee on Foreign Relations, *Report, Tax Convention with the United Kingdom*, Exec. Rpt. 108–2, Mar. 13, 2003; Senate Committee on Foreign Relations, *Report, Protocol Amending the Tax Convention with Australia*, Exec. Rpt. 108–3, Mar. 13, 2003; Senate Committee on Foreign Relations, *Report, Protocol Amending the Tax Convention with Mexico*, Exec. Rpt. 108–4, Mar. 13, 2003.

[47] *See*, e.g., Code sec. 904.

practical matter, thus leaving some double taxation in place. For these reasons, dividend withholding taxes are commonly viewed as barriers to cross-border investment. The principal argument in favor of eliminating withholding taxes on certain direct dividends in the proposed treaty is that it would remove one such barrier.

Direct dividends arguably present a particularly appropriate case in which to remove the barrier of a withholding tax, in view of the close economic relationship between the payor and the payee. Whether in the United States or in Japan, the dividend-paying corporation generally faces full net-basis income taxation in the source country, and the dividend-receiving corporation generally is taxed in the residence country on the receipt of the dividend (subject to allowable foreign tax credits). If the dividend-paying corporation is more than 50-percent owned by the dividend-receiving corporation, it is arguably appropriate to regard the dividend-receiving corporation as a direct investor (and taxpayer) in the source country in this respect, rather than regarding the dividend-receiving corporation as having a more remote investor-type interest that would warrant the imposition of a second-level source-country tax.

Although the United States only recently first agreed to bilateral zero rates of withholding tax on direct dividends, many other countries have a longer history of including such provisions in one or more of their bilateral tax treaties. These countries include OECD members Austria, Denmark, France, Finland, Germany, Iceland, Ireland, Japan, Luxembourg, Mexico, the Netherlands, Norway, Sweden, Switzerland, and the United Kingdom, as well as non-OECD-members Belarus, Brazil, Cyprus, Egypt, Estonia, Israel, Latvia, Lithuania, Mauritius, Namibia, Pakistan, Singapore, South Africa, Ukraine, and the United Arab Emirates. In addition, a zero rate on direct dividends has been achieved within the European Union under its "Parent-Subsidiary Directive." Finally, many countries have eliminated withholding taxes on dividends as a matter of internal law (e.g., the United Kingdom and Mexico). Thus, although the zero-rate provision in the proposed treaty is a relatively recent development in U.S. treaty history, there is substantial precedent for it in the experience of other countries. It may be argued that this experience constitutes an international trend toward eliminating withholding taxes on direct dividends, and that the United States would benefit by joining many of its treaty partners in this trend and further reducing the tax barriers to cross-border direct investment.

General direction of U.S. tax treaty policy

Looking beyond the U.S.-Japan treaty relationship, the Committee may wish to determine whether the inclusion of the zero-rate provision in the proposed treaty (as well as in the U.K., Australia, and Mexico treaties) signals a general shift in U.S. tax treaty policy. Specifically, the Committee may want to know whether the Treasury Department: (1) intends to pursue similar provisions in other proposed treaties in the future; (2) proposes any particular criteria for determining the circumstances under which a zero-rate provision may be appropriate or inappropriate; (3) expects to seek terms and conditions similar to those of the proposed treaty in connection with any zero-rate provisions that it may negotiate in the

future; and (4) intends to amend the U.S. model to reflect these developments.[48]

Impact on U.S.-Mexico income tax treaty

The zero-rate provision in the proposed treaty could impact U.S. commitments under the U.S.-Mexico income tax treaty. Under the U.S.-Mexico treaty, as amended in 2003, if the United States agrees to a zero-rate provision in another treaty under conditions "more beneficial" than those of the U.S.-Mexico treaty, Mexico is entitled to consultations with the United States with a view to incorporating a similar provision into the U.S.-Mexico treaty. As noted above, the zero-rate provision in the proposed treaty applies to greater-than-50-percent owners of stock in the dividend-paying company, whereas the zero-rate provision in the U.S.-Mexico treaty applies only to 80-percent-or-greater owners. Because the provision in the proposed treaty applies in a wider range of circumstances than the provision in the U.S.-Mexico treaty, it may be viewed as "more beneficial," thus triggering Mexico's right to consultations with a view to lowering the ownership threshold in that treaty.

In light of these ramifications, the Committee may seek to determine whether Mexico would be likely to invoke its right to consultations on this matter, and whether modifying the zero-rate provision in the U.S.-Mexico treaty to match the provision of the proposed treaty would be desirable from the U.S. perspective.

[48] *See* Part VI.I of this pamphlet for a discussion of the status of the U.S. model.

B. Anti-Conduit Rules

In general

The proposed treaty includes anti-conduit rules that can operate to deny the benefits of the dividends article (Article 10), the interest article (Article 11), the royalties article (Article 12), and the other income article (Article 21).[49] These rules are similar to, but significantly narrower and more precise than, the "main purpose" rules that the Senate rejected in 1999 in connection with its consideration of the U.S.-Italy and U.S.-Slovenia treaties.[50] These rules are not found in the U.S. or OECD models and were included in the proposed treaty at the request of Japan. The purpose of the rules, from the Japanese perspective, is to prevent residents of third countries from improperly obtaining the reduced rates of Japanese tax provided under the treaty by channeling payments to a third-country resident through a U.S. resident (acting as a "conduit").

Unlike Japan, the United States provides detailed rules in its domestic law governing arrangements to reduce tax through the use of conduits.[51] The Technical Explanation emphasizes that the inclusion of narrow anti-conduit rules in the proposed treaty should create no inference that the generally broader anti-conduit rules (and other anti-abuse rules) of U.S. domestic law would not apply in a particular situation.

Description of provisions

Under the anti-conduit rules of the proposed treaty, the treaty's provisions with respect to dividends will not apply to dividends paid pursuant to certain back-to-back preferred stock arrangements. Specifically, a resident of a contracting state will not be considered the beneficial owner of dividends in respect of preferred stock or other similar interest if such preferred stock or other interest would not have been established or acquired unless a person that is not entitled to the same or more favorable treaty benefits and that is not a resident of either contracting state held equivalent preferred stock or other interest in the resident.

Similarly, for purposes of applying the interest article, a resident of a contracting state will not be considered the beneficial owner of interest in respect of a debt-claim if such debt-claim would not have been established unless a person that is not entitled to the same or more favorable treaty benefits and that is not a resident of either contracting state held an equivalent debt-claim against the resident. For purposes of applying the royalties article, a resident of the United States or Japan shall not be considered the beneficial owner of royalties in respect of intangible property if such

[49] The proposed treaty also includes an anti-conduit rule that can operate to deny the benefits of the waiver of the insurance excise tax. The anti-conduit rule in this context raises a separate set of issues and is discussed in the explanation of Article 2 and in Part VI.C of this pamphlet.

[50] *See* Senate Committee on Foreign Relations, *Report, Tax Convention with Italy*, Exec. Rpt. 106–8, Nov. 3, 1999; Senate Committee on Foreign Relations, *Report, Tax Convention with Slovenia*, Exec. Rpt. 106–7, Nov. 3, 1999; *see also* Joint Committee on Taxation, *Explanation of Proposed Income Tax Treaty and Proposed Protocol between the United States and the Italian Republic* (JCS–9–99), October 8, 1999; Joint Committee on Taxation, *Explanation of Proposed Income Tax Treaty between the United States and the Republic of Slovenia* (JCS–11–99), October 8, 1999.

[51] *See* Code sec. 7701(l); Treas. Reg. sec. 1.881–3.

royalties would not have been paid unless the resident pays royalties in respect of the same intangible property to a person that is not entitled to the same or more favorable treaty benefits and that is not a resident of either the United States or Japan. Finally, for purposes of applying the other income article, a resident of a contracting state will not be considered the beneficial owner of other income in respect of a right or property if such other income would not have been paid to the resident unless the resident pays other income in respect of the same right or property to a person that is not entitled to the same or more favorable treaty benefits and that is not a resident of either contracting state.

Issues

In view of the existence of detailed anti-conduit rules under U.S. domestic law, the adoption of different anti-conduit rules in the proposed treaty may be a source of confusion for taxpayers. The Technical Explanation mitigates this potential confusion by making it clear that the anti-conduit rules and other anti-abuse rules of U.S. domestic law will still be applied, regardless of whether an arrangement may pass muster under the anti-conduit rules of the proposed treaty. The Committee may wish to satisfy itself that this measure adequately addresses the potential confusion and uncertainty that could arise from including anti-conduit rules in the proposed treaty.

The Committee also may ask why, if a perceived deficiency in Japanese tax law motivated the inclusion of anti-conduit rules in the proposed treaty, the rules were made applicable not only to arrangements involving a reduction in Japanese taxes, but also to arrangements involving a reduction in U.S. taxes. Although treaty provisions are usually "symmetrical," some may argue that, in this case, confusion could have been avoided by adopting an "asymmetrical" set of anti-conduit rules applicable only to arrangements to reduce Japanese taxes.

The Committee also may note that this same issue was encountered in connection with a similar (but broader) anti-conduit provision included in the U.S.-U.K. income tax treaty. That provision was without precedent in the U.S. treaty network, and it was understood to be a concession to the specific needs of the United Kingdom.[52] Now that a similar provision has been included in the proposed treaty with Japan, the Committee may wish to satisfy itself that it understands the current state of U.S. treaty practice in this regard—i.e., whether the Committee should expect to encounter treaty-specific anti-conduit rules in the future, or whether the circumstances surrounding the U.K. and Japan treaties were exceptional and unlikely to be repeated.

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[52] *See* Joint Committee on Taxation, *Explanation of Proposed Income Tax Treaty Between the United States and the United Kingdom* (JCS–4–03), March 3, 2003, 76–78.

C. Insurance Excise Tax

The proposed treaty waives the application of the U.S. insurance excise tax on foreign insurers and reinsurers.[53] Thus, for example, a Japanese insurer or reinsurer generally may receive premiums on policies with respect to U.S. risks free of this tax. As further discussed below, waiver of this tax may raise concerns if a substantial tax is not imposed by Japan or a third country on the foreign insurer or reinsurer.

Waivers of the insurance excise tax in other treaties have raised serious congressional concerns. For example, concern has been expressed over the possibility that such waivers may place U.S. insurers at a competitive disadvantage with respect to foreign competitors in U.S. markets if a substantial tax is not otherwise imposed (e.g., by the treaty partner country) on the insurance income of the foreign insurer or reinsurer.[54] Moreover, in such a case, a waiver of the tax does not serve the primary purpose of treaties to prevent double taxation, but instead has the undesirable effect of eliminating all tax on such income.

The U.S.-Barbados and U.S.-Bermuda tax treaties each contained such a waiver as originally signed. In its report on the Bermuda treaty, the Committee expressed the view that those waivers should not have been included. The Committee stated that waivers should not be given by Treasury in its future treaty negotiations without prior consultations with the appropriate committees of Congress. Congress subsequently enacted legislation to ensure the sunset of the waivers in the two treaties.

The Committee may wish to satisfy itself that the Japanese tax imposed on Japanese insurers and reinsurers on premium income results in a burden that is not substantially lower than the U.S. tax on U.S. insurers and reinsurers, so that the effect of the insurance excise tax waiver is not to eliminate all or nearly all tax but rather to relieve double taxation.

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[53] The proposed treaty incorporates an anti-conduit rule to prevent persons not entitled to equivalent treaty benefits from obtaining the benefit of the insurance excise tax waiver under the proposed treaty. Under this anti-conduit rule, the waiver applies to the extent that the risks covered by such premiums are not reinsured with a person not entitled to the benefits of the proposed treaty or any other tax treaty entered into by the U.S. that provides exemption from the U.S. insurance excise tax. In contrast, in the U.S.-U.K. treaty, the insurance excise tax was waived with the application of a "main purpose" anti-conduit treaty provision, but the Technical Explanation to that treaty stated that in the context of the insurance excise tax waiver, the United States will interpret the anti-conduit provision of the treaty by analogy to the rules of domestic U.S. law as they may evolve over time. The anti-conduit rule in the proposed treaty with Japan, however, applies regardless of purpose, so that under the proposed treaty, the insurance excise tax would be imposed whenever a risk is reinsured with a person that would not be entitled to equivalent benefits, even if the reinsurance occurs in the ordinary course of business. Issues relating to the application of anti-conduit rules outside the context of the insurance excise tax waiver are discussed in the preceding section of this pamphlet.

[54] *See, e.g.*, U.S. Treasury Department, *Report to Congress on the Effect on U.S. Reinsurance Corporations of the Waiver by Treaty of the Excise Tax on Certain Reinsurance Premiums* (March 1990).

D. Taxation of Gains on Shares in Restructured Financial Institutions

Paragraph 3 of Article 13 of the proposed treaty contains a unique exception to the traditional residence-based taxing rule applicable to capital gains. The exception may warrant the attention of the Committee due to its uniqueness and its special relevance to Japan, as its banking system is restructured.

Under the exception, if a treaty country (including, in the case of Japan, the Deposit Insurance Corporation of Japan) provides substantial financial assistance to a financial institution resident in that country, pursuant to its bank insolvency restructuring laws, and a resident of the other treaty country acquires shares in the financial institution from the first treaty country, the first treaty country may tax gains derived from the later disposition of such shares by such acquirer. The exception does not apply if the taxpayer's holding period exceeds five years from the first date on which such financial assistance was provided. The exception does not appear in any other U.S. treaties, including the U.S. model and the current U.S.-Japan treaty, or in the OECD model.

The exception would not apply if the resident of the United States acquired any shares in the financial institution from Japan before the date the proposed treaty enters into force (or pursuant to a binding contract entered into before that date). Thus, a person that acquired any shares before the treaty enters into force will not be subject to tax under paragraph 3 with respect to any shares acquired after the treaty enters into force. It is difficult to determine the extent to which U.S. investors have purchased such shares to date or would have the opportunity to acquire such shares (or enter into a binding contract to acquire such shares) before the treaty enters into force.[55]

One effect of this exception may be to shift some of the cost of Japan's bank restructurings to the U.S. fisc, to the extent U.S. investors in future restructurings claim foreign tax credits for Japanese taxes imposed on non-exempt gains.

Restructuring of Japanese banks may occur in a number of ways. For example, a failing bank may be acquired by the government of Japan (or by an agency of the government). The government may first restructure the insolvent bank, inject capital or guarantee distressed loans, and then sell certain shares of the restructured entity to other banks, to corporate investors or to investment funds. The purchasers might intend to operate the new bank, or to cash out in (or soon after) a public offering or listing of the restructured bank.

In one recent report in the tax press, officials of the Japanese Ministry of Finance and the National Tax Agency reportedly stated that the authority to tax such a bank restructuring investment fund rests with the country in which the investment fund is launched, under the applicable tax treaty. That report stated that it was estimated that the persons who formed one particular fund would be able to earn "several billions of dollars" if the bank shares

[55] The proposed treaty will enter into force on the date of the exchange of instruments of ratification. Article 30, paragraph 1.

are publicly sold.[56] Such statements, if accurately reported, may clarify the view of the government of Japan that Japan would not seek to tax such gains in the hands of residents of its treaty partners except in cases to which the proposed treaty applies (or a similar provision of a third country's new treaty with Japan). The Committee may wish to satisfy itself that this unique provision is warranted by Japan's special circumstances, that the provision will not unduly inhibit U.S. investors from participating in future Japanese bank restructurings, and that U.S. investors are not being singled out by Japan for adverse tax treatment relative to investors from other countries.

[56] *See Capital Gains Tax Authority Rests With Fund Issuing Nation, Japan Says,* Daily Tax Report (Bureau of National Affairs), January 28, 2004 at G–3. The Japanese tax officials reportedly also said that Japan could deem fund investors (rather than a fund) to be the taxpayers, but even so, the authority to tax an investor would belong to the country where the investor is located, under the applicable Japanese bilateral tax treaty.

E. Income from the Rental of Ships and Aircraft

The proposed treaty includes a provision found in the U.S. model and many U.S. income tax treaties under which profits from an enterprise's operation of ships or aircraft in international traffic are taxable only in the enterprise's country of residence. This provision includes income from the rental of ships and aircraft on a full basis (i.e., with crew) when such ships and aircraft are used in international traffic. However, in the case of profits derived from the rental of ships and aircraft on a bareboat basis (i.e., without crew), the rule differs from the U.S. model by limiting the right to tax to the country of residence only if the rental income is incidental to other income of the lessor from the operation of ships and aircraft in international traffic. If the lease is not merely incidental to the international operation of ships and aircraft by the lessor, then profits from rentals on a bareboat basis generally would be taxable by the source country as business profits (if such profits are attributable to a permanent establishment).

In contrast, the U.S. model provides that profits from the rental of ships and aircraft operated in international traffic on a bareboat basis are taxable only in the country of residence, without requiring that the rental income be incidental to other profits of the lessor from the international operation of ships and aircraft. Thus, unlike the U.S. model, the proposed treaty provides that an enterprise that engages only in the rental of ships and aircraft on a bareboat basis, but does not engage in the operation of ships and aircraft, would not be eligible for the rule limiting the right to tax income from operations in international traffic to the enterprise's country of residence and would be taxable by the source country as business profits to the extent such profits are attributable to a permanent establishment. It should be noted that, under the proposed treaty, profits from the use, maintenance, or rental of containers used in international traffic are taxable only in the country of residence, regardless of whether the recipient of such income is engaged in the operation of ships or aircraft in international traffic. The Committee may wish to consider whether the proposed treaty's rules treating profits from certain rentals of ships and aircraft on a bareboat basis less favorably than profits from the operation of ships and aircraft (or from the rental of ships and aircraft with crew) are appropriate.

F. Non-Arm's Length Payments and Contingent Interest Payments

Background

With regard to the limitations on source country taxation of interest and royalties, the U.S. model provides a special rule for payments between related parties (and parties having an otherwise special relationship) of amounts that exceed the arm's-length amount. Under the U.S. model, such excess amounts are taxable according to the laws of each country, taking into account the other provisions of the treaty. For example, the U.S. model provides that excess interest paid by a subsidiary in one treaty country to its parent corporation in the other treaty country may be treated as a dividend under local law and, thus, entitled to any benefits of treaty provisions relating to dividends.

The U.S. model provides a similar special rule with regard to payments of interest the amount of which is determined with reference to (1) receipts, sales, income, profits, or other cash flow of the debtor or a related person, (2) any change in the value of any property of the debtor or a related person, or (3) any dividend, partnership distribution, or similar payment made by the debtor to a related person (i.e., "contingent interest"). Under the U.S. model, such contingent interest generally may be taxed in the source country in accordance with its laws.[57]

Proposed treaty

Non-arm's length payments

Unlike the U.S. model and most recent U.S. tax treaties, the proposed treaty provides that non-arm's length payments of interest and royalties (as well as certain other income) between related parties are taxable in the treaty country of source at a rate not to exceed five percent of the gross amount of the excess of the payment over the arm's-length amount of the payment.

The Technical Explanation states that the treatment of the excess amount of such payments under the proposed treaty "is consistent in most circumstances with the results under the U.S. model and U.S. domestic law and practice [i.e., dividend or contribution to capital]." With regard to Japanese-source non-arm's length interest payments, the Technical Explanation states that Japanese domestic tax law generally would impose (absent the proposed treaty provision) its 20–percent interest withholding tax on the excess amount of such payments, while denying a deduction to the payor of the excess amount. However, Japanese domestic tax law does not recharacterize such payments (e.g., as dividends or contributions to capital).

Contingent interest

The proposed treaty does not include the special rule for contingent interest that is contained in the U.S. model and most recent

[57] However, if the beneficial owner of the contingent interest is a resident of the other treaty country, the U.S. model provides that the gross amount of the interest may be taxed at a rate not exceeding the rate prescribed in the treaty for dividends paid to shareholders that own less than 10 percent of the dividend-paying company.

U.S. tax treaties. The Technical Explanation states that the provision concerning contingent interest payments that is contained in the U.S. model is not included in the proposed treaty "because the highest rate applicable to dividend income (10 percent, as prescribed in paragraph 2 of Article 10 (Dividends)) is the same as the general rate applicable to interest income (10 percent, as prescribed in paragraph 2 of Article 11 (Interest))."

Issue

The special rules in the U.S. model and most recent U.S. tax treaties for non-arm's length payments of interest and royalties and for payments of contingent interest are designed to ensure that the treaty countries are not precluded from taxing such payments in accordance with their substance rather than their form. These special rules are consistent with longstanding principles of internal U.S. tax law.[58]

By contrast, the proposed treaty prescribes a maximum rate of five percent for non-arm's length payments of interest and royalties (as well as certain other income). Similarly, by not including the special rule for contingent interest that is contained in the U.S. model, the proposed treaty limits the source-country taxation of contingent interest in accordance with the provisions of the proposed treaty relating to interest (Article 11).[59]

The Technical Explanation suggests that the provisions in the proposed treaty concerning non-arm's length payments and payments of contingent interest generally reach the same result as the provisions contained in the U.S. model. However, in the case of non-arm's length payments, the applicable limitations on source-country taxation under the U.S. model depend upon the characterization of the non-arm's length amount by the source country and—where the source country characterizes such amount as a dividend—the level of stock ownership of the dividend recipient in the dividend-paying company.[60] Given the various limitations on source-country taxation under the proposed treaty, the applicable limitation on source-country taxation of a particular arm's length amount would not necessarily equal five percent if the proposed treaty followed the U.S. model in this regard rather than providing a specified five percent limitation on all non-arm's length amounts.

For example, payments of non-arm's length amounts of interest by a U.S. corporation to a Japanese resident who owns less than 10 percent of the stock of the corporation likely would be treated as dividends under U.S. internal tax law. Under the U.S. model,

[58] In the case of contingent interest, the U.S. tax law principles of recognizing substance over form are reflected in the Code, which generally provides an exemption from U.S. withholding tax for interest payments on portfolio debt held by nonresident aliens and foreign corporations, but excludes from this exemption payments of certain contingent interest. See Code secs. 871(h)(4) and 881(c)(4).

[59] Under Article 11, source-country tax on interest paid to a beneficial owner that is resident in the other treaty country generally is limited to 10 percent. However, the proposed treaty provides a complete exemption from source-country tax in certain circumstances, including interest paid to a beneficial owner that is a financial institution or pension fund.

[60] Under Article 10 of the proposed treaty, source-country taxation of dividends generally is limited to 10 percent of the gross amount of the dividends paid to residents of the other treaty country. However, a lower rate of five percent applies if the beneficial owner of the dividend is a company that owns at least 10 percent of the voting stock of the dividend-paying company, and dividends beneficially owned by a company that has owned more than 50 percent of the voting power of the dividend-paying company for at least a year generally are exempt from source-country taxation.

the non-arm's length payments would not be eligible for the exemption from U.S. withholding tax generally provided for interest payments. Instead, such payments would be subject to U.S. withholding at the 15-percent rate prescribed in the U.S. model for dividends received by shareholders of less than 10 percent of the voting stock of the dividend-paying corporation. In contrast to the U.S. model, the proposed treaty would permit U.S. withholding tax of five percent on the non-arm's length payments by the U.S. corporation to the Japanese resident, rather than the 10-percent rate permitted for portfolio dividends that would apply if the proposed treaty conformed to the U.S. model in this regard.

Similarly, in the case of contingent interest payments, the general limitations on source-country taxation of interest under the proposed treaty depend upon the nature of the beneficial owner (i.e., interest payments may be completely exempt from source-country taxation if the beneficial owner of the payments is a financial institution or a pension fund). Therefore, the equivalency of results between the U.S. model and the proposed treaty with regard to payments of contingent interest depends upon the nature of the beneficial owner of the payment.

For example, payments of contingent interest by a U.S. corporation to a Japanese bank would not be entitled to the exemption from U.S. withholding tax provided for interest under the U.S. model but, instead, would be subject to the dividend provisions of the U.S. model that would permit the imposition of a 15-percent U.S. withholding tax on the contingent interest payments. In contrast to the U.S. model, the proposed treaty would provide a complete exemption from U.S. withholding tax on the contingent interest payments (because the beneficial owner is a bank) because the proposed treaty does not include the special rule for contingent interest payments that is contained in the U.S. model.

The Committee may wish to consider the advisability of diverging from the U.S. model, most recent U.S. tax treaties, and longstanding principles of internal U.S. tax law with respect to non-arm's length payments and payments of contingent interest, particularly to the extent that the proposed treaty could create opportunities for taxpayers to inappropriately reduce (or eliminate entirely) source-country taxation on such payments by virtue of the absence of U.S. model provisions that properly characterize the payments according to their substance rather than their form.

G. Sale of U.S. Real Property Holding Corporations

The proposed treaty may not protect the United States' ability to apply the FIRPTA rules to the full extent of U.S. internal law in all instances.

Generally, under the internal U.S. tax laws, gain realized by a foreign corporation or a nonresident alien from the sale of a capital asset is not subject to U.S. tax unless the gain is effectively connected with the conduct of a U.S. trade or business or, in the case of a nonresident alien, he or she is physically present in the United States for at least 183 days in the taxable year. However, the Foreign Investment in Real Property Tax Act ("FIRPTA"), effective June 19, 1980, extended the reach of U.S. taxation to dispositions of U.S. real property by foreign corporations and nonresident aliens regardless of their physical presence in the United States. FIRPTA contained a provision expressly overriding any tax treaty (including the current U.S.-Japan treaty) but generally delaying such override until after December 31, 1984.[61]

Under FIRPTA, a nonresident alien or foreign corporation is subject to U.S. tax on the gain from the sale of a U.S. real property interest as if the gain were effectively connected with a trade or business conducted in the United States. A "U.S. real property interest" includes an interest in a domestic corporation if at least 50 percent of the assets of the corporation consist of U.S. real property at any time during the five-year period ending on the date of disposition (a "U.S. real property holding corporation").[62] The rules provide an exception for a person who disposes of shares that are part of a class of stock regularly traded on an established securities market, if such person did not hold more than five percent of such class of stock at any time during the five-year testing period.[63]

Under the proposed treaty, gains directly derived by a resident of Japan from the alienation of real property situated in the U.S. may be taxed under the FIRPTA rules. The proposed treaty also generally preserves U.S. taxing jurisdiction over gains from the indirect alienation of U.S. real property by means of alienation of certain entities holding an interest in U.S. real property. Under the proposed treaty, the U.S. may tax gains derived by a resident of Japan from the alienation of shares in a domestic company that derives at least 50 percent of its value directly or indirectly from U.S. real property. The treaty provides an exception to U.S. taxation of such share gains if the relevant class of shares is traded on a recognized stock exchange and the alienator (and persons related thereto) own in the aggregate five percent or less or such class of shares.[64]

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[61] *See* Foreign Investment in Real Property Tax Act, Pub. L. No. 96–499, sec. 1125(c)(1) (1980).

[62] Code sec. 897(c)(1)(A). The regulations provide detailed rules for determining whether a corporation is a U.S. real property holding corporation, including rules specifying the dates on which such determination must be made. Treas. Reg. sec. 1.897–2(c). A U.S. real property interest does not include an interest in a domestic corporation if, as of the date of disposition of such interest, such corporation does not hold any U.S. real property interests and any U.S. real property interests held during the five-year period were disposed in taxable transactions (or ceased to be U.S. real property interests by means of application of this rule to other corporations). Code sec. 897(c)(1)(B).

[63] Code sec. 897(c)(3).

[64] A "recognized stock exchange" is defined as any stock exchange established under the terms of the Securities and Exchange Law of Japan, any stock exchange registered with the Securities and Exchange Commission as a national securities exchange under the Securities Exchange Act of 1934, NASDAQ, and any other stock exchange agreed upon by the competent authorities. Ar-

In most instances, these treaty provisions have the effect of permitting the United States to tax a Japanese resident's disposition of a U.S. real property holding corporation under its domestic law rules. However, a few of the provisions of the proposed treaty are somewhat more favorable to taxpayers than their counterparts in the Code. Under the proposed treaty, the testing of whether a domestic company is a U.S. real property holding corporation is performed on the date of disposition and not throughout the five-year testing period as under FIRPTA. For example, under the proposed treaty, a Japanese resident would not be subject to U.S. tax on the sale of shares of a domestic corporation if, at the time of such sale, interests in U.S. real property comprise 40 percent of the value of the assets of such corporation. Absent the proposed treaty, however, U.S. tax would be imposed on such a sale if, at any time over the prior five years, 50 percent or more of the corporation's assets consisted of U.S. real property.

In addition, although FIRPTA and the proposed treaty provide similar exclusions for dispositions of relatively small share interests in U.S. real property holding corporations traded on an established securities market, the FIRPTA exclusion is more difficult to obtain than the exclusion provided in the proposed treaty. FIRPTA requires that such shares be "regularly" traded at any time during the calendar year of disposition[65] and provides a five-year "lookback" testing period for the ownership test.

The rules of the proposed treaty differ from the U.S. model treaty, which closely follows the Code.[66] The Committee may wish to consider whether the divergence from current treaty practice is acceptable with regard to Japanese residents, historically heavy investors in U.S. real property.[67]

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ticle 22, paragraph 5(b). The parallel concept in FIRPTA, an "established securities market," has substantially the same meaning. *See* Treas. Reg. sec. 1.897-1(m).

[65] A class of interests traded on an established U.S. securities market is treated as regularly traded for any calendar quarter during which it is regularly quoted by brokers or dealers making a market in those interests. Temp. Treas. Reg. sec. 1.897-9T(d)(2). A quantitative test and certain reporting are required to show that shares are regularly traded on a foreign securities market. Temp. Treas. Reg. sec. 1.897-9T(d)(1) and (3).

[66] The U.S. model treaty, unlike the proposed treaty, includes the language "U.S. real property interest." The inclusion of such language in effect invokes the relevant FIRPTA rules.

[67] The provisions in the proposed treaty regarding U.S. real property holding corporations are similar to those in the 1999 treaty with the Republic of Slovenia.

H. Teachers, Students, and Trainees

Treatment under proposed treaty

The proposed treaty generally would not change the application of income taxes to certain U.S. individuals who visit Japan as teachers, professors, and academic researchers, but would make changes in the application of income taxes to certain Japanese individuals who visit the United States as teachers, professors, and academic researchers (Article 20). The present treaty (Article 19) provides that a professor or teacher who visits Japan from the United States for a period of two years or less to engage in teaching or research at a university, college, or other educational institution is exempt from tax by Japan on any remuneration received for such teaching or research. Under Article 20 of the proposed treaty, a professor or teacher who visits the United States from Japan for a period of two years or less to engage in teaching or research at a university, college, or other educational institution, and who while visiting in the United States remains a resident of Japan, is exempt from tax by the United States on any remuneration received for such teaching or research. Unlike the present treaty, if a professor or teacher visiting the United States from Japan does not remain a resident of Japan while visiting in the United States, there is no exemption.

The proposed treaty would make some changes in the application of income taxes to certain individuals who visit the United States or Japan as students, so-called "business apprentices" engaged in full-time training, and certain recipients of research or study grants. The present treaty (Article 20) provides that certain payments that a student or business apprentice, or the recipient of a grant for research or study, who visits the United States from Japan or Japan from the United States to pursue full-time education at a university or college or to engage in full-time training are exempt from taxation by the host country. The exempt payments are limited to those payments the individual may receive for his or her maintenance, education or training as long as such payments are from sources outside the host country. Such an exemption is permitted for a period of five years. In addition to the exemption for payments from outside the host country for maintenance and education and training expenses, the visiting individual is exempt on $2,000 annually in remuneration for personal services performed in the host country. If the visiting individual is participating in a program of training, study, or research of the host government of duration of less than one year, then the $2,000 exemption is increased to $10,000. However, if the visiting individual is an employee of a resident of the home country and is visiting in the host country to acquire technical, professional, or business experience or to study at a university the exemption in the host country is for a period not more than 12 consecutive months and the exemption is limited to $5,000 in remuneration from his or her employer.

Under Article 19 of the proposed treaty, U.S. taxpayers who are visiting Japan and individuals who immediately prior to visiting the United States were resident in Japan will be exempt from income tax in the host country on certain payments received if the

purpose of their visit is to engage in full-time education at a university or college or to engage in full-time training. The exempt payments are limited to those payments the individual may receive for his or her maintenance, education or training as long as such payments are from sources outside the host country. In the case of individuals engaged in full-time training, the exemption from income tax in the host country applies only for a period of one year or less. Unlike the present treaty, no special provision is made for individuals engaged in study or research under a grant. Also, unlike the present treaty, no amount of personal service income is exempt from host country income tax under the proposed treaty.

Issues

Teachers and professors

Unlike the U.S. model, but like the present treaty, the proposed treaty, in most cases, would provide an exemption from the host country income tax for income an individual receives from teaching or research in the host country. Article 19 of the present treaty and Article 20 of the proposed treaty provide that a teacher who visits a country for the purpose of teaching or engaging in research at a recognized educational institution generally is exempt from tax in that country for a period not exceeding two years. Under the proposed treaty, a U.S. person who is a teacher or professor may receive effectively an exemption from any income tax for some amount of income earned related to visiting Japan for the purpose of engaging in teaching or research for a period of two years or less. Under the terms of the treaty, Japan would exempt any such income of a U.S. person from Japanese income tax. Under Code sec. 911, $80,000 would be exempt from U.S. income tax in 2004 through 2007,[68] and in addition certain living expenses would be deductible from income. To the extent the U.S. teacher's or professor's remuneration related to his or her visit to Japan was less that $80,000, the income would be tax free.

Under the proposed treaty, two cases arise in the case of a Japanese person who is a teacher or professor visiting in the United States. If the individual is deemed to be a resident of Japan even while visiting in the United States, the individual receives an exemption from U.S. income tax for income earned related to visiting the United States for the purpose of engaging in teaching or research for a period of two years or less. However, as a resident of Japan, the individual would be liable for Japanese income tax on such income. If the individual visiting the United States is not deemed a resident of Japan while teaching or undertaking research in the United States, no exemption applies any remuneration for teaching or research is subject to U.S. income tax. As an individual not resident in Japan, the individual is only subject to income tax on income from sources in Japan. The individual may be able to claim a foreign tax credit against any Japanese income tax liability to the extent permitted under Japanese law. Japanese individuals who are employed by the Japanese government, including teachers and professors at public institutions are deemed residents of Japan,

[68] For years after 2007, the $80,000 amount is indexed for inflation after 2006 (Code sec. 911(b)(2)(D)).

even if they are not physically present in Japan. Japanese teachers or professors employed at private educational institutions generally would not be considered resident in Japan if not physically present in Japan.

The effect of both the present treaty and the proposed treaty is to make such cross-border visits more attractive financially for U.S. teachers and professors. Ignoring relocation expenses, a U.S. citizen or permanent resident may receive more net, after-tax remuneration from teaching or research from visiting Japan as a teacher or researcher than if he or she had remained in the United States. Relative to the present treaty, the proposed treaty makes no change with respect to a Japanese teacher or professor at a public institution who visits the United States for teaching or research. Under the present treaty, a Japanese teacher or professor at a private institution could receive effectively an exemption from any income tax for income earned related to visiting the United States as the United States would exempt any such income from U.S. income tax and as an individual not resident in Japan such income generally would not be taxable by Japan. Under the proposed treaty, the income of such an individual will be subject to U.S. income tax. Increasing (decreasing) the financial reward may serve to encourage (discourage) cross-border visits by academics. Such cross-border visits by academics for teaching and research may foster the advancement of knowledge and redound to the benefit of residents of both countries.

On the other hand, complete exemption from income tax in both the United States and Japan for U.S. teachers and professors who visit Japan may be seen as unfair when compared to persons engaged in other occupations whose occupation or employment may cause them to relocate temporarily abroad. For a U.S. citizen or permanent resident who is not a teacher or professor, but who temporarily takes up residence and employment in Japan, his or her income is subject to income tax in Japan and may be subject income tax in the United States. In other words, the proposed treaty could be said to violate the principle of horizontal equity by treating otherwise similarly economically situated taxpayers differently.

The proposed treaty stands in partial contrast to the U.S. model in which no such exemption would be provided to teachers and professors visiting from either country. The proposed treaty provides Japanese teachers and professors from private institutions the treatment recommended by the U.S. model. For Japanese teachers and professors from public institutions the proposed treaty provides treatment comparable to that recommended by the U.S. model to the extent that the tax burdens of the Japanese individual income tax is comparable to the tax burdens of the U.S. individual income tax. For U.S. teachers and professors who visit Japan, the proposed treaty provides an exemption, where the U.S. model would provide no such exemption. While this is the position of the U.S. model, an exemption for visiting teachers and professors has been included in many bilateral tax treaties. Of the more than 50 bilateral income tax treaties in force, 30 include provisions exempting from host country taxation the income of a visiting individual engaged in teaching or research at an educational institution, and an additional 10 treaties provide a more limited exemption from taxation

in the host county for a visiting individual engaged in research. Indeed, four of the most recently ratified income tax treaties did contain such a provision.[69] However, the proposed protocol with Sri Lanka would not provide such an exemption. In that treaty, all the remuneration of teachers, professors, and researchers visiting in a host country is fully taxable as provided under the laws of the host country.

The Committee may wish to satisfy itself that the inclusion of such an exemption for a limited class of individuals is appropriate. Looking beyond the U.S.-Japanese treaty relationship, the Committee may wish to determine whether the inclusion of the exemption from host country taxation for visiting teachers and professors signals a shift in U.S. tax treaty policy. Specifically, the Committee may want to know whether the Treasury Department intends to pursue similar provisions in other proposed treaties in the future and intends to amend the U.S. model to reflect such a development.[70]

Full-time students and persons engaged in full-time training

The proposed treaty generally has the effect of exempting payments received from outside the host country for the maintenance, education, and training of full-time students and persons engaged in full-time training as a visitor from the United States to Japan or as a visitor from Japan to the United States from the income tax of the host country. This conforms to the U.S. model and generally conforms to the OECD model provisions with respect to students and trainees.

This provision generally would have the effect of reducing the cost of education and training received by visitors. The proposed treaty would broaden the exemption provided under the current treaty to persons who are engaged in full-time education by removing the five-year limitation of the present treaty. This may encourage individuals in both countries to consider study abroad, particularly in those fields whose course of study is of longer duration.

The proposed treaty, like the present treaty, limits the exemption provided to persons engaged in full-time training as a business apprentice to payments made relating to training received during a period of one year or less. This follows the U.S. model but deviates from the OECD model.[71] By potentially subjecting such payments related to training that exceeds one year to host country income tax, the cost for cross-border visitors of engaging in training programs of longer duration would be increased. This may discourage visitors to such programs in both the United States and Japan. It could be argued that the training of a business apprentice relates primarily to specific job skills of value to the individual or the individual's employer rather than enhancing general knowledge and cross-border understanding, as may be the case in the university

[69] The treaties with Italy, Slovenia, and Venezuela, each considered in 1999, and the treaty with the United Kingdom considered in 2003, contain provisions exempting the remuneration of visiting teachers and professors from host country income taxation. The treaties with Denmark, Estonia, Latvia, and Lithuania, also considered in 1999, did not contain such an exemption, but did contain a more limited exemption for visiting researchers. However, the protocols with Australia and Mexico, ratified in 2003, did not include such exemptions.

[70] See Part VI.I of this pamphlet for a discussion of divergence from the U.S. model tax treaty.

[71] The OECD model does not limit the duration of exemption for business trainees.

or college education of a full-time student. This could provide a rationale for providing more open-ended treaty benefits in the case of students as opposed to business apprentices. However, if this provides the underlying rationale, a question might arise as to why training requiring one year or less is preferred to training that requires a longer visit to the host country? As such, the proposed treaty would favor certain types of training arrangements over others. On the other hand, both the present and proposed treaties leave undefined who constitutes an "apprentice" or "business trainee." The limitation of treaty benefits to a one-year period might serve to limit a visiting person's ability to claim benefits under the treaty without the necessity of more accurately defining the class of individuals to whom the benefit is intended to apply.

The proposed treaty also would eliminate the limited exemptions from host country income taxation for personal service income. For example, this could permit host country taxation of the full value of a teaching fellowship paid to a graduate student or the salary paid to a business trainee. Relative to the present treaty, this would increase the cost of receiving training or a graduate education for visitors from the United States or from Japan. While this conforms to the U.S. model and OECD model, many U.S. income tax treaties provide such a limited exemption for certain personal service income.

Similarly, the proposed treaty would eliminate the exemptions applicable to visitors engaged in research or study under a grant. Subjecting certain payments from grants to host country taxation may reduce the value of such grants to their recipients relative to treatment under the present treaty. This may reduce the magnitude of cross-border research and study that such grants are intended to foster. On the other hand, the exemptions of the present treaty have the effect of making the host country's taxpayers implicitly subsidize the research or study of the visitor that, in name, is funded by a grant making organization. Benefits for researchers could still be claimed under Article 20 of the proposed treaty, but only if the research is through an academic institution. Likewise certain aspects of payments for grants for study could still be exempt under Article 19, but only if the individual is enrolled as a full-time student. Such limitations may narrow the scope of research or study to which treaty benefits apply. Many U.S. income tax treaties provide such a limited exemption for visitors engaged in research or study under a grant, but many U.S. income tax treaties do not. The Committee may wish to satisfy itself that it is appropriate to provide exemptions for certain types of research or study and not research or study that is not directly connected to an academic institution.

I. U.S. Model Tax Treaty Divergence

Background

It has been longstanding practice for the Treasury Department to maintain, and update as necessary, a model income tax treaty that reflects the policies of the United States pertaining to income tax treaties. The current U.S. policies on income tax treaties are contained in the U.S. model. Some of the purposes of the U.S. model are explained by the Treasury Department in its Technical Explanation of the U.S. model:

> [T]he Model is not intended to represent an ideal United States income tax treaty. Rather, a principal function of the Model is to facilitate negotiations by helping the negotiators identify differences between income tax policies in the two countries. In this regard, the Model can be especially valuable with respect to the many countries that are conversant with the OECD Model. * * * Another purpose of the Model and the Technical Explanation is to provide a basic explanation of U.S. treaty policy for all interested parties, regardless of whether they are prospective treaty partners.[72]

U.S. model tax treaties provide a framework for U.S. treaty policy. These models provide helpful information to taxpayers, the Congress, and foreign governments as to U.S. policies on often complicated treaty matters. For purposes of clarity and transparency in this area, the U.S. model tax treaties should reflect the most current positions on U.S. treaty policy. Periodically updating the U.S. model tax treaties to reflect changes, revisions, developments, and the viewpoints of Congress with regard to U.S. treaty policy would ensure that the model treaties remain meaningful and relevant.[73]

With assistance from the staff of the Joint Committee on Taxation, the Senate Committee on Foreign Relations reviews tax treaties negotiated and signed by the Treasury Department before ratification by the full Senate is considered. The U.S. model is important as part of this review process because it helps the Senate determine the Administration's most recent treaty policy and understand the reasons for diverging from the U.S. model in a particular tax treaty. To the extent that a particular tax treaty adheres to the U.S. model, transparency of the policies encompassed in the tax treaty is increased and the risk of technical flaws and unintended consequences resulting from the tax treaty is reduced.

Proposed treaty

It is recognized that tax treaties often diverge from the U.S. model due to, among other things, the unique characteristics of the legal and tax systems of treaty partners, the outcome of negotiations with treaty partners, and recent developments in U.S. treaty

[72] Treasury Department, Technical Explanation of the United States Model Income Tax Convention, at 3 (September 20, 1996).

[73] The staff of the Joint Committee on Taxation has recommended that the Treasury Department update and publish U.S. model tax treaties once per Congress. Joint Committee on Taxation, *Study of the Overall State of the Federal Tax System and Recommendations for Simplification, Pursuant to Section 8022(3)(B) of the Internal Revenue Code of 1986* (JCS–3–01), April 2001, vol. II, pp. 445–447.

policy. However, even without taking into account the central features of tax treaties that predictably diverge from the U.S. model (e.g., withholding rates, limitation on benefits, exchange of information), the technical provisions of recent U.S. tax treaties have diverged substantively from the U.S. model with increasing frequency. The proposed treaty continues this apparent pattern,[74] which may be indicative of a growing obsolescence of the U.S. model.

Issue

While each instance of divergence from the U.S. model may be justified on an individual basis by particular factors relating to the development and negotiation of the proposed treaty, the cumulative effect of provisions of the proposed treaty that diverge from the U.S. model is that the tax policies incorporated into the proposed treaty are more obscured than they otherwise would have been if the proposed treaty had conformed more closely to the U.S. model. In addition, provisions of the proposed treaty that diverge from the U.S. model generally have not been as thoroughly considered and commented upon by various stakeholders as the U.S. model provisions. Consequently, such provisions of the proposed treaty carry a heightened risk of technical defects and opportunities for taxpayer abuse.

The Committee may wish to satisfy itself that the degree to which the proposed treaty diverges substantively from the U.S. model—in a continuation of the apparent pattern of recent U.S. tax treaties—does not unduly inhibit the review function of the Committee in the Senate treaty ratification process. In addition, the Committee may wish to satisfy itself that provisions of the proposed treaty that diverge from the U.S. model have not resulted in any technical deficiencies and opportunities for abuse that are substantial in relation to the overall objectives of the proposed treaty. The Committee also may wish to inquire of the Treasury Department as to the current state of the U.S. model and whether the Treasury Department has any intention of updating the U.S. model in the foreseeable future.

[74] Some of the provisions in the proposed treaty that diverge substantively from the U.S. model include: Article 1 (General Scope), paragraph 3(a)(ii) (multilateral treaties and other bilateral treaties between the United States and Japan); Article 5 (Permanent Establishment), paragraph 4(f) (combination of preparatory or auxiliary activities); Article 7 (Business Profits), paragraphs 2 (attribution of business profits to a permanent establishment) and 4 (inadequate information); Article 9 (Associated Enterprises), paragraph 1 (application of OECD Transfer Pricing Guidelines); Article 11 (Interest), paragraph 5 (treatment of late payment penalty charges as interest); Article 12 (Royalties), paragraph 2 (gains from alienation of rights or property); Article 14 (Income from Employment), paragraph 3 (remuneration from employment aboard ships or aircraft operated in international traffic); Article 15 (Directors' Fees) (director's fees or similar payments); Article 16 (Artistes and Sportsmen), paragraph 1 ($10,000 compensation threshold); Article 17 (Pensions, Social Security, Annuities, and Child Support Payments), paragraph 1 (social security payments); Article 18 (Government Service), paragraphs 2(a) (government-owned corporations) and 3 (government contractors); Article 22 (Limitation on Benefits), paragraph 2(b) (substantial trade or business threshold) and 3 (testing periods); Article 25 (Mutual Agreement Procedure), paragraph 2 (suspension of assessment and collections procedures); Article 30 (Entry into Force), paragraph 3 (grandfather rules for visiting students, trainees, teachers and professors); and Article 31 (Termination) (5-year period before earliest termination). In addition, the proposed treaty does not include Article 14 (Independent Personal Services) of the U.S. model which, like the OECD model and most recent U.S. tax treaties, has been incorporated into Article 7 (Business Profits).