

Tax Treaty Developments

On March 30, 2004 the United States and Japan exchanged instruments of ratification for a new income tax treaty (the "New Treaty"), that will replace the existing tax treaty between the two countries that dates back to 1971 (the "Old Treaty"). On March 8, just several weeks earlier, the United States and the Netherlands signed a protocol to their existing 1993 income tax treaty (the "Dutch Protocol"). Most notably, the New Treaty and the Dutch Protocol reduce withholding taxes on income from cross-border investments and business transactions.

Japanese Income Tax Treaty

The New Treaty's withholding tax provisions, which take effect on July 1 of this year, substantially reduce withholding taxes on dividends, interest and royalties. The royalty provision generally provides for the complete elimination of withholding taxes on cross-border royalty payments albeit certain limited exceptions exist, (e.g., a 5 percent withholding tax is imposed on non-arm's length royalties paid between related parties). Under the Old Treaty, royalties were subject to a 10 percent withholding tax.

The interest provision in the New treaty eliminates withholding taxes on certain cross-border interest payments. Interest exempt from withholding tax includes cross-border interest payments to financial institutions, pensions (provided the interest is not directly or indirectly related to carrying on a business) and other creditors to the extent the indebtedness arose as part of

the sale of equipment or merchandise on credit. Similar to the non-arm's length royalty penalty provision, a 5 percent withholding tax is imposed on non-arm's length interest paid between related parties. Other interest is subject to withholding tax at a 10 percent rate.

The New Treaty also eliminates withholding taxes on the payment of cross-border dividends by a subsidiary to its parent company. Under the New Treaty, the dividend withholding tax is eliminated if the parent company owns at least 50 percent of the subsidiary. (The terms of the dividend withholding tax provision in the New Treaty compares favorably with similar provisions in recently negotiated agreements with Australia, Mexico, the Netherlands and the United Kingdom, which eliminate dividend withholding tax only if the parent company owns at least 80 percent of the subsidiary.) Cross-border dividend payments to a parent company owning between 10 percent and 50 percent of a subsidiary's stock are subject to a 5 percent dividend withholding tax. All other dividends are subject to a 10 percent tax. Dividend withholding taxes under the Old Treaty varied from 5 to 15 percent.

U.S. persons that anticipate the receipt of royalties, interest and dividends from Japanese persons and U.S. persons required to gross-up royalty and interest payments made to Japanese persons for withholding taxes, may wish to consider options for deferring the payment of these items until after June 30th if the payment would be exempt from withholding tax or qualifying

for a reduced rate of withholding tax under the New Treaty. Because withholding tax is imposed based on the treaty provisions in effect at the time an item of income is credited or paid and not necessarily when the item of income is accrued, deferring the payment of an item of income accrued before July 1 until after June 30 could result in a tax savings.

Other notable provisions in the New Treaty include a provision regarding the application of international standards for cross-border transfer prices set between affiliated companies and a provision that extends treaty benefits to investments made through partnerships and other fiscally transparent entities, e.g., limited liability companies. The later provision is particularly important in light of a recent tax assessment made by the Japanese tax authorities who had ruled that a Delaware limited partnership should be treated as a corporation for Japanese income tax purposes and accordingly, denied a Japanese limited partner deductions for his allocable share of the limited

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partnership's losses. U.S. residents who hold Japanese investments through limited partnerships or limited liability companies will be entitled to treaty benefits (and thereby reduced withholding tax rates), provided the limited partnership or limited liability company is fiscally transparent for U.S. federal income tax purposes. New Treaty provisions, other than those which impact withholding taxes, take effect on January 1, 2005.

Dutch Protocol

The Dutch Protocol reduces withholding taxes on dividends. (Royalties and interest were already exempt from withholding tax under the 1993 treaty.) Cross-border dividends paid by a subsidiary to its parent company are exempt from withholding tax provided the parent owned on the dividend declaration date, more than 80 percent of the voting power of the subsidiary's outstanding stock for 12 months and certain other conditions, designed primarily to prevent treaty shopping, are satisfied. The branch tax is also eliminated if these other conditions are satisfied. Cross-border dividends paid by a subsidiary to a parent company that owns at least 10 percent and less than 80 percent of the voting power of the subsidiary's stock are subject to a 5 percent withholding tax. All other dividends are subject to a 15 percent withholding tax.

The Dutch Protocol also addresses the taxation of income received through a hybrid entity, (*i.e.*, an entity that is treated as a corporation by one country but as a partnership or other fiscally transparent entity by the other country). Generally, an item of income paid to a hybrid entity shall be considered derived by an owner of the entity (and thus possibly eligible for reduced withholding tax rates) only to the extent the item is treated as income of such owner by the owner's country of residence. Thus, interest paid by a resident of the Netherlands to a hybrid business entity organized in country X will be exempt from Dutch withholding tax to the extent (i) the interest paid to the hybrid entity is allocable to a U.S. resident eligible for treaty benefits,

and (ii) the U.S. owner/resident is required to include such interest in his gross income for U.S. federal income tax purposes. (The classification of the entity for country X purposes is irrelevant.)

The Protocol also simplifies the limitation on benefits article of the 1993 treaty (which read like Tolstoy's War and Peace). In an accompanying memorandum, both countries have agreed that in the event a company is treated as a resident of a third country pursuant to an income tax treaty, that same entity will not be treated as a resident of the Netherlands or the United States for the purpose of applying the 1993 income tax treaty.

The Dutch Protocol will enter into force once the countries have notified each other that the constitutional formalities in their countries have been completed. With respect to dividend withholding taxes, the Dutch Protocol will take effect on the first day of the second month following the date on which it enters into force. With respect to all other taxes, the Dutch Protocol will take effect on the first day of January of the year following the date it enters into force (which is expected to be in 2004). ■