EDITORIAL

The Japan–US Income Tax Treaty

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The tax authorities of the United States and the United Kingdom will commence negotiations in January 1999 with the aim of updating the current income tax treaty, which has been in effect since 1975. This announcement prompted the writer to reflect upon the income tax treaty between Japan and the United States, which has been in effect since 1973. Is it now time to update the Japan–US treaty?

The fundamental purpose of income tax treaties is to eliminate double taxation. In the introduction to its Model Tax Convention on Income and on Capital, the OECD stresses the importance of this goal:

> '(Double taxation's) harmful effects on the exchange of goods and services and movements of capital, technology and persons are so well known that it is scarcely necessary to stress the importance of removing the obstacles that double taxation presents to the development of economic relations between countries.'

Yet, it is questionable whether the current Japan–US treaty does in fact eliminate double taxation. An area of particular concern is withholding tax on payments of royalties and dividends by a resident of Japan to a resident of the US.

1. Royalties

Under the Japan–US treaty, the definition of royalty includes 'payment of any kind made as consideration for the use of, or the right to use, copyrights of literary, artistic, scientific works, or motion picture films or films or tapes used for radio or television broadcasting, patents, designs or models, plans, secret processes or formulae, trademarks, or other like property or rights, or know-how.' Under Japanese domestic tax law, royalty payments are subject to a 20 per cent rate of withholding tax. This rate is reduced to 10 per cent under the Japan–US treaty.

Therefore, payments by a Japanese company to a US company in respect of intangible property such as copyrights, patents, trademarks or know-how are subject to 10 per cent withholding tax. With the exception of pre-packaged software, most payments for computer software are treated by the Japanese tax authorities as being payments for the use of copyrights and are therefore subject to 10 per cent withholding tax. This may create a problem for the US company, depending on its US tax position. In many cases, a start-up high technology company is in a loss position in its early years as a result of the investments it has made to develop the technology. In this case, a 10 per cent withholding tax suffered in Japan is a real cost to the US company. Even if the US company is profitable, depending on its foreign tax credit position, the 10 per cent withholding tax may be a real cost or a cash-flow disadvantage.

Under the OECD Model Convention, royalties are taxable only in the Contracting State of which the beneficial owner is a resident. Under the US treaties with major trading partners such as Canada, the UK and Germany, the rate of withholding tax applicable to royalties may be reduced to zero. There is growing concern in the business community that the 10 per cent royalty withholding tax rate applicable to payments from Japan to the US and other countries is acting as a barrier to investment in Japan. Reducing the rate to zero would accord with the OECD guidelines, would be more appropriate to Japan's status as a highly developed economy and would encourage foreign investment in the Japanese economy.

2. Dividends

Under the Japan–US treaty, the rate of withholding tax applicable to dividends paid by a Japanese company to a US company is 10 per cent, if the US company owns at least 10 per cent of the Japanese company and certain other conditions are met.

Under recently renegotiated treaties with France and the Netherlands, Japan has reduced the rate of withholding tax on dividends to 5 per cent in certain cases. US businesses have noted this advantage and are arguing the case for similar treatment to apply to dividends paid to a US parent company.

A reduction in the rate of dividend withholding tax may also help to reduce the excess foreign tax credit situation in which many US-parent companies find themselves in respect of their Japanese subsidiaries. The effective rate of corporation tax for a company doing business in Tokyo is currently approximately 48 per cent. Accordingly, profits of ¥1,000 made by a Japanese company would be subject to ¥480 of corporation tax. If the profits after tax are fully remitted to the US parent, withholding tax of ¥52 would be deducted, leaving the US parent with ¥468 of cash. The combined rate of Japanese corporation tax and withholding tax in this example is over 53 per cent. The effective rate of corporation tax in the US is approximately 41 per cent depending on the state. Accordingly, the US parent may not be able fully to credit the taxes suffered in Japan.

Prime Minister Obuchi has stated that it is his intention to reduce the rate of corporation tax to approximately 40 per cent. This would reduce the combined rate of Japanese corporation tax and withholding tax in the above example to 46 per cent, still in excess of the US effective rate. If the reduction in corporation tax were to be accompanied by a cut in the treaty rate of dividend withholding tax to 5 per cent, the combined rate of Japanese corporation tax and withholding tax would fall to 43 per cent, much closer to the US rate.

Reduction of treaty withholding rates would give US companies a greater incentive to invest in Japan and would assist the Japanese economy. It will be interesting to see whether the Japanese and US authorities indicate that they share this view by announcing that they will commence negotiations to update the Japan–US treaty.

