Some taxpayers are able to adjust their work schedules to satisfy the foregoing tests. Other taxpayers are able to benefit by holding rental real estate in entities owned by a spouse who can satisfy the necessary time requirement. Those taxpayers willing to make some lifestyle adjustments and keep careful records can certainly benefit from the preferential treatment the Code provides for real estate.

NEW U.S.-JAPAN INCOME TAX TREATY

by Nancy M. Beckner, Newville, PA

On November 6, 2003, the U.S. and Japan signed a new income tax treaty, and a Protocol, Notes and Understanding of Negotiators.[1] The Treaty entered into force on March 30, 2004, and will generally be effective January 1, 2005, although there is a July 1, 2004 effective date for withholding taxes. This Point will highlight some of the more innovative provisions of the Treaty.

With its strong business and economic focus, the Treaty reflects current U.S. and Japan tax treaty policies. The Joint Committee Staff's Explanation[2] (the "Staff Explanation") notes that in addition to the traditional tax treaty rationales of reducing or eliminating double taxation and preventing tax avoidance and evasion, "[a] principal rationale for negotiating tax treaties is to improve the business climate …" for cross-border sales, services and investment. (Part IV.A. of the Staff Explanation.) This view is shared by Japanese authorities, some of whom have described the Treaty as the "second shot" to revitalize Japan's economy.[3]

OVERVIEW

Treasury's comprehensive February 24, 2004 Technical Explanation (the "Technical Explanation") is the "official" guide to the new Treaty. Key provisions include (1) zero rate withholding on certain inter-corporate dividends, on all royalties, and on certain interest, including interest derived by banks, insurance companies and other financial institutions; (2) the addition of a branch profits tax provision; (3) a comprehensive limitation on benefits ("LOB") article; (4) a Protocol provision addressing employee stock options; and (5) certain helpful transfer pricing provisions not found in other treaties. The Treaty also contains various anti-conduit rules requested by Japan; these are generally narrower than those applicable under U.S. domestic law, and their inclusion in the Treaty creates no inference that broader U.S. anti-conduit and other anti-abuse rules would not apply in a given situation. Article 4 addresses income derived through fiscally transparent entities and includes rules for determining residence, including (for Japan purposes) special requirements for U.S. citizens or aliens having U.S. permanent resident status ("green-card holders"). While the Treaty is similar to other recent U.S. treaties, the 1996 U.S. Model Treaty and the 1992 OECD Model, there are significant deviations, as identified in Part V of the Staff Explanation and throughout the Technical Explanation.[4]

Important elements of the new Treaty include:

RESIDENCE AND PASS-THROUGH ENTITIES: ARTICLE 4

Except as otherwise provided, the Treaty applies only to residents of the U.S. or Japan. Rules for determining residence generally follow the U.S. Model Treaty. Nevertheless, certain provisions merit special mention.

U.S. Citizens/Green-card Holders Living Abroad (4.2). To obtain Treaty benefits as a U.S. resident for Japan tax purposes, a U.S. citizen or green-card holder (a) cannot be a resident of Japan (under Article 4.1), (b) must have a substantial presence, permanent home or habitual abode in the U.S. and (c) cannot be a resident of a third state under the terms of an income tax treaty which Japan has with that other state. For example, an individual resident of Mexico who is a U.S. citizen by birth but who never lived in the U.S. would not be entitled to Treaty benefits. That individual is, however subject to the savings clause of Article 1.4, and would be subject to U.S. tax on world-wide income under the Code.

Exempt Entities as Treaty "Residents." Article 4.1(b) and (c) clarify that certain tax exempt entities (such as charitable organizations and pension funds) can be residents of a contracting state, even if exempt from tax in that contracting state.

Transparent Entities (4.6). Income derived through fiscally transparent entities is discussed at length in the Technical Explanation of Article 4.6. Results under the Treaty are generally consistent with other recent U.S. treaties and Treasury regulations promulgated under Section 894(c).

Sleeping Partnerships. Paragraph 13 of the Protocol addresses Japanese "sleeping partnerships" (Tokumei Kumiai) and permits the U.S. and Japan to apply their respective domestic rules to such arrangements and distributions. Thus, a Japanese resident operator or investor in the arrangement would not qualify for

1. Unless otherwise stated, these documents are hereinafter referred to collectively as the "Treaty." The Treaty can be found at www.treas.gov/offices/tax-policy/documents.shtml from which cite you can access the relevant documents. The Understanding is attached to Treasury's Technical Explanation of the Treaty. See also the May 19, 2004 "record of discussions" (released May 21) which clarifies a procedure for withholding tax on a group basis for interest derived by financial institutions.
2. Explanation of the Proposed Treaty (JCS 1-04) dated February 19, 2004, prepared by the Staff of the Joint Committee on Taxation.
3. See comments of Masatsugu Asakawa, director of the Tax Bureau's international tax policy division, as reported in Gary M.Thomas, *Opportunities and Challenges in New International Tax Era in Japan,* 34 Tax Notes International 1161, 1162 (June 14, 2004).
4. The March 4, 2004 Report of Senator Lugar, Committee on Foreign Relations, to accompany Treaty Doc. 108-14 notes that the divergence of the Treaty and certain other recent treaties from the U.S. model indicates the growing obsolescence of the model and strongly encourages Treasury to complete the pending update of the model in the coming year. See Committee Conclusions at IV.H. of the Report.

Treaty benefits with respect to U.S. source interest, and Japan may impose tax on a U.S. investor's share of distributions that are deductible, for Japanese tax purposes, by the person making the distribution. (In Japan, the income of a sleeping partnership is taxed to the operator who can deduct payments made to a sleeping partner.)

ROYALTIES: ARTICLE 12

Under the new Treaty, a zero tax rate applies to royalties (under prior treaty, the rate was 10 percent). Anti-conduit provisions disallow Treaty benefits for certain back-to-back royalties.

DIVIDENDS: ARTICLE 10

The Treaty reduces (or in some cases eliminates) tax imposed by the source state on dividends paid by a resident of that contracting state and beneficially owned by a resident of the other contracting state. Except for the zero rate on certain inter-company dividends discussed below, the rate is generally five percent if the beneficial owner is a company that owns, directly or indirectly, at least ten percent of the voting stock of the payor company (on the date entitlement to dividends is determined); otherwise the rate is ten percent.

Article 10.3 eliminates tax if the beneficial owner is a company resident in the other contracting state, that has owned (directly or indirectly through one or more residents of either contracting state) more than 50% of the voting stock of payor company for the 12 month period ending on the date entitlement to the dividends is determined. In addition, the beneficial owner must satisfy one of two sets of conditions set forth in the LOB provisions of Article 22 or have received a special determination from the Competent Authority of the source state that its residence and operation do not have, as one of their principal purposes, obtaining Treaty benefits (Article 22.4). One such set of conditions applies to non-publicly traded companies and their subsidiaries, which must satisfy both (1) the ownership and base erosion tests of Article 22.1(f) and the active business requirement of Article 22.2. Protocol Paragraph 12 clarifies that in applying the active business requirement to a person, activities conducted by a partnership in which the person is a partner or by persons connected to a person are attributed to such person. In requiring that the ownership, base erosion and the active business tests all be satisfied, the Treaty differs from the U.S.-Mexico (protocol) and the new U.S.-U.K. treaties.

BRANCH PROFITS TAX: ARTICLE 10.9

Under the new Treaty, the U.S. can impose its branch profits tax (section 884) on profits attributable to a U.S. permanent establishment (similar authority is granted to Japan) but the rate of tax is limited to five percent. The branch profits tax will not apply to companies that meet the same requirements of Article 22 that must be satisfied under Article 10.3(a)(i), (ii) or (iii) to qualify for zero rate tax on dividends (see Dividends discussion above).

INTEREST: ARTICLE 11

Rates. A ten percent rate generally applies to cross-border payments of interest, but the rate is reduced to zero in several situations (Article 11.3). These include (a) interest beneficially owned by a government entity or by a resident with respect to government guaranteed, insured or indirectly financed debt-claims; (b) interest beneficially owned by a bank (including investment bank), insurance company, registered securities dealer or other enterprise that in the three preceding years meets certain liability and asset requirements relating to issuance of bonds, taking deposits and holding debt-claims against unrelated persons; (c) interest beneficially owned by pension funds; and (d) interest from indebtedness arising on a credit sale of equipment or merchandise.

Special Procedures for Certain Financial Institutions. In response to concerns voiced by the financial community, the U.S. and Japan have clarified that in some cases financial institutions can determine qualification for reduced withholding on a group basis.[5] Other clarifying points in the record of discussions are noted in Kevin A. Bell, *U.S., Japan Use Novel Approach to Clarify Tax Treaty*, 34 TAX NOTES INTERNATIONAL 921 (May 31, 2004).

Branch Interest. Articles 11.7 and 11.10 of the Treaty permit application of the Branch Interest provisions of Section 884 for interest attributable to a permanent establishment or subject to tax under the real property provisions of Articles 6 or 13.1 or 13.2; ten percent rate applies to such branch interest unless it qualifies for zero rate in accordance with the applicable provisions.

Back-Stop of Section 860G. To back-stop section 860G, Article 11.9 applies an anti-abuse provision for excess inclusions from entities used to securitize real estate mortgages and other assets.

STOCK OPTIONS: PROTOCOL PARAGRAPH 10

Benefits enjoyed by employees under stock option plans between the time of grant and exercise are treated as "other similar remuneration" (i.e., like wages) to which Article 14 (the dependent services article) applies. Special allocation rules limit risk of double tax where an employee has exercised his or her employment in both the U.S. and Japan during the period between grant and exercise of the option and remains employed at the date of exercise.

TRANSFER PRICING: ARTICLE 9, PROTOCOL PARAGRAPH 5 AND PARAGRAPH 3 OF THE NOTES

The Treaty includes certain unique features, including required application of the OECD Transfer Pricing Guidelines. For affiliated companies

5. See reference to the May 19 record of discussions at note 1 *supra*.

operating in both the U.S. and Japan, there is also a seven-year time limit within which examinations must be initiated for purposes of adjusting profits from transactions between affiliates. For a more detailed discussion of these transfer pricing provisions, see Robert T. Cole, *Unique Transfer Pricing Provisions in New Income Tax Treaty with Japan*, 33 TAX MGMT INT'L 370 (June 11, 2004).

LIMITATIONS ON BENEFITS: ARTICLE 22

Unlike the former U.S.-Japan treaty, the new Treaty includes a comprehensive LOB Article that may limit a Treaty resident company's eligibility for benefits. The Technical Explanation of Article 22 explains these LOB conditions, requirements and limitations, which include ownership and, in some cases, base erosion tests to qualify for all benefits accorded residents and an active business test that may offer Treaty benefits with respect to items of income even though the resident does not satisfy the ownership requirements or base erosion limitation.

FORMS FOR APPLYING NEW TREATY[6]

Claiming benefits under the new Treaty will require advance preparation by U.S. residents receiving income from Japan .

Japan. Japan recently released new application forms for obtaining relief from Japanese tax under the Treaty and, in certain cases, other treaties to which Japan is a party. The new Japanese forms and procedures are discussed in Gary Thomas and Linda Ng, *Asia-Pacific Tax Review: Japan Issues Applications Form for the New Japan-U.S. Income Tax Treaty*, 35 TAX NOTES INTERNATIONAL 523 (August 9, 2004).

Thomas and Ng report that to reduce or exempt income from withholding, the income recipient must submit the appropriate application form (in duplicate) to the payor who then files the original with the appropriate district tax office by the day before the involved payment is made (see Thomas and Ng, *supra* at 524-25 for further information on the requirements described in this paragraph). The income recipient must provide its U.S. taxpayer identification number, and unless an exception is available, a special form must also be completed with respect to the LOB provisions of the Treaty. To claim an exemption from withholding for dividends and interest, the recipient must obtain certification of U.S. residency from the U.S. competent authority before such person's application is submitted to the payor. For the exemption applicable to royalties, the recipient must always include a U.S. residency certification and a document describing the contract on which payment is based. It appears that Japanese language translations will be required for documents written in a language other than Japanese.

New U.S. Form for U.S. Residency Certification. Beginning July 5, 2004, taxpayers who require certification of U.S. residency for purposes of claiming benefits under a treaty must use new IRS Form 8802, Application for United States Residency Certification.

Finally, I feel compelled to remind readers that this Point was designed to highlight only a few important features of the Treaty. Practitioners should review carefully the provisions of the Treaty and Treasury's Technical Explanation before offering advice on the effects of the Treaty. ■

6. U.S. rules to claim Treaty benefits for U.S. tax purposes are beyond the scope of this Point. In general, see the regulations issued pursuant to sections 1441 and 1442 and IRS Form W-8 BEN or other applicable Forms W-8; see also section 6114 and Reg. §301.6114-1 dealing with "Treaty-Based Return Positions."

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