Tax

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Australia, Japan Sign New Tax Treaty

Japan and Australia signed a new income tax treaty on January 31, 2008. The new treaty will be effective generally from January 1, 2009 subject to procedures in the respective countries for ratification being completed prior to 31 December 2008. The new treaty represents a comprehensive revision of the current tax treaty which dates to 1969 and is one of Japan's oldest tax treaties.

The updating of the Japan-Australia treaty is significant and long overdue in view of the very substantial trade and investment links between the two countries. As noted in the official Australian government announcement of the treaty, bilateral trade totalled A$55 /¥5.3 trillion for 2006 and Japan has been Australia's largest export market for 40 years. (Press Release TK06/2008 http://www.australia.or.jp/english/seifu/pressreleases/index.html?pid=TK06/2008)

1. Taxes Covered

The new treaty applies in the case of Japan to individual income tax and corporate tax. As with most of Japan's tax treaties, Japan's local inhabitants tax and enterprise tax are outside the scope of the new treaty. In the case of Australia, the treaty covers not only income tax but also petroleum resource rent tax ("PRRT"). PRRT applies to taxable profits derived from certain offshore oil and gas projects. The new treaty clarifies that PRRT is a creditable foreign tax for Japanese foreign tax credit purposes. (Protocol, paragraph 19.)

2. Eligible Persons

The new treaty will be applicable to residents of a contracting state who derive income from the other contracting state. As with the Japan–US tax treaty, the treaty provides special rules for the applicability of treaty benefits to hybrid entities at Article 4(5), generally as follows:

(a) An entity organized and treated as a pass-though in a contracting state will also be treated as a pass-through for treaty purposes regardless of how the other contracting state treats it.

(b) An entity organized in a third country that is treated as a pass-through in a contracting state will also be treated as a pass-through for treaty purposes regardless of how the other contracting state treats it.

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Rules regarding hybrid entities have appeared in recent Japanese tax treaties, but are novel in an Australian tax treaty.

Also consistent with recent Japanese tax treaties, the dividend, interest and royalty provisions contain anti-conduit rules.

3. Permanent Establishment

The definition of permanent establishment is generally in line with the OECD model tax treaty definition which excludes an independent agent from the scope of a permanent establishment, but at least from a Japanese perspective, has some novel features.

A special rule applies to activities relating to the exploration for or exploitation of natural resources, and an enterprise is regarded as having a permanent establishment if it carries on such activities for a period or periods of 90 days in any 12 month period. In addition, a permanent establishment will exist if an enterprise operates substantial equipment in the other contracting state for periods exceeding 183 days in any 12 month period.

The dependent agent provision is unusual in providing explicitly that negotiation of contracts in substance (as well as conclusion of contracts) by a dependent agent will give rise to a PE. The reference to negotiation of contracts in substance merely explicitly states the position the Japanese tax authorities consistently take regarding the nature of a dependent agent.

The dependent agent provision also provides that contract manufacturing activities will create a PE if carried out by a dependent agent if they exceed the scope of activities allowed within the “processing” exception to fixed base PE status. From a Japanese perspective, the manner in which the contract manufacturing dependent agent provision will be applied is of interest due to the novelty of this provision (although similar provisions are included in many of Australia’s double tax treaties).

4. Transfer Pricing Rules

The Exchange of Notes, paragraph 2, provides that, for purposes of transfer pricing adjustments under the Associated Enterprises provision, the OECD Transfer Pricing Guidelines will apply, and will override inconsistent domestic transfer pricing rules.

5. Dividends

A 15% limitation for withholding tax applies under the existing treaty. The new treaty changes the limitation in a number of instances:

(a) Dividends are exempt from withholding tax under the new treaty if a corporate shareholder, who is a resident of one of the contracting states and is a “qualified person”, owns at least 80% of the voting power of the corporation paying the dividends subject to a 12 month holding period and other requirements;

(b) Dividend withholding tax is reduced to 5% if a corporate shareholder owns at least 10% of the voting power of the dividend paying corporation; and

(c) The maximum rate is 10% in other cases (although a 15% rate still applies to certain distributions from Australian REITS and Japanese REITS which are entitled to a deduction for dividends paid).

The revised dividend provision will benefit Australian investors by offering a reduction in Japan's domestic dividend withholding tax rate of 20% (7% for listed companies until March 2009, 15% thereafter). In Australia, the benefits will be for Japanese shareholders that derive unfranked dividends (i.e. broadly, dividends paid from untaxed profits) from Australian companies. Such dividends would currently be subject to 15% withholding tax. Note that regardless of the treaty, no Australian dividend withholding tax applies to franked dividends.

6. Interest

The new treaty leaves unchanged the general 10% withholding tax rate for interest, but adds certain exemptions from interest withholding. Interest payments will be exempt from withholding if received by a government or its political divisions, or by a financial institution that is unrelated to the payer. The latter exemption is subject to an anti-abuse provision which will deny the exemption for interest paid to a financial institution if paid under a back-to-back loan arrangement.

7. Royalties

The new treaty reduces the withholding tax applicable to royalties to 5% from the 10% rate under the prior treaty. The definition of royalty has also been changed such that payments for the use of industrial, commercial or scientific equipment will no longer constitute royalties for the purposes of the treaty.

8. Capital Gains

The new treaty includes a comprehensive alienation of property clause. Capital gains derived from the disposal of real property or shares in a real estate holding company (50% or more of total assets consisting of real estate) will be taxable in the county where the real property is situated.

The new treaty also includes specific provisions for allocating taxing rights for gains derived by a resident of one of the contracting states from the sale of shares in a non-real estate holding company that is resident in the other contracting state.

For example, capital gains derived by an Australian resident that are not taxed in Australia from a transfer of shares in a Japanese company other than a real estate holding company may be taxed in Japan but only if the Australian transferor owns at least 25% of total issued shares in the Japanese company at any time during the taxable year in which the transfer took place, and transfers more than 5% of the shares during the taxable year. This provision permits Japan to impose tax only if the gain is not taxed in Australia. Whether Australia would tax such a capital gain derived by an Australian resident depends on the circumstances (for example, Australia has a capital gains tax exemption that applies to certain sales of shares in a non-resident companies that carry on an "active" business). The Protocol provides that the subject to tax in the country of residency requirement will be deemed met if the disposition of shares is part of a tax-deferred reorganization. This provision might be relevant, for example, in the event that the sale of shares in a Japanese company by an Australian resident was subject to Australian capital gains tax, but the capital gains tax liability was deferred through a rollover.

Conversely, the new treaty would also allow Australia to tax capital gains derived by a Japanese resident in the same circumstances. However, under current Australian law, Australian capital gains tax generally only applies to a non-resident in respect of the sale of Australian real property, the sale of shares in a company the assets of which predominantly consist of Australian real property, or the sale of the business assets of an Australian permanent establishment.

9. TK Distributions

The new treaty specifically addresses distributions from *tokumei kumiai* ("TK" or Japanese silent partnerships) in Article 20 which gives Japan the right to tax TK distributions pursuant to Japanese domestic law (i.e., 20% withholding tax).

10. Other Income

Income not specifically dealt with in the new treaty will also be taxable in the source country.

11. Limitation of Benefits ("LOB")

Article 23 provides a comprehensive LOB clause. From an Australian perspective, this clause is somewhat unusual (although it does appear in the Australia/US treaty). No treaty benefit will be given in the source country unless the resident of the other contracting state that is claiming treaty benefits meets certain conditions to be a qualified person under the LOB clause.