108TH CONGRESS
2d Session

SENATE

EXEC. REPT.
108–9

TAXATION CONVENTION WITH JAPAN (TREATY DOC. 108–14).

MARCH 4, 2004.—Ordered to be printed

Mr. LUGAR, from the Committee on Foreign Relations, submitted the following

REPORT

[To accompany Treaty Doc. 108–14]

The Committee on Foreign Relations, to which was referred the Convention Between the Government of the United States of America and the Government of Japan for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, together with a Protocol and an Exchange of Notes, signed at Washington on November 6, 2003, having considered the same, reports favorably thereon and recommends that the Senate give its advice and consent to ratification thereof, as set forth in this report and the accompanying resolution of ratification.

CONTENTS

I. PURPOSE

The principal purposes of the proposed income tax treaty between the United States and Japan 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 continue to promote close economic cooperation between the two countries and to eliminate possible barriers to trade

29–119

and investment caused by overlapping taxing jurisdictions of the two countries.

II. Background

The proposed treaty and proposed protocol were signed on November 6, 2003. The United States and Japan exchanged notes on the same day to provide clarification with respect to the application of the proposed treaty. The proposed treaty, together with the proposed protocol and the exchange of notes, would replace the existing income tax treaty between the United States and Japan that was signed in 1971.

The proposed treaty, together with the proposed protocol and the exchange of notes, was transmitted to the Senate for advice and consent to its ratification on December 9, 2003 (*see* Treaty Doc. 108–14). The Committee on Foreign Relations held a public hearing on the proposed treaty on February 25, 2004.

III. Summary

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.

As in other U.S. tax treaties, the purposes of the Treaty 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 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 the 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) and the other income article (Article 21) 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).

IV. Entry Into Force and Termination

A. ENTRY INTO FORCE

The proposed treaty will enter into force upon the exchange of instruments of ratification. The effective dates of the Treaty's provisions, however, vary.

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 or 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 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 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 twelve-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.

B. 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 for 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 income taxes that are not withheld 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.

V. COMMITTEE ACTION

The Committee on Foreign Relations held a public hearing on the proposed treaty with Japan (Treaty Doc. 108–14) on February 25, 2004. The hearing was chaired by Senator Lugar.[1] The committee considered the proposed treaty on March 4, 2004, and ordered the proposed treaty with Japan favorably reported by a vote of 19 in favor and 0 against, with the recommendation that the Senate give its advice and consent to ratification of the proposed treaty.

VI. COMMITTEE COMMENTS

On balance, the Committee on Foreign Relations believes that the proposed treaty with Japan is in the interest of the United States and urges that the Senate act promptly to give advice and consent to ratification. The committee has taken note of certain issues raised by the proposed treaty and believes that the following comments may be useful to the Treasury Department officials in providing guidance on these matters should they arise in the course of future treaty negotiations.

---

[1] The transcript of this hearing will be forthcoming as a separate committee print.

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 more than 50 percent of the stock of the dividend-paying corporation (often referred to as "direct dividends"), provided that certain conditions are met. 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 impose as a matter of internal law. The principal immediate effects of the zero-rate provision on U.S. taxpayers and 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.

Until 2003, no U.S. treaty provided for a complete exemption from withholding tax under these circumstances and the U.S. and OECD models 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 Australia, Mexico, and the United Kingdom. These provisions are similar to the provision in the proposed treaty, although the proposed treaty allows a lower ownership threshold than the Mexico, Australia, and United Kingdom 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.

Description of Provision

Under the proposed treaty, the withholding tax rate is reduced to zero on dividends beneficially owned by a company that has owned more 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 of Article 22 (Limitation on Benefits).[2]

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., 5 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,[3] withholding taxes may not be fully creditable as a 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 warranting 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 done so 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 with-

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

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

holding 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.

Committee Conclusions

The committee believes that every tax treaty must strike the appropriate balance of benefits in the allocation of taxing rights. The agreed level of dividend withholding for intercompany dividends is one of the elements that make up that balance, when considered in light of the benefits inuring to the United States from other concessions the treaty partner may make, the benefits of facilitating stable cross-border investment between the treaty partners, and each partner's domestic law with respect to dividend withholding tax.

In the case of this treaty, considered as a whole, the committee believes that the elimination of withholding tax on intercompany dividends appropriately addresses a barrier to cross-border investment. The committee believes, however, that the Treasury Department should only incorporate similar provisions into future treaty or protocol negotiations on a case-by-case basis, and it notes with approval Treasury's past statement that "[i]n light of the range of facts that should be considered, the Treasury Department does not view [elimination of withholding tax on intercompany dividends] as a blanket change in the United States' tax treaty practice." [4]

The committee encourages the Treasury Department to develop criteria for determining the circumstances under which the elimination of withholding tax on intercompany dividends would be appropriate in future negotiations in future negotiations with other countries. The committee expects the Treasury Department to consult with the committee with regard to these criteria and to the consideration of elimination of the withholding tax on intercompany dividends in future treaties.

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). These rules are not included in the U.S. or OECD models. The 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.[5] The rules are

[4] Senate Committee on Foreign Relations, Report, *Tax Convention with the United Kingdom,* Exec. Rept. 108–2, Mar. 13, 2003.

[5] *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 Slo-*

Continued

also similar to, but narrower than, the anti-conduit rule approved in the U.S.-U.K. treaty.[6]

The rules were included 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").

From the U.S. perspective, the rules are unnecessary because U.S. domestic law provides detailed rules governing arrangements to reduce U.S. tax through the use of conduits.[7] 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 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

venia, 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.

[6] Under the U.S.-U.K. treaty, the benefits of the dividends, interest, royalties, and other income articles are denied in connection with any payment made under a "conduit arrangement." The term "conduit arrangement'" is defined as a transaction, or series of transactions, that meets both of the following criteria: (1) a resident of one contracting state receives an item of income that generally would qualify for treaty benefits, and then pays (directly or indirectly, at any time or in any form) all or substantially all of that income to a resident of a third state who would not be entitled to equivalent or greater treaty benefits if it had received the same item of income directly; and (2) obtaining the increased treaty benefits is the main purpose or one of the main purposes of the transaction or series of transactions.

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

income in respect of a right or property if such other income would not have been paid to the resident unless the resident pays others 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

The proposed anti-conduit rule may create confusion, because they apply not only to conduit arrangements in which a reduction in Japanese tax is claimed, but also to conduit arrangements in which a reduction in U.S. tax is claimed, despite the fact that there is no apparent reason for the rule to apply in the latter circumstance, in view of the existence of anti-conduit provisions under U.S. domestic law. To the extent that the proposed treaty's anti-conduit rule and the U.S. domestic-law anti-conduit rules are not consistent in every particular, taxpayers may be confused as to which set of rules the United States will apply in certain situations.

Committee Conclusions

The committee emphasizes that the inclusion of the narrow anti-conduit rules in the proposed treaty should create no inference that the generally broader anti-conduit rules of U.S. domestic law would not apply in a particular situation. On balance, the committee believes that the Technical Explanation prevents any potential for 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.

C. INSURANCE EXCISE TAX

The proposed treaty, unlike the present treaty, waives the application of the U.S. insurance excise tax on foreign insurers and reinsurers. Thus, for example, a Japanese insurer or reinsurer generally may receive premiums on policies with respect to U.S. risks free of this tax. However, the tax is imposed to the extent that the risks covered by such premiums are reinsured with a person not entitled to the benefits of the proposed treaty or another treaty providing exemption from the tax. This latter rule is known as the "anti-conduit" clause.

Waivers of the insurance excise tax in other treaties have raised serious congressional concerns. Specifically, concern has been expressed 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 by the treaty partner country or any other country on the insurance income of the foreign insurer or reinsurer. Furthermore, in such a case, a waiver of the tax does not serve the primary purpose of tax 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 and 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 waivers in the two treaties.

Committee Conclusions

The committee, while recognizing the concerns raised by the excise tax waiver, believes that the inclusion of the excise tax waiver in this treaty is consistent with the criteria the committee has previously laid down for waiver of the tax. As noted in the Technical Explanation, the U.S. negotiators agreed to include in the Treaty a waiver of these insurance excise taxes "only after a review of Japanese tax law indicated that the income tax imposed by Japan on Japanese resident insurers results in a burden that is substantial in relation to the U.S. tax on U.S. resident insurers." Thus, unlike Bermuda and Barbados, Japan imposes substantial tax on income, including insurance income, of its residents. Therefore, the committee feels that the excise tax waiver is not harmful in this particular case since its effect is not to eliminate all or nearly all tax but rather to relieve double taxation.

D. TAXATION OF GAINS ON SHARES IN RESTRUCTURED FINANCIAL INSTITUTIONS

The proposed treaty contains a unique exception to the traditional residence-based taxing rule applicable to capital gains. 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 U.S. treaty, including the U.S. model, or the OECD model. It was included at the insistence of Japan.

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 of Article 13 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.

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.

Committee Conclusions

The committee expresses concern that the provision may inhibit U.S. investors from participating in future Japanese bank restructuring and may be singling out U.S. investors by Japan for adverse tax treatment relative to investors from other countries. The committee understands from the Treasury Department that this narrow provision is a unique accommodation to the treaty partner and concludes that the provision is acceptable under these circumstances.

E. 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.[8]

Proposed Treaty

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 pay-

[8] 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.

ments, 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).

The proposed treaty does not include the special rule for contingent interest that is contained in the U.S. model and most recent 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.[9]

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).[10] 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.[11] 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.

[9] 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).

[10] 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.

[11] 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.

model in this regard rather than providing a specified five percent limitation on all non-arm's length amounts.

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.

Committee Conclusions

The committee expresses concern about the advisability of any divergence from the intended results of the U.S. model, most recent U.S. tax treaties, and longstanding principles of U.S. tax law with respect to non-arm's length payments and payments of contingent interest. The committee encourages the Treasury Department to carefully evaluate deviations from the language of these provisions of the U.S. model to ensure that the results achieved are consistent with the policies reflected in the U.S. model.

F. SALE OF U.S. REAL PROPERTY HOLDING CORPORATIONS

Generally, under U.S. tax law, 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.[12]

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

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

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").[13] 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.[14]

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.[15]

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

[13] 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).

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

[15] 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. Article 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).

requires that such shares be "regularly" traded at any time during the calendar year of disposition[16] and provides a five-year "look-back" testing period for the ownership test.

Committee Conclusions

The committee is concerned about the recurrence of this divergence from normal practice. The committee notes that similar provisions were included in the 1999 treaty with the Republic of Slovenia. In view of the many benefits to the United States under this treaty, the committee is willing to acquiesce to these provisions in this treaty. The committee cautions the Treasury Department about such provisions and directs it to ensure in the future that U.S. taxing rights with respect to U.S. real property interests are fully protected.

G. TEACHERS, STUDENTS, AND TRAINEES

In General

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.

Issues

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 an 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

[16] 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).

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,[17] 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, 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 ad-

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

vancement 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. 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.

Committee Conclusions

The committee notes that while the provision regarding the taxation of visiting teachers and professors is inconsistent with the U.S. model, over half of the bilateral income tax treaties in force contain a similar provision. At the same time, of the three treaties that the committee has recently considered, only the U.K. treaty included such a provision, while the treaties with Mexico and Australia did not. The proposed protocol with Sri Lanka does not include such a provision. The committee encourages the Treasury Department to develop criteria for determining under what circumstances this provision is appropriate and to consult with the committee regarding these criteria.

H. U.S. MODEL TAX TREATY DIVERGENCE

It has been longstanding practice for the Treasury Department to maintain, and update as necessary, a model income tax treaty that reflects the current policies of the United States pertaining to income tax treaties. The 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.[18]

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.

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 advice and consent to 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.

Committee Conclusions

The committee recognizes 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 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), the technical provisions of recent U.S. tax treaties have diverged substantively

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

from the U.S. model with increasing frequency. The proposed treaty continues this apparent pattern, which may be indicative of a growing obsolescence of the U.S. model. The important purposes served by the U.S. model tax treaty are undermined if that model does not accurately reflect current U.S. positions and the committee notes with approval the intention of the Treasury Department to update the U.S. model treaty and strongly encourages the Treasury Department to complete the update in the coming year.[19] In the process of revising the U.S. model, the committee expects the Treasury Department to consult with the committee generally, and specifically regarding the potential implications for U.S. trade and revenue of the policies and provisions reflected in the new model.

VII. Budget Impact

The committee has been informed by the staff of the Joint Committee on Taxation that the proposed treaty is estimated to cause a negligible change in Federal budget receipts during the fiscal years 2004–2013 period.

VIII. Explanation of Proposed Treaty

A detailed, article-by-article explanation of the proposed income tax treaty between the United States and Japan can be found in the pamphlet of the Joint Committee on Taxation entitled *Explanation of Proposed Income Tax Treaty Between the United States and Japan* (JCS–1–04), February 19, 2004.

IX. Resolution of Ratification

Resolved (two-thirds of the Senators present concurring therein), That the Senate advise and consent to the ratification of the Convention between the Government of the United States of America and the Government of Japan for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, together with a Protocol and an Exchange of Notes, signed at Washington on November 6, 2003 (Treaty Doc. 108–14).

○

[19] Testimony of Barbara M. Angus, International Tax Counsel, United States Department of the Treasury, Before the Senate Committee on Foreign Relations on Pending Income Tax Agreements, February 25, 2004.