New Japan-Netherlands tax treaty

Executive summary

The governments of Japan and the Netherlands announced on 25 August 2010 that they had signed a new treaty for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income (“the New Treaty”).

The New Treaty reduces and, under certain circumstances, eliminates withholding tax rates for dividends, interest and royalties to encourage mutual investment between Japan and the Netherlands. In addition, the New Treaty contains various provisions to prevent treaty abuse, including a new Limitation on Benefits (LOB) clause and an anti-conduit provision. Also worth noting is the introduction of arbitration procedures to address issues in which the competent authorities are unable to reach an agreement pursuant to the normal mutual agreement process. More specific guidance was subsequently made public on 1 September 2010 by the tax authorities in terms of the process for requesting arbitration.

The treaty protocol also makes it clear that Japan can withhold tax on income generated through a Tokumei Kumiai (TK, or silent partnership) agreement.

While both countries have stated their desire to implement the New Treaty by 1 January 2011, it is more likely that the New Treaty will become effective as of 1 January 2012 given all the required steps to complete the ratification process in both countries. However, it is important to note that if a person is entitled to greater benefits under the current treaty than under the New Treaty, such person can elect for the current treaty to remain effective in its entirety for a period of 12 months from the date the New Treaty would apply (i.e., a one year extension).

Below is a more detailed discussion of the New Treaty along with commentary on the potential impact it will have on investment into Japan through the Netherlands. We also provide a summary of arbitration procedures.
1. Tax rates on investment income and capital gains

To encourage mutual investment between the two countries, the New Treaty lowers or eliminates withholding tax on investment income – dividends, interest and royalties – and introduces measures against treaty abuse. The New Treaty also imposes a tax in the source country on capital gains derived from the disposition of shares in a bankrupt financial institution or shares in a company that constitutes a real property holding company (RPHC), i.e., a company of which total assets are at least 50% real properties located in Japan or other shares of RPHC.

Chart 1: Tax rates on investment income and capital gains; anti-tax evasion measures

<table>
<thead>
<tr>
<th>Current treaty</th>
<th>New treaty</th>
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<tbody>
<tr>
<td><strong>Beneficiary/income details</strong></td>
<td><strong>Beneficiary/income details</strong></td>
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<tr>
<td><strong>Dividends</strong></td>
<td></td>
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<tr>
<td>Company owning at least 25% of shares representing voting rights of a dividend paying company for a period of six months before the final day of the fiscal year when the dividend is determined.</td>
<td>Company owning, directly or indirectly, at least 50% of shares representing voting rights of a dividend paying company for a period of at least six months before the recipient of dividend is determined.</td>
</tr>
<tr>
<td>Certain pension funds</td>
<td></td>
</tr>
<tr>
<td><strong>Interest</strong></td>
<td></td>
</tr>
<tr>
<td>Government agency, etc.</td>
<td>(a) Government of a signatory country, local government, local public organization, central bank and agencies held by the government (b) Resident of a signatory country receiving payment of interest where debt is guaranteed debt where insurance was accepted or debt associated with indirect loans by those applying to (a) above (c) (i) Bank, insurance company or securities company (ii) Companies, other than in (i) above, receiving interest from credit associated with trust against those fulfilling certain requirements (assets and liabilities test) (d) Pension fund (where pension fund does not receive interest through direct or indirect business activity) (e) Resident of a signatory country receiving interest from credit due to credit offering, sales of goods or provision of service</td>
</tr>
<tr>
<td>Other than above</td>
<td></td>
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<tr>
<td><strong>Royalties</strong></td>
<td></td>
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<td><strong>Capital gains on stock sales</strong></td>
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<td></td>
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2. Introduction of measures to prevent treaty abuse

(1) Limitation on Benefits

Article 21 of the New Treaty includes a comprehensive Limitation on Benefits provision that limits the availability of treaty benefits to qualified residents (individuals, qualifying government bodies, listed companies and its subsidiaries, pension funds, etc.), and will apply to income that is sought to be fully exempted from withholding tax under the New Treaty, including certain dividends (Article 10-3), interest (Article 11-3), royalties (Article 12), capital gains (Article 13) and other income (Article 20). Even if a resident is not a qualified person, the benefits may be available if the resident meets either: the equivalent beneficiary test, active trade or business test, headquarter test, or competent authority. However, if an authority decides not to allow the benefits to a resident of the other country, it must inform the tax authority of that country in advance.

(2) Measures to restrict tax treaty benefits on conduit transactions

Under the New Treaty, measures to restrict tax treaty benefits on conduit transactions will apply for investment income and other income. Benefits prescribed under the New Treaty for dividends (Article 10), interest (Article 11), royalties (Article 12), and other income (Article 20) will not be applicable for the recipient party if it can be construed as a conduit transaction (e.g., the recipient remits similar type of income to a third-party country resident after receiving such income).

(3) Hybrid entity measures

Under the New Treaty, measures are introduced to address the treatment of income received through entities that are treated differently in Japan and the Netherlands for tax purposes. Under these measures, the determination of whether an income recipient is entitled to tax treaty benefits will be based on the tax treatment of entities according to the laws in the recipient's country of residence.

3. Impact on investment

(1) Japanese multinational companies operating overseas

Under the existing treaty, a withholding tax rate of 5% is imposed in the Netherlands, on dividends received by a Japanese corporation from its Dutch subsidiary. In this respect, Japan's foreign dividend exemption rules\(^1\) introduced in April 2009 resulted in an increase of the consolidated effective tax rate for certain Japanese corporations because such withholding taxes on dividends paid in foreign jurisdictions were not creditable or deductible in Japan. In contrast, the New Treaty provides exemptions on such withholding tax in the Netherlands, provided the recipient of such dividends has owned 50% or more of voting shares of the Dutch subsidiary for a period of at least six months ending on the date on which entitlement to the dividends is determined. Thus, under the New Treaty and provided all the necessary conditions are met, Japanese corporations receiving dividends from their Dutch subsidiaries will likely no longer be exposed to an increase in their effective tax rate as a result of the elimination of Dutch withholding tax.

\(^1\) Japanese companies must directly hold at least 25% of issued shares or voting shares for at least six months before the entitlement date of the dividends in order to be eligible for the foreign dividend exemption rule. Where the ownership test is 25%, if the required ownership percentage is lower in the tax treaty with the country where the foreign subsidiary is located, this reduced percentage can be used for the determination of whether the subsidiary is eligible for the exemption. Under the New Treaty, the ownership test threshold is reduced from 25% to 10% of either issued shares or voting shares (Article 22-2).
It should be noted that several countries in Europe, for example Germany, still impose a withholding tax on dividend distributions to Japanese corporations, which thus results in a potential increase to the recipient Japanese corporation’s effective tax rate, as discussed above. Consequently, the New Treaty in tandem with Japan’s recently enacted foreign dividend exemption regime provides Japanese multinationals with an opportunity to revisit their holding company structure to ascertain if structural changes could enhance the efficient flow of capital within the organization. For example, by using the Netherlands as a regional holding company of the European subsidiaries (see the following chart), there will be no or reduced withholding taxes paid on distributions to the Japanese parent company, and thus, the overall tax cost can be better managed.

Chart 2: Reduction of withholding tax on dividends through a Dutch holding company
Foreign companies with headquarters in the US or the UK generally tend to invest, lend or grant licenses to a Japanese company through the Netherlands. The current treaty generally provides benefits with regards to income earned by a Dutch company from Japan sources if all the requirements of the treaty are satisfied. These requirements do not currently include an LOB clause which makes the qualifying threshold for treaty benefits easier to attain. However, as discussed above, the New Treaty contains an LOB clause which is triggered when the Dutch recipient of the underlying income stream wishes to benefit from the zero Japan tax withholding rates. Thus, under certain circumstances, the New Treaty's LOB clause could stop certain holding companies from meeting the requirements of a “qualified person” as defined in Article 21, which would thus prevent the Dutch recipient from benefiting from the zero percent tax withholding rates on certain types of income.

Even if a Dutch recipient is not a “qualified person”, such person could still be eligible for the zero withholding rates provided by the New Treaty if one of the following tests is met: equivalent beneficiary, active trade or business, headquarters, or competent authority. Meanwhile, due to the measures to restrict tax treaty benefits on conduit transactions mentioned above, in cases where, “except for the treaty benefit provided under the Dutch-Japan treaty, there is no other reason for non-Dutch investors to invest into Japan through the Netherlands”, and where, “borrowing from Japan, and borrowing from Netherlands are basically the same in terms of face value and duration etc.,” as illustrated in Chart 3, it is unlikely the treaty benefits will be available. Hence, in particular, certain financing vehicles/arrangements structures into Japan will need to be revisited in light of the more stringent requirements to qualify for benefits under the New Treaty.

Chart 3: Impact from measures to restrict tax treaty benefits on conduit transactions

<table>
<thead>
<tr>
<th>Current treatment</th>
<th>Possible treatment</th>
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<tbody>
<tr>
<td>Parent company*</td>
<td>Parent company*</td>
</tr>
<tr>
<td>Loan</td>
<td>Loan</td>
</tr>
<tr>
<td>Interest</td>
<td>Interest</td>
</tr>
<tr>
<td>Withholding tax 0%</td>
<td>Withholding tax 0%</td>
</tr>
<tr>
<td>Withholding tax 10%</td>
<td>Withholding tax 20%?</td>
</tr>
</tbody>
</table>

* If Parent Company were to make loans directly to Japanese Subsidiary (rather than through a Dutch Company), applicable withholding tax rate would be 20%.
(3) Private equity and real estate investment funds

The New Treaty could also impact private equity and real estate investment funds that invest into Japan through the Netherlands (Chart 4). Specifically, because these investment vehicles generally have more private equity and real estate investment funds have a greater number of investors and in many cases will be ineligible for benefits under the derivative benefits test, due to the absence of an ultimate parent company. This would generally result in higher taxes in Japan.

Chart 4: Impact on private equity and real estate investment funds

(4) Conclusions

The New Treaty, in tandem with Japan’s recently enacted foreign dividend exemption regime, provides Japanese multinationals with an opportunity to revisit their holding company structure to ascertain if structural changes could enhance the efficient flow of capital within the organization. Similarly, for investments into Japan, existing vehicles that use the Netherlands as the entry point should be revisited to determine if the anti-conduit and LOB provisions will adversely impact the availability of benefits under the New Treaty. If so, investors should begin the process of developing viable solutions designed to minimize (if not eliminate) any adverse consequences triggered by the New Treaty.
4. Arbitration rules for mutual agreement

Article 24-5 of the New Treaty introduces arbitration rules for mutual agreement procedures for the first time in Japan. This arbitration process is not intended to serve as an alternative to the mutual agreement procedures. It is intended to serve as supplemental tool which would be available only if the competent authorities are unable to reach an agreement to resolve a particular case within two years from the date the case was presented for review pursuant to the mutual agreement procedures. It should be noted that the request for arbitration is initiated by the impacted taxpayer and such request can only be made after the expiration of the two years period mentioned above. Further, the two countries must abide by the decision of the arbitration committee, which consists of three independent arbitrators, except for cases where the taxpayer does not accept the decision. In addition, an arbitration request by a taxpayer will not be accepted if a settlement has already been reached due to a decision by a court or administrative tribunal.

With the introduction of these arbitration rules, the two tax authorities are encouraged to reach settlements based on mutual agreement, thus leading to a higher expectation for the avoidance of double taxation.

For additional information with respect to this alert, please contact the following:

**Ernst & Young Shinnihon Tax, Tokyo, Japan**

**International and Transaction Tax Services**

Koichi Sekiya  
Partner  
+81 3 3506 2447  
koichi.sekiya@jp.ey.com

Masako Kanaya  
Partner  
+81 3 3506 2430  
masako.kanaya@jp.ey.com

Chizuko Tomita  
Partner  
+81 3 3506 2111  
chizuko.tomita@jp.ey.com

Jose L. Huerta  
Executive Director  
+81 3 3506 2575  
jose.huerta@jp.ey.com

Hiroyuki Nishida  
Senior Manager  
+81 3 3506 2026  
hiroyuki.nishida@jp.ey.com

Frank Jansen  
Senior Manager  
+81 3 3506 2671  
frank.jansen@jp.ey.com